Chapter 6

Accounting Standards Update: 2014-09 (Topic 606)

Online Update to Accompany Financial Accounting, 5e
by Dyckman, Hanlon, Magee, and Pfeiffer

INTRODUCTION

When the fifth edition of the textbook went to press, the new accounting standard for revenue recognition had been issued, but very little was available in terms of guidance or examples. The required implementation of the standard is still some months off for many companies, but more guidance and a handful of examples are currently available. This update serves to expand the appendix we included in edition 5 and to provide examples of companies' disclosures about how the new standard might affect their financial statements as well as some examples from early adopters. We highlight those areas that differ from previous practices and that could affect a financial statement reader.

THE NEW STANDARD

The long-standing principles that have guided accounting for revenue are that revenue should be recognized when it has been earned and when it is realized or realizable. As you know from Chapter 6 in the textbook, the SEC's Staff Accounting Bulletin 101 interpreted these conditions to mean that there was evidence of an exchange agreement *and* that delivery had occurred *and* the price was fixed or determinable *and* collectibility was reasonably assured. These conditions, along with a variety of industry-specific interpretations are referred to below as "legacy GAAP."

In May of 2014, the FASB and the IASB issued new, converged accounting standards for revenue recognition.[1] The new standard is intended to develop a common revenue standard between U.S. GAAP and IFRS and to consolidate the guidance and rules for revenue recognition into one standard as opposed to the patchwork of standards and sources of guidance that had developed over time for various transactions and industries. The new standard is more principles-based and requires management to exercise more judgment; however, it broadly employs many of the same overriding concepts to revenue recognition as the previous standards.

Public business entities,[2] certain not-for-profit entities, and certain employee benefit plans are required to apply the guidance in the new standard to annual reporting periods beginning after December 15, 2017, including interim reporting periods within the annual reporting period. So, for calendar year-end public companies, the required effective date is January 1, 2018. Early adoption is permitted, but only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that annual reporting period. As of this writing, only a few

[1] FASB issued Accounting Standards Update (ASU) 2014-09 and the IASB issued International Financial Reporting Standards 15, both entitled *Revenue from Contracts with Customers*. The new standard creates Topic 606, *Revenue from Contracts with Customers*, in codified GAAP, which supersedes the revenue recognition requirements in Topic 605, *Revenue Recognition*, including most industry-specific revenue recognition guidance.

[2] The term "entity" is used to identify the organization that is recognizing revenue as the contract is fulfilled.

companies have issued reports using the new standard. All other entities, including private business entities, have an additional year (though early adoption is also permitted for these entities).

Revenue From Contracts with Customers—The New Revenue Recognition Standard

The new standard's core principle is the following:

> An entity should recognize revenue to depict the transfer of 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 and services.

FASB outlines the following five steps in the revenue recognition process:

1. Identify the contract with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price
5. Recognize revenue when or as the entity satisfies a performance obligation

We next discuss each of these steps in more detail.

Step 1: Identify the Contract with a Customer A contract is an agreement between two or more parties that creates enforceable rights and obligations. Contracts can be written, oral, or implied by an entity's customary business practices. A contract must create enforceable rights and obligations to fall within the scope of the standard. Enforceability of a contract is a matter of law and thus varies across jurisdictions.[3]

NOTABLE CHANGES: For the financial statement reader, there are a couple of facets of this first step in revenue recognition that can be illustrated for a health care entity. First, the contract must be approved by both parties—the reporting entity and the patient/customer. And second, the new standard makes significant changes in the treatment of variable consideration, including implicit price concessions.

Using an example from the new standard, suppose a patient arrives at a hospital emergency room, needing immediate services. The hospital has no previous experience with this patient, but is obliged (by law or by its own procedures/practices) to provide such services. Can the hospital recognize revenue as the services are performed? The answer is no, because the patient's ability and/or willingness to perform his or her obligations under the contract are unknown at this point in time.

As more information becomes available, suppose that the patient does not have health insurance, is not eligible for government subsidies and does not qualify for the hospital's own charity case treatment. The standard rate (i.e., list price) for the services performed in the emergency room

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[3] To assist entities in determining whether and when arrangements are contracts under the standard, FASB established the following criteria.

a. The parties to the contract have approved the contract—in writing, orally, or in accordance with other customary business practices—and are committed to perform their respective obligations.
b. The entity can identify each of the party's rights regarding the goods or services to be transferred.
c. The entity can identify the payment terms for the goods and services to be transferred.
d. The contract has commercial substance—the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract.
e. It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods and services that will be transferred to the customer. In evaluating whether collectibility of an amount is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the prices stated in the contract if the consideration is variable because the entity may offer the customer a price concession.

is $10,000. But the hospital expects to accept a lower amount of consideration for the services provided. Based on the available information, the hospital estimates the implicit price concession (i.e., variable consideration) and determines that it expects to be entitled to $1,000. It is from this amount (rather than the full $10,000) that collectibility is assessed.

