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Process & Industrial Products Spotlight
Revenue Recognition Rebuilt

In This Issue:

The ASU outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance.

The Bottom Line

- On May 28, 2014, the FASB and IASB issued their final standard on revenue from contracts with customers. The standard, issued as ASU 2014-09[1] by the FASB and as IFRS 15[2] by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance.[3]
- The new standard requires management to use judgment to (1) determine whether contracts with one customer (or related parties) should be combined and treated as a single contract, (2) identify the performance obligations in a contract (i.e., the unit of account), and (3) determine the transaction price.
- Variable consideration that may be created by sales incentives, such as volume discounts or customer rebates, will need to be estimated and may be constrained.
- Revenue from contracts for customized parts that an entity creates by providing a "service" to a customer (i.e., the parts have no alternative use to the entity and the entity has a right to payment for performance to date) will need to be recognized over time as the parts are constructed.
- An entity will need to determine whether contract costs should be capitalized and amortized as goods and services are transferred to the customer or whether such costs should be expensed as incurred.
- Since the new standard requires significantly more extensive disclosures, process and industrial products (P&IP) entities may need to modify their systems and processes to gather information about contracts with customers that is not otherwise readily available.

[1] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers*.

[2] IFRS 15, *Revenue From Contracts With Customers*.

[3] The SEC has indicated that it plans to review and update the revenue recognition guidance in SEC Staff Accounting Bulletin (SAB) Topic 13, "Revenue Recognition," in light of the ASU. The extent to which the ASU's guidance will affect a public entity will depend on whether the SEC removes or amends the guidance in SAB Topic 13 to be consistent with the new revenue standard.

Beyond the Bottom Line

This *Process & Industrial Products Spotlight* discusses the framework of the new revenue model and highlights key accounting issues and potential challenges for P&IP entities that recognize revenue under U.S. GAAP or IFRSs. For additional information about the new standard, see Deloitte's May 28, 2014, *Heads Up*.

Background

The goals of the ASU are to clarify and converge the revenue recognition principles under U.S. GAAP and IFRSs while (1) streamlining, and removing inconsistencies from, revenue recognition requirements; (2) providing "a more robust framework for addressing revenue issues"; (3) making revenue recognition practices more comparable; and (4) increasing the usefulness of disclosures. The ASU states that the core principle for revenue recognition is that an "entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."

The ASU indicates that an entity should perform the following five steps in recognizing revenue:

- "Identify the contract(s) with a customer" (step 1).
- "Identify the performance obligations in the contract" (step 2).
- "Determine the transaction price" (step 3).
- "Allocate the transaction price to the performance obligations in the contract" (step 4).
- "Recognize revenue when (or as) the entity satisfies a performance obligation" (step 5).

As a result of the ASU, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary.

As a result of the ASU, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary. Entities are also required to provide significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, used in applying the revenue model; and (3) the assets recognized from costs to obtain or fulfill a contract with a customer.

Key Accounting Issues

Collectibility

The ASU establishes a collectibility threshold under which an entity must determine whether "[i]t is probable that the entity will collect the consideration to which it will be entitled." If the threshold is not met, the entity is precluded from applying the remaining steps in the ASU and recognizing revenue until it is probable[4] that the consideration will be collected. Any amounts received before collectibility is considered probable would be recorded as revenue only if the consideration received is nonrefundable and either (1) all performance obligations in the contract have been satisfied and substantially all of the promised consideration has been received or (2) the contract has been terminated or canceled. If those conditions are not met, any consideration received would be recognized as a liability.

For contracts that have a variable sales price (including price concessions), entities would first estimate the consideration due under the contract (see Variable Consideration below) and would then apply the collectibility threshold to the estimated transaction price.

[4] Under U.S. GAAP, "probable" refers to a "future event or events [that] are likely to occur." This threshold is considered higher than "probable" as used in IFRSs, under which the term means "more likely than not."

Thinking It Through

While the ASU's probability threshold is generally the same as that in current U.S. GAAP (i.e., collectibility is reasonably assured), current practice may change as a result of the new requirement. Currently, entities typically assess collectibility under SAB Topic 13.A and, when the collectibility threshold is not passed, defer revenue recognition until cash is received. Under the new standard, further deferral could be required even when nonrefundable cash has been received.

