Revenue Recognition

2nd Annual North Texas CPE Day

December 6, 2018

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Agenda

- Baseline
- Complexity
- Contracts
- Performance Obligations
- Transaction Price
- Allocation
- Recognition
- Disclosures

Baseline

Effective Dates:

- Public Entities: Periods ending after December 15, 2017
- Private Entities: Years ending after December 15, 2018 (Does not apply to interim periods in year of adoption)

Baseline

Revenue Definition from ASC 606-10-20:

Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

Baseline

Step 1	Identify the contract with the customer
Step 2	Identify the performance obligations in the contract
Step 3	Determine the transaction price
Step 4	Allocate the transaction price
Step 5	Recognize revenue when each performance obligation is satisfied

Revenue recognition impact

Financial

Perform-ance metrics

Control environ-ment

Tax planning

Operations

Processes and systems

Employee incentives

Organization

Stake-holder relations

Training and Comm-unication

Drivers of Complexity

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Less complex	More complex
Domestic operations	International operations
Single line of business	Multiple, diverse businesses
Shorter revenue cycle	Long-term contracts
Highly centralized	Decentralized
No change to existing performance obligations	Changes in the number of performance obligations
One accounting system	Multiple accounting and data storage centers
Strong governance	Loose governance and change management
	Bundled arrangements with multiple inter-related performance obligations

Contract Attributes

- Parties approve contract; committed to perform their obligations (minimums, terminations)
- Identifies rights regarding the goods or services to be transferred
- Payment terms can be identified
- Commercial substance
- Collection of consideration from customer is probable (price concessions)

Collectability

- Partly a forward-looking assessment.
- Judgment required to consider the facts and circumstances, such as customary business practices and knowledge of the customer, in determining whether it is **probable that the entity will collect substantially all of the consideration** to which it will be entitled.
- Not necessarily based on the customers ability and intention to pay the entire amount of promised consideration for the entire duration of the contract.

Collectability

Consider mitigations to credit risk:

- **Payment terms** may limit the entity's exposure to credit risk through upfront payments or deposits.
- **Delivery terms** may limit the entity's exposure if performance can be suspended when the customer fails to pay. The collectability consideration would be limited to the unsecured delivery amount.
- Ability to repossess an asset should **not** be considered a mitigation to credit risk.

Risks – Contracts

Contracts	Risks
Identifying the customer	Customer / supplier relationship is unclear and not defined in assessment of contract
Approving contract	Lack evidence of contract approval by both parties to the contract or failure to consider whether parties are committed to perform their obligations
Collectability	Collectability is not appropriately considered at contract inception
Combining contracts	Contracts inappropriately evaluated separately or inappropriately combined to change revenue recognition timing or gross profit result
Contract modifications	Modifications incorrectly treated as new contract or change to existing contract
Established business practices	Business practices not considered as part of the contract evaluation considerations that would change revenue recognition timing
Determining legal enforceability	Reliance upon a contract or contract term that is not legally enforceable such as non-refundable deposits or collection actions

Contract Term

The period in which enforceable rights and obligations exist may be affected by termination provisions in the contract.

ASC 606-10-25-4 "…a contract does not exist if each party to the contract has the unilateral right to terminate a wholly unperformed contract without compensating the other party (or parties)."

When a customer has unlimited termination rights there is no contract.

Case Study #1 – Contract Term

Q: Entity A enters into a three-year contract with a customer to provide maintenance services. Entity A begins providing the services immediately. Consideration is payable in equal monthly installments, and each party has the unilateral right to terminate the contract without compensating the other party if it provides 30 days' notice.

What is the term of the contract?

Case Study #1 – Contract Term

A: While Entity A may historically have considered the contract term to be three years, its rights and obligations are enforceable only for 30 days. Under ASC 606, the contract would be accounted for as a one-month contract with a renewal option for an additional month of maintenance services because the customer or Entity A could cancel the agreement upon 30 days' notice without paying a substantive termination payment.