For instance, under legacy GAAP, HCA Holdings, Inc. (a large U.S. health services company) reports the following for revenues on its income statement.

	2016	2015	2014
Revenues before the provision for doubtful accounts	$44,747	$43,591	$40,087
Provision for doubtful accounts	3,257	3,913	3,169
Revenues	41,490	39,678	36,918

That is, the "bad debt expense" is listed separately on the income statement as a reduction in arriving at "Revenues" (or Net revenues). But in describing the likely effects of the new revenue standard, HCA Holdings writes "We believe the most significant impact will be to the presentation of our income statement where the provision for doubtful accounts will be recorded as a direct reduction to revenues and will not be presented as a separate line item." They do not expect the net revenues themselves to be significantly affected.

Collectibility of payment continues to be an important issue for revenue recognition just as under legacy GAAP. Under the new standard, collectibility should be assessed in determining whether a contract exists and revenue can be recognized (i.e., whether the entity has passed Step 1 of the 5-step revenue recognition process listed above). In other words, the objective of the collectibility threshold is to determine whether the contract is valid and represents a substantive transaction.[4]

Step 2: Identify the Performance Obligations in the Contract The unit of accounting under the new standard is a "performance obligation." Entities will identify as a performance obligation each promise to transfer to the customer either a) a good or service (or bundle of goods or services) that is distinct or b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. A good or service is distinct if *both* of the following criteria are met:

a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer

b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract—in other words, the promise to transfer the good or service is distinct within the context of the contract.

Many times the determination with respect to the first criterion is easy to make. For example, if the entity regularly sells the good or service separately then it can be distinct.

NOTABLE CHANGES: In assessing whether the promise to transfer goods or services to the customer are separately identifiable, the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that may indicate items are not separately identifiable are, for example, if there are significant integration services, significant modification or customization of one item by another, and if the goods and services are highly interdependent.

For some companies, the new standard may result in combining items that were previously deemed to be individual products and services and, for other companies, separating a previously

[4] In general, the new revenue recognition standard does not conceptually change the accounting for bad debts from the current rules, However, the new standard requires more judgment on the part of management in determining whether the expectation of partial payment on a sales contract is 1) evidence that the contract lacks collectibility in which case revenue cannot be recorded, 2) due to a price concession in which case revenue should be recorded but at the lower expected amount, or 3) a bad debt, in which case sales should be recognized in full but with bad debt provision recorded. The additional required judgment about collectibility could lead to uncertainty and potentially significant changes to revenue recognition for some entities.

combined product or service into separate performance obligations. In describing the expected impact of the new standard, Fluor Corporation states the following in its 2016 10-K:

> Under existing guidance, the company typically segments revenue and margin recognition between the engineering and construction phases of its contracts. Upon adoption, the company expects that the entire engineering and construction contract will typically be a single unit of account (a single performance obligation), which will result in a more constant recognition of revenue and margin over the term of the contract. The company will adopt ASU 2014-09 during the first quarter of 2018. The company expects to adopt this new standard using the modified retrospective method that will result in a cumulative effect adjustment as of the date of adoption.

Currently, Fluor has contracts that involve design and engineering, followed by construction, and the company treats these two components as separate sources of revenue and margin. But the new standard considers the integration of design and engineering with construction to create a single performance obligation, which will smooth out differences in margin between the two activities.

There are also cases where revenue was recognized on items that were treated as a single revenue transaction, but are regarded as separate performance obligations under the new standard. For instance, **Southwest Airlines Co.** reports the following in its 2016 annual report:

> The Company has formed a project team to evaluate and implement the standard, and currently believes the most significant impact of this ASU on its accounting will be the elimination of the incremental cost method for frequent flyer accounting, which will require the Company to re-value its liabilities associated with Customer flight points with a relative fair value approach, resulting in a significant increase in the liabilities. The Company's liabilities associated with these flight points was $63 million at December 31, 2016, and the Company currently estimates that applying a relative fair value would increase the liabilities by approximately twenty times that value. The adoption of the new standard is also expected to result in different income statement classification for certain types of revenues, such as ancillary revenues, which are currently classified as Other revenues. The Company currently anticipates utilizing the full retrospective method of adoption allowed by the standard, in order to provide for comparative results in all periods presented, and plans to adopt the standard as of January 1, 2018.

