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ASU 2016-20: FASB ASC 606 Technical Corrections & Improvements
Implementation Issues on New Revenue Recognition Standard

The FASB issued Accounting Standards Update (ASU) 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers.* The amendments in ASU 2016-20 make technical corrections and improvements to FASB *Accounting Standards Codification* (FASB ASC) 606 and other FASB ASC topics amended by ASU 2014-09, *Revenue from Contracts with Customers*, (i.e., the new revenue recognition standard) related to 13 issues. While the amendments affect narrow aspects of the guidance issued in ASU 2014-09 and do not change any of the principles of the new revenue recognition standard, the amendments reflect implementation challenges certain entities are facing with the new revenue recognition standard.

In this report, we will focus on several issues as these issues are likely to be relevant to many private companies starting implementation of the revenue recognition standard (hopefully) shortly. Entities which have construction-type and production-type contracts will find the amendments in ASU 2016-20 particularly relevant.

CPEA Observation: The title of the new ASU, *Technical Corrections and Improvements* implies a certain level of relative insignificance as is generally the case with technical corrections related ASUs (ASU 2015-10 being one notable exception). However, this ASU was passed with the minimum number of affirmative votes from FASB Members. Controversy surrounded the relief provided on disclosure of transaction price allocated to remaining performance obligations. Two Board Members dissented from the issuance of ASU 2016-20 advocating that the disclosure relief provided compromised relevant quantitative disclosures to users about remaining performance obligations that has been long sought by certain users currently relying on non-U.S. GAAP backlog information.

Provisions for Losses on Construction-Type and Production-Type Contracts (Issue 4)

The new revenue recognition standard, codified in FASB ASC 606, supercedes substantially all of FASB ASC 605, *Revenue Recognition,* (current revenue recognition guidance). One notable exception is the portion of FASB ASC 605-35 on loss contracts (also referred to as "onerous contracts"). Late in the deliberations on the new revenue recognition standard the FASB decided to retain current U.S. GAAP on loss contracts, as developing guidance across all industries on onerous contracts proved challenging. Accordingly, the loss contract guidance will remain only applicable to construction-type and production-type entities inside the scope of FASB ASC 605-35. However, certain conforming amendments were necessary to FASB ASC 605-35 since, as noted in the Basis for Conclusions (BC), current guidance in Section 605-35-25 requires that the loss contract test be performed at the total contract level unless the contract is segmented or combined.

The new revenue recognition standard removed the term "individual segments" in paragraph 605-35-25-47 and replaced it with "performance obligation" for determining a provision for a loss contract at a level lower than the contract level. In some circumstances, this would require an entity to perform the loss assessment at a lower level than the level used in current practice since, as noted in the BC, the new revenue recognition standard does not include a contract segmentation concept. While the purpose of the original conforming amendments was to reference performance obligations to align terminology with that used in FASB ASC 606, the concept of a performance obligation is not equivalent to the concept of an individual segment (in current U.S. GAAP). Normally, the contract level is the lowest level required for determining loss provisions. However, the FASB decided to allow an entity to determine the loss at the performance obligation level as an accounting policy election, because, in some cases, performance obligations might equate to individual segments and, in those cases, it might be more operable for the entity to determine the loss at the performance obligation level.

CPEA Observation: This accounting policy election now will allow construction-type and production-type entities flexibility under the new revenue recognition standard in the accounting determination of a "loss contract" since these entities now can make an accounting policy election to make this determination at a contract or performance obligation level. An entity's pricing strategy and pricing integration could be key factors in making the accounting policy election. For example, "loss leading" performance obligations at the start of the contract, like design and setup, could be combined with more profitable activities later in the contract if all of the performance obligations are in one contract. This new flexibility is limited however, as ASU 2016-20 indicates that, "an entity shall apply this accounting policy election in the same manner for similar types of contracts."

Disclosure of Remaining Performance Obligations (Issue 6)

As entities have started to fully digest the financial reporting implications of the new revenue recognition standard, some have expressed concern about certain of the disclosures. The originally issued ASU 2014-09, codified in FASB ASC 606, required disclosure of transaction price allocated to remaining performance obligations. Specifically, FASB ASC 606-10-50-13 requires that an entity disclose:

a. The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period

b. An explanation of when the entity expects to recognize as revenue the amount disclosed in accordance with paragraph (a) above, which the entity shall disclose in either of the following ways:

1. On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations

2. By using qualitative information.

When originally issued, the FASB did permit an entity, as a practical expedient, to avoid disclosure of transaction price allocated to remaining performance obligations if one of the following criteria was met:

a. The performance obligation is part of a contract that has an original expected duration of one year or less

b. The entity recognizes revenue from the satisfaction of the performance obligation in accordance with paragraph 606-10-55-18 (see note below).

Practice Note: In the context of a contract where revenue is recognized over the life of a contract, FASB ASC 606-10-55-18 allows, as a practical expedient, an entity to recognize revenue in the amount to which the entity has a right to invoice if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided). This is often referred to as the "PxQ" or price x quantity provision.