Contract Combination

Entities must also assess whether to account for multiple contracts as a single contract. The ASU requires entities to combine contracts entered into at or around the same time with the same customer (or parties related to the customer) if one or more of the following criteria are met:

- "The contracts are negotiated as a package with a single commercial objective."
- "The amount of consideration to be paid in one contract depends on the price or performance of the other contract."
- "The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation."

Unlike current U.S. GAAP, under which entities may consider combining contracts in certain circumstances, the ASU requires contract combination when certain criteria are met.

Thinking It Through

Unlike current U.S. GAAP, under which entities may consider combining contracts in certain circumstances, the ASU requires contract combination when certain criteria are met. P&IP entities often enter into multiple contracts with the same customer around the same time but may not specifically evaluate whether those contracts are interdependent. After establishing controls to ensure that this evaluation is performed, P&IP entities may need to use judgment to determine whether the ASU's contract-combination criteria are met. A conclusion that the criteria are met could significantly affect (1) how performance obligations are identified, (2) how consideration is allocated to those obligations, or (3) when revenue is ultimately recognized. Note that contracts with different customers (that are not related parties) would not be combined.

Example

In March 20X4, Entity A, an industrial products supplier located in the United States, enters into two separate contracts with Entity B to supply parts: one with Entity B's U.S. subsidiary and one with its Chinese subsidiary. Because the contracts are with the same customer, Entity A would be required to assess whether the contract-combination criteria are met. Specifically, if the pricing in one contract depends on the price or performance of the other contract, Entity A may be required to account for the two contracts as a single contract.

Contract Modification

The ASU requires entities to account for contract modifications as separate contracts if such modifications result in (1) the addition of "distinct" performance obligations (see Identification of Performance Obligations below) and (2) an increase in the price of the contract by an amount of consideration that reflects the entity's stand-alone selling price for the separate performance obligations. For a contract modification that does not meet the criteria to be accounted for as a separate contract, an entity must determine whether it should be accounted for (1) as a termination of the original contract and the creation of a new contract (i.e., the amount of consideration not yet recognized would be allocated to the remaining performance obligations) or (2) as if it were part of the original contract (i.e., the entity would update the transaction price and the measure of progress toward complete satisfaction of the performance obligation and would record a cumulative catch-up adjustment to revenue). The ASU provides specific guidance on making this determination. Depending on how revenue is recognized (i.e., over time or at a point in time) and the terms of a contract modification, the amount of current and ongoing revenue recognized can dramatically differ.

Identification of Performance Obligations

The ASU requires entities to evaluate the goods and services promised in a contract to identify "performance obligations." Specifically, the ASU requires an entity to account for a "distinct" good or service (or bundle of goods or services) or a series of distinct goods or services (if they are substantially the same and have the same pattern of transfer) as a performance obligation (i.e., a separate unit of account). The ASU defines a distinct good or service as one that meets both of the following criteria:

- "The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct)."
- "The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract)."

A good or service that does not meet these criteria would be combined with other goods or services in the contract until the criteria are met. While the first criterion is generally consistent with the current guidance in ASC 605-25[5] on determining whether a good or service has "stand-alone value," the second criterion is a new concept. The ASU provides the following indicators for evaluating whether a promised good or service is separable from other promises in a contract:

The ASU requires entities to evaluate the goods and services promised in a contract to identify "performance obligations."

- "The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract . . . . In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer."
- "The good or service does not significantly modify or customize another good or service promised in the contract."
- "The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services."

Thinking It Through

P&IP entities may promise to provide multiple goods or services to their customers in a single contract. Under current U.S. GAAP, entities may conclude that certain deliverables are inconsequential or perfunctory obligations or that they constitute "marketing" deliverables. However, the new revenue standard does not have an exception for inconsequential or perfunctory obligations or for obligations that constitute marketing deliverables. An entity may need to use significant judgment in identifying all the goods or services in contracts with a customer and applying the above criteria to determine each performance obligation (especially when considering the new concept of "distinct within the context of the contract").

[5] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Variable Consideration

P&IP entities often offer sales incentives to their customers, such as volume discounts, rebates, or price concessions, which create variability in the pricing of the goods or services offered to customers. Under the ASU, if the transaction price is subject to variability, an entity would be required to estimate the transaction price by using either (1) the "expected value" (probability-weighted) approach or (2) the "most likely amount" approach, "depending on which method the entity expects to better predict the amount of consideration to which the entity will be entitled." Therefore, entities will need to use judgment in determining whether the expected value or the most likely amount is more predictive of the amount of consideration in the contract.

