The new year brings with it adoption of FASB ASC 606 for most calendar year private companies. In this report, we will discuss certain implementation questions we have been receiving to assist our members with common questions regarding FASB ASC 606.

- Opting Out of U.S. GAAP?
- What if a Contract’s Enforceable Terms on a Right to Payment for Performance to Date if Terminated for Convenience Are Not Clear (or Disputed)?
- Does an Entity Have to Take Physical Title to be Considered a Principal (Example-Drop Ship Arrangements)?
- Does a History of Giving Customers Price Concessions on Future Purchases or Free Goods and Services Result in an Implied Promise?
- How Are Contract Mobilization Costs Treated Once Performance on the Contract has Started?

FASB Revenue Recognition Q&A
Practitioners should be aware that the FASB also has recently issued a Revenue Recognition Q&A- Compiled from Previously Issued Educational Material (“Revenue Recognition Q&A”) that practitioners may wish to consult.

Opting Out of U.S. GAAP?

With broader recognition of the cost/benefit of applying FASB ASC 606, some entities are questioning continuing to use U.S. generally accepted accounting principles (U.S. GAAP). In a recent CPEA member webcast, a poll question was what percentage would be switching from U.S. GAAP to an alternative financial reporting framework as a result of the costs of the new revenue of lease standard.
The results demonstrate some level of movement away from U.S. GAAP. We will be monitoring this further in the future. Practitioners may wish to reference previous CPEA reports on this topic including those referenced below:

- Common Questions About Special Purpose Frameworks
- Revenue Recognition: A Comparison of Alternative Financial Reporting Frameworks
- Revenue Recognition Disclosures in Non-GAAP Financial Statements

CPEA members also can access the OCBOA Practice Aid on the CPEA website. The Practice Aid is intended to provide preparers of cash- and tax-basis financial statements with guidelines and best practices to promote consistency and to assist in resolving the often difficult questions regarding the preparation of such financial statements. This Practice Aid is nonauthoritative and should not be used as a substitute for the preparer’s professional judgment. Members also should note that the Practice Aid has not been updated since its publication and, therefore, does not reflect the effects of professional standards that have been issued since its publication.

What if a Contract's Enforceable Terms on a Right to Payment for Performance to Date if Terminated for Convenience Are Not Clear (or Disputed)?

In determining when to recognize revenue, all entities are required to recognize revenue over the life of the contract when there is no alternative use for the good or service and...
an enforceable right to payment for performance to date exists. As a result, some entities which have historically recognized revenue at a point in time, typically when products are shipped, will recognize revenue sooner than under legacy U.S. GAAP. We detailed this practice issue with current adopters in our two previous CPEA reports (available here and here). While this impacts all industries, specifically, TIC and CPEA raised concerns related to short-cycle and customized product manufacturers, that will likely need to shift from recognizing revenue at a point in time to over time for some contracts and the need to have controls over contracts to make determinations about the existence of an enforceable right to payment for performance to date.

In response, FASB staff clarified there is no requirement in FASB ASC 606 that indicates companies are required to consult with legal counsel for all revenue transactions. The staff also noted in the basis for conclusions, the general notion is that, if a company is creating a customized asset for a customer, then it will want to protect itself by requiring payment throughout the contract.

Previous FASB staff guidance (now centralized in the Revenue Recognition Q&A) addresses questions that have arisen about how to handle contracts in circumstances in which the entity creates a good with no alternative use and the contract with its customer does not specify by its written terms the entity’s right to payment upon contract termination. Some stakeholders have asked whether it was the FASB’s intent that companies analyze every law in every jurisdiction to determine whether there is recoverability. In the staff’s view, a reasonable interpretation of the guidance is that, when a contract’s written terms do not specify the entity’s right to payment upon contract termination, an enforceable right to payment is presumed not to exist.

**CPEA Observation**

We have seen detailed legal opinions on the application by state of the Uniform Commercial Code supporting the existence of an enforceable right to payment in the event of customer termination for convenience for customized products in cases where the contract’s terms are not specific. In these cases, the entities desired revenue recognition over time. The legal opinions referred to are highly case specific and should not be blindly applied to other customized products. While customized manufacturers desiring to recognize revenue over time may be in the minority, the dynamic set up by the standard and the staff Q&A appears to be one where the accounting outcome desired can be achieved with appropriate documentation when a contract’s written terms do not specify the entity’s right to payment upon contract termination for convenience.
While the FASB staff guidance may be helpful in some situations, we are aware of circumstances where it is unclear what terms and conditions have been agreed to. In these cases, it is common for the entity to assert in its terms and conditions an enforceable right to payment for performance to date in the event of customer termination for convenience. However, these terms and conditions may not be agreed to by the customer. In some cases, the customer asserts its own terms and conditions that may conflict. Frequently, this conflict in terms is never resolved as the issues that give rise to the conflicting terms (such as customer termination for convenience) do not take place. It appears to us that legal consultation will be necessary in these cases.

