



How to Properly Recognize Revenue.



The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have provided standards regarding revenue recognition. The standards bring uniformity to revenue recognition for public and nonpublic entities across many industries.

Under the standards, companies recognize revenue based on the value and timing of when control of the goods and services are transferred to the customer. The purpose of the standards is to provide investors with more transparency into a company's financials, and should make it easier to compare apples to apples when considering different investments.

5-Step Process for Revenue Recognition

FASB issued a five-step process to help companies recognize revenue under the standard: First, you should identify the contract(s) with a customer. A contract is any clear agreement made verbally or in writing that outlines specific terms and has value.

Second, you should identify the performance obligations in the contract(s). These may include goods or services or a mixture of both. Each performance obligation should be distinct, meaning that it provides value to the customer on its own.

Third, you should determine the transaction price. Many contracts have a clear transaction price. Others may include additional factors that should be considered, including variable considerations, noncash considerations and considerations made payable to the customer: Variable considerations are factors that may affect the final collectible price, such as discounts or rebates.

Noncash considerations include any goods or services used as payment, if the price won't be paid in full with cash. These items should be considered at fair market value.

Considerations made payable to the customer are other items you will pay to the customer as a result of the contract. These should be included in the transaction price. Additionally, considerations paid to clients of the customer should be included.



Fourth, you should allocate the transaction price to the performance obligations in the contract. Use the individual price of each obligation, if it were sold separately, as the basis. If discounts or other considerations apply, include those with the respective obligation. If these considerations apply to the entire contract, allocate them across all obligations accordingly.

Finally, you should recognize the revenue when the entity satisfies a performance obligation. FASB states that you have satisfied the obligation when the control is transferred to the customer.

Extended Contracts

If the contract covers an extended period of time, FASB allows companies to recognize a portion of the revenue continuously over the specified period as long as one of the following three criteria are met:

1. The customer simultaneously receives and consumes the benefits provided by the company's performance as it occurs.
2. The company's performance creates or enhances an asset that the customer controls as the asset is created or enhanced
3. The company's performance doesn't create an asset with an alternative use to the entity, and the company has an enforceable right to payment for performance completed to date.

In most situations, one of these criteria will be included in the contract. However, if none of the criteria are met, the company should wait until the full obligation is met to recognize any of the revenue, at which point it should be recognized all at once.

Change Orders

FASB also provides additional information for change orders. If the change order adds distinct goods or services, then it should be treated as a separate contract. If the change order does not add distinct goods or services, it should be added to the original contract and treated as a variable consideration.



Final Thoughts

This document is intended to provide a brief overview of the process for recognizing revenue and is not a substitute for speaking with one of our expert advisors.

If you have additional questions or need assistance implementing these standards, please contact our office.

We'd be happy to discuss your specific situation.



About Pugh CPAs

We got our start in Knoxville, Tennessee in 1969 and have grown into a regional firm with global connections. We've been in business a LONG time and that means we've worked with a diverse group of industries and clients. Of course, we do tax planning, compliance, auditing, and accounting but our passion is collaborating with our clients to ensure that your business and financial goals are met. It's critical for your business advisors to understand how your business operates within your industry—we get that! Our longevity is connected to the relationships we build with our clients and that's how we build trust. You can be confident that Pugh CPAs has the knowledge, skills and abilities to help you achieve your goals. Brilliant people with servant hearts work here.



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