Auditing the Application of the New Revenue Recognition Standard

FSA Consortium
Deloitte University

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Agenda

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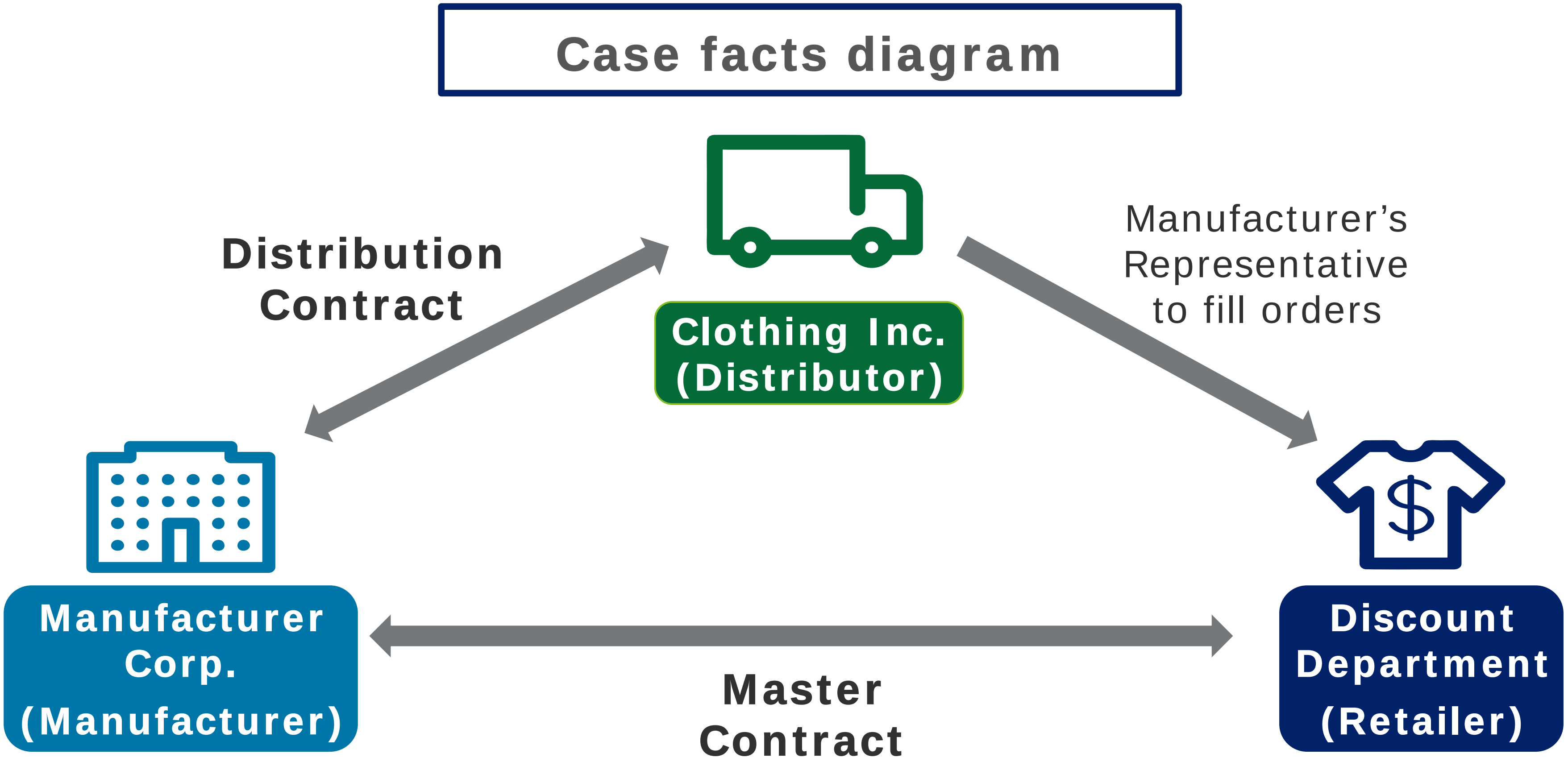
Introduction and overview

Principal versus agent considerations

Principal versus agent case example



Activity: Principal versus agent – part 1

Task	
Task 1	• Read the case study facts in Part 1 of **Handout 1**
Task 2	Answer the following questions: 1. What is a possible risk of material misstatement ("RoMM") applicable to transactions that involve principal versus agent considerations within the case study? 2. What substantive procedures would you perform to address the RoMM?