Under the legacy GAAP rules, when a Southwest customer travels on a flight and earns frequent flyer credits, the company recognizes the ticket price as revenue and records an expense for the frequent flyer credits equal to the incremental cost of flying the customer when the credits are redeemed. But the new standard regards the frequent flyer credits as distinct performance obligations. (For example, some airlines allow customers to purchase club memberships with miles or with cash. Others allow the purchase of miles for cash.) Therefore the ticket price must be divided into an amount for the flight and an amount for the frequent flyer credits. As Southwest describes, this change will increase their reported liability from $63 million to more than $1.2 billion!

In addition, the new standard defines a second type of performance obligation—a promise to transfer to the customer a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.[5] If a series of distinct goods or services meets the criteria for the series provision, an entity is required to treat that series as a single performance obligation—it is not optional.

For instance, an entity might contract to provide nightly cleaning services for an office building for a period of a year. In theory, one could view each day's cleaning as a separate performance

[5] There are two criteria that must be met to fall under the series provision:

a. Each distinct good or service in the series that the entity promises to transfer represents a performance obligation that would be satisfied over time, if it were accounted for separately.

b. The entity would measure its progress toward satisfaction of the performance obligation using the same measure of progress for each distinct good or service in the series.

obligation and require that the transaction price be allocated to the individual day. But that was regarded as not cost effective, so instead the entire contract is viewed as a single performance obligation that is fulfilled over time based on a single measure of progress.

Step 3: Determine the Transaction Price The new standard states that an entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (like sales taxes). The consideration promised may include fixed amounts, variable amounts, or both.

NOTABLE CHANGES: Determining the transaction price is an important step in applying the standard because this is the amount that is recognized as revenue as performance obligations are satisfied. The legacy GAAP standard required that the transaction price be "fixed or determinable" before revenue could be recognized. The new standard provides for what is known as *variable consideration*, which is common in practice. Variable consideration includes (but is not limited to) price concessions, volume discounts, rebates, refunds, credits, incentives, performance bonuses, and royalties.

As an example of the accounting issue, if an entity offers a volume discount to customers that purchase at or above a certain volume for the calendar year, the entity should take the expectation of the customer receiving the volume discount into account when recording revenue. To illustrate, an entity's customer may purchase a good for $10/unit, with the agreement that if the customer purchases 700 or more units over the year, the cost of all units purchased falls to $9/unit. In the first quarter, the customer purchases 150 units and, based on that order and past history with the customer, the selling entity does not think the volume discount will be reached. Therefore the seller recognizes $1,500 in revenue (150 units at $10 each). Then in the second quarter, the customer purchases 250 units, and the seller now estimates that the volume discount will be met. The second quarter revenue would be $2,100 (250 units at $9, less a $150 correction for the first quarter). The revenue for the second quarter purchase order should be the stated price less the volume discount (even before the volume threshold is reached). The process would work symmetrically if the selling entity started the year expecting the customer to earn the volume discount and subsequently found that not to be the case.[6]

Two further aspects of the new standard are worth noting. First, entities can estimate the amount of variable consideration in one of two ways, depending on which method better predicts that amount of consideration to which it will be entitled. One alternative is the expected value—the sum of probability-weighted amounts over the range of possible outcomes. The second alternative is to report the single most likely amount over the range of possible outcomes. The range of outcomes and probabilities should consider all information that is reasonably available. Once selected, the same method should be used for the duration of the contract.

Second, for situations in which the variable consideration is sufficiently uncertain, the new reporting standard includes a constraint on the amount of variable consideration that can be recognized. Specifically, the cumulative amount of variable consideration recognized cannot be so high that a significant reversal of this cumulative revenue is probable (i.e., likely to occur).[7]

Step 4: Allocate the Transaction Price The new standard generally requires entities to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (with some exceptions). If a contract has only one performance obligation, no allocation is required. A standalone selling price is the price at which an entity would sell a good or service on a standalone (or separate) basis at contract inception. An observable, standalone price is the best evidence of a standalone selling price. If a standalone selling price is not readily observable,

[6] The example of R1 RCM, Inc. at the end of this document provides a stark example of the effect of the new standard on variable consideration.