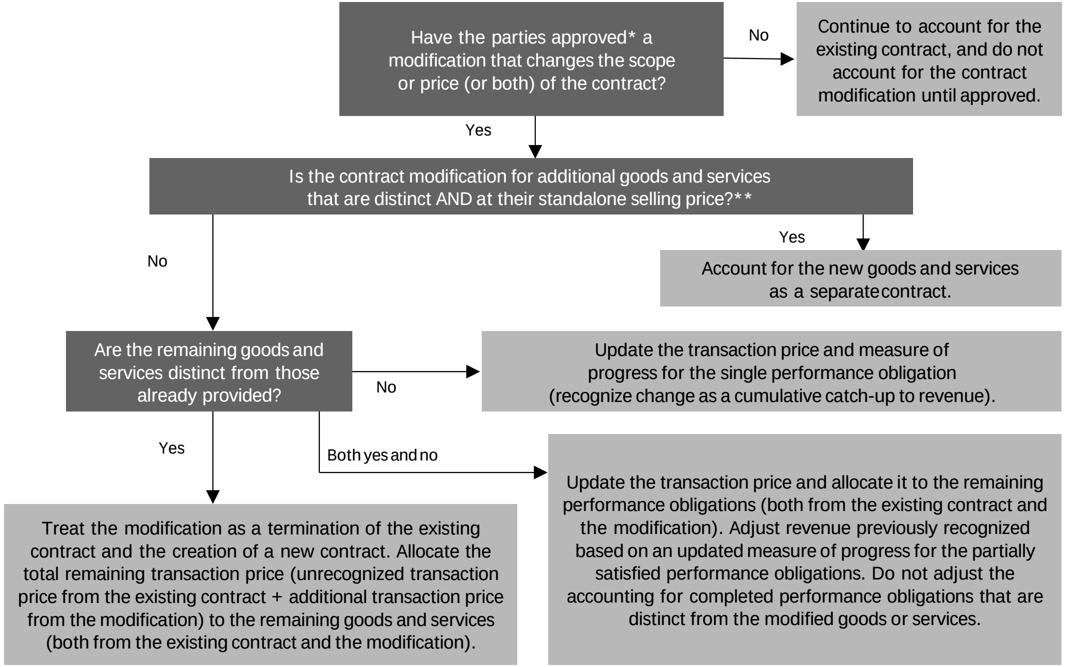
Entity A also would need to evaluate the accounting for the renewal option to determine whether it is a material right.

Combining Contracts

Combine contracts entered into at or near the same time with the same customer when one of these applies

- Negotiated together with single commercial objective
- Consideration to be paid on one contract dependent on price or performance of another
- Goods or services promised are a single performance obligation

Modifications



* Under ASC 606-10-25-10, a contract modification can be approved in writing, by oral agreement or implied by customary business practices. ASC 606-10-25-11 states that an entity may have to account for a contract modification prior to the parties reaching final agreement on changes in scope or pricing (or both), provided that the rights and obligations that are created or changed by a modification are enforceable.

** Under ASC 606-10-25-12, an entity may make appropriate adjustments to the standalone selling price to reflect the circumstances of the contract and still meet the criteria to account for the modification as a separate contract.

Principal Vs. Agent

- More than one party involved in providing goods or services to a customer, then an entity must determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer.
- **Principal** and therefore records revenue on a **gross** basis if it controls a promised good or service before transferring that good or service to the customer.
- **Agent** and records as revenue the **net** amount it retains for its agency services if its role is to arrange for another entity to provide the goods or services.

Principal Vs. Agent

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Is more than one party involved in providing goods or services to a customer?

Yes

Identify the specified goods or services to be provided to the customer.

No

No principal/agent evaluation.

For each specified good or service, does the entity control it before it is transferred to the customer? As part of this analysis, entities are required to consider the definition of control in ASC 606-10-25-25 and, as additional support, may find it helpful to consider the indicators in ASC 606-10-55-39.

Indicators

If it is unclear whether the entity controls a specified good or service after consideration of the definition of control in ASC 606-10-25-25, consider the following indicators from ASC 606-10-55-39:

- The entity is primarily responsible for fulfillment and acceptability.
- The entity has inventory risk before or after transfer to the customer.
- The entity has discretion in setting the price.

Yes

Recognize revenue gross as the principal for the specified good or service.