**CPEA Observation**

If uncertainties exist about an enforceable right to payment for performance to date in the event of customer termination for convenience, it would appear to be good business practice to resolve those uncertainties for goods that have no alternative use. We previously noted that some entities now only are seeking cost reimbursement in these cases, which generally is not sufficient to trigger a requirement to recognize revenue over time due to the lack of profit margin.

**Does an Entity Have to Take Physical Title to be Considered a Principal (Ex-Drop Ship Arrangements)?**

Many distributors and other third-party resellers have historically recorded revenue as a principal (gross) when product is directly shipped from the distributor’s supplier to the distributor’s customer (known as a “drop ship”). This treatment may or may not be appropriate under FASB ASC 606. Things to consider include-

- Taking physical title is not determinative. Rather it is an indicator of acting as a principal - the ability to direct the use of and obtain substantially all the remaining benefits of an asset.
- Other indicators may be present, and an entity can obtain control of the good or service in other ways.
- Drop shipments of tangible goods for distributors have been a significant area of tension under the new revenue standard. The control concept in the new revenue standard may be easier to apply with tangible goods; however, difficulties still could be encountered when control over tangible goods is short.
- A distributor (or other facilitator) with drop ship transactions will need to review contracts with both suppliers and customers to make the judgment regarding control over tangible goods in drop shipment transactions.
- See the September 2018 CPEA report on this topic.
Does a History of Giving Customers Price Concessions on Future Purchases or Free Goods and Services Result in an Implied Promise?

A contract with a customer may include promises that are implied by an entity’s customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a reasonable expectation of the customer that the entity will transfer a good or service to the customer. Accordingly, a history of giving customers price concessions on future purchases or free goods and services may result in an implied promise.

How Are Contract Mobilization Costs Treated Once Performance on the Contract has Started?

Guidance was provided by the FASB for costs to fulfill a contract which are not within the scope of another FASB ASC topic (such as inventory or plant, property, and equipment). Cost incurred to fulfill a contract must directly relate to a specific contract and may include both direct costs, such as labor and materials, as well as allocations of costs as long as they relate directly to a contract. Costs to fulfill a contract are broken into two categories—costs that may be capitalized and costs which are expensed as incurred. To determine if the cost should be capitalized, all of the following must be met:

- The costs relate directly to a contract or to an anticipated contract that can be specifically identified
- The costs generate or enhance resources of the contractor which will be used to satisfy performance obligations in the future
- Costs are expected to be recovered

Within the construction industry, common types of costs incurred are set-up and mobilization costs. These costs may include costs incurred to move people and equipment to a job site as well as costs to construct temporary facilities such as scaffolding, offices, and parking areas to be used by the construction entity, as well as costs to build access roads and run utilities to be used on the job site. Careful consideration of these types of costs is required to determine if these activities are providing services that should be considered as separate performance obligations, part of another performance obligation within the contract, or preparing the contractor to provide the services in the contract. Some factors which should be considered in making that determination include:

- The nature of the promise to the customer
- Whether control is transferred
- Whether another entity would have to reperform the work
We feel that costs incurred to fulfill a contract do need to be considered for capitalization after an entity has started to satisfy a performance obligation. This is based on FASB ASC 340-40-25-5 which indicates costs that are the result of continuing to satisfy a performance obligation shall be recognized as an asset (emphasis added):

**Costs to Fulfill a Contract**

An entity shall recognize an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

a) The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).

b) The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.

c) The costs are expected to be recovered.

We think that confusion in this area stems from FASB ASC 340-40-25-8(c):

An entity shall recognize the following costs as expenses when incurred:

a) General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity shall evaluate those costs in accordance with paragraph 340-40-25-7)

b) Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract

c) Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)

d) Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

Our understanding is that the (c) above is meant to focus on the part in parenthesis- that costs incurred in relation to past performance should no longer be capitalized. However, if costs are incurred in relation to activities which relate to future performance or completion of a performance obligation, those costs would be eligible for capitalization assuming the other criteria noted are met.
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