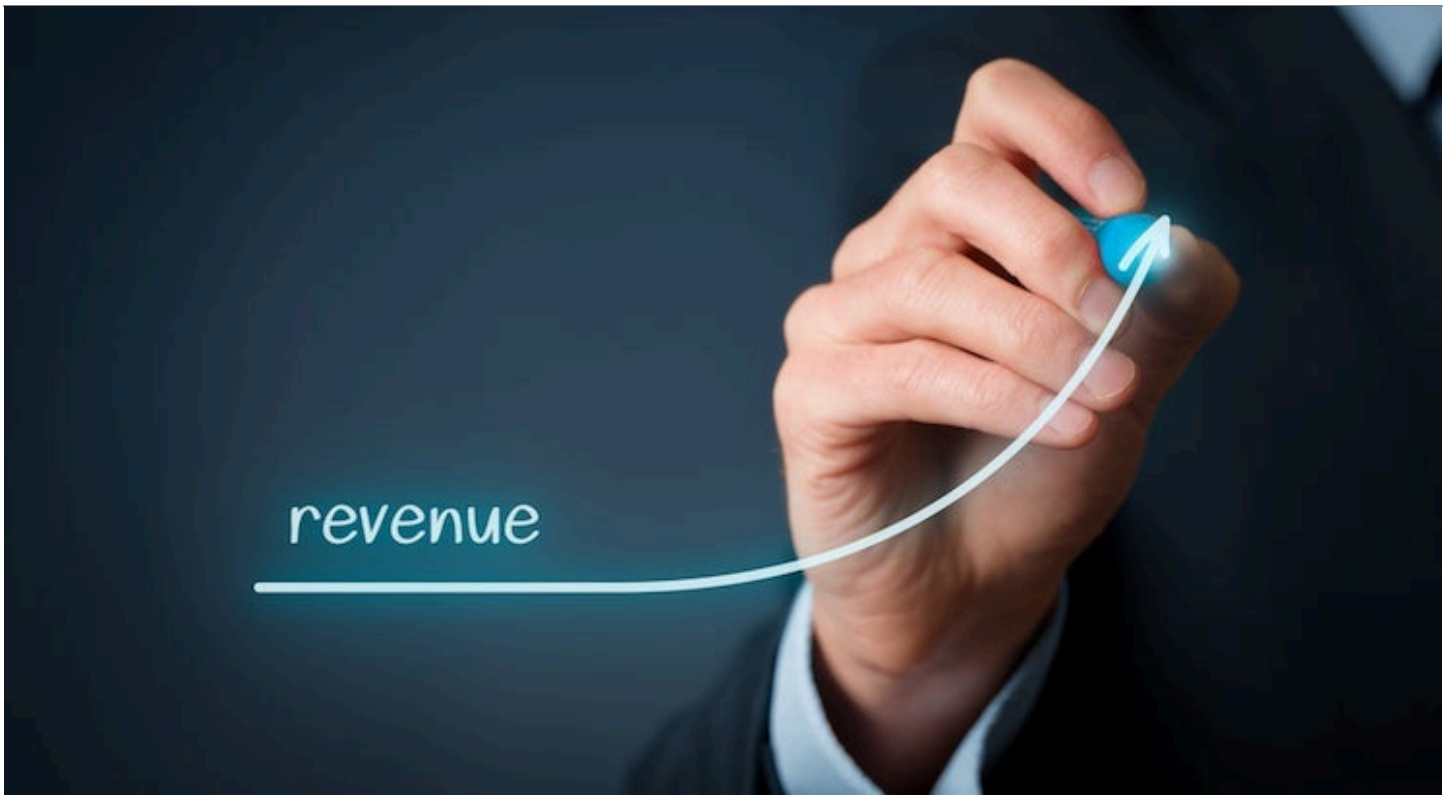


ASC 606: How Revenue from Litigation Settlement Contracts is Recognized

Litigation and Dispute Resolution



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This is the first part of a two-part series discussing the updated ASC 606. In this article, Litigation Columnist Noah Webster covers the fundamentals of the guidance and its effects on revenue recognition.

Accounting Standards Update No. 2014-09 Revenue from Contracts with Customers (ASU 2014-09) changes the fundamental guidance for determining how revenue is recognized. Public companies are adopting it, effective the first reporting period after December 15, 2017. Nonpublic companies have an extra year. This new guidance can apply to litigation settlements, so in-house litigators need to be aware of its basics.

What is it?

ASU 2014-09 is the Financial Accounting Standards Board (FASB) guidance for reporting revenue from contracts with customers. The update has two parts: “ASC Topic 606 Revenue from Contracts with Customers” and “Subtopic 340-40 Other Assets and Deferred Costs – Contracts with Customers” (together, ASC 606).

Other ASC topics cover revenue from other sources and non-revenue. For example, ASC 606 does not cover lease contracts, guarantees, contracts related to financial instruments, contracts for insurance entities, and nonmonetary exchanges between entities in the same line of business to facilitate sales to customers.

Why does it matter?