No

Recognize revenue net as the agent for the specified good or service.

Risks – Perf Obligations

Performance Obligations	Risks
Identifying goods and services	Distinct goods and services or combinations of goods and services provided are not appropriately identified
Identifying performance obligations	Distinct or combined performance obligations are not appropriately identified
Service-type warranties	Warranties designed in a way that establish a performance obligation are not identified; such as ability to purchase a separate warranty or services attached to the warranty assurance
Options granting a material right	Options to purchase or receive an additional goods or services that provide a right to receive something else for free or at a substantial discount are not identified as separate performance obligations
Shipping goods to customers	Shipping and handling services are not appropriately identified as a performance obligation when control transfers to the customer before shipment (policy election related to fulfillment cost)

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Distinct

A promised good or service is distinct, requiring them to be established as separate performance obligations, when both of these criteria are met:

- The customer can benefit from the good or service either on its own or together with other resources that are readily available.
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Separately Identifiable

Separately identifiable refers to the concept ‘distinct in the context of the contract’.

Determine whether the nature of the promise is to transfer them individually or as a combined item. Factors indicating not separately identifiable:

- Goods or services are inputs to produce or deliver the combined promised outputs.
- One or more of the goods or services significantly modifies or customizes another.
- Goods or services are highly interdependent or interrelated (will not operate as designed without each other).

Case Study #2 – Obligations

Q: Contractor enters into a contract to build a house for a new homeowner. Contractor is responsible for the overall management of the project and identifies various goods and services that are provided, including architectural design, site preparation, construction of the home, plumbing and electrical services, and finish carpentry. Contractor regularly sells these goods and services individually to customers.

How many performance obligations are in the contract?

Case Study #2 - Obligations

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A: The goods or services are distinct, but not separately identifiable from other promises in the contract. Contractor's overall promise in the contract is to transfer a combined item (the house) to which the individual goods or services are inputs. This conclusion is supported by the fact that Contractor provides a significant service of integrating the various goods and services into the home that the homeowner has contracted to purchase.

