ASC 606: Measuring Performance Obligations Over Time

PROFESSIONALS

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PRACTICE AREAS

Revenue Recognition/ ASC 606

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The effective date of the highly anticipated revenue recognition standard, *Accounting Standards Codification Topic 606: Revenue from Contracts with Customers* ("ASC 606"), has been modified. For public entities, the effective date began with fiscal years beginning after December 15, 2017. For all nonpublic entities, the effective date is for fiscal years beginning after December 15, 2018, however, ASU 2020-05 extends by one year the effective date for all private entities that have not issued their financial statements.

ASC 606 directs entities to recognize revenue when the promised goods or services are transferred to the customer. The amount of revenue recognized should equal the total consideration an entity expects to receive in return for the goods or services. The Financial Accounting Standards Board (FASB) created a five-step approach that entities should apply when determining the amount and timing of revenue recognition:

- Step 1: Identify the contract 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

HCVT has published a series of articles discussing the various steps described above; this article briefly summarizes the guidance in Step 5, *Recognize revenue when (or as) the entity satisfies a performance obligation* – specifically the guidance around measuring a performance obligation over time.

The fifth and final step in ASC 606 is to recognize revenue when or as the performance obligations are satisfied and the performance obligations are satisfied when control of the good or service has been transferred to the customer. This differs from the current revenue recognition standard, in which the transfer of risks and rewards triggers revenue recognition. ASC 606 defines control as “the ability to direct the use of and obtain substantially all of the remaining benefits from the asset” (ASC 606-10-20). Under the new standard, once the customer has control or, in other words, is able to direct the use of a good or service as well as obtain substantially all of the benefits from it, revenue should be recognized.

Performance obligations that are fulfilled at a point in time are fulfilled when that obligation is satisfied. For performance obligations that are satisfied over time, the entity must decide how to appropriately measure the progress and completion of the performance obligation and recognize revenue accordingly.

To be considered “over time”, the following criteria need to be met:

1. The customer simultaneously receives and consumes the benefit provided by the entity as the entity performs.
2. The entity’s performance enhances or creates assets that the customer controls while the assets are being enhanced or created.
3. The 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 (ASC 606-10-25:27).

More complex judgments will be necessary when recognizing revenue from performance obligations satisfied over time. This concept will be commonly applied by contractors, service entities, and professional service organizations. It may also include manufacturing for certain specialized products made to customer specifications without alternative uses, such as in government contracting. For these types of performance obligations, a single method of measurement must be chosen that best depicts a reasonable and reliable measure of progress. An entity will use judgment when determining an appropriate method of measuring progress and must consider the nature of the promised good or service. In addition, only one method per performance obligation can be used, and that method must be applied consistently to similar performance obligations and in similar circumstances. Any subsequent change in the method used is considered a change in estimate.

Methods of measuring progress toward complete satisfaction of a performance obligation include output methods and input methods. An output method looks at the fair market value of goods and services transferred to the customer to date. An input method will be based on the costs for labor and materials as the business incurs them.

Measuring Progress – Output Methods
Output methods are based on direct measurements of value delivered to the customer. When using an output method, revenue is recognized based on an objective measure of the value of goods or services delivered to the customer relative to the remaining promised goods or services to be delivered in

satisfaction of the respective performance obligation. The entity will measure its progress toward satisfying its performance obligation over time using a single measure of progress for each performance obligation that depicts the transfer of control of the promised good or service to the customer.

Examples of output methods include, but are not limited to: (i) units produced; (ii) units delivered; (iii) amount of time elapsed; (iv) milestones reached; (v) survey of performance completed to date; and (vi) appraisal of results achieved. The list below includes examples of performance obligations satisfied over time and for which an output method would likely be appropriate.

- Research and development arrangements
- Certain types of long-term manufacturing contracts
- New product and/or service offerings (as there would likely be a limited amount of available information about the related performance obligations and satisfaction thereof)
- Services that do not qualify for the "Right to Invoice" practical expedient

Measuring Progress – Input Methods

Input methods are based on the inputs used by the entity in satisfying a performance obligation. When using an input method, an entity will recognize revenue based on inputs expended in proportion to the total inputs the entity expects to expend to completely satisfy the performance obligation. Examples of inputs that may be incorporated into an input method include labor hours expended, costs incurred, and machine hours used. When applying an input method, an entity identifies a single measure of progress for each performance obligation that depicts the transfer of control of the promised good or service to the customer.

Conclusion

Most entities will encounter significantly more complexities in recognizing revenue than under the current Generally Accepted Accounting Principles (GAAP). This will include the application of more management judgment than previously required. When control is transferred is an area that may result in changes in revenue recognition as compared to pre-ASC 606 guidance. It will be important for management to assess when performance obligations are truly satisfied. Management will need to establish appropriate processes, and internal controls over financial reporting will likely need to be designed over the process of assessing when control has transferred and obligations have been satisfied. Judgment will be required to determine the best method to measure progress towards the satisfaction of performance obligations. Public companies are already required to report revenue under ASC 606; for privately-held businesses now is the time to review their contracts and determine the appropriate method to recognize revenue.

About Sam Bachstein, Audit Partner

Sam has over 20 years of experience in public accounting, providing audit services for privately-held companies. He serves clients in the manufacturing, retail and distribution industry sectors, as well as clients in the nonprofit, agriculture, technology, software, and professional services industries. Sam's experience also includes five years in private industry in the finance group of a public company where he was responsible for financial reporting to the Securities and Exchange Commission.