Regardless of which technique is used to estimate the transaction price, some or all of an estimate of variable consideration is only included in the transaction price to the extent that it is probable[6] "that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved" (this concept is commonly referred to as the "constraint"). As a result, entities may have to recognize some or all of the probability-weighted amount or most likely amount estimated.

Entities will need to use judgment in determining whether the expected value or the most likely amount is more predictive of the amount of consideration in the contract.

Thinking It Through

Entities should consider factors that could indicate that an estimate of variable consideration is subject to significant reversal, such as susceptibility to factors outside the entity's influence (e.g., subsequent third-party sales, volatility in a market, weather conditions), limited experience with similar types of contracts, long period before uncertainty is resolved, practices of providing concessions, or a broad range of possible consideration amounts. Some or all of an estimate of variable consideration is only included in the transaction price to the extent that it is probable that subsequent changes in the estimate would not result in a "significant reversal" of revenue (this concept is commonly referred to as the "constraint"). The ASU requires entities to update this estimate in each reporting period to reflect changes in facts and circumstances.

Adjusting for the Time Value of Money

The ASU requires entities to adjust the transaction price for the time value of money when a significant financing component exists (and provides guidance on determining when such a financing exists). The objective of this requirement is to adjust the promised amount of consideration to reflect what the selling price would have been if the customer had paid cash for the goods or services at the time (or over the period during which) such goods or services were transferred to the customer. As a practical expedient, an entity is not required to account for a significant financing component in a contract if, at contract inception, the expected time between payment and the transfer of the promised goods and services is one year or less. In addition, a significant financing component would not exist if the difference between the promised consideration and the cash selling price of the good or service arises "for reasons other than the provision of finance . . . and the difference between those amounts is proportional to the reason for the difference."[7]

6 Like the term "probable" regarding the collectibility threshold, "probable" in this context has the same meaning as in ASC 450-20: "the event or events are likely to occur." In IFRS 15, the IASB uses the term "highly probable," which has the same meaning as the FASB's "probable."

7 ASC 606-10-55-244 through 55-246 provide an example of factors to consider in the assessment of whether the payment terms in a contract were structured primarily for reasons other than the provision of finance to the entity.

Thinking It Through

P&IP entities commonly enter into contracts with varying payment terms. To the extent that an entity receives an up-front payment for which the related revenue will be recognized over several years (i.e., the customer is providing the entity with financing) or the customer is not required to pay for a certain period after a performance obligation is satisfied (i.e., the entity is providing the customer with financing), the transaction price may need to be adjusted for the time value of money (as if a hypothetical loan was provided to one of the parties in the contract).

However, in some situations, the payment terms may be structured for reasons other than financing (e.g., to protect customers from the entity's failure to adequately complete some or all of its obligations under a contract). The ASU would not require an entity to account for a significant financing component if the payment terms were structured for reasons other than "for the provision of finance."

Recognizing Revenue

Under the ASU, entities recognize revenue as "control" of the goods or services underlying a performance obligation is transferred to the customer.[8] This control-based model differs from the risks-and-rewards model generally applied under current U.S. GAAP. Entities must first determine whether control is transferred over time. If not, it is transferred at a point in time. Under the ASU, control is transferred over time if any of the following criteria are met:

- "The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs."
- "The entity's performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced."
- "The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date."

If none of these criteria are met, an entity would determine the point in time at which the customer obtains control of the good or service. Factors indicating that control has been transferred at a point in time include, but are not limited to, the following:[9]

- "The entity has a present right to payment for the asset."
- "The customer has legal title to the asset."
- "The entity has transferred physical possession of the asset."
- "The customer has the significant risks and rewards of ownership of the asset."
- "The customer has accepted the asset."

After carefully evaluating whether revenue should be recognized over time (as production occurs) or at a point in time (most likely when the customer obtains the goods or services), P&IP entities will need to determine either how to measure progress toward satisfying the performance obligation over time or, if the performance obligation is satisfied at a point in time, the specific point at which control has been transferred to the customer.

The ASU would not require an entity to account for a significant financing component if the payment terms were structured for reasons other than "for the provision of finance."

[8] Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset as well as the ability to prevent other entities from directing the use of and obtaining the benefits from the asset.

[9] The individual indicators listed below are not definitive in and of themselves. An entity would consider all relevant facts and circumstances when determining the point in time at which control is transferred to the customer.

