

BDO KNOWS: REVENUE RECOGNITION



TOPIC 606, REVENUE FROM CONTRACTS WITH CUSTOMERS - EXPLORING TRANSITION METHODS

1. Introduction

ASU 2014-09, *Revenue from Contracts with Customers* (Topic 606), comes into effect for public business entities (PBE) for annual reporting periods beginning after December 15, 2017, including interim periods within that year. Therefore, a calendar year-end public entity will reflect the new standard in its first quarter ending March 31, 2018, each subsequent quarter, and also in the year ending December 31, 2018. Early adoption is permitted only as of annual reporting periods beginning after December 15, 2016, including interim periods within that year.

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All other entities will adopt the standard for annual reporting periods beginning after December 15, 2018, and interim periods within annual reporting periods beginning after December 15, 2019. Therefore, a calendar year-end nonpublic entity will first apply the new standard for the year ending December 31, 2019. If it also prepares interim financial statements, the new standard will first take effect for those interim periods in 2020. Early adoption is permitted as of either:

- ▶ An annual reporting period beginning after December 15, 2016, including interim periods within that year, or
- ▶ An annual reporting period beginning after December 15, 2016 and interim periods within annual reporting periods beginning one year after the annual period in which an entity first applies the new standard.

Further, the SEC staff has indicated it will not object if an entity that qualifies as a PBE solely because its financial statements or financial information is included in another entity's filing with the SEC adopts the new revenue standard using the effective dates applicable to private entities. Refer to BDO's July 2017 [SEC Alert](#) for more information.

Topic 606 sets out a single and comprehensive framework for revenue recognition. It addresses virtually all industries in U.S. GAAP, including those that previously followed industry-specific guidance. For many entities, the timing and pattern of revenue recognition will change. In some areas, the changes will be significant and will require careful planning.

A comprehensive overview of the standard is available [here](#).

Entities need to determine the impact of this new standard. They need to identify which contracts and transaction types will be impacted, determine which processes and systems will require modifications and communicate the impact to stakeholders.

Many entities enter into long-term contracts with customers that will straddle the transition dates (i.e., years beginning after December 15, 2016, 2017, or 2018). Topic 606 permits a number of different transition approaches; these various approaches will result both in different reported profit and loss and in different levels of complexity.

Although when issued in 2014 Topic 606 was fully converged with IFRS 15, subsequent amendments made by the FASB and IASB created minor differences.

2. Transitional Provisions

The transitional requirements, set out in paragraph 606-10-65-1, define the term 'date of initial application' which is the start of the reporting period in which an entity first applies Topic 606. This date is relevant for a number of transitional options that are available. For example, for a public entity with a calendar fiscal year that does not elect early adoption, the date of initial application will be January 1, 2018, regardless of which transition method it selects.

The other key defined term in paragraph 606-10-65-1 is 'completed contract' which represents a contract for which all (or substantially all) of the revenue was recognized in accordance with the revenue guidance in effect before the date of initial application.

There are two methods under which Topic 606 can be adopted – the retrospective method and the cumulative effect method (also referred to as the "modified retrospective" method). Certain practical expedients are available under each method. The requirements of each of these methods are summarized in the following table:

RETROSPECTIVE METHOD	CUMULATIVE EFFECT METHOD
Apply Topic 606 retrospectively to each prior reporting period	Cumulative effect shown as an adjustment to retained earnings
Cumulative effect adjustment to retained earnings is at the start of the earliest comparative period presented	Adjustment is at the date of initial application
Comparative period shows Topic 606 amounts	Comparative period shows pre-Topic 606 amounts
Choice of 4 practical expedients available	1 practical expedient is available

The four practical expedients available when the retrospective method is applied are:

1. Completed contracts (those which begin and end within the same annual reporting period) need not be restated. Although this simplifies transition, entities that publish quarterly financial reports may not include fully comparable information for each of the periods presented.
2. For completed contracts that have variable consideration, an entity can use the transaction price at the date the contract was completed rather than having to estimate the variable consideration amounts that existed in the comparative reporting periods.
3. For all reporting periods presented before the date of initial application, it is not necessary to disclose the amount of the transaction price allocated to the remaining performance obligations or disclose when that amount is expected to be recognized as revenue.
4. For contracts that were modified before the beginning of the earliest period presented, an entity may elect not to retrospectively restate the contract for those modifications and instead would reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented when identifying satisfied and unsatisfied performance obligations, determining the transaction price and allocating the transaction price to performance obligations.