You have 10 minutes to complete this activity.

Principal versus agent audit considerations

What is a possible RoMM applicable to transactions that involve principal vs. agent considerations?

Possible RoMM

Management inappropriately concludes on the accounting of whether the entity is acting as the principal or the agent in its contracts with customers resulting in revenue being recorded at an inaccurate amount.

What substantive procedures would be performed?

Principal versus agent audit considerations (cont.)

Possible RoMM:
"Management inappropriately concludes on the accounting of principal versus agent in its arrangement with Retailer resulting in revenue being recorded at an inaccurate amount."

Substantive solution summary

- **Inspect, review,** and **evaluate** entity's accounting policies in accordance with ASC 606. **Understand** the key assumptions used to determine whether the entity is the principal or agent in its contracts with customers.
- **Obtain** and **inspect** contract terms and conditions and **evaluate** against policy.
- **Review** contract terms and **evaluate** the key assumptions (e.g., indicators).
- **Obtain** evidence for key assumptions including evaluating potential contradictory evidence and evidence obtained for other audit procedures.

Principal versus agent audit considerations

Possible RoMM

Management inappropriately concludes on the accounting of whether the entity is acting as the principal or the agent in its contracts with customers resulting in revenue being recorded at an inaccurate amount.

What specific review activities are performed by the Controller?

Control

The accounting for all distributor arrangements is reviewed and approved by the Controller.

Principal versus agent audit considerations (cont.)

Control

The accounting for all distributor arrangements is reviewed and approved by the Controller.

Specific Activities Performed by Reviewer

- **Determine** all relevant terms have been identified
- **Evaluate** the appropriate accounting against policy
- **Conclude** on the appropriateness of accounting conclusions
- **Approve** the appropriate accounting for each contract

Over time versus point in time recognition

Over time versus point in time recognition – example

Customer enters into contract

$6,000,000

Sailboat Company

April 1, 20X6

Estimated cost to complete contract = $4,000,000

- Ownership transfers to Customer once construction is complete
- Customer has design requirements that would require significant rework to sell to another customer
- If Customer cancels contract, Sailboat Company is entitled to reimbursement of costs + 25% margin for work completed to date
- Sailboat Company will not be reimbursed for materials purchased to fulfill contract but not yet used

Over time versus point in time recognition – accounting guidance

ASC 606-10-25-27 requires that revenue be recognized <u>over time</u> if any of the following three criteria are met:

(a) The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

(b) The entity's performance creates or enhances a customer-controlled asset.

(c) The entity's performance does not create an asset with an <u>alternative use</u> to the entity, and the entity has an <u>enforceable right to payment</u> for performance completed to date.

Over time versus point in time recognition – accounting guidance (cont.)

Criterion (c) 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.

Is there an alternative use?

Met. The sailboat being constructed by the Company will only transfer to the Customer once the construction of the entire sailboat is complete. Further, the sailboat has no alternative use to the Company because the Customer has various design requirements that would require significant rework to be performed should the sailboat be transferred to another customer. Remember that when evaluating whether an asset has an alternative use, entities should consider whether the asset in its completed state has an alternative use, not whether the partially completed asset has an alternative use.

Over time versus point in time recognition – accounting guidance (cont.)

Is there an enforceable right to payment?

Met. The terms of the contract require the Customer to reimburse the Company for the costs of work completed to date plus a 25% margin, which is considered to be reasonable. Remember that a “reasonable margin” does not necessarily need to be the selling price for the completed good, but rather just the amount that is reasonable based on the entity’s performance to date under the contract.

Therefore, does the performance obligation meet any of the criteria for recognition of revenue over time?

Over time versus point in time recognition – solution

The performance obligation to construct the sailboat <u>meets</u> the criterion in ASC 606-10-25-27(c).

Therefore, revenue should be recognized <u>over time</u>.

The determination of whether a performance obligation is satisfied at a point in time or over time **can significantly impact the timing of revenue recognition**. Additionally, depending on the payment terms in the contract, the timing of revenue recognition as compared to the payment terms **could result in a significant financing component**.

