EISNERAMPER

Edison Partners

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Revenue Recognition

Overview of the Standard

Background

What?

- On May 28, 2014 the Financial Accounting Standards Board (FASB) issued the final revenue recognition standard to establish the principles that an entity shall apply to report useful information to users of financial statements about **the nature, amount, timing, and uncertainty of revenue and cash flow** arising from a contract with a customer.
- The objectives of the new revenue standard are to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP that would:
    1. Remove inconsistencies and weaknesses in revenue requirements.
    2. Provide a more robust framework for addressing revenue issues.
    3. Improve comparability of revenue recognition practices.
    4. Provide more useful information to users through improved disclosure requirements.
    5. Simplify the preparation of financial statements by reducing the number of requirements.

Timing?

- **The standard was effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017.**
- **The standard is effective for private companies for annual reporting periods beginning after December 15, 2018.**
- **Early adoption is permitted for annual reporting periods beginning after December 15, 2016.**

Scope of the New Revenue Standard

- **Applies to an entity's contracts with customers**
- **Does not apply to:**
  - **Lease contracts (ASC 840, ASC 842)**
  - **Insurance contracts (ASC 944)**
  - **Certain financial instruments and other contractual rights or obligations**
  - **Guarantees (other than product or service warranties)**
  - **Nonmonetary exchanges whose purpose is to facilitate a sale to another party**
- **Some key aspects apply to transfer (sale) of nonfinancial assets**

Glossary terms

Contract: An agreement between two or more parties that creates enforceable rights and obligations

Customer: 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

Overview of New Revenue Recognition Standard

Core principle:

Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled in exchange for those goods or services through the 5 step model depicted below.

Identify the contract with a customer (Step 1)

Identify the performance obligations in the contract (Step 2)

Determine the transaction price (Step 3)

Allocate the transaction price to performance obligations (Step 4)

Recognize revenue when (or as) the entity satisfies a performance obligation (Step 5)

This revenue recognition model is based on a control approach, which differs from the risks and rewards approach applied under current U.S. GAAP

Examples of Potential Impacts

- Variable pricing
- Sales incentives
- Gift cards
- Loyalty programs
- Warranty
- Free goods and services
- Right of return
- Gross vs Net revenue recognition
- Contract combinations and modifications
- Licensing arrangements / royalties
- Disclosures

Step 1: Identifying the Contract

A legally enforceable contract (oral or implied) must meet all of the following requirements:

- The parties have approved the contract and are committed to perform
- The entity can identify each party's rights regarding goods or services
- The entity can identify the payment terms for the goods or services to be transferred
- The contract has commercial substance

A contract will not be in the scope if:

It is probable the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer

Collectibility threshold

The contract is wholly unperformed

AND

Each party can unilaterally terminate the contract without compensation

Step 2: Identifying Performance Obligations

The ASU defines a performance obligation as a promise to transfer to the customer a good or service (or a bundle of goods or services) that is distinct

A series of goods or services with the same pattern of transfer may be a single obligation

Identify all (explicit or implicit) promised goods and services in the contract

Are promised goods and services distinct from other goods and services in the contract?

CAPABLE OF BEING DISTINCT

Can the customer benefit from the good or service on its own or together with other readily available resources?

AND

DISTINCT WITHIN CONTEXT OF CONTRACT

Is the good or service separately identifiable from other promises in the contract?

YES → Account for as a performance obligation

NO → Combine 2 or more promised goods or services and reevaluate

Step 2: Identifying Performance Obligations (cont'd)

Warranties

- Assurance warranties (those that assure compliance with agreed-upon specifications) use a cost accrual accounting model
- An option to purchase or those warranties that provide a service in addition to agreed-upon specification would be a potential performance obligation

Upfront fees

- An entity should assess whether the fee relates to the transfer of a promised good or service.
- An upfront fee is often an advance payment for future goods or services and, therefore, would be recognized as revenue when those future goods or services are provided.
- Generally recognize advance payments when future good or services are provided (may be beyond initial contract term)
- Period of benefit may not be the entire expected customer life