Thinking It Through

A P&IP entity may manufacture for a customer a customized part that will have no alternative use (e.g., only one customer can use the part because of its specialized nature). In evaluating the payment terms, when an entity determines under the ASU that it has an enforceable right to payment throughout the production process and the goods do not have an alternative use, the entity is providing a production service and is required to recognize revenue over time (as production occurs). If the entity recognizes revenue at a point in time, it will have to use judgment in evaluating the indicators for determining when "delivery" has occurred. This provision differs from the prescriptive guidance on this topic in current U.S. GAAP.

Shipping Terms

P&IP entities may ship goods "FOB shipping point" but have arrangements with their customers under which the seller continues to bear risk of loss or damage (either explicitly or implicitly) that is not covered by the carrier while the product is in transit. If damage or loss occurs under these circumstances, the seller may be obligated to provide (or may have a practice of providing) the buyer with replacement products at no additional cost. The seller may insure this risk with a third party or "self-insure" the risk.

Such shipping terms are often called synthetic FOB destination shipping terms because the seller has retained the risk of loss or damage during transit. Under these terms, all risks and rewards of ownership have not been substantively transferred to the buyer, and it would not be appropriate to recognize revenue before the goods are ultimately delivered to the buyer under current U.S. GAAP.

The ASU contains criteria for determining when to capitalize costs associated with obtaining and fulfilling a contract.

Under the ASU, entities are required to recognize revenue by using a control-based model rather than the risks-and-rewards model of current U.S. GAAP. Accordingly, entities would consider indicators (see Recognizing Revenue above) in evaluating the point at which control of an asset has been transferred to a customer.

Thinking It Through

Under the ASU, arrangements involving synthetic FOB destination shipping terms may give rise to two performance obligations: (1) sale of a product and (2) protection against the risk of loss during transit. Instead of deferring all revenue recognition in such circumstances, P&IP entities need to allocate the transaction price to each identified performance obligation and assess the satisfaction of each performance obligation separately. In such cases, revenue recognition could be accelerated depending on the determination of when control related to the underlying performance obligations is transferred.

Contract Costs

The ASU contains criteria for determining when to capitalize costs associated with obtaining and fulfilling a contract.

- *Incremental costs of obtaining a contract* — Entities are required to recognize an asset for incremental costs of obtaining a contract (e.g., sales commissions) when those costs are expected to be recovered (the ASU provides a practical expedient allowing entities to "expense these costs when incurred if the amortization period is one year or less").
- *Fulfillment costs* — Costs of fulfilling a contract (that are not within the scope of other guidance such as that on inventory in ASC 330) would be capitalized only when they (1) are directly related to a contract, (2) generate or enhance resources that will be used to satisfy performance obligations, and (3) are expected to be recovered. The ASU also requires entities to expense certain costs, such as those related to satisfied (or partially satisfied) performance obligations.

Capitalized costs would be amortized in a manner consistent with the pattern of transfer of the goods or services to which the asset is related (i.e., as the related revenue is recognized). In certain circumstances, the amortization period may extend beyond the original contract term (e.g., when future anticipated contracts or expected renewal periods exist). All capitalized-cost assets would be subject to impairment testing if any impairment indicators exist.

Thinking It Through

P&IP entities may need to consider the impact of the new standard on their current policies for capitalizing the costs of obtaining a contract. Under current U.S. GAAP, there is limited guidance on the capitalization of such costs, and entities generally make an accounting policy election to expense them or, in certain cases, to capitalize them by analogy to the guidance in ASC 310 on deferred loan origination costs.

In the P&IP industry, many of the costs incurred in fulfilling a customer contract are likely to be accounted for in accordance with the inventory guidance in ASC 330. Such guidance would continue to apply to performance obligations satisfied at a point in time. However, if a performance obligation is satisfied over time, the costs would most likely be related to a partially satisfied performance obligation and would therefore need to be expensed as incurred (as noted above).

Warranties

P&IP entities often sell products with warranties that assure customers that the products comply with agreed-upon specifications. In some cases, entities may also offer more extensive warranties (e.g., warranties that provide services for a fixed period after the initial warranty period has expired).

The ASU allows entities to continue to use a cost accrual model to account for warranty obligations (in accordance with ASC 460), but only for warranties ensuring that the good or service complies with agreed-upon specifications. To the extent that a warranty provides a service beyond ensuring that the good or service complies with agreed-upon specifications, it would be accounted for as a performance obligation (consideration would be allocated to this obligation and recognized as it is satisfied). Further, if the customer has the option to purchase the warranty separately, it would also be accounted for as a performance obligation.