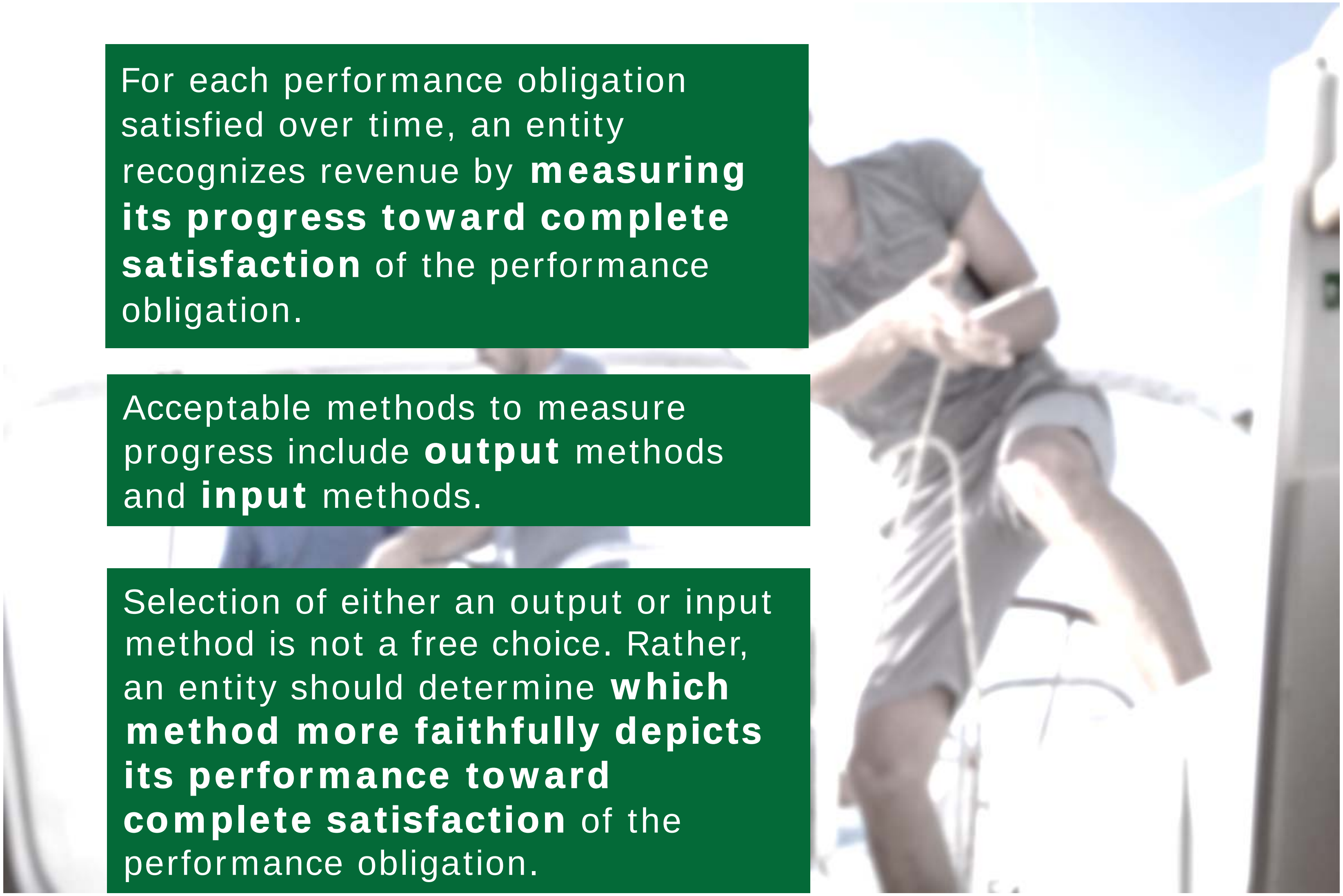
Over time versus point in time recognition – additional facts

Three months ended	Quarterly component parts purchased	Component parts remaining in inventory as of quarter end	Quarterly component parts integrated in project	Quarterly costs to integrate component parts
June 30, 20X6	$300,000	$100,000	$200,000	$50,000
September 30, 20X6	$2,000,000	$1,300,000	$800,000	$200,000
December 31, 20X6	$1,700,000	$0	$3,000,000	$750,000

- **As of September 30, 20X6, the Company revised its total cost estimate from $4,000,000 to $5,000,000**
- **As of December 31, 20X6, the construction project was completed**
- **All of the component parts purchased by the company are generic**

How should the Company recognize revenue for the:
- **Three months ended June 30, 20X6?**
- **Three months ended September 30, 20X6?**
- **Three months ended December 31, 20X6?**

Over time versus point in time recognition – accounting guidance



For each performance obligation satisfied over time, an entity recognizes revenue by **measuring its progress toward complete satisfaction** of the performance obligation.