Series Guidance

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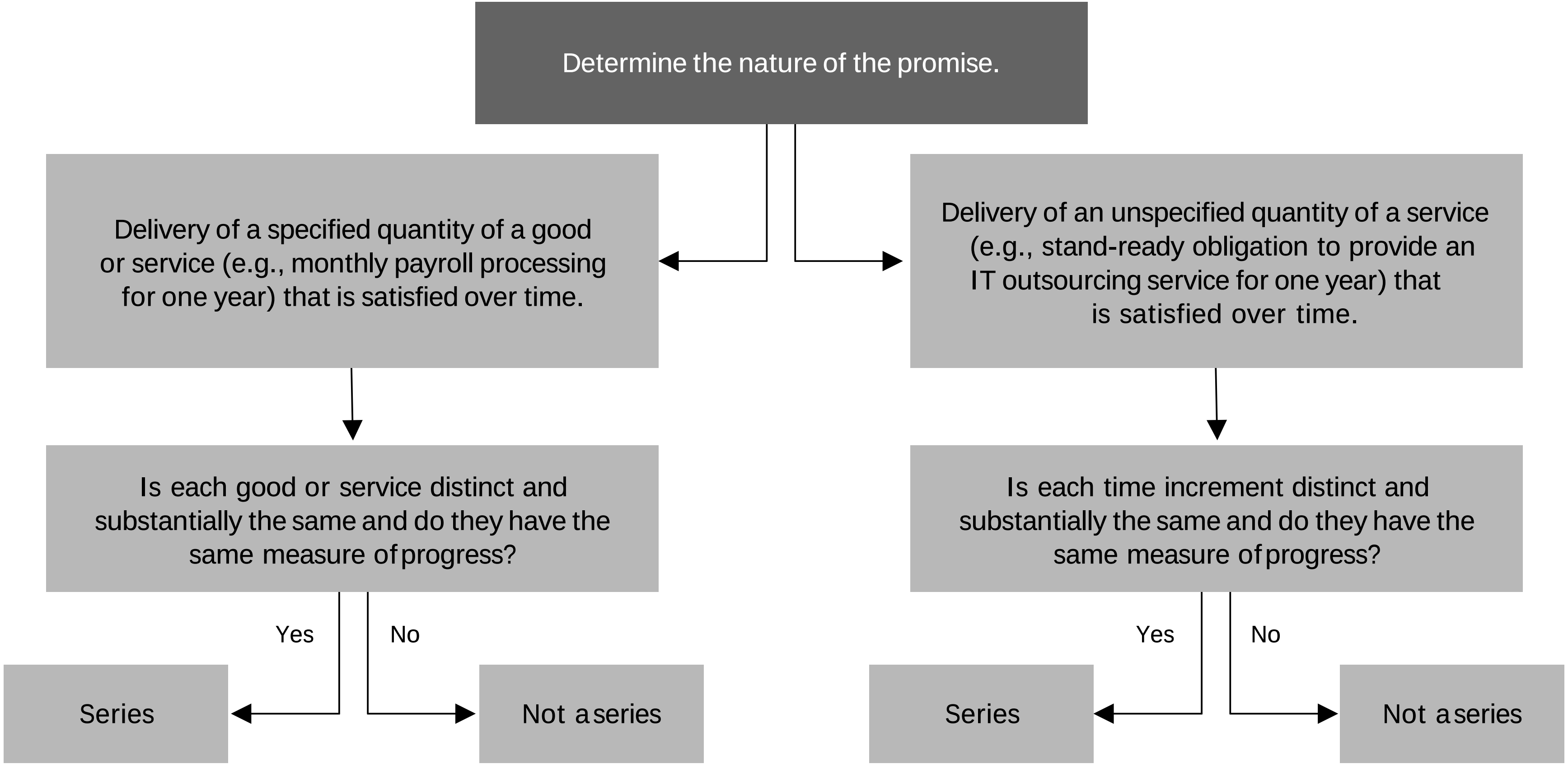
- Series Provision - A promise to transfer to the customer a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer, if both of the following criteria are met:
  - Each distinct good or service in the series that the entity promises to transfer represents a performance obligation that would be satisfied over time if it were accounted for separately.
  - 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.
- If a series of distinct goods or services meets the criteria in the series provision, an entity is **required** to treat that series as a single performance obligation (i.e., it is not optional guidance).

Series Guidance



Case Study #3 – Series

Q: Entity C enters into a 10-year IT outsourcing arrangement in which Entity C continuously delivers the outsourced activities over the contract term (e.g., server capacity, manages the customer's software, runs IT help desk). The total monthly invoice is calculated based on different units consumed for the respective activities, and the Entity C concludes that the customer simultaneously receives and consumes the benefits provided by its services as it performs (meeting over-time criterion).

Case Study #3 – Series

*A: Entity C first considers the nature of its promise to the customer. Because Entity C has promised to provide an **unspecified quantity of activities**, rather than a defined number of services, Entity C could reasonably conclude that the nature of **the promise is an obligation to stand ready** to provide the integrated outsourcing service each day. If the nature of the promise is the overall IT outsourcing service, each day of service could be considered distinct because the customer can benefit from each day of service on its own and each day is separately identifiable. Entity C could reasonably conclude that each day of service is substantially the same. That is, **even if the individual activities** that comprise the performance obligation **vary from day to day, the nature of the overall promise is the same from day to day**.*

*Accordingly, it would be reasonable for an entity to conclude that this **contract meets the series provision.***

