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FASB Proposal Would Clarify Scope and Application of Revenue Topic

The FASB proposed technical corrections and improvements to its revenue topic, and also proposed amendments to other Codification topics to address unintended consequences from applying the revenue topic.[1] Many of the proposed changes address questions raised by the FASB / IASB Joint Transition Resource Group for Revenue Recognition (TRG). Comments are due July 2, 2016.

Key Facts

- An entity that does not have to estimate variable consideration to recognize revenue no longer would be required to estimate that amount when disclosing the transaction price allocated to remaining performance obligations.
- The current guidance on capitalization of pre-production costs in long-term supply arrangements would be superseded to require using the cost guidance in the revenue topic.
- An entity could determine a contract loss on long-term construction- and production-type contracts at either the contract level or the performance obligation level.
- An example that illustrates the guidance about contract modifications would be amended to clearly link the outcome to the guidance in the revenue topic.

Key Impacts

- An entity that recognizes revenue based on the amount invoiced may not be required to disclose the transaction price allocated to performance obligations. This would provide relief for contracts accounted for using the series guidance or the royalties exception for sales- or usage-based royalties on licenses of intellectual property.
- Several of the proposed amendments would clarify the scope or application of the revenue topic.

Contents

[1] FASB Proposed Accounting Standards Update, Technical Corrections and Improvements to Update 2014-09, Revenue from Contracts with Customers (Topic 606), May 18, 2016, available at www.fasb.org.

Disclosure Relief for Remaining Performance Obligations

The proposed amendments to the FASB's revenue topic may create some differences with IFRS.

The revenue topic requires an entity to disclose the aggregate amount of the transaction price allocated to unsatisfied or partially satisfied performance obligations each reporting period, and when it expects to recognize this amount as revenue.[2]

The topic includes practical expedients that would not require this disclosure if the performance obligation is part of a contract with an expected duration of one year or less, or if an entity qualifies for the practical expedient to recognize revenue in the amount to which it has the right to invoice.[3] The FASB provided the practical expedients because it did not want an entity to be required to estimate the transaction price for disclosure purposes if it was not required to do so for recognition purposes.[4]

The proposed amendments would expand the practical expedients to two additional scenarios in which an entity would not be required to estimate variable consideration when determining the transaction price for recognition purposes. The disclosure would not be required for contracts for which:

- The sales- or usage-based royalties exception on a license of intellectual property applies.
- Variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied distinct good or service that is part of a single performance obligation.

The practical expedients would not be applied to fixed consideration or variable consideration that does not meet one of the above conditions.

The proposed amendments would also require an entity that applies the practical expedients to disclose the nature of the performance obligations and the remaining duration, and to describe the variable consideration (e.g., the nature of the variability and how it is resolved). This information should be detailed enough to enable financial statements users to understand the extent of the remaining performance obligations.

Example

Franchisor A enters into a 10-year franchise agreement with a franchisee. The contract requires an initial franchise fee of $40,000 and ongoing royalties equal to 5 percent of the franchisee's sales.

Franchisor A elects to apply the practical expedient and not disclose the estimated royalties. However, Franchisor A would disclose the portion of the initial franchise fee that has not yet been recognized as revenue. It would also disclose that it has elected to apply the disclosure practical expedient and describe these details:

[2] FASB ASC paragraph 606-10-50-13, available at www.fasb.org.

[3] FASB ASC paragraphs 606-10-50-14 and 55-18, available at www.fasb.org.

[4] FASB Accounting Standards Update No. 2014-09, paragraph BC352, available at www.fasb.org.

Example

- The nature of the performance obligation;
- That the agreement includes a right to symbolic intellectual property that is recognized over time;
- The duration of the franchise right; and
- The 5 percent royalty that is recognized as sales occur.

KPMG Observations

The proposed practical expedient would apply to wholly unsatisfied performance obligations. This includes contracts with a single distinct good or service (a performance obligation that does not apply the series guidance), but only until services commence. This may require judgment to determine whether the performance obligation is wholly unsatisfied.

For example, Entity B enters into a noncancellable contract to build an aircraft carrier for a customer. The contract includes a single performance obligation satisfied over time. Consideration is variable based on time and materials. When the contract is initially executed, Entity B could elect to apply the practical expedient and not disclose the estimated transaction price allocated to the unsatisfied performance obligation. However, when Entity B commences work on the aircraft carrier, the disclosure would be required under the proposed amendments.