Acceptable methods to measure progress include **output** methods and **input** methods.

Selection of either an output or input method is not a free choice. Rather, an entity should determine **which method more faithfully depicts its performance toward complete satisfaction** of the performance obligation.

Over time versus point in time recognition – example solution

Three months ended June 30, 20X6

- **Project revenue: $6,000,000**
- **Expected total costs: $4,000,000**
- **Purchases: $300,000**
- **Direct costs incurred: <u>$50,000</u>**
- **Component parts integrated into project: <u>$200,000</u>**

Total costs

$200,000 + $50,000 = $250,000

Period revenue

($250,000 / $4,000,000) * $6,000,000 = <u>$375,000</u>

Over time versus point in time recognition – example solution (cont.)

Three months ended September 30, 20X6

- **Project revenue: $6,000,000**
- **Expected total costs (revised): $5,000,000**
- **Purchases: $2,300,000 ($2,000,000 additional in 3 mos)**
- **Direct costs incurred: <u>$250,000</u> ($200,000 additional in 3 mos)**
- **Component parts integrated into project: <u>$1,000,000</u> ($800,000 additional in 3 mos)**

Total costs

$250,000 + $1,000,000 = $1,250,000

Cumulative (YTD) revenue

($1,250,000 / $5,000,000) * $6,000,000 = $1,500,000

Period revenue

$1,500,000 - $375,000 = <u>$1,125,000</u>

From previous slide

Over time versus point in time recognition – example solution (cont.)

Three months ended December 31, 20X6

- **Project revenue: $6,000,000**
- **Total costs: $5,000,000**
- **Purchases: $4,000,000 ($1,700,000 additional in 3 mos)**
- **Direct costs incurred: <u>$1,000,000</u> ($750,000 additional in 3 mos)**
- **Component parts integrated into project: <u>$4,000,000</u> ($3,000,000 additional in 3 mos)**

Total costs

$1,000,000 + $4,000,000 = $5,000,000

Cumulative (YTD) revenue

($5,000,000 / $5,000,000) * $6,000,000 = $6,000,000

Period revenue

$6,000,000 - $1,500,000 = <u>$4,500,000</u>

From previous slide

Over time versus point in time recognition – RoMM

What is a possible RoMM applicable to over time versus point in time revenue recognition?

Possible RoMM

For performance obligations that are satisfied over time, revenue is not recognized in the correct period or at the correct amount because the method used by the entity to measure progress or faithfully depict the entity's performance is not applied appropriately (i.e., the measurement of inputs or outputs is not accurate or complete).

What's an example control that might address this RoMM?

Over time versus point in time recognition – control example

Possible RoMM

For performance obligations that are satisfied over time, revenue is not recognized in the correct period or at the correct amount because the method used by the entity to measure progress or faithfully depict the entity's performance is not applied appropriately (i.e., the measurement of inputs or outputs is not accurate or complete).

Control

The accounting for the contract is reviewed and approved by the Controller.

What specific review activities are performed by the Controller?

Over time versus point in time recognition – specific review activities

Control

The accounting for the contract is reviewed and approved by the Controller.

Specific Activities Performed by Reviewer

- The Controller **evaluates** whether the appropriate accounting conclusions were reached as to whether performance obligations are recognized at a point in time or over time.
- For performance obligations recognized over time, the Controller **evaluates** whether the selected method to measure progress (inputs and outputs) faithfully depicts the progress of the contract.
- The Controller **recalculates** the inputs and outputs expected to date relative to the estimated total expected inputs and outputs for the contract.
- Revenue to be recognized from this evaluation is **reviewed** by management prior to the journal entry being posted.

Note: likely there is some information used in the control (e.g., detail of total costs incurred to date) for which controls will need to be identified.

Over time versus point in time recognition – control example

Possible RoMM

For performance obligations that are satisfied over time, revenue is not recognized in the correct period or at the correct amount because the method used by the entity to measure progress or faithfully depict the entity's performance is not applied appropriately (i.e., the measurement of inputs or outputs is not accurate or complete).

What is another control that addresses this RoMM?

What specific review activities are performed by the Controller?