Step 3: Determining Transaction Price

Principle: 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 (which excludes estimates of variable consideration that are constrained)

Transaction price shall include …

- Fixed consideration
- Variable consideration (estimated and potentially constrained)
- Noncash consideration (FASB updates)
  - Measure at fair value at contract inception
  - Constraint would not apply to variability due to the form of the consideration
- Adjustments for significant financing component
- Adjustments for consideration payable to customer

Practical expedient to present sales taxes on a net basis (scope consistent with existing GAAP)

Transaction price does NOT include …

- Effects of customer credit risk

Step 4: Allocating Transaction Price

Allocate transaction price on a relative stand-alone selling price basis (estimate stand-alone selling price if not observable)

- The expected cost-plus margin method, adjusted market assessment method, or residual method (only if price is highly variable or uncertain) are acceptable

Allocate transaction price to all performance obligations (and subsequent changes based on initial allocation), unless a portion of (or changes in) the transaction price relate entirely to one or more obligations and certain criteria are met

Do not reallocate for changes in stand-alone selling prices

If certain criteria are met, a discount or variable consideration may be allocated to one or more, but not all, of the performance obligations in a contract

Allocation Exceptions:

<u>Discount</u>:

- Allocated entirely to one or more, but not all, performance obligations if certain criteria are met.

<u>Variable consideration</u>:

- Allocated entirely to one performance obligation if certain criteria are met.

Step 5: Recognizing Revenue

Evaluate if control of a good or service transfers over time, if not then control transfers at a point in time. An entity satisfies a performance obligation over time if …

The customer receives and consumes the benefit as the entity performs (*e.g.*, cleaning service)

OR

Performance creates or enhances a customer controlled asset (*e.g.*, home addition)

Measure progress toward completion using input/output methods

** An entity has a right to payment only if, at all times throughout the duration of the contract, the entity is entitled to an amount that at least compensates for performance completed to date. This compensation should approximate the selling price of the goods/services (i.e., costs incurred plus a reasonable profit margin)*

OR

Performance does not create an asset with an alternative use and the entity has an enforceable right to payment* for performance completed to date

Step 5: Recognizing Revenue (cont'd)

Output Methods:

- Recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date.

Over Time: Measuring Progress

Input Methods:

- Recognize revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation.

Step 5: Recognizing Revenue (cont'd)