If the cumulative effect method is used, the practical expedient related to contract modifications may be applied for all contract modifications occurring before the beginning of the earliest period presented. Further, if the cumulative effect method is applied, an entity may elect to apply the new guidance retrospectively either:

- ▶ To all contracts at the date of initial application, or
- ▶ Only to contracts that are not completed contracts at the date of initial application.

The examples in Section 3 of this publication illustrate the effect of choosing each of the transition methods on the current and prior year financial statements, and the examples in Section 4 illustrate the effects of choosing one or more of the practical expedients available under each method. Section 5 highlights the different disclosure requirements of each method. For the purpose of simplicity in this publication, income tax effects associated with each example have been excluded.

Entities should carefully consider the method of adoption they select. This includes assessing which method is the most appropriate to the entity and its stakeholders.

Retrospective Method: While the retrospective method requires more effort, it provides users with comparative financial information that can be relevant for trend and variance analyses.

Cumulative Effect Method: The cumulative effect method may initially be more appealing to entities because it could be less costly to apply in comparison to the retrospective method. However, it impairs the comparability of financial information between current and prior periods and therefore can be seen as less useful to investors. This method also requires additional disclosures in the year of initial adoption.

BDO OBSERVATION

Entities must assess the needs of the users of their financial statements, the impact of the method chosen, and the cost of compliance when deciding which approach to follow. Determining which method to apply may also be influenced by the methods selected by competitors and industry peers.

3. Common Examples of Transition Effect

Below are four common examples of transition effects when contracts result in a change in revenue recognition from current practice. It is assumed that in these scenarios, the vendor has a calendar year-end and will adopt Topic 606 on January 1, 2018. The impact of the new standard in the year of adoption along with comparative information for 2017 (and 2016 if applicable) is shown. Each example includes a brief discussion of the accounting changes from existing guidance (Topic 605) to Topic 606 and also provides the transition effects under the retrospective method and the cumulative effect method.

EXAMPLE 1 – LICENSE OF INTELLECTUAL PROPERTY

A vendor, a software developer, licenses a specified software product to a customer from March 1, 2017 to February 28, 2018. The customer has the right to use the license during this period, with the option to renew for additional years. The contract is non-cancellable and the customer is required to pay \$12,000 at inception, which is the price for the one-year license. The nature of the vendor's promise to its customer is to provide the customer with the ability to use the software in its condition at the start of the license period.

Accounting under Topic 605

The revenue for the term license was recognized straight-line over 12 months.

2017 Revenue - \$10,000
(\$12,000* 10/12 months)

2018 Revenue - \$2,000
(\$12,000* 2/12 months)

Accounting under Topic 606

The license to intellectual property is considered functional. Therefore the vendor's performance obligation is satisfied at a point in time. The vendor recognizes all of the revenue at the point at which the customer is able to use, and obtain substantially all the benefits, of the licensed intellectual property, which is determined to be March 1, 2017.

2017 Revenue - \$12,000

2018 Revenue - \$0

Transition Effects under each Method

	Retrospective	Cumulative Effect
Analysis	The 2017 comparative figures are adjusted to account for the contract under Topic 606.	Revenue for 2017, as reported under Topic 605, is not adjusted because the new standard is only applied from the date of initial application (January 1, 2018). At the date of initial application, an adjustment is made to opening retained earnings for the difference in revenue that would have been recorded in previous periods under the new standard.
2017	+\$2,000 Revenue -\$2,000 Deferred Revenue	No change
2018	2018 Reported \$0 Revenue \$0 Deferred Revenue	2018 Opening B/S Adjustment -\$2,000 Deferred Revenue Cumulative Adjustment +\$2,000 Retained Earnings Cumulative Adjustment 2018 Reported \$0 Revenue 2018 – additional transition disclosures required

BDO OBSERVATION

In this example, \$2,000 in additional revenue is recognized through the 2017 income statement under the retrospective method as compared to the cumulative effect method. Under the cumulative effect method, this \$2,000 amount will not be recognized as revenue through the 2017 income statement. Rather, it is an adjustment to opening retained earnings in 2018.