[7] "Probable" is defined as "the future event or events are likely to occur." Of course, this definition still leaves considerable room for judgment. This threshold is similar to the guidance in legacy GAAP where collectibility of revenue that is recognized has to be reasonably assured.

the entity must estimate a standalone price, similar in concept to how revenue is allocated in multiple-element contracts under legacy GAAP.

NOTABLE CHANGES: The requirement to estimate a standalone selling price may be a significant change for entities that have historically followed the software revenue recognition guidance. That prior guidance had a different threshold for determining the standalone selling price (e.g., a hierarchy of evidence), requiring observable evidence and not management estimates.

Legacy GAAP requires software entities to allocate the transaction price using vendor-specific objective evidence (VSOE) based on a significant majority of their transactions. These are not required under the new standard. As a result, entities may end up using different approaches than they do currently to estimate standalone selling prices.

For instance, in its 2016 10-K, Electronic Arts, Inc. reported the following expected effects of adopting the new standard.

> The New Revenue Standard will have a significant impact on our Consolidated Financial Statements and related disclosures as it relates to the accounting for substantially all of our transactions with multiple elements or "bundled" arrangements. For example, for sales of online-enabled games as currently reported, we do not have vendor-specific objective evidence of fair value ("VSOE") for unspecified future updates, and thus, revenue recognized from these sales are recognized ratably over the estimated offering period. However, under the New Revenue Standard, the VSOE requirement for undelivered elements is eliminated, allowing us to essentially "break-apart" our online-enabled games and account for the various promised goods or services identified as separate performance obligations. For example, for the sale of an online-enabled game, we often have multiple distinct performance obligations such as software, updates, and an online service. The software performance obligation represents the initial game delivered digitally or via physical disc. The updates performance obligation may include software patches or updates, maintenance, and/or additional free content to be delivered in the future. And lastly, the online service performance obligation consists of providing the customer with a service of online activities (e.g., online playability). Under current software revenue recognition rules, we recognize as revenue the entire sales price over the estimated offering period. However, under the New Revenue Standard, we will recognize a portion of the sales price as revenue upon delivery of the software performance obligation with the updates and online services portions recognized over the estimated offering period.

Step 5: Recognize Revenue when or as the Entity Satisfies a Performance Obligation A performance obligation is considered satisfied under the new standard when a promised good or service is transferred to a customer. A good or service is considered to be transferred when the customer obtains control. Control is defined as an entity's ability to direct the use of and obtain substantially all of the remaining benefits of an asset. FASB goes on to define each of those terms and phrases (e.g., ability, direct the use, and obtain benefits from). Recognizing revenue when control is transferred is different from legacy GAAP where the model is based on risks and rewards.[8] If control does not transfer over time, it is presumed to transfer at a point in time.

NOTABLE CHANGES: The new revenue recognition standard does not use the terms percentage-of-completion method, cost-recovery method, or completed contract method for long-term contracts. All contracts fall under the 5-step process and revenue is recognized as performance

[8] The new standard states that at the inception of a contract an entity must determine whether it will transfer control of a promised good or service over time or at a point in time. FASB (in 606-10-25-27) provides three criteria that an entity must evaluate to determine whether the performance obligation is satisfied over time. If any one of the following criteria is met, control is considered to be transferred over time, meaning the performance obligation is satisfied over time and that revenue should be recognized over time.

a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

b. 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.

c. 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.

obligations are satisfied, that is, when control of the good or service transfers to the customer. A construction company would need to determine whether the performance obligation is satisfied over time or at a point in time. For most long-term contracts, revenue will be recognized over time. Under the new standard, measuring progress toward completion is done using either what is called the input method or the output method. According to the new standard, "Output methods recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract." Whether the company uses an output measure (milestones, surveys of performance, etc.) or an input measure (cost incurred, time elapsed, etc.), the measure should "faithfully depict the entity's performance toward complete satisfaction of the performance obligation."

It is likely that for many long-term contracts, such as construction contracts, the satisfaction of most performance obligations will be measured over time using the input method. This method of revenue recognition is generally consistent with the percentage-of-completion method that is often applied under legacy GAAP. However, it is likely the case that many entities will need to perform new and/or different analyses than they do under legacy GAAP.

