The Effect of the New Revenue Recognition Standards (Topic 606) on Long-Term Contracts

Greg Gaynor, College of Business, California State University, Long Beach, 1250 Bellflower Blvd, Long Beach, CA 90840, greg.gaynor@csulb.edu

John Palmer, College of Business, California State University, Long Beach, 1250 Bellflower Blvd, Long Beach, CA 90840, john.palmer@csulb.edu

Sudha Krishnan, College of Business, California State University, Long Beach, 1250 Bellflower Blvd, Long Beach, CA 90840, sudha.krishnan@csulb.edu

Sabrina Landa, College of Business, California State University, Long Beach, 1250 Bellflower Blvd, Long Beach, CA 90840, sabrina.landa@csulb.edu

ABSTRACT

Firms have recently begun implementing the updated revenue recognition guidance under Topic 606-Revenue from Contracts with Customers. Compared to the old standards under Topic 605, these latest revenue standards can often mean key changes in the accounting for long-term contracts as well as dramatic differences in reported financial performance—making it well worth it for managers to understand the latest guidance. This paper compares the old Topic 605 to the new Topic 606 and provides examples on how to account for long term contracts under Topic 606 and its impact on revenue.
Keywords: Revenue Recognition, Long Term Contracts

INTRODUCTION

Background

The Financial Accounting Standards Board (FASB) issued Topic 606- Revenue from Contracts with Customers (ASU 2014-09) back in 2014, as part of its joint project with the International Accounting Standards Board (IASB) to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and International Financial Reporting Standards (IFRS). In an acknowledgment of the primary role that revenue recognition plays in firm financial performance, as well as the significant changes brought upon by the new guidance, it was not until several years later that firms were required to begin reporting their results under the new standards.

FASB states that "the core principle of the guidance is that an entity should 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." (Topic 606, pg. 2)

To achieve the core principle of the new revenue recognition guidance, the FASB provides the following 5-step model:

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

Applying the New Guidance to Long-Term Contracts

For long-term contracts, Topic 606 superseded the guidance provided by Topic 605-35, which had often provided firms the option of accounting for long-term contracts through either the completed contract method or the percentage-of-completion method (the recommended method when reliable estimates were possible). The main conceptual changes that the new guidance prescribes for long-term contracts are the requirements to divide a contract into separate performance obligations, assigning a transaction price to each, and to determine when the customer has control of the contracted good or service. These key changes can translate to dramatic differences in the timing of revenue, expense, and profit recognition for long-term contracts.

Regarding performance obligation transaction prices, the FASB states that an entity should allocate the transaction price to each performance obligation based upon its observed or estimated standalone selling price at contract inception. On the issue of control, an entity should recognize revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when (or as) the customer obtains control of that good or service. The FASB states that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time if at least one of the following criteria is met (Topic 606, pg. 5):

1. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
2. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.
3. 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.

For performance obligations that an entity satisfies (and recognizes revenue for) over time, the contractor should consistently apply a method of measuring the progress toward complete satisfaction of that performance obligation using either an output method (e.g. units of delivery) or an input method (e.g. costs incurred). If a contractor does not satisfy a performance obligation over time, the performance obligation is considered to be satisfied (and revenue recognized) at a point in time—when control is eventually transferred to the customer.

The rest of the paper provides hypothetical examples where we demonstrate the accounting techniques for a long-term contract under both the old (Topic 605) and new (Topic 606) revenue guidance. In doing so, we highlight key differences between the old and new revenue standards as well as the inherent managerial discretion that exists in revenue and expense recognition timing based on the structure of a specific long-term contract.