EXAMPLE 2 – CONTRACT WITH VARIABLE CONSIDERATION

A vendor enters into an 18 month contract with a customer to provide call center services for a retail customer on November 1, 2016. The consideration includes a fixed amount of \$180,000, paid in monthly installments, plus an additional amount of up to \$100,000 if certain customer wait time targets are achieved by specific dates. The additional amount is earned as follows:

- ▶ \$100,000 if targets achieved by April 30, 2017, or
- ▶ \$50,000 if targets achieved by December 31, 2017

The vendor attained the targets on December 1, 2017 and became entitled to \$50,000.

Accounting under Topic 605

The vendor recognizes revenue on a straight line basis over the contract term for the fixed amount of \$180,000. The targets are assessed at each reporting date to determine whether the additional consideration is earned. At contract inception, the additional amount of consideration is not recorded; rather, the vendor recognizes the consideration only when the targets are met. That is, \$50,000 of contingent revenue is recognized in 2017 when the wait time targets are achieved (i.e., when the contingency is resolved).

2016 Revenue - \$20,000

2017 Revenue - \$170,000

2018 Revenue - \$40,000

Accounting under Topic 606

An analysis of the contractual terms indicates that revenue will continue to be recognized on a straight line basis over the contract term. In determining the transaction price, the vendor considers the approach that will best predict the amount of consideration that it will ultimately be entitled to, and determines that the most likely amount method is the appropriate approach.

The estimated amount of variable consideration is updated at each reporting date to reflect the position at that date, and any changes in circumstances since the last reporting date.

Variable consideration is estimated at \$50,000 at the inception date. This amount would have been included in the transaction price, because it was highly probable that it would not be subject to a significant reversal in the future (Monthly revenue: $\$230,000 / 18 = \$12,778$). The vendor re-evaluates the estimate of variable consideration each reporting period, and determines that there are no changes in the estimate.

2016 Revenue - \$25,556

2017 Revenue - \$153,336

2018 Revenue - \$51,108

Transition Effects under each Method

	Retrospective	Cumulative Effect
Analysis	The 2016 and 2017 comparative figures are adjusted to account for the contract under Topic 606.	Revenue for 2016 and 2017, as reported under Topic 605, is not adjusted because the new standard is only applied from the date of initial application (January 1, 2018). At the date of initial application, an adjustment is made to opening retained earnings for the difference in revenue that would have been recorded in previous periods under the new standard.
2016	+\$5,556 Revenue	No change
2017	-\$16,664 Revenue	No change
2018	2018 Reported \$51,108 Revenue	2018 Opening B/S Adjustment -\$11,108 Retained Earnings Cumulative Adjustment 2018 Reported \$51,108 Revenue 2018 – additional transition disclosures required

BDO OBSERVATION

Upon adoption of the new standard in this example, more revenue is presented within the income statement, over the three years affected by the contract, under the cumulative effect method than under the retrospective method, as depicted below:

Revenue shown in income statement:	2016	2017	2018	Total
Full retrospective	\$25,556	\$153,336	\$51,108	\$230,000
Cumulative effect	\$20,000	\$170,000	\$51,108	\$241,108

EXAMPLE 3 – SOFTWARE, UPGRADES, AND TECHNICAL SUPPORT

A vendor enters into a contract with a customer to supply a 2 year term license for a standard 'off the shelf' software package and to provide unspecified upgrades and technical support for the same period as the license (2 years) beginning on July 1, 2016 for total consideration of \$480,000. The vendor does not sell the license, upgrades, or technical support separately, and therefore does not have vendor specific objective evidence (VSOE) of fair value for any of these items. The software is functional without the upgrades and technical support.

Accounting under Topic 605

Due to the lack of VSOE for any of the elements of the arrangement, the vendor recognizes revenue for the license, upgrades and technical support on a straight-line basis over the 2-year contract term, at \$20,000 per month.