Raytheon Company adopted the new revenue standard beginning on January 1, 2017. In its first quarter 10-Q, it included the following in its footnote on revenue recognition.

We generally recognize revenue over time as we perform because of continuous transfer of control to the customer. For U.S. government contracts, this continuous transfer of control to the customer is supported by clauses in the contract that allow the customer to unilaterally terminate the contract for convenience, pay us for costs incurred plus a reasonable profit and take control of any work in process. Similarly, for non-U.S. government contracts, the customer typically controls the work in process as evidenced either by contractual termination clauses or by our rights to payment for work performed to date plus a reasonable profit to deliver products or services that do not have an alternative use to the Company.

Because of control transferring over time, revenue is recognized based on the extent of progress towards completion of the performance obligation. The selection of the method to measure progress towards completion requires judgment and is based on the nature of the products or services to be provided. We generally use the cost-to-cost measure of progress for our contracts because it best depicts the transfer of assets to the customer which occurs as we incur costs on our contracts. Under the cost-to-cost measure of progress, the extent of progress towards completion is measured based on the ratio of costs incurred to date to the total estimated costs at completion of the performance obligation. Revenues, including estimated fees or profits, are recorded proportionally as costs are incurred. Costs to fulfill include labor, materials and subcontractors' costs, other direct costs and an allocation of indirect costs including pension and any other postretirement benefit (PRB) expense under U.S. government Cost Accounting Standards (CAS).

CONTRACT ASSETS AND CONTRACT LIABILITIES

Under the new standard, the term *contract liability* refers to "an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer." Such contract liabilities are commonly seen in legacy GAAP statements as deferred revenue or unearned revenue liabilities. On the asset side, a *contract asset* is "an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when the right is conditional on something other than the passage of time (for example, the entity's future performance)." A contract asset is distinct from a *receivable* which is an unconditional right to consideration that depends only on the passage of time. In legacy GAAP, consulting companies occasionally report unbilled receivables in their assets to represent revenues that have been earned, but for which the company cannot yet bill its customer.[9] However, under the new standard, contract assets will be more common.

[9] Under the new standard, entities may choose to use more descriptive terminology for contract assets and liabilities.

As an example, suppose Company A has entered into an agreement with Company B. Company A will deliver to Company B four customized units of Product 1 on March 1 and six customized units of Product 2 on June 1. The total price for the units is $1,400. Company A has determined that the deliveries of Products 1 and 2 represent separate performance obligations, with $800 and $600 of the purchase price being allocated to Products 1 and 2, respectively. Companies A and B have agreed that A will send an invoice with the delivery of Product 1 for $720 (due to be paid on March 31) and another invoice for $680 with the delivery of Product 2. Essentially, Company B "holds back" ten percent of the Product 1 value against A's future performance on the entire contract.

On March 1, Company A would recognize revenue of $800, because that is the consideration to which it expects to be entitled for delivering four units of Product 1. Company A would recognize a receivable for $720 and a contract asset for $80. The receivable would be collected at the end of March, and the contract asset would become a receivable when Company A delivers Product 2 at the beginning of June.

Disclosure Requirements

Significant changes in disclosure are also required in the new standard. Companies will need to provide both qualitative and quantitative disclosure about contracts with customers including revenues recognized, disaggregation of revenues, contract balances and performance obligations (including transaction prices allocated to remaining performance obligations). Additional disclosures will also be required about judgments and changes in judgments such as determining the timing of satisfaction of performance obligations (over time or at a point in time) and determining the transaction price and amounts allocated to performance obligations. Entities will need to consider the disclosure requirements seriously along with the rule requirements of how to recognize revenue as they adopt the new standard.

Transition Alternatives

Companies have two options to make the transition from legacy GAAP to the new reporting standard. *Full retrospective method* requires that—in the year of adoption—all current and past financial statements be presented based on the new standard. A company adopting the new standard for calendar year 2018 would be required to present its income statements from 2016, 2017 and 2018 and its balance sheets for December 31, 2017 and 2018 all based on the new reporting standard for revenue from contracts with customers. Disclosures would be required to explain differences between past periods' financial statements as originally presented and as they are now reported under the new standard. The *cumulative effect* method (also called modified retrospective method) requires that the opening balance sheet of the adoption year be adjusted to the new standard (including a cumulative adjustment to retained earnings) and then the new standard is applied to the year of adoption. A company adopting the new revenue standard for calendar year 2018 would report its December 31, 2017 balance sheet under legacy GAAP and its December 31, 2018 balance sheet and 2018 income statement under the new standard. All financial statement line item differences between the new revenue recognition method and the legacy GAAP methods must be disclosed and explained.