Control

Project costs are estimated at the time of inception of a new contract based on the product specifications as requested by the customer. On a quarterly basis, the Controller performs a budget to actual analysis to update the estimate to complete for remaining costs of the project based on work completed to date. Adjustments to the overall budget are made as needed and reviewed and approved by the CFO prior to the journal entry being posted.

Over time versus point in time recognition – steps of the review

Control

Project costs are estimated at the time of inception of a new contract based on the product specifications as requested by the customer. On a quarterly basis, the Controller performs a budget to actual analysis to update the estimate to complete for remaining costs of the project based on work completed to date. Adjustments to the overall budget are made as needed and reviewed and approved by the CFO prior to the journal entry being posted.

Specific Activities Performed by Reviewer

- **Review the analysis** of costs incurred to date relative to total costs for the contract by recalculating the inputs and agreeing total costs incurred to supporting documents.
- **Review the budget-to-actual analysis** to determine if an adjustment to the expected costs of the contract is needed for the quarter.

Over time versus point in time recognition – substantive procedures

What substantive procedures would be performed?

Possible RoMM

For performance obligations that are satisfied over time, revenue is not recognized in the correct period or at the correct amount because the method used by the entity to measure progress or faithfully depict the entity's performance is not applied appropriately (i.e., the measurement of inputs or outputs is not accurate or complete).

Substantive solution summary

- **Determine the accounting** for recognizing revenue based on the contract terms.
- **Obtain evidence** outside of the contract to support the accounting conclusions.
- **Evaluate** management's method used to measure the progress.
- **Test** the accuracy and completeness of the inputs used in the method to measure progress.

Examples of SEC Comment Letters

You disclose you recognize revenue over time using an input measure (e.g., costs incurred to date relative to total estimated costs at completion). Revise to disclose why this method is a faithful depiction of the transfer of goods or services pursuant to ASC 606-10-50-18(b).

We note that you recognize revenue at a point in time for the manufacture of business-jet aircraft in your Aerospace group, which is generally when the customer accepts the fully outfitted aircraft. Please tell us, and revise to disclose, what significant judgments were evaluated in determining that this was the appropriate point to recognize revenue. Refer to ASC 606-10-25-30 and 606-10-50-19. In addition, please provide us with your analysis regarding whether revenue for your business-jet aircraft should be recognized over time in accordance with ASC 606-10-25-2 through 29. In this regard, please specifically address your consideration of customer deposits and customer specific specifications.

Source: https://www.sec.gov/Archives/edgar/data/40533/000119312517278933/filename1.htm

Licenses of intellectual property

Case facts overview

Case Facts

- On 1/1/X1 creators of a TV show enter into **2-year arrangement** with Network JKL (cable TV network).
- Network JKL is granted an **exclusive license** to historical content that exists at contract inception and new content (i.e., one future season), which will be made available at the beginning of the second year of the contract term (i.e., 1/1/X2).
- Upon inception Network JKL obtains **airing rights** to the show & historical content transferred.
- Once the new content is made available at 1/1/X2, Network JKL may **ONLY** air the new content.
- Network JKL will televise **one episode** of the show **each weekday**.

Accounting guidance

Does the content associated with the TV show represent **functional intellectual property** or **symbolic intellectual property**?

Functional intellectual property

Intellectual property that has **significant stand-alone functionality**. Significant stand-alone functionality can be demonstrated through the ability to process a transaction, perform a function or task, or be played or aired.

Symbolic intellectual property

Intellectual property that does **NOT** have **significant stand-alone functionality**. Substantially all of the utility of this type of intellectual property is derived from its association with the entity's past or ongoing activities.

Accounting analysis

Does the content associated with the TV show represent **functional intellectual property** or **symbolic intellectual property**?

Solution

The historical and new content associated with the TV show represent <u>FUNCTIONAL INTELLECTUAL PROPERTY</u> due to the contents' significant stand-alone functionality.

Analysis

- The licensed intellectual property (the historical & new TV show content) has **significant stand-alone functionality** separate from the TV creator's **ongoing activities** of producing the future season of the TV show and promoting the TV show.
- Although such **additional activities** may be important to attracting viewers, the TV show can be aired without the TV show creator's further involvement.

Auditing considerations – nature of intellectual property

Possible RoMM

The **intellectual property "IP"** in license agreements within contracts with customers is **inappropriately identified** as symbolic IP or functional IP causing revenue to be recognized at the incorrect amount in the incorrect period.