2016 Revenue - \$120,000

2017 Revenue - \$240,000

2018 Revenue - \$120,000

Accounting under Topic 606

The vendor concludes that the customer can benefit from each of the goods or services either on their own or together with other goods or services that are readily available to the customer. In addition, each of the promises to transfer goods or services is separately identifiable; because the upgrades and technical support do not significantly modify or customize the software, these each represent a separate promise by the vendor, and not one overall combined output. The software is determined to be functional intellectual property, therefore the vendor's performance obligation is satisfied at a point in time.

The vendor identifies the following distinct goods or services and allocates the transaction price based on relative standalone selling price as follows:

- ▶ Software license - \$360,000
- ▶ Upgrades - \$40,000
- ▶ Technical support - \$80,000.

The revenue attributable to the license is recognized at the delivery date of June 1, 2016.

The upgrades and technical support are each satisfied over time and it is determined that progress is best depicted by the passage of time. In other words, revenue for those two performance obligations will still be recognized ratably over the 2-year contract term.

2016 Revenue - \$390,000

2017 Revenue - \$60,000

2018 Revenue - \$30,000

Transition Effects under each Method

	Retrospective	Cumulative Effect
Analysis	The 2016 and 2017 comparative figures are adjusted for Topic 606 accounting.	Revenue for 2016 and 2017 as reported under Topic 605 is not adjusted, because the new standard is only applied from the date of initial application (January 1, 2018). At the date of initial application, an adjustment is made to opening retained earnings for the difference in revenue that would have been recorded in previous periods under the new standard.
2016	+\$270,000 Revenue	No change
2017	-\$180,000 Revenue	No change
2018	2018 Reported \$30,000 Revenue	2018 Opening B/S Adjustment +\$90,000 Retained Earnings Cumulative Adjustment 2018 Reported \$30,000 Revenue 2018 – additional transition disclosures required

BDO OBSERVATION

In this example, \$90,000 more revenue is recognized through the income statement under the retrospective method than under the cumulative effect method. Under the cumulative effect method this \$90,000 difference will not be recognized as revenue through the income statement, as it is an adjustment to opening retained earnings in 2018.

EXAMPLE 4 – CONTRACT MANUFACTURER

A contract manufacturer enters into a contract with a customer to deliver 10 units per month priced at \$50 each over a one year period, for a total of 120 units, from July 1, 2017 to June 30, 2018. The cost to produce each unit is \$40. As of December 31, 2017, the manufacturer has delivered 60 units to the customer, and has completed production of an additional 30 units but has not yet delivered them to the customer.

Accounting under Topic 605

The manufacturer recognizes revenue as each unit is delivered, because that is when the risks and rewards have passed to the buyer. In addition, the manufacturer concludes that collectibility is probable, there is evidence of a contract, and the price is fixed.

2017 Revenue - \$3,000 (60 units* \$50)

2017 Cost of Revenue - \$2,400
(60 units* \$40)

2017 Net Income - \$600

Accounting under Topic 606

Under the new standard, the manufacturer determines that the promise in the contract represents one performance obligation satisfied over time. The units are unique to this customer with no alternative use, and the manufacturer has an enforceable right to payment for progress completed to date in the event of contract termination.

The manufacturer determines the best measure of progress to be an output method based on units produced.

2017 Revenue – \$4,500 (90 units* \$50)

2017 Cost of Revenue - \$3,600 (90 units* \$40)

2017 Net Income - \$900

Accounting under Topic 605		Accounting under Topic 606
2018 Revenue - \$3,000 (60 units* \$50)		2018 Revenue - \$1,500 (30 units* \$50)
2018 Cost of Revenue - \$2,400 (60 units* \$40)		2018 Cost of Revenue - \$1,200 (30 units* \$40)
2018 Net Income - \$600		2018 Net Income - \$300