Product liabilities, such as compensation paid by an entity for harm or damage caused by its product, do not represent a performance obligation in the contract and would continue to be accounted for in accordance with the existing literature on loss contingencies in ASC 450-20.

Thinking It Through

The ASU should not change the accounting for most warranties (i.e., typical warranties assuring that the good or service complies with agreed-upon specifications), which are generally accounted for under a cost accrual model. However, P&IP entities may want to reassess all of their warranties to ensure that the warranties are not providing any services beyond assuring the customer that the product complies with agreed-upon specifications.

Disclosures

The ASU requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The ASU's disclosure requirements, which are significantly more comprehensive than those in existing revenue standards, include the following (with certain exceptions for nonpublic entities):

- Presentation or disclosure of revenue and any impairment losses recognized separately from other sources of revenue or impairment losses from other contracts.

The ASU requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers."

- A disaggregation of revenue to "depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors" (the ASU also provides implementation guidance).
- Information about (1) contract assets and liabilities (including changes in those balances), (2) the amount of revenue recognized in the current period that was previously recognized as a contract liability, and (3) the amount of revenue recognized in the current period that is related to performance obligations satisfied in prior periods.
- Information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions).
- Information about an entity's transaction price allocated to the remaining performance obligations, including (in certain circumstances) the "aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied)" and when the entity expects to recognize that amount as revenue.
- A description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition (including information about the timing of satisfaction of performance obligations, the determination of the transaction price, and the allocation of the transaction price to performance obligations).
- Information about an entity's accounting for costs to obtain or fulfill a contract (including account balances and amortization methods).
- Information about the policy decisions (i.e., whether the entity used the practical expedients for significant financing components and contract costs allowed by the ASU).

The ASU requires entities, on an interim basis, to disclose information required under ASC 270 as well as to provide annual disclosures (described above) about (1) the disaggregation of revenue, (2) contract asset and liability balances and significant changes in those balances since the previous period-end, and (3) the transaction price allocated to the remaining performance obligations.

Nonpublic entities can use certain practical expedients under the ASU to avoid providing some of the disclosures required of public entities. For additional information about the disclosure relief provided, see Appendix C of Deloitte's May 28, 2014, *Heads Up*.

Effective Date and Transition

For public entities, the ASU is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2016. Early application is not permitted (however, early adoption is optional for entities reporting under IFRSs).

The effective date for nonpublic entities is annual reporting periods beginning after December 15, 2017, and interim reporting periods within annual reporting periods beginning after December 15, 2018. Nonpublic entities may also elect to apply the ASU as of any of the following:

- The same effective date as that for public entities (annual reporting periods beginning after December 15, 2016, including interim periods).
- Annual periods beginning after December 15, 2016 (excluding interim reporting periods).
- Annual periods beginning after December 15, 2017 (including interim reporting periods).

For public entities, the ASU is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2016. Early application is not permitted. The effective date for nonpublic entities is annual reporting periods beginning after December 15, 2017, and interim reporting periods within annual reporting periods beginning after December 15, 2018.

Entities have the option of using either a full retrospective or a modified approach to adopt the guidance in the ASU.

- *Full retrospective application* — Retrospective application would take into account the requirements in ASC 250 (with certain practical expedients).
- *Modified retrospective application* — Under the modified approach, an entity recognizes "the cumulative effect of initially applying [the ASU] as an adjustment to the opening balance of retained earnings . . . of the annual reporting period that includes the date of initial application" (revenue in periods presented in the financial statements before that date is reported under guidance in effect before the change). Under the modified approach, the guidance in the ASU is only applied to existing contracts (those for which the entity has remaining performance obligations) as of, and new contracts after, the date of initial application. The ASU is not applied to contracts that were completed before the effective date (i.e., an entity has no remaining performance obligations to fulfill). Entities that elect the modified approach must disclose an explanation of the impact of adopting the ASU, including the financial statement line items and respective amounts directly affected by the standard's application. The following chart illustrates the application of the ASU and legacy GAAP under the modified approach for a public entity with a calendar year-end:

January 1, 2017	2017	2016	2015
Initial Application Year	Current Year	Prior Year 1	Prior Year 2
New contracts	New ASU		
Existing contracts	New ASU + cumulative catch-up	Legacy GAAP	Legacy GAAP
Completed contracts		Legacy GAAP	Legacy GAAP

Entities have the option of using either a full retrospective or a modified approach to adopt the guidance in the ASU.