Substantive solution summary

- **Understand** the terms of the contract and compare to the definitions of IP under U.S. GAAP.
- **Evaluate** the utility of each of the elements of the arrangement considering evidence obtained from outside the contract and any contradictory evidence (e.g., details on the entity's website, communications with the customer, other customer agreements, industry customary practices).

Specific activities performed by reviewer

- **Evaluate** the conclusions regarding the stand-alone functionality of licenses to be supportable considering the details of the contract and information outside the contract.
- **Review** and **approve** the accounting for each contract with licenses.

Accounting guidance – identifying performance obligations

- Distinguish between the (1) contrac requiring an entity to transfer cont to use or access intellectual proper provisions that define the attribute license.
- Evaluate separation guidance to est distinct.
  Must meet BOTH of the following criteria
  - Capable of being distinct
  - Distinct within the context of the contract
- Evaluate the indicators of whether a promised good or service is not separately identifiable.

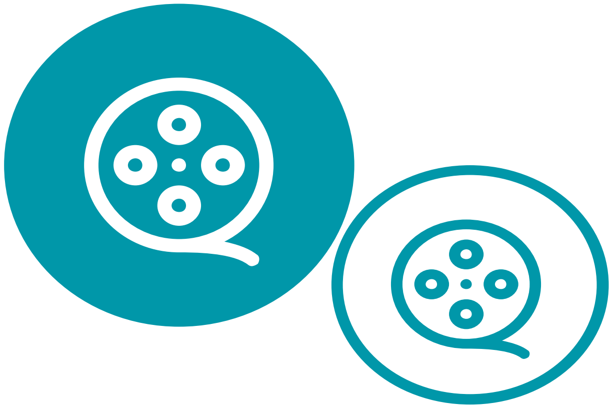
Does the license to use the library of historical content and the future content of the TV show within the two-year term represent a **single** or **multiple performance obligations**?

Accounting analysis – identifying performance obligations

Solution

The arrangement between Network JKL & TV Show creators consists of MULTIPLE PERFORMANCE OBLIGATIONS:

- **The right to use the library of historical content.**
- **The right to use the library of future content.**



Auditing considerations – identifying performance obligations

Possible RoMM

All **promised goods** or **services** are **not** properly **identified** in the contract or **inappropriately combined** with other promised goods or services, causing performance obligations to be inaccurately identified.

Substantive solution summary

- **Identify** explicit or implicit promised goods or services in the contract.
- **Determine** if the promises are capable of being distinct and distinct within the context of the contract based on accounting literature.
- **Review** published policies, other contracts, and competitors' published policies to identify additional performance obligations.

Specific activities performed by reviewer

- **Evaluate** the license within the contract to determine if it has significant stand-alone functionality and, if so, is appropriately accounted for as "right to use".
- **Review** and **approve** the accounting for each contract with licenses.

Additional case facts

Additional Case Facts

- In exchange for granting license, Network JKL pays creator a **royalty of $1 per viewer per airing** of the show (both historical and new content.)
- Contract has a **minimum guarantee of $100M / year** for each of the 2 years.
- Assume Network JKL **had 500,000 viewers per airing** in each year of the contract term.
- **New content** is made available to Network JKL on **1 / 1 / X2**.
- Assume that the **stand-alone selling price** of the **historical content** and **new content** is the **same** (i.e., the transaction price should be allocated equally to each performance obligation).