Transition Effects under each Method		
	Retrospective	Cumulative Effect
Analysis	The 2017 comparative figures are adjusted to account for the contract under Topic 606.	Revenue for 2017, as reported under Topic 605, is not adjusted because the new standard is only applied from the date of initial application (January 1, 2018). At the date of initial application, an adjustment is made to opening retained earnings for the difference in revenue that would have been recorded in previous periods under the new standard.
2017	+\$1,500 Revenue +\$1,500 Unbilled Receivable -\$1,200 Inventory +\$1,200 Cost of Revenue	No change
2018	2018 Reported \$1,500 Revenue \$1,200 Cost of Revenue \$300 Net Income	2018 Opening B/S Adjustment +\$300 Retained Earnings Cumulative Adjustment 2018 Reported \$1,500 Revenue \$1,200 Cost of Revenue \$300 Net Income 2018 – additional transition disclosures required

BDO OBSERVATION

In this example, \$1,500 less revenue and \$300 less net income are recognized through the 2017 income statement under the cumulative effect method than under the retrospective method. However, the 2017 net impact (\$300 in additional net income) will be recognized as an adjustment to opening retained earnings in 2018.

4. Practical Expedients

There are four practical expedients available to ease the transition to Topic 606 for entities using the retrospective approach. An entity can choose to use one or more of the practical expedients. One practical expedient is available if the cumulative effect method is used.

The practical expedients must be applied consistently to all contracts within all reporting periods presented.

Completed contracts discussed in practical expedients one and two below are defined as contracts for which all (or substantially all) of the revenue was recognized in accordance with revenue guidance that is in effect before the date of initial application.

The illustration below explains each practical expedient (PE).

-
- PE 1** Completed contracts (those which begin and end within the same annual reporting period) need not be restated.
-
- PE 2** For completed contracts that have variable consideration, an entity can use the transaction price at the date the contract was completed rather than having to estimate the variable consideration amounts that existed in the comparative reporting periods.
-
- PE 3** For all reporting periods presented before the date of initial application, it is not necessary to disclose the amount of the transaction price allocated to the remaining performance obligations or disclose when that amount is expected to be recognized as revenue.
-
- PE 4** For contracts that were modified before the beginning of the earliest period presented, an entity may elect not to retrospectively restate the contract for those modifications and instead will reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented when identifying satisfied and unsatisfied performance obligations, determining the transaction price and allocating the transaction price to performance obligations.
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If the cumulative effect method is used, PE 4 may be applied for all contract modifications occurring before the beginning of the earliest period presented.

Three additional examples below illustrate the application of PE 1, PE 2, and PE 4.

EXAMPLE 5 – PE 1 COMPLETED CONTRACTS BEGINNING AND ENDING IN THE SAME ANNUAL REPORTING PERIOD

A contract manufacturer enters into a contract on February 1, 2017 to build a customized product for a customer for \$1,000. The vendor will assemble the product over the three month period from February 1 to May 1. The product will be delivered on May 1, 2017.

Accounting under Topic 605

The vendor recognizes revenue of \$1,000 on May 1, 2017 when the product is delivered.

2017 Revenue - \$1,000

2018 Revenue - \$0

Accounting under Topic 606

The vendor determines that the control transfers over time and that revenue should be recognized over time, with progress measured using an input method based on costs incurred.

2017 Revenue - \$1,000

2018 Revenue - \$0

Transition Effects under each Method

	Retrospective	Cumulative Effect
Analysis	<p>There is no impact on revenue recognition for the 2017 year because the contract is completed within the same annual period.</p> <p>PE 1 is available because the contract began and was completed in the same annual reporting period under Topic 605. Assuming it was elected, the entity is not required to assess the contract under Topic 606.</p>	Revenue for 2017, as reported under Topic 605, is not adjusted because the new standard is only applied from the date of initial application (January 1, 2018).
2017 (using PE 1)	No change	Not applicable
2017 (not using PE 1)	No change	No change
2018	2018 Reported \$0	2018 Opening B/S Adjustment \$0 2018 Reported \$0

BDO OBSERVATION

In this example, there is no adjustment to the 2017 figures reported under either the retrospective method or the cumulative effect method. However, if the entity reported quarterly, there would be an effect on amounts reported in the 2017 periods under the retrospective method. This could result in loss of comparability. Assume that in the example above, there was an identical contract in 2018, and assume costs are incurred evenly during the three months of the contract. The following amounts would be reported in the Q1 and Q2 2018 interim reports:

Revenue reported in profit or loss	Retrospective Method - No practical expedient	Retrospective Method with PE 1
Q1 2017	\$666	-
Q2 2017	\$334	\$1,000
Q1 2018	\$666	\$666
Q2 2018	\$334	\$334

EXAMPLE 6 – PE 2 COMPLETED CONTRACTS THAT HAVE VARIABLE CONSIDERATION

A small company that conducts research and development of pharmaceutical products enters into a contract on July 1, 2014 with a customer, a large pharmaceutical company that manufactures, markets, and distributes medications. The vendor will research and develop a new drug to treat a specific condition. The contract contains the following four major phases, each including specific deliverables. The contract ends on June 30, 2017, unless extended per agreement by both parties. The customer will pay consideration to the vendor upon successful completion of each phase, as specified below:

1. Pre-development research and clinical study planning – \$30 million
2. Drug discovery and product development - \$30 million
3. Pre-clinical research and testing - \$20 million
4. Clinical trials - \$20 million

Accounting under Topic 605

The vendor accounted for the arrangement using the milestone method under Subtopic 605-28. The vendor identified the substantive milestones in the arrangement and deferred recognition of revenue for each milestone until the date it was achieved.

Accounting under Topic 606

The vendor determines that the contract contains four performance obligations, and control transfers over time for each. The vendor recognizes revenue for each performance obligation over the appropriate time period, with progress measured using an input method based on time lapsed. In determining the transaction price, the vendor considers the approach that will better predict the amount of consideration that it will ultimately be entitled to, and determines that the expected value method is the appropriate approach because there is a range of potential outcomes. The estimated amount of variable consideration is updated at each reporting date to reflect the position at that date, and any changes in circumstances since the last reporting date.

Variable consideration is estimated at \$100 million at contract inception date. In other words, the entire contract value is variable consideration since payment of each installment depends upon completion of the relevant milestone. The vendor applies the constraint on variable consideration and determines that at contract inception it is probable that consideration for the first two milestones (\$60 million) would not be subject to significant reversal in the future, because the vendor has previously completed such milestones in similar contracts, and completion of these milestones is not significantly dependent upon regulatory approvals. Conversely, the vendor concludes that consideration for the third and fourth milestones (\$40 million) is significantly dependent upon regulatory approvals, and should be constrained because it cannot conclude those amounts would not be subject to reversal in the future.

Therefore, the vendor begins to recognize revenue for the first two milestones over the period from contract inception to when it expects to complete them. The contractor re-evaluates the estimate of variable consideration at the end of each reporting period. No changes to variable consideration are reflected for the years ended December 31, 2014 and 2015. However, as of December 31, 2016, the vendor determines that achievement of the third and fourth milestones is probable, therefore it begins to recognize revenue for the additional \$40 million over the appropriate timeframe.

Transition Effects under each Method

Retrospective

Without applying any practical expedients, the 2016 and 2017 comparative figures are adjusted to account for the contract under Topic 606. The contractor includes its estimate of the amount of variable consideration, as constrained, in the transaction price at the inception of the contract and the transaction price is recognized over time.

PE 2 is available because the contract has variable consideration and was completed by the date of initial application of the new standard. Assuming it was elected, the contractor records revenue based on the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.

Cumulative Effect

Revenue for 2016 and 2017 reported under Topic 605 is not adjusted, because the new standard is only applied from the date of initial application. In this example, the contract was complete prior to the date of initial application.

BDO OBSERVATION

In this example, by applying the practical expedient available under the retrospective method, the vendor accounts for the contract over time based on the final transaction price of \$100 million.

EXAMPLE 7 – PE 4 CONTRACT MODIFICATIONS

Company B manufactures widgets and enters into a 10-year supply contract in 2014 with a customer to provide a specified number of widgets. The price and the number of widgets is modified regularly (3-4 times a year) based on discussions with the customer.

Accounting under Topic 605

Under Topic 605 revenue is recognized based on the agreed upon transaction price for each unit. Under the guidance in Subtopic 605-35, an option or an addition to an existing contract is treated as a separate contract or is combined with the original contract depending on the facts and circumstances. Accordingly, Company B determines that each modification should be combined with the original order, rather than treated as a separate contract.