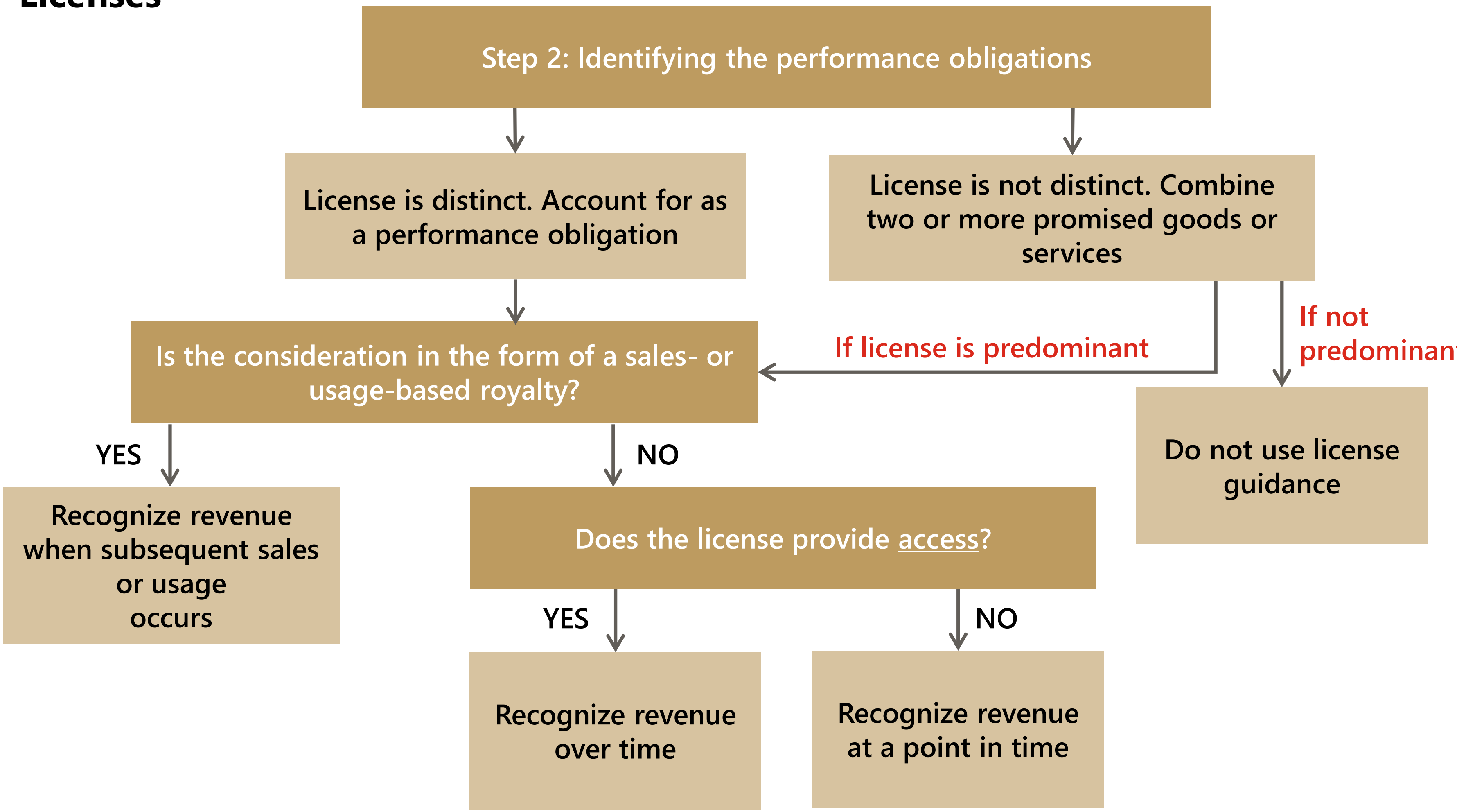
Point in time

For performance obligations satisfied at a point in time, indicators that control transfers include, but are not limited to, the following:

- The entity has a present right to payment
- The customer has legal title
- The entity has transferred physical possession
- The customer has the significant risks and rewards of ownership
- The customer has accepted the asset

Step 5: Recognizing Revenue (cont'd)

Licenses



Step 5: Recognizing Revenue (cont'd)

Nature of IP License

Does the IP have significant standalone functionality?

YES

<u>Functional IP</u>
Form or functionality of IP expected to change as a result of activities of licensor that do not transfer a promised good or service to the customer, *and* the customer has the right only to the most current version of the IP?

YES

<u>Right to Access License</u>
Recognize revenue
over time

NO

<u>Right to Use License</u>
Recognize revenue at a point in time

NO

<u>Symbolic IP</u>
Entity will undertake activities to support and maintain the IP; activities significantly affect the utility of the IP
Right to Access License
Recognize revenue *over time*

Other Considerations

Other Considerations – Contract Costs

Costs to obtain a contract

- Capitalize costs of obtaining a contract if they are incremental and expected to be recovered (*e.g.*, sales commissions)
  - <u>One-year practical expedient</u>

Costs to fulfill a contract

- Recognize assets in accordance with other Topics (*e.g.*, inventory, PP&E, software), otherwise capitalize costs that:
  - Relate directly to the contract (or specific anticipated contract);
  - Generate/enhance a resource that will be used to satisfy obligations in the future; and
  - Are expected to be recovered
- Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) must be expensed when incurred

Amortization & impairment

- Capitalized costs are amortized on a systematic basis consistent with the transfer of the related goods or services
- Recognize impairment immediately if costs not deemed recoverable

Other Considerations – Principal vs. Agent

Determine whether entity's responsibility is to provide goods or services (gross) to the customer or arrange for another party to provide goods or services (net).