Remember! Only the new content is aired once it's made available

Accounting guidance – sales- or usage-based royalties

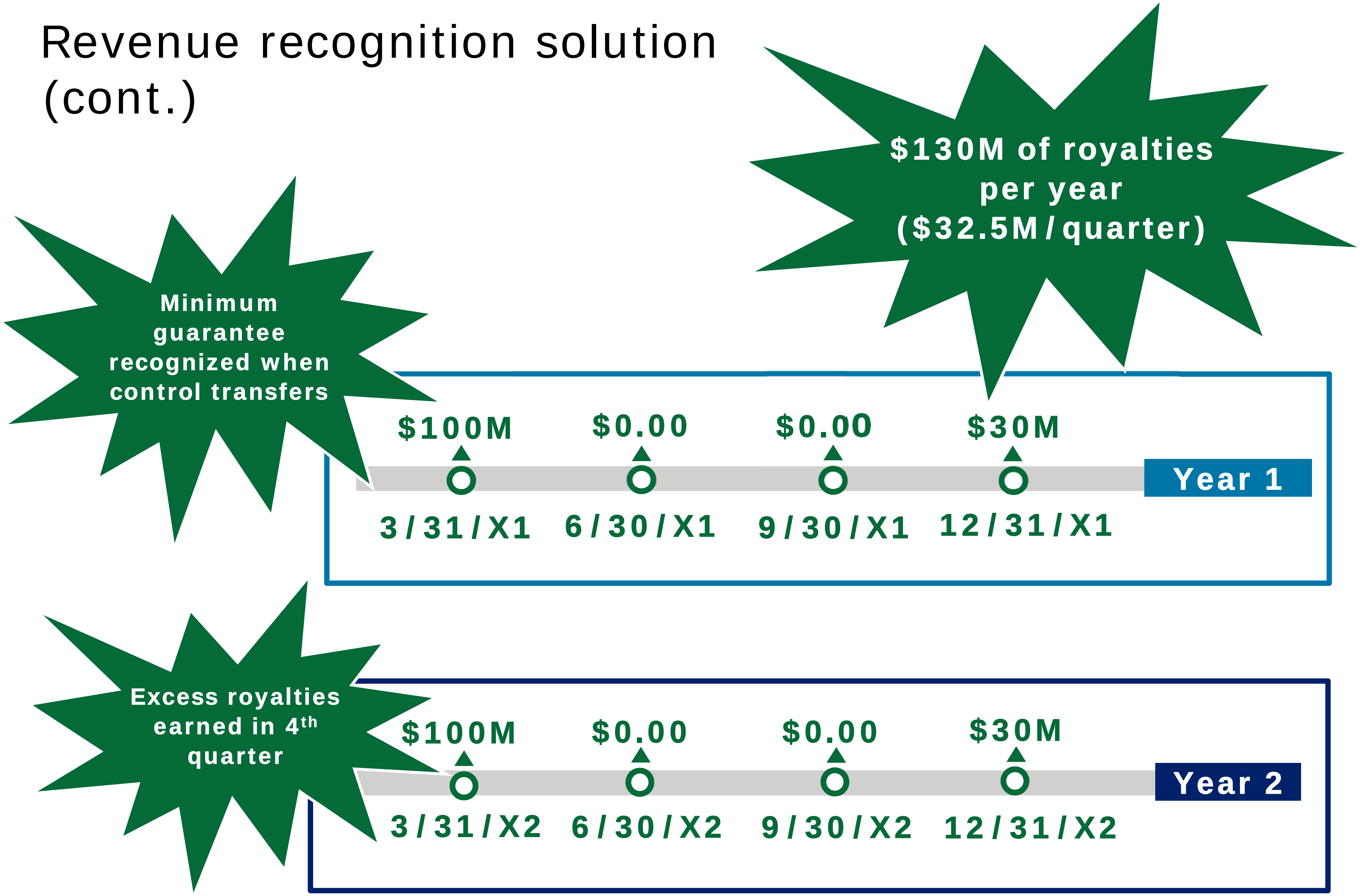
- Recognize revenue when the later of the following events occurs:
  - The subsequent sale or usage occ…urs.
  - The associated perforr… …en satisfied.

- Consider guid… …es of functional i…
  - Point i… …license to the cu…
  - Recogn… …itee as the subseq… …tual property occurs.

- DO NOT recogniz… …tinct good or service until
  - The entity provides the distinct licens… …makes the license available) to the customer, AND
  - The customer is able to use and benefit …m the distinct license.

How should the TV show creator recognize revenue for the **minimum guarantee** and **excess royalties** received from Network JKL?

Revenue recognition solution (cont.)



Auditing considerations – sales- or usage-based royalties

Possible RoMM

Licensing arrangements when the entity receives consideration from a customer in the form of a sales- or usage-based royalty are **recorded** at the **incorrect amount** or at the **incorrect time**.

Substantive solution summary

- **Obtain** audit evidence to test the amount of consideration received and the period it was recorded.
- **Recalculate** the amount of consideration to be received based on the royalty clause in the contract agreement including consideration of any minimum guarantees promised in the contract.

Specific activities performed by reviewer

Review license agreements **to evaluate** whether the determination is appropriate that consideration received under the contract is in the form of a sales- or usage-based royalty, and if so, the license is accounted for as such an arrangement.


Questions?