Accounting under Topic 606

Under Topic 606 Company B would assess each change to the terms of the contract to determine if it created a new contract in addition to the original contract or if it is a contract modification. If it is a contract modification, it would then have to determine if the modification is a termination of the old contract and establishment of a new contract, a continuation of the existing contract or a combination of the two approaches.

Transition Effects under each Method

Retrospective

Without applying any practical expedients, the 2017 comparative figures are adjusted to account for the contract under Topic 606. This would require analyzing each change to the terms of the contract since contract inception to determine how the change should be accounted for.

PE 4 is available because a number of contract modifications took place before the earliest period presented. PE 4 allows the use of hindsight. This results in aggregating the impact of all modifications prior to the earliest period presented and including them in the identification of the satisfied and unsatisfied performance obligations, determination of the transaction price and allocation of the transaction price to the performance obligations.

Cumulative Effect

Revenue for 2017 reported under Topic 605 is not adjusted, because the new standard is only applied from the date of initial application (January 1, 2018). Instead, at the date of initial application, an adjustment is made to opening retained earnings for the difference in revenue that would have been recorded in previous periods under the new standard. To make this determination, Company B would perform a similar analysis as under the retrospective method.

PE 4 is available because a number of contract modifications took place before the earliest period presented. PE 4 allows the use of hindsight. This results in aggregating the impact of all modifications prior to the earliest period presented and including them in identifying the satisfied and unsatisfied performance obligations, determining transaction price and allocating the transaction price to the performance obligations.

BDO OBSERVATION

Use of the practical expedient for contract modifications will significantly reduce the effort required on transition for contracts that have been subject to multiple modifications.

5. Transitional Disclosures

Topic 606 includes specific transitional disclosures which generally supplement the transitional or change in accounting policy disclosure requirements of existing GAAP. An entity is required to provide an explanation to users of financial statements about which practical expedients were used and, to the extent reasonably possible, a qualitative assessment of the estimated effect of applying those practical expedients.

RETROSPECTIVE METHOD TRANSITIONAL DISCLOSURE

If an entity applies Topic 606 retrospectively, comparative information will be restated. An entity applying a new accounting policy is required to follow Topic 250, including disclosure of:

- ▶ The nature of and reason for the change in accounting principle.
- ▶ A description of the prior-period information that has been adjusted.
- ▶ The effect of the change on prior-period income from continuing operations, net income, and other affected line items, as well as earnings per share amounts affected. The transitional guidance in Topic 606 provides an exemption to the requirement to disclose these effects for the current period.
- ▶ The cumulative effect of the change on retained earnings or equivalent as of the beginning of the earliest period presented.

An entity that issues interim financial statements is required to present these disclosures in both the interim and annual financial statements in the year of adoption.

CUMULATIVE EFFECT METHOD TRANSITIONAL DISCLOSURE

Under the cumulative effect method, the comparative information will not be restated. As a result, additional disclosures are required to help users of financial statements understand the effect on trend information. Consequently, when an entity uses the cumulative effect transition method, the entity is required to disclose the following information for reporting periods that include the date of initial application:

- ▶ Whether it has applied this guidance to all contracts at the date of initial application or only to contracts that are not completed at the date of initial application.
- ▶ The amount by which each financial statement line item is affected in the current year as a result of the entity applying Topic 606 rather than previous revenue guidance.
- ▶ An explanation of the reasons for the significant changes in those financial statement line items.

An entity that issues interim financial statements is required to present these disclosures in both the interim and annual financial statements in the year of adoption.

BDO OBSERVATION

To provide the required disclosures, an entity would have to determine the amounts recognized under the previous revenue standards in the year of adoption. This is the only way to determine the effect of applying Topic 606 on each line item in the current year.

REMAINING PERFORMANCE OBLIGATION DISCLOSURES

Topic 606 requires an entity to disclose information about its remaining performance obligations, including the aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period and when the entity expects to recognize that amount as revenue. However, for periods presented before the date of initial application, one of the practical expedients on transition is that an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.

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