Thinking It Through

The modified transition approach provides entities relief from having to restate and present comparable prior-year financial statement information; however, entities will still need to evaluate existing contracts as of the date of initial adoption under the ASU to determine whether a cumulative adjustment is necessary. Therefore, entities may want to begin considering the typical nature and duration of their contracts to understand the impact of applying the ASU and to determine the transition approach that is practical to apply and most beneficial to financial statement users.

Considerations and Challenges for P&IP Entities

Increased Use of Judgment

Management will need to exercise significant judgment in applying certain aspects of the ASU's requirements, including those related to the identification of performance obligations and allocation of revenue to each performance obligation. It is important for P&IP entities to consider how the ASU specifically applies to them so that they can prepare for any changes in revenue recognition patterns.

Retrospective Application

The ASU allows entities to apply the standard retrospectively and use certain optional practical expedients at their discretion. As a result, P&IP entities may need to review contracts that commenced several years before the ASU's effective date. In addition, P&IP entities will most likely be required to perform dual tracking of revenue balances during the retrospective period given the potential difficulty of retroactively recalculating revenue balances when the new ASU becomes effective.

Systems, Processes, and Controls

To comply with the ASU's new accounting and disclosure requirements, P&IP entities will have to gather and track information that they may not have previously monitored. The systems and processes associated with such information may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems. P&IP entities with large volumes of sales deals may find it operationally challenging to assess each sales deal to categorize and account for customer incentives in accordance with the ASU. Such entities may need to make substantial system modifications to facilitate this process.

P&IP entities may also face challenges when they recognize as an asset certain costs of obtaining or fulfilling a contract (as opposed to recognizing such costs as expenses immediately, if the amortization period is one year or less). In such cases, P&IP entities may need to revise their accounting practices and make appropriate system modifications to track data on contract duration, contract costs, and periodic amortization and impairment testing of capitalized costs.

Further, to ensure the effectiveness of internal controls over financial reporting, management will need to assess whether additional controls should be implemented. P&IP entities may also need to begin aggregating essential data from new and existing contracts since many of these contracts will most likely be subject to the ASU.

Note that the above are only a few examples of changes P&IP entities may need to make to their systems, processes, and controls. P&IP entities should evaluate all aspects of the ASU's requirements to determine whether any other modifications may be necessary.

To comply with the ASU's new accounting and disclosure requirements, P&IP entities will have to gather and track information that they may not have previously monitored.

Income Taxes

Federal income tax law provides both general and specific rules for recognizing revenue on certain types of transactions (e.g., long-term contracts and arrangements that include advance payments for goods and services). These rules are often similar to the method a taxpayer uses for financial reporting purposes and, if so, the taxpayer employs the revenue recognition method it applies in maintaining its books and records (e.g., cash basis, U.S. GAAP, IFRSs). Although the Internal Revenue Code (IRC) does not require entities to use any particular underlying financial accounting method to determine their taxable income (such as U.S. GAAP), entities must make appropriate adjustments (on Schedule M) to their financial accounting pretax income to determine taxable income under the IRC.

The ASU may change the timing of revenue recognition and, in some cases, the amount of revenue recognized for entities that maintain their books and records under U.S. GAAP or IFRSs. These changes may also affect taxable income. Thus, it will be important for tax professionals to understand the detailed financial reporting implications of the standard so that they can analyze the tax ramifications and facilitate the selection of any alternative tax accounting methods that may be available.

If a change in a tax accounting method is advantageous or expedient (including circumstances in which the book method has historically been used), the taxpayer will most likely be required to obtain approval from the relevant tax authorities to use the method. Similar implications may arise in foreign jurisdictions that maintain statutory accounting records under U.S. GAAP or IFRSs. Additional record keeping will also be required when entities are not permitted to use the ASU's revenue recognition method for tax purposes.

Thinking Ahead

Although the ASU is not effective until annual reporting periods beginning after December 15, 2016 (with a maximum deferral of one year for nonpublic entities that apply U.S. GAAP), P&IP entities should start carefully examining the ASU and assessing the impact it may have on their current accounting policies, procedures, systems, and processes.

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