ASC 606 governs how revenue from your litigation settlement contracts will be accounted for and reported. By learning the ins and outs of ASC 606, you can understand how a settlement agreement will be accounted for and whether it will support your company’s revenue goals.

The new guidance represents a sea change in accounting. Corporate operations expert Eric Roberts explains: “Companies must adjust their back-office financial methods, policies, and systems to ensure compliance and make certain that investors and analysts clearly understand the reporting transition.” Disclosures made by early adopters demonstrate Roberts’ point and the potential impact of reporting of revenue under ASC 606. In August 2017, Microsoft restated revenues for two prior years under the new guidance to educate its investor community. Its fiscal 2017 revenue increased from around US$90 billion to US$96.6 billion.

This was due to a move to upfront recognition for several sources of revenue, including non-volume based patent licensing revenue.

Why the change?

FASB promulgated ASC 606 to improve and converge revenue guidance across industries. Under the legacy GAAP, there were “complex, detailed, and disparate revenue recognition requirements for specific transactions and industries including, for example, software and real estate.” ASC 606 establishes principles that create consistency across similar transactions, reducing the number of distinct guidance requirements that an organization must reference for accounting and reporting. On the other hand, with fewer rules, the application of ASC 606 requires more estimation and judgment.

What are the new revenue principles?

The principles of ASC 606 fit into this five-step revenue recognition model:

1. *Identify the contract(s) with a customer;*
2. *Identify the performance obligations in the contract;*
3. *Determine the transaction price;*
4. *Allocate the transaction price to the performance obligations in the contract; and,*
5. *Recognize revenue when (or as) the entity satisfies a performance obligation.*

This requires that distinct obligations, even under one contract, will be accounted for separately. A transaction price is allocated for each obligation.

Revenue is recognized when an entity performs the applicable obligation by transferring control of promised goods or services. This can be at a point in time. For goods, satisfaction of an obligation and transfer of control is relatively easy to determine.

If a transfer is rendered continuously over time, then revenue will also be recognized over time (e.g., ratably). This is often the case with services. Factors for determining whether a transfer occurs over time include:

- *The customer simultaneously receives and consumes the benefits as the entity performs (e.g., a cleaning service).*
- *The performance creates or enhances an asset that customer controls as that asset is*

created or enhanced (e.g., a work in process).

- *The entity's performance for customer does not create an asset with alternative use to the entity; and the entity has an enforceable right to payment at all times for performance completed to date (e.g., building a specialized asset that only a specific customer can use, like building a government satellite designed for one purpose).*

Where can you find more information about it?

Your external auditors and internal finance team should be up to speed with ASC 606. In addition, each of the large accounting firms have published information on the Internet explaining ASC 606. KPMG's provides the most commentary concerning litigation settlements.

What are some of the implications for litigation settlements?

ASC 606 is applicable to litigation settlements, and other contracts, to the extent they constitute revenue from contracts with customers. That is, goods or services must be provided:

***Under contract**, which means an "agreement between two or more parties that creates enforceable rights and obligations."*

- *These factors indicate whether an agreement is formed:*

1. *The parties approved and are committed to the contract. Can be in writing, verbal, or in accordance with customary business practices;*
2. *The entity can identify each party's rights;*
3. *The entity can identify payment terms;*
4. *The contract has commercial substance; and,*
5. *It is probable that entity will collect all of the consideration to which it will be entitled.*

- *There is no contract if either party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party.*

***To a customer**, which means "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." This can include an opposing party who agrees to settle litigation.*

In practice, whether ASC 606 is applicable — and the proceeds of a settlement constitute revenue — often depends on whether the promised goods and services are an output from an ordinary business activity. Only "ongoing major or central operations" are ordinary business activities.

A party to a contract is not a customer if, for example, it shares in the risks and benefits that result from the activity or process under the contract, such as collaborating to develop and distribute a new product. Such a contract is not about obtaining that output of the other party's ordinary activities. In addition, if another ASC topic covers a contract, then ASC 606 does not apply.

Read the second article in the ASC 606 series to learn how the new guidance impacts classifying settlement proceeds and IP licenses.

Resources

Microsoft New Accounting Standards and FY18 Investor Metrics Conference Call, August 3, 2017.

FASB, Revenue from Contracts with Customers (Topic 606) at Summary.

Under legacy GAAP, revenue is generally recognized when delivery occurs or service is rendered.

KPMG, Handbook: Revenue Recognition, December 2017 at 397-98.

KPMG, Handbook: Revenue Recognition, December 2017. See KPMG, Handbook: Revenue for software and SaaS (Question A60).

KPMG, Handbook: Revenue Recognition at 16.

KPMG, Handbook: Revenue Recognition at 18.

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Noah Webster is chief legal & compliance officer for Everbridge, a global software company that empowers enterprises and government organizations to anticipate, mitigate, respond to, and recover stronger from critical events. In today’s unpredictable world, resilient organizations minimize impact to people and operations, absorb stress, and return to productivity faster when deploying critical event management (CEM) technology. Everbridge digitizes organizational resilience by combining intelligent automation with the industry’s most comprehensive risk data to Keep People Safe and Organizations Running.