Clearly, full retrospective application has greater past-period information requirements than the cumulative effect method. The former requires that a company be able to apply the new reporting standard years before its actual adoption, while the latter requires only the cumulative effects that would appear in the balance sheet at the beginning of the year of adoption. This requirement may affect companies' choice of transition method.

The differing transition methods may make it more difficult for financial statement readers to make comparisons and forecasts of future performance. As a result, it is possible that some companies will make the choice strategically. A careful reading of the balance sheets and required disclosures should be helpful in interpreting the revenues presented under the new standard.

We offer some conjectures and observations about the transition to the new standard. First, the cumulative effect method will likely offer less comparability. Firms in which shareholders (or other stakeholders) value comparability will, we predict, be more likely to choose the full retrospective method. Second, the cumulative effect method may, under certain circumstances, yield "lost revenue." For example, consider an entity with significant deferred revenue balances before the date of initial application. It is possible that those amounts will ultimately be reflected in the restated prior periods or as part of the cumulative adjustment upon adoption and, as a result, are never reported as revenue in a future period. There is also some chance of the reverse outcome—a double counting of revenue where an entity would end up having reported revenue under legacy GAAP in a year prior to transition but then the same revenue again in a year after the transition. It will be important for financial statement users to carefully read the (likely extensive) disclosures about the new revenue recognition standard, the transition method and its effects for the firm being evaluated. We will be able to provide more observations about transition issues as firms adopt the new standard and provide disclosures.

An Example

The Background

U.S. companies are required to adopt the new reporting standard for fiscal years beginning after December 15, 2017, which means 2018 for a calendar-year firm. Early adoption is allowed for fiscal years beginning after December 15, 2016. However, *CFO* magazine (May 2017, pages 14–16) reports that only five companies in the S&P 500 have adopted as of January 1, 2017.[10]

One company that has adopted the new standard starting January 1, 2017 and issued a 10-Q under the new standard is R1 RCM, Inc. (formerly Accretive Health, Inc.). As described in its latest 10-K, R1 RCM, Inc. (R1) is in the revenue cycle management (RCM) and physician advisory services (PAS) businesses for health care institutions. From that 10-K:

> Our primary service offering consists of end-to-end RCM, which we deploy through a co-managed relationship or an operating partner relationship. Under a co-managed relationship, we leverage our customers' existing RCM staff and processes, and supplement them with our infused management, subject matter specialists, proprietary technology and other resources. Under an operating partner relationship, we provide comprehensive revenue cycle infrastructure to providers, including all revenue cycle personnel, technology, and process workflow. We also offer modular services, allowing customers to engage us for only specific components of our end-to-end RCM service offering. Our PAS offering assists hospitals in complying with payer requirements regarding whether to classify a hospital visit as an in-patient or an out-patient observation case for billing purposes. This offering consists of both concurrent review and retrospective chart audits to help our customers achieve compliant and accurate billing. We also provide customers with retrospective appeal management service support for both governmental and commercial payers. Our physicians conduct detailed retrospective reviews of medical records to identify medical necessity for hospital services and the required documentation to appropriately support an appeal. We employ trained physicians to deliver these services.

A significant part of R1's revenue is performance-based, and under legacy GAAP, the company encountered some questions as to when the price to the customer became "fixed or determinable." In early 2013, the company announced that it would restate at least nine quarterly financial statements, in part because of revenue recognition errors. In its restatement, the company wrote

> The Company's RCM contracts contain performance based fees, in net operating and incentive fees, that are contingent in nature and are not finalized until the end of the contract or at another contractual agreement event, as defined in Note 3, Summary of Significant Accounting Policies. Previously, the Company recorded revenue on these agreements for the estimated amount earned to date. However, in the restated consolidated financial statements, the Company corrected its accounting to defer recognition of all contingent fees until they are contractually finalized, which often occurs at the end of the contract term or at the end of the customer relationship.[11]

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[10] There are some non-calendar-year firms like Microsoft and Apple who plan to adopt early, but their reports are not available at the time of this writing. However, Microsoft has an excellent presentation of the impact of accounting changes (including revenue recognition) on its financials at https://view.officeapps.live.com/op/view.aspx?src=https://c.s-microsoft.com/en-us/CMSFiles/New_accounting_standards.pptx?version=bd475a49-90ec-1e3a-fbdd-102cad6153f7.