ASU clarifies:

- To determine the nature of an entity's promise, it should (paragraph 606-10-55-36A):
  - Identify the specified goods or services (*i.e.*, distinct performance obligations or distinct bundle of goods or services) to be provided to the customer
  - Assess whether it controls each specified good or service before that good or service is transferred to the customer

The result is that an entity may be the principal for some distinct performance obligations and the agent for others.

- When an entity that is a principal obtains control, if another party is involved in providing goods or services to a customer (paragraph 606-10-55-37A)
- Indicators of control before specified good or service is transferred to the customer (paragraph 606-10-55-39 and 55-39A):
  - The entity is primarily responsible for fulfilling the promise to provide the specified good or service
  - The entity has inventory risk before the good or service is transferred or after that transfer (for example, on return)
  - The entity has discretion in establishing prices

Transition

Transition

SEC registrants are required to provide both annual and interim disclosures in their first interim reporting after adopting the new accounting standard and in each subsequent quarter in their year of adoption, as long as the information is material and not duplicated.

Transition

With the new revenue standard, Companies can choose between the two methods of transition; full retrospective method, and modified retrospective method. As we have noted earlier, the majority of companies have chosen to apply the modified retrospective method in their implementation of the new standard. You may find some high level information on both of the transition methods below:

1) Full retrospective method

- The full retrospective method, the new revenue standard would be applied on a retrospective basis to all prior periods presented in accordance with the guidance on accounting changes in ASC 250.

- Entities electing to use the full retrospective method are required to disclose information about a change in accounting principle upon initial adoption of the new revenue standard, except that it does not need to disclose the effect of the changes on the current period as it otherwise would be required to do. In addition, the entity is required to disclose the effect of the changes on any prior periods that have been retrospectively adjusted.

2) Modified retrospective method

- With the modified retrospective method, entities are required to apply it retrospectively with a recorded cumulative adjustment to opening retained earnings in the year of adoption.

- Companies applying the modified retrospective method are required to disclose the amount by which each financial statement line item is affected by the application of the new revenue standard in the current period, as well as an explanation of the reasons for any significant changes.

- Entities applying the modified retrospective method are also required to disclose whether they have 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.

- **Under both methods, entities must disclose whether they have applied any of the transition practical expedients provided.**

Transition (cont'd)

Retrospective Restatement

- Show three columns (as reported, adjustments, as adjusted) for each year presented in the 2018 financial statements (2016-2017)
- Recognize the cumulative effect as of the beginning of the earliest year presented (January 1, 2016) through an adjustment to retained earnings
- Certain limited practical expedients
    - Completed contracts that begin and end within the same annual period do not need to be restated for quarters
    - For 2016 and 2017, no requirement to disclose the amount of transaction price allocated and an explanation of amounts anticipated to be recognized as revenue for remaining performance obligations

Cumulative Effect Adjustment --- MOST COMPANIES HAVE ELECTED TO APPLY THIS APPROACH

- Apply guidance for new and existing contracts at January 1, 2018 (day one of 2018 fiscal year)
- Recognize the cumulative effect as an adjustment to the opening balance of retained earnings for the initial year of application (January 1, 2018)
- Do not restate revenue in 2017 or 2016 (prior revenue recognition rules apply)
- Disclose the impact of the new guidance on each financial statement line item in 2018, and provide an explanation of the significant changes between applying the new and prior guidance
- An example of public companies applying this approach is shown below:

Transition – Illustrative Tabular Disclosure

Impact of Adoption of the New Revenue Standard Consolidated Balance Sheet			
Assets	**As previously reported (before ASC 606 adoption)**	**Adjustments**	**As reported (after ASC 606 adoption)**
Accounts receivable	$ [xxx]	$ [xxx]	$ [xxx]
Deferred costs	[xxx]	[xxx]	[xxx]
Other current assets	[xxx]	[xxx]	[xxx]
Total current assets	**[xxx]**	**[xxx]**	**[xxx]**
Other long-term assets	[xxx]	[xxx]	[xxx]
Deferred long-term costs	[xxx]	[xxx]	[xxx]
Total assets	**[xxx]**	**[xxx]**	**[xxx]**
Liability and Stockholders Equity			
Accrued liabilities	$ [xxx]	$ [xxx]	$ [xxx]
Deferred revenue	[xxx]	[xxx]	[xxx]
Total current liabilities	**[xxx]**	**[xxx]**	**[xxx]**
Deferred revenue and other long-term liabilities	[xxx]	[xxx]	[xxx]
Total liabilities	**[xxx]**	**[xxx]**	**[xxx]**
Retained earnings	[xxx]	[xxx]	[xxx]
Total stockholders' equity	[xxx]	[xxx]	[xxx]
Total liabilities and stockholders equity	[xxx]	[xxx]	[xxx]

Impact of Adoption of the New Revenue Standard Consolidated Income Statement			
Income Statement	**As previously reported (before ASC 606 adoption)**	**Adjustments**	**As reported (after ASC 606 adoption)**
Revenue from inventory sold	$ [xxx]	$ [xxx]	$ [xxx]
Revenue from services rendered	[xxx]	[xxx]	[xxx]
Total revenue (net)	[xxx]	[xxx]	[xxx]
Income before income taxes	[xxx]	[xxx]	[xxx]
Net income	[xxx]	[xxx]	[xxx]
Net income attribute to the Entity	[xxx]	[xxx]	[xxx]

Disclosure Requirements

Disclosure Requirements

New Disclosures	Quantitative	Qualitative	Interim Basis	Key Decisions and Considerations

I. Disaggregation of revenue	✓	✓	✓	• Determination of disaggregation categories incorporating information from:
				  • Earnings releases
				  • Information prepared by the company and reviewed by the Chief Operating Decision Maker
				  • MD&A
				  • Segment disclosures
				• Identify data requirements and sources
				• Establish a process and determine system capability to reconcile disaggregated revenue to segment revenue
				• Choice between quantitative or qualitative reconciliation to segment revenue

II. Contract asset/ liability balances	✓	✓	✓	• Determination of whether the reporting requirement for receivables is already met elsewhere • System capability to capture both the amount of and reason for changes in the contract asset/liability balances • Analysis of the effects of the timing of satisfaction and timing of payment on contract asset/liability balances
III. Nature of performance obligations		✓		• Descriptions of performance obligations needed (e.g. timing of satisfaction, significant payment terms, nature of goods, etc.)

Disclosure Requirements (cont'd)

New Disclosures	Quantitative	Qualitative	Interim Basis	Key Decisions and Considerations
IV. Amount of the transaction price allocated to remaining performance obligations and timing of recognizing that amount as revenue	✓		✓	• Ability to capture remaining transaction price for contracts and the estimated amounts to be recognized by year • Quantitative or qualitative explanation of when amounts will be recognized as revenue • Determination of whether to apply practical expedient or disclose information for all contracts regardless of the contract term
V. Significant judgments used in determining the transaction price and amounts allocated to and timing of satisfaction of performance obligations			✓	• Determination of whether there should be a specific list of judgments from which to choose or whether the disclosure should be more general in the nature of judgments used
VI. Assets recognized from the costs to obtain or fulfill a contract		✓	✓	• Disclose the closing balances of capitalized contract costs, amount of amortization, method of amortization, and judgments made to determine the amount of capitalized costs
VII. Election of the practical expedients related to time value of money or contract acquisition costs			✓	• System capability to identify and apply the use of a practical expedient consistently to appropriate contracts

Disclosure Requirements (cont'd)

Below is an example of a revenue disaggregation by major product / service lines that covers geographical, customer type, and timing of revenue:

"The following tables disaggregates our revenues by major service lines and types of customers, as well as the timing of revenue recognition for our operations in North America, South America, Europe and Asia:

North America - For the three months ended March 31, 2018					
Major Product / Service Lines by Customer Type	**Segment A**	**Segment B**	**Segment C**	**Eliminations**	**Total**
Commercial – Tier 1					
Product sales revenues	$ [xxx]	$ [xxx]	$ [xxx]	$ [xxx]	$ [xxx]
Service revenues	[xxx]	[xxx]	[xxx]	[xxx]	[xxx]
Ancillary revenues	[xxx]	[xxx]	[xxx]	[xxx]	[xxx]
Commercial – Tier 2					
Product sales	$ [xxx]	$ [xxx]	$ [xxx]	$ [xxx]	$ [xxx]
Service revenue	[xxx]	[xxx]	[xxx]	[xxx]	[xxx]
Ancillary revenues	[xxx]	[xxx]	[xxx]	[xxx]	[xxx]
Government					
Product sales	$ [xxx]	$ [xxx]	$ [xxx]	$ [xxx]	$ [xxx]
Service revenue	[xxx]	[xxx]	[xxx]	[xxx]	[xxx]
Ancillary revenues	[xxx]	[xxx]	[xxx]	[xxx]	[xxx]
Total	**[xxx]**	**[xxx]**	**[xxx]**	**[xxx]**	**[xxx]**
Timing of Revenue Recognition	$ [xxx]	$ [xxx]	$ [xxx]	$ [xxx]	$ [xxx]
Point in time revenues	[xxx]	[xxx]	[xxx]	[xxx]	[xxx]
Over time revenues	[xxx]	[xxx]	[xxx]	[xxx]	[xxx]
Total	**[xxx]**	**[xxx]**	**[xxx]**	**[xxx]**	**[xxx]**

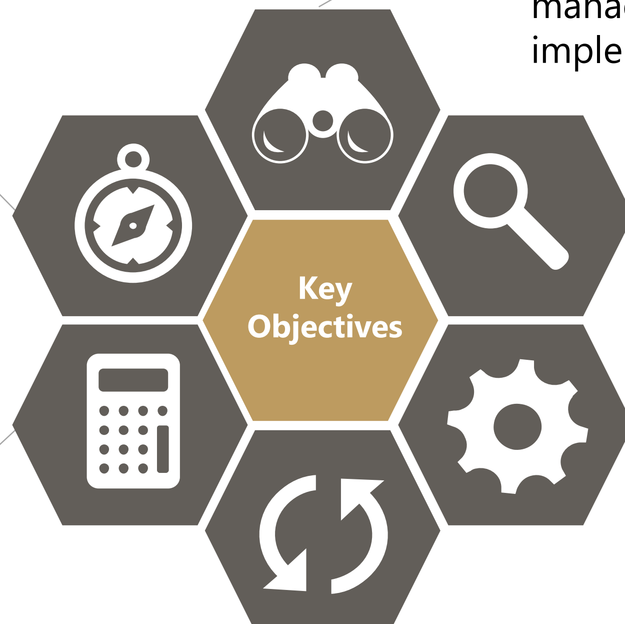
Implementation Steps

Project Objectives

Below are the main objectives that we will achieve during the revenue recognition assessment:

Establish project management office (“PMO”) to standardize project management practices and facilitate implementation of ASC 606

Analyze and document impact on process changes, internal controls, policies and procedures



Identify revenue streams to ensure completeness of assessment

Evaluate the impact of the new standard on revenue streams through detailed review of customer contracts and analyze additional disclosure requirements

Hold scoping workshops and interviews to gain an in-depth understanding of revenue streams

Identify potential accounting challenges per revenue stream and document accounting conclusions

Overview of Approach

The following outlines the key activities and milestones that will help us achieve the objectives li
the previous slide:

1. PMO and Engagement Planning

2. Scoping Workshops and Interviews

3. Analysis: Identification of Issues and Documentation of Accounting Treatment

4. Controls: Establish Internal Controls, Policies and Procedures

Activities

1. PMO and Engagement Planning

- Kickoff and establish PMO and cadence for project management execution
- Prepare project plan and monitor progress
- Identify stakeholder groups
- Identify revenue streams
- Determine structure and audience of scoping workshops