Pre-production Costs

The proposed amendments would supersede the guidance on capitalization of pre-production costs related to long-term supply arrangements.[5] The current guidance about when costs are capitalized is inconsistent with the new guidance in the revenue topic on capitalization of fulfillment costs.[6]

While the current guidance was developed in the context of contract manufacturers, in practice it has been applied more broadly. Because the revenue topic superseded cost guidance for other contracts (e.g., long-term construction- and production-type contracts), it is unclear whether an entity should continue to apply the pre-production cost guidance for long-term supply arrangements or begin applying the new fulfillment cost guidance.[7] The proposed amendments would provide this clarification by superseding the guidance on capitalization of pre-production costs, which would require the application of the new fulfillment cost guidance.

Under the proposed amendments, costs that were previously capitalized using the pre-production cost guidance and do not meet the criteria for capitalization as fulfillment costs would be expensed.

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[5] FASB ASC Subtopic 340-10, Other Assets and Deferred Costs–Overall, available at www.fasb.org.

[6] FASB ASC Subtopic 340-40, Other Assets and Deferred Costs–Contracts with Customers, available at www.fasb.org.

[7] FASB ASC Subtopic 605-35, Revenue Recognition, Construction-Type and Production-Type Contracts, available at www.fasb.org.

Impairment of Contract Costs

An entity recognizes an impairment loss on capitalized contract acquisition costs and fulfillment costs to the extent that the carrying amount of the asset exceeds the remaining amount of consideration that it expects to receive, less the costs that relate directly to those goods or services that have been previously expensed. The proposed amendments would clarify that when an entity measures the consideration that it expects to receive, it should evaluate the consideration from the contract with the customer that the entity expects to receive in the future, and that the entity has received but has not recognized as revenue in exchange for the goods or services to which the asset relates. The entity should also consider expected contract renewals and extensions with the same customer.

The proposed amendments also would require costs to be tested for impairment in a specific order:

1. Assets outside the scope of Topic 340 (e.g., inventory costs within the scope of Topic 330);[8]
2. Assets within scope of Topic 340;
3. Asset groups for amortizable and depreciable assets within the scope of Topics 350 and 360;[9] and
4. Goodwill reporting units under Topic 350.

Costs Incurred by Investment Companies

The proposed amendments would conform the accounting requirements for offering costs for advisors to both private and public investment funds. An entity would defer and amortize the incremental direct costs and expense the indirect costs when incurred.

Long-term Construction- and Production-type Contracts

The proposed amendments would provide a policy election to determine anticipated losses on long-term construction- and production-type contracts at either the contract level or the performance obligation level. An entity would apply this accounting policy election consistently to similar types of contracts. The proposed amendments will retain the flexibility that exists in current U.S. GAAP to determine anticipated losses at least at the contract level, but optionally at the segment level if an entity chooses to use a lower level.

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[8] FASB ASC Topics 340, Other Assets and Deferred Costs, and 330, Inventory, both available at www.fasb.org.

[9] FASB ASC Topics 350, Goodwill and Other; and 360, Property, Plant and Equipment, both available at www.fasb.org.

Scope of Revenue Topic for Insurance Entities

The proposed amendments would clarify that all contracts, including insurance contracts and investment contracts that are within the scope of the insurance topic, would be excluded from the scope of the revenue topic.[10]

Contract Modifications

Example 7 of the revenue topic illustrates how to apply the contract modifications guidance to a service contract. In the example, the contract term is extended but the pricing is not commensurate with the stand-alone selling price of the service. Therefore, the modification is accounted for as the termination of the existing contract and the creation of a new contract.

In the original example, the pricing of *all* remaining services (including the remaining services to be provided under the original contract and the services to be provided as a result of the modification) was compared with the stand-alone selling price. The proposed amendments would compare the selling price of the services to be provided as a result of the modification with the stand-alone selling price. The proposed amendments would clearly link the Basis for Conclusions with the guidance in the revenue topic it is intended to explain.

Fixed-odds Wagering Contracts

Many gaming entities (casinos) participate in fixed-odds wagering contracts (e.g., slot machines or sports betting). The revenue guidance for casinos in current U.S. GAAP will be superseded when the new revenue topic is effective.[11] The proposed amendments would specify that these contracts are accounted for under the revenue guidance and not under the derivatives guidance.

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[10] FASB ASC Topic 944, Financial Services—Insurance, available at www.fasb.org.

[11] FASB ASC Subtopic 924-605, Entertainment—Casinos—Revenue Recognition, available at www.fasb.org.