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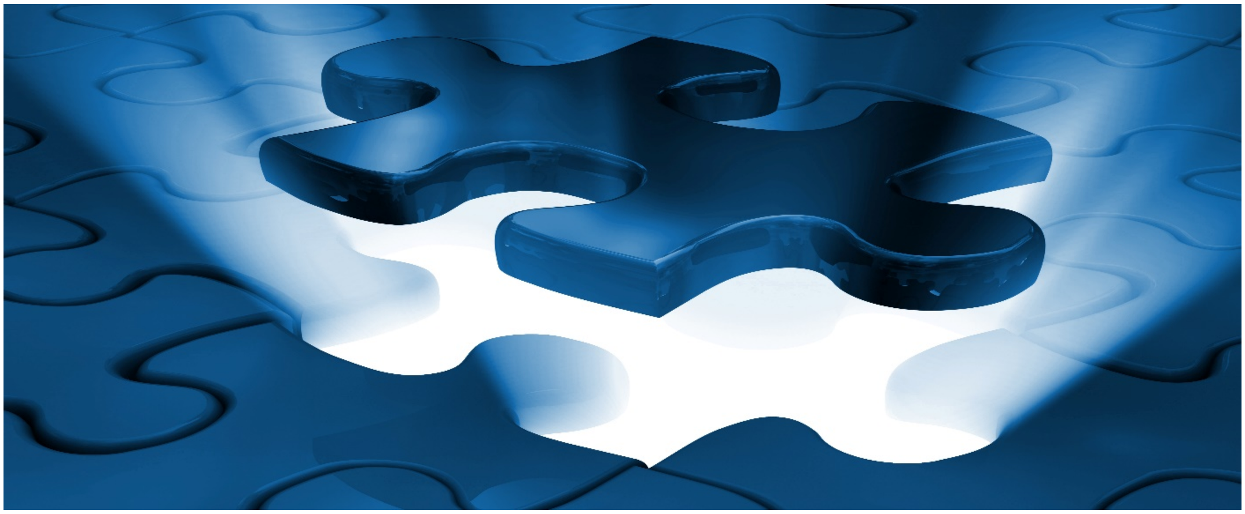
ASC 606: Five Challenging Issues



Executive Summary

- Many companies are far down the path of adoption and are continuing to identify challenges in the guidance
- Contract modifications require a specific analysis which needs to be incorporated on a "go-forward" basis
- Immaterial goods and services may be excluded from analysis, but need to be analyzed on a contract-by-contract basis
- Milestone payments may be recognized at different points in time and companies should incorporate this change into their budgeting process
- Allocating variable consideration requires

Overview

As we're rounding 3rd base on the implementation of ASC 606, *Revenue from Contracts with Customers*, there are a number common themes that we are seeing. While no implementation is the same, included below are five areas of struggle that have continued to arise in practice, as well as corresponding implementation and adoption considerations.

#1 – Combination of contracts and contract modifications

Under legacy guidance, companies were required to treat multiple contracts as one revenue arrangement in certain circumstances. Companies should evaluate their internal policies to determine if any of the revised criteria impact the scenarios in which they combine contracts.

The more critical consideration that may have a significant impact in this space is contract modifications. For example, while two separate contracts may not be combined as one revenue arrangement, a subsequently issued contract may be considered a contract modification under the new guidance and therefore impact the accounting of the original contract. Companies should have a policy in place for identifying contract modifications and be able to document and support their conclusions.

judgment and can result in material differences to revenue recognition
- Determining when performance obligations are satisfied requires a detailed understanding of your contracts
- Controls should be put in place to ensure contract amendments and new contracts do not impact point in time/over time determination

#2 – Practical expedient for immaterial goods and services

Under legacy guidance, there was not a specific definition as to what was considered a deliverable impacting the determination of the units of accounting in an arrangement. The new guidance allows for companies to exclude immaterial goods and services from the performance obligation analysis. However, the analysis needs to be performed at the contract level. As such, while certain items may be immaterial in one contract, those same goods or services may be material in another contract and would thus be incorporated into that contract's performance obligations analysis.

#3 – Milestone payments

Milestone payments are typically considered variable consideration whose impact will need to be continuously evaluated to determine when they should be incorporated into the transaction price. Companies have often been able to apply a constraint on the amount recognized by highlighting the susceptibility of the payments to outside factors, as well as the lack of experience (at the company and within an industry) for estimating milestone payments. As milestone payments become more certain, companies will need to incorporate such payments into their transaction price as the constraints are lifted (i.e., when factors indicate that a significant revenue reversal would not occur). Given the typical magnitude of milestone payments, Companies should take a fresh look at their budgeting and planning process to ensure that they are reflecting not only when milestones will be legally achieved, but also when they will be recorded as revenue and impact earnings.

#4 – Allocating variable consideration

In general, entities must use the relative standalone selling price for allocating the consideration. However, with variable consideration, there are certain instances where that variable consideration may be allocated to a specific part of the contract or performance obligation. For this to occur, the terms of the variable consideration must relate specifically to an entity's effort to satisfy the performance obligation and allocating the amount meets the allocation objective of the standard. For arrangements with multiple performance obligations, this determination is challenging; companies must clearly document which activities give rise to the variable consideration and whether or not they are specifically related to one performance obligation or multiple performance obligations within the arrangement.

#5 – Enforceable right to payment

An entity recognizes revenue as performance obligations are satisfied. Performance obligations may be satisfied over time if they meet certain defined criteria. If an 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 their performance completed to date, a performance obligation is considered satisfied over time. Determining whether an enforceable right to payment exists for performance to date may be challenging as: 1) the right to payment is required to include a portion of or the expected profit margin of the contract or a reasonable return of the entity's cost of capital and 2) the contract must be legally enforceable.

Entities operating in many jurisdictions and without standard contracts may find it challenging to determine what the terms of payment are and if they include a margin. Companies may also need to obtain a legal letter to opine on whether a particular provision is considered enforceable. This is also an area that should be monitored closely after adoption to ensure that new contracts or future amendments do not impact the previous conclusion surrounding point in time/over time determination.

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