Transaction Price

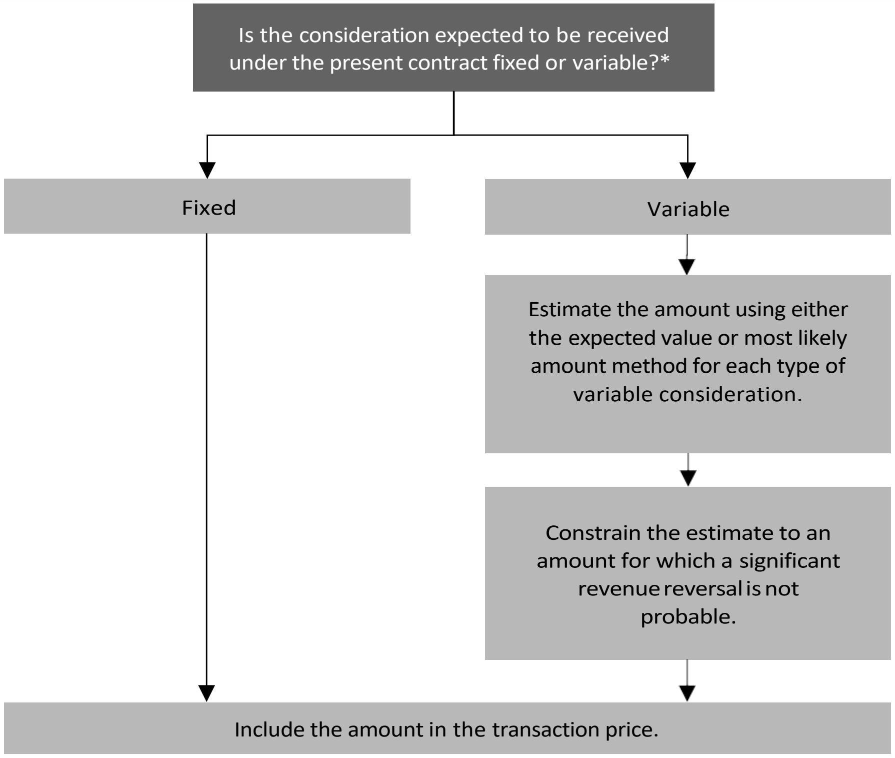
Transaction Price Definition from ASC 606-10-32-2:

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 (for example, some sales taxes). The consideration promised in a contract with a customer may include* ***fixed*** *amounts,* ***variable*** *amounts, or both.*

Risks – Transaction Price

Transaction Price	Risks
Base transaction price	Transaction price is inadequately estimated above or below actual entitled consideration
Variable consideration (bonuses, returns, rebates)	Estimated transaction price does not consider variable consideration drivers such as price concessions, volume discounts, rebates, refunds, credits, incentives, performance bonuses and royalties
Constraint	Failure to adequately consider that constraint of variable consideration, meaning not enough is known about the variable consideration to be able to conclude it is probable a reversal of revenue will not occur
Significant financing components	Failure to include significant timing differences in payment terms in transaction price (more than one year) or improper estimate of financing component impact through estimate of timing or discount rate
Non-cash consideration	Transaction price estimate does not appropriately consider the value of non-cash consideration at contract inception
Payments to customers	Payments made to customers are not appropriately considered in establishing the estimated transaction price
Changes in transaction price	Transaction price estimate is not appropriately revised as facts and circumstances evolve

Transaction Price



* Consideration expected to be received under the contract can be variable even when the stated price in the contract is fixed. This is because the entity may be entitled to consideration only upon the occurrence or nonoccurrence of a future event.

Variable Consideration

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- If the consideration promised in a contract includes a variable amount, an entity shall **estimate the amount of consideration to which the entity will be entitled** in exchange for transferring the promised goods or services to a customer.
- Cause of variability: discounts, rebates, refunds, returns, credits, price concessions, incentives, performance bonuses, penalties, or other similar items.
- Also variable if an entity's entitlement to the consideration is contingent on the occurrence or nonoccurrence of a future event. An amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

Case Study #4 – Variable Consideration

Q: Entity D enters into a contract with a customer on January 1, 20X8, to sell Product A for $100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to $90 per unit. Consequently, the consideration in the contract is variable. For the first quarter ended March 31, 20X8, Entity D sells 75 units of Product A to the customer. Entity D estimates that the customer's purchases will not exceed the 1,000-unit threshold required for the volume discount in the calendar year.

Case Study #4 – Variable Consideration

A: Entity D considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration, including the factors in paragraph 606-10-32-12. Entity D determines that it has significant experience with this product and with the purchasing pattern of the customer. Thus, Entity D concludes that it is probable that a significant reversal in the cumulative amount of revenue recognized (that is, $100 per unit) will not occur when the uncertainty is resolved (that is, when the total amount of purchases is known). Consequently, the entity recognizes revenue of $7,500 (75 units × $100 per unit) for the quarter ended March 31, 20X8.