ASU 2016-20 permits an entity to not disclose the information in paragraph 606-10-50-13 (referenced above) for variable consideration for which either of the following conditions is met:

a. The variable consideration is a sales-based or usage-based royalty promised in exchange for a license of intellectual property accounted for in accordance with paragraphs 606-10-55-65 through 55-65B

b. The variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation in accordance with the series provisions in FASB ASC 606-10-25-14(b), for which the criteria in paragraph 606-10-32-40 have been met.

The optional exemptions in paragraphs 606-10-50-14(b) and 606-10-50-14A shall not be applied to fixed consideration.

Practice Note: The series provision of FASB ASC 606-10-25-14(b) referred to in Step 2 of the new revenue model requires entities to consider as one performance obligation, "a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer." Potential examples of performance obligations that may be required to use the series provision include multi-period cleaning contracts, hotel management service contracts, and certain production-type and construction-type contracts (in particular those which require the production of multiple substantially similar goods or services). In cases where variable consideration exists with certain performance obligations that are considered one performance obligation in accordance with the series provision, FASB ASC 606-10-32-40 requires that variable consideration be allocated to a specific performance obligation. For example, a contract for construction of multiple pieces of substantially similar equipment (considered one performance obligation under the series provision) could have a performance bonus applicable to the timely completion of one particular piece of equipment. This performance bonus would likely be variable consideration that would be allocated only to the particular piece of equipment that it pertains to consistent with FASB ASC 606-10-32-40.

Qualitative Disclosures Required

ASU 2016-20 requires an entity to disclose which optional exemptions to the disclosure requirement of transaction price allocated to remaining performance obligations in FASB ASC 606-10-50-13 it is applying. In addition, entities applying the optional exemptions shall disclose the nature of the performance obligations, the remaining duration, and a description of the variable consideration (for example, the nature of the variability and how that variability will be resolved). This information shall include sufficient detail to enable users of financial statements to understand the remaining performance obligations that the entity excluded from

the information disclosed in accordance with the disclosure requirement of transaction price allocated to remaining performance obligations in FASB ASC 606-10-50-13. In addition, an entity shall explain whether any consideration from contracts with customers is NOT included in the transaction price and, therefore, not included in the information disclosed in accordance with the disclosure requirement of transaction price allocated to remaining performance obligations in FASB ASC 606-10-50-13. For example, an estimate of the transaction price would not include any estimated amounts of variable consideration that are constrained (FASB ASC 606-10-32-11 through 32-13).

CPEA Observation: The BC indicates that the majority of the FASB did not originally intend for an entity to estimate variable consideration for disclosure when those amounts are not needed to recognize revenue currently (as is the case with future revenue associated with a sales and usage based royalty; and variable consideration allocated to an unsatisfied distinct performance obligation which is part of a larger performance obligation required to be treated as one under the series provision rules in FASB ASC 606-10-25-14(b).) The dissenting FASB members felt that this information (variable consideration) was relevant to users based on the need for similar non-U.S. GAAP backlog information. These new disclosure requirements and optional exemptions will be relevant to some private companies where non-U.S. GAAP backlog information is important to users. This will include many contracts that are considered construction-type and production-type today. ASU 2016-20 also noted that these optional disclosure exemptions do NOT apply to fixed consideration. Accordingly, in spite of the optional disclosure exemptions, many entities will be disclosing in U.S. GAAP financial statements (and practitioners will be auditing) more information about transaction prices associated with remaining performance obligations than they do today.

<u>Contract Asset versus Receivable (Issue 9)</u>

Questions have arisen regarding when an asset should be presented as a receivable or some other asset (for example, a contract asset). As originally issued, Example 38, Case B references the due date for a receivable being the appropriate time to record a receivable. The BC notes that FASB ASC 606-10-45-4 provides guidance about the presentation of an asset as a receivable. That guidance indicates that “a receivable is an entity’s right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due.” Accordingly, Example 38, Case B was revised to emphasize that the receivable should be recognized when the unconditional right to consideration exists by removing the references to the due date of the consideration.

The FASB also observed in the BC that the guidance in FASB ASC 606-10-45-4 should be sufficient to enable organizations to assess whether an asset should be presented as

a receivable. The guidance in FASB ASC 606-10-45-4 does not exist in current U.S. GAAP. Therefore, an entity should evaluate the guidance when presenting an asset as a receivable. In the view of the FASB, in most cases, this guidance generally should not result in a significant change in practice from current U.S. GAAP. The FASB notes that there is some diversity in practice today for presentation of receivables and the guidance in FASB ASC 606 might not eliminate that diversity.

Other Matters Addressed

The amendments in ASU 2016-20 address ten other areas:

- Loan guarantee fees
- Contract costs—impairment testing
- Contract costs—interaction of impairment testing with guidance in other FASB ASC topics
- Scope of FASB ASC 606
- Disclosure of prior-period performance obligations
- Contract modifications example (Example 7)
- Refund liability
- Advertising costs
- Fixed-odds wagering contracts in the casino industry
- Cost capitalization for advisors to private funds and public funds

Effective Date

The effective date and transition requirements for the amendments in ASU 2016-20 are the same as the effective date and transition requirements for FASB ASC 606 (and any other FASB ASC amended by ASU 2014-09).