[11] In addition, part of the revenue recognition corrections had to do with gross versus net presentation of revenue when R1 was an agent rather than a principal.

As a result of this change, R1's performance-based revenue was recognized (usually) at the end of a contract. The effect on the company's financial statements was material. Revenue for 2011 went from $826 million to $102 million, and net income went from $29 million to a loss of $72 million. On the balance sheet, retained earnings went from $11 million to an accumulated deficit of $328 million, while the deferred revenue liability increased by more than $460 million. The effect on periodic reports was extreme, as can be seen from the following table. Revenue amounts ($ thousands) vary greatly by quarter and even by year depending on when contracts end.

	1st Quarter Ended March 31,		2nd Quarter Ended June 30,		3rd Quarter Ended September 30,		4th Quarter Ended December 31,	
	2016	2015	2016	2015	2016	2015	2016	2015
Net services revenue	$352,193	$10,971	$8,672	$22,085	$125,535	$15,842	$106,157	$68,341

The Effect of the New Standard

R1 is an early adopter of ASU 2014-09 (also referred to as Topic 606), and the principal effect comes through Step 3: Determine the transaction price. In particular, the new standard requires that companies estimate any variable consideration to which they expect to be entitled as performance obligations are met. The company's 10-Q for the first quarter of 2017 provides the following description of the accounting for incentive compensation under ASU 2014-09:

> The Company recognizes revenue related to incentive fees ratably as the performance obligation for RCM services is satisfied, to the extent that it is probable that a significant reversal of cumulative revenue will not occur once the uncertainty is resolved. Incentive fees are structured to reflect quarterly or annual, performance and are evaluated on a contract-by-contract basis. The Company's incentive fees generally meet the variable consideration allocation exception in Topic 606, allowing the Company to recognize fees in the period of performance when the uncertainty is resolved on a quarterly or annual basis. Incentive fees where the uncertainty is resolved annually are subject to refund based on final performance outcome and the Company has recorded a refund liability (see Note 7. Customer Liabilities) for the amount it believes may be at risk. Incentive fees are typically billed and paid on a quarterly basis.

The effect of this change can be seen in the accompanying tables from R1's first-quarter 2017 10-Q which contrast the end-of-quarter-1 statements under the old practices and the new practices. On the balance sheet, the accumulated deficit is reduced by $156 million, and the customer liabilities (mostly deferred revenue) are reduced by $241 million. On the income statement, the reported revenue is $72 million higher and the new loss is reduced by $42 million. In addition to the one-time effects of the accounting change, the management of R1 expects that the quarter-to-quarter results will be much more reflective of the company's performance.

R1 RCM Inc.
Notes to Consolidated Financial Statements (Unaudited)

i. Condensed Consolidated Balance Sheets	Impact of Changes in Accounting Policies		
	As Reported March 31, 2017	Adjustments	Balances without Adoptions of Topic 606
Assets			
Current assets:			
Cash and cash equivalents	$142.7	$—	$142.7
Accounts receivable, net	90	(0.6)	84
Accounts receivable, net—related party	25.5	(12.0)	13.5
Prepaid income taxes	0.2	—	0.2
Prepaid expenses and other current assets	28.0	(0.3)	27.7
Total current assets	205.4	(12.9)	192.5
Property, equipment and software, net	35.0	—	35.0
Noncurrent deferred tax assets	100.8	97.4	198.2
Restricted cash equivalents	1.5		1.5
Other assets	81	0.2	8.3
Total assets	$350.8	$ 84.7	$435.5
Liabilities			
Current liabilities:			
Accounts payable	2.3	0.5	2.8
Current portion of customer liabilities	2.1	67.8	69.9
Current portion of customer liabilities—related party	13.7	(5.2)	8.5
Accrued compensation and benefits	28.1		28.1
Other accrued expenses	16.3	(1.2)	15.1
Total current liabilities	62.5	61.9	124.4
Noncurrent portion of customer liabilities	1.0	—	1.0
Noncurrent portion of customer liabilities—related party	6.1	178.4	184.5
Other noncurrent liabilities	14.0	—	14.0
Total liabilities	$ 83.6	$240.3	$323.9
8.00% Series A convertible preferred stock	175.9	—	175.9
Stockholders' equity (deficit)		—	—
Common stock	1.2	—	1.2
Additional paid-in capital	343.9	—	343.9
Accumulated deficit	(194.0)	(155.6)	(349.6)
Accumulated other comprehensive loss	(2.0)	—	(2.0)
Treasury stock, at cost	(57.8)	—	(57.8)
Total stockholder equity (deficit)	91.3	(155.6)	(64.3)
Total liabilities and stockholders' equity (delicit)	$350.8	$ 84.7	$435.5