Case Study #4 – Variable Consideration

Q: In May 20X8, Entity D's customer acquires another company and in the second quarter ended June 30, 20X8, sells an additional 500 units of Product A to the customer. In light of the new fact, Entity D estimates that the customer's purchases will exceed the 1,000-unit threshold for the calendar year and, therefore, it will be required to retrospectively reduce the price per unit to $90.

Case Study #4 – Variable Consideration

A: Consequently, Entity D recognizes revenue of $44,250 for the quarter ended June 30, 20X8. That amount is calculated from $45,000 for the sale of 500 units (500 units × $90 per unit) less the change in transaction price of $750 (75 units × $10 price reduction) for the reduction of revenue relating to units sold for the quarter ended March 31, 20X8 (see paragraphs 606-10-32-42 through 32-43).

Allocation

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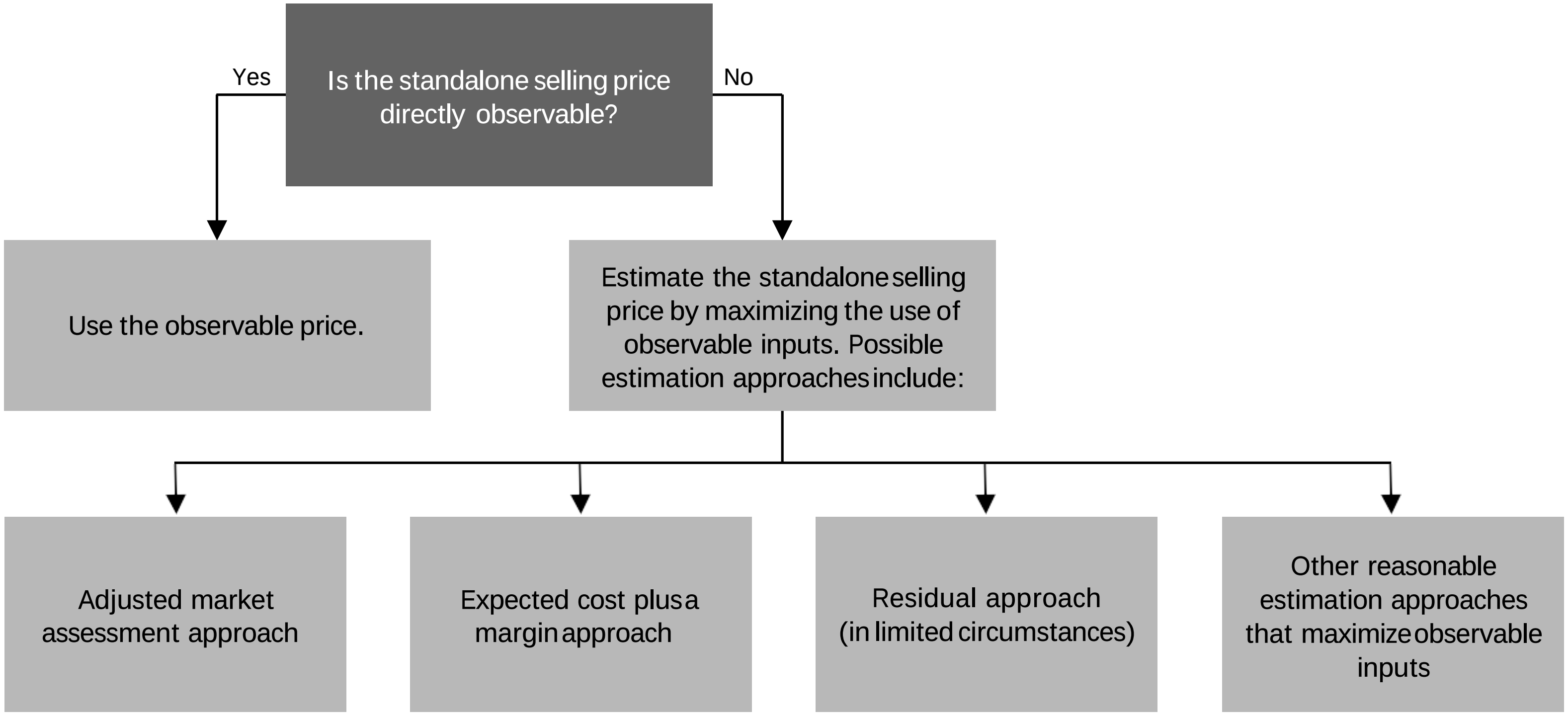
Allocation from ASC 606-10-32-31:

To allocate the transaction price to each performance obligation on a relative standalone selling price basis, an entity shall determine the standalone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those standalone selling prices.

Risks – Allocation

Allocation	Risks
Determining stand-alone selling price	Relative stand-alone selling prices are not adequately established to allocate the transaction price and goods or services with no stand-alone pricing are not sufficiently documented to establish the estimated stand-along selling price
Allocating attributable variable consideration	Inappropriate allocation of variable consideration to performance obligations or failure to consider allocation of variable consideration to specific performance obligations
Allocating attributable discount	Inappropriate allocation of discounts to performance obligations or failure to consider the applicability of discounts to specific performance obligations

Allocation


Is the standalone selling price directly observable?
Yes
No
Use the observable price.
Estimate the standalone selling price by maximizing the use of observable inputs. Possible estimation approaches include:
Adjusted market assessment approach
Expected cost plus a margin approach
Residual approach (in limited circumstances)
Other reasonable estimation approaches that maximize observable inputs

Recognition Timing

Recognition from ASC 606-10-25-23:

An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. ***An asset is transferred when (or as) the customer obtains control of that asset.***

Risks – Recognition

Recognition Timing	Recognition Timing
Transfer of control: point in time or over time	Failure to appropriately identify whether control transfers to the customer at a point in time or over time
Measures of progress over time	When recognizing revenue over time the method of recognizing progress toward satisfaction of a performance obligation is inadequate to depict the transfer of control of the goods or services

Transfer of Control

- A customer obtains control of a good or service if it has the ability to:
  - Direct the use of the good or service
  - Obtain substantially all of the remaining benefits from that good or service
- Directing the use
  - a customer’s right to deploy that asset,
  - allow another entity to deploy it,
  - or restrict another entity from using it.
- An asset’s benefits are the potential cash inflows (or reduced cash outflows) that can be obtained in various ways.

Point in Time Recognition

- A performance obligation is satisfied at a point in time if none of the criteria for satisfying a performance obligation over time are met.
- In addition, the revenue standard provides five <u>indicators</u> (not criteria) that a customer has obtained control of an asset:
  - The entity has a present right to payment.
  - The customer has legal title.
  - The customer has physical possession.
  - The customer has the significant risks and rewards of ownership.
  - The customer has accepted the asset.

Over Time Recognition

Over Time Criteria from ASC 606-10-25-27:

- *The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (e.g. services)*
- *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 (e.g. construction)*
- *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 (e.g. customized asset)*

Disclosures

Disclosures about contracts with customers	Disclosures about significant judgments and estimates	Other required disclosures	Interim-only disclosures
Disaggregation of revenue into categories (segment)	Description of significant judgments such as when control passes for obligations satisfied at a point in time *	Practical expedients	ASC 270, *Interim Reporting*
Information about contract balances	Transaction price, stand alone selling price, allocation methods, and assumptions	Contract costs	IAS 34, *Interim Financial Reporting*
Remaining performance obligations	Variable consideration with separate discussion of each significant type and evaluation of reversal	Roll forward of contract assets and liabilities	
Information about performance obligations, including when they are satisfied ^			
Payment terms, refund, return, warranty, and similar provisions	Judgements made to determine amount of costs to obtain contract		

* Disclosure not required for interim reporting

^ IAS 34 was only amended to require disaggregated revenue information; none of the other annual disclosures will be required in interim financial statements for IFRS preparers.

Questions?

Jody Allred
Partner – Risk Advisory Services
Jody.Allred@Weaver.com
817.882.7750

Chad Valentine
Partner - Audit
Chad.Valentine@Weaver.com
432.570.3138