2. Scoping Workshops and Interviews

- Conduct scoping workshops with key stakeholders to understand revenue streams and related arrangements
- Conduct interviews with key personnel as necessary to further understand current revenue recognition
- Prepare summaries of findings from workshops and interviews

3. Analysis

- Determine relevant contracts for material revenue streams
- Review sample customer contracts for each identified material revenue stream
- Conduct additional working sessions and interviews based on findings in scoping sessions and reviews of sales arrangements
- Prepare a white paper and technical summary

4. Controls

- Gain an understanding of the current internal control policies and procedures (leverage existing knowledge and meetings and interviews during analysis of existing contracts and Phase 1)
- Assist in documenting revised policies and procedures under ASC 606
- Document a process to identify changes in the contract terms (both new and existing contracts) from the "standard protocol."

Project Management

- Proactively monitor and control changes to the project plan
- Anticipate and proactively identify issues and risks, and assist with resolution
- Inform project stakeholders of overall status, jeopardy items, and calls to action
- Prepare bi-weekly status reports and status meetings

Timeline

The timeline below shows the estimated duration for the allotted effort of each activity and expected relative timing:

Activities (Weeks)	1	2	3	4	5	6	7
1. Engagement Planning	Kick off and project planning						
2. Scoping Workshops and Interviews		Conduct scoping workshops and interviews with key personnel					
3. Analysis: Identification of Issues and Documentation of Accounting Treatment			Review contracts, prepare white papers and technical summary				
4. Controls: Establish Internal Controls, Policies and Procedures					Document revised policies and procedures under ASC 606		
5. Project Management	Proactively monitor and adjust project plan; inform project stakeholders of overall status and risks to project plan; schedule periodic status meetings with stakeholders to ensure milestones will be reached						

The number and complexity of revenue streams may impact timeline.

Immediate Next Steps

Following today's meeting, immediate next steps to commence the project will include:

1. Identify revenue streams and determine structure and audience of scoping workshops
2. Develop format of weekly status cadence and schedule status meetings
3. Finalize project plan
4. Develop and distribute scoping session agendas
5. Schedule scoping workshops

?

Q&A

How can EisnerAmper help?

A typical ASC 606 implementation requires companies to assess their revenue streams in detail, identify and document their promises, POs, their accounting considerations and conclusions.

EisnerAmper can help companies perform these key tasks, and help them identify and quantify the potential impacts of the Standard.

- Establish project management office ("PMO") to standardize project management practices and facilitate implementation of ASC 606
- Identify revenue streams to ensure completeness of assessment
- Hold scoping workshops and interviews to gain an in-depth understanding of revenue streams
- Identify potential accounting challenges per revenue stream and document accounting conclusions
- Evaluate the impact of the new standard on revenue streams through detailed review of customer contracts and analyze additional disclosure requirements
- Analyze and document impact on process changes, internal controls, policies and procedures

How can EisnerAmper help?

Mark Sabates

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Mark Sabates is an Audit Partner with experience in public and non-public company audits, initial public offerings and a worldwide audit of a Fortune 500 company. He also has experience in performing audits of employee benefit plans. Mark's industry expertise focuses on technology, manufacturing and distribution.

Mark heads our Technical Accounting Advisory Services (TAAS). TAAS professionals provide our non-attest clients with technical accounting expertise and assist with adaption to new regulations such as ASC 606 (revenue recognition) and ASC 842 (leases).

Prior to joining the firm, Mark spent nearly 15 years at a Big Four accounting firm. During that time, he frequently traveled the country as a national instructor, developed training courses for in-house continuing professional education programs and spent time in the national office in the effective audit group.

SPECIALTIES

- Audit & Assurance

CREDENTIALS/EDUCATION

- Certified Public Accountant (CPA)
- Seton Hall University: BS, Accounting

AFFILIATIONS

- American Institute of Certified Public Accountants
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Visit our website https://www.eisneramper.com/RevRec for more information on revenue recognition accounting and its implications.

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