R1 RCM Inc.
Notes to Consolidated Financial Statements (Unaudited)

ii. Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)	Impact of Changes in Accounting Policies		
	As Reported March 31, 2017	Adjustments	Balances without adoption of Topic 606
Net services revenue	$ 86.9	$ (72.3)	$ 14.6
Operating expenses:			
Cost of services	80.9	(3.0)	77.9
Selling, general and administrative	14.3	—	14.3
Other	0.2	—	0.2
Total operating expenses	95.4	(3.0)	92.4
Income (loss) from operations	(8.5)	(69.3)	(77.8)
Net interest income	0.1	—	0.1
Income (loss) before income tax provision	(8.4)	(69.3)	(77.7)
Income tax provision (benefit)	(0.1)	(27.1)	(27.2)
Net income (loss)	$ (8.3)	$ (42.2)	$ (50.5)
Net income (loss) per common share:			
Basic	$ (0.12)	$ (0.42)	$ (0.54)
Diluted	$ (0.12)	$ (0.42)	$ (0.54)
Weighted average shares used in calculating net income (loss) per common share:			
Basic	101,364,424	—	101,364,424
Diluted	101,364,424	—	101,364,424
Consolidated statements of comprehensive income (loss)			
Net income (loss)	(8.3)	(42.2)	(50.5)
Other comprehensive loss:			
Foreign currency translation adjustments	0.8	—	0.8
Comprehensive income (loss)	$ (7.5)	$ (42.2)	$(49.7)

REFERENCES

FASBASC 606: Revenue from Contracts with Customers.

E&Y, August, 2016. Financial Reporting Developments: A Comprehensive Guide. Revenue from Contracts with Customers (ASC 606).

KPMG, May, 2016. Illustrative Disclosures—Revenue US GAAP.

PwC, 2016. Revenue from Contracts with Customers. Global Edition.

END-OF-ADDENDUM MATERIALS

Problem 6A-1 Haskins, Inc. has reached an agreement with a customer, Skaife Corporation, to deliver 200 units of a customized product. The standard billing price per unit is $1,000, and there are no discounts. At the time of the agreement on April 6, Skaife Corporation provides a $40,000 cash deposit to Haskins, Inc. Haskins agrees to deliver 120 units to Skaife Corporation on May 31 and at that time, Haskins can send an invoice for $50,000 to be paid by Skaife Corporation on June 15. The remaining 80 units are to be delivered on July 15, accompanied by an invoice for the remaining amount of the total $200,000 purchase price to be paid on July 31.

REQUIRED:
Assume that Haskins, Inc. has no uncertainties about its own ability to meet the terms of the contract or about Skaife Corporation's ability and willingness to pay. Provide the journal entries to record the above events (leaving out the accounting for Haskins, Inc.'s costs).

Problem 6A-2

Rasmussen Corp. offers volume discounts to customers who purchase 10% more units than the previous year. Gaertner, Inc. purchased 1200 units of Rasmussen's product NH507 in 2016. The per-unit list price for product NH507 is $50 (in 2016 and 2017), but if Gaertner, Inc. purchases 1320 units or more in 2017, the unit price decreases to $45 on all units purchased over the year. Rasmussen Corp. sends invoices based on the list price until the customer actually achieves the volume discount.

In the first quarter of 2017 (the year in which Rasmussen Corp. adopted the new revenue standard), Gaertner, Inc. purchased 400 units of product NH507. Based on these purchases and prior experience with this customer, at the end of the first quarter Rasmussen Corp. expects that Gaertner will achieve the volume discount for the year.

REQUIRED:

a. Assume that Gaertner, Inc.'s purchases in quarters 2, 3 and 4 were exactly the same as quarter 1. Provide the revenue journal entries for each quarter of 2017.

b. Assume that in the second quarter of 2017, Gaertner Inc. experiences a sudden drop in its business. It purchases only 100 units of product NH507, and Rasmussen now believes that Gaertner will not qualify for the volume discount. Provide the revenue entries for Rasmussen Corp. for the first quarter of 2017 and the second quarter of 2017.