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ASC 606 Revenue Recognition:
The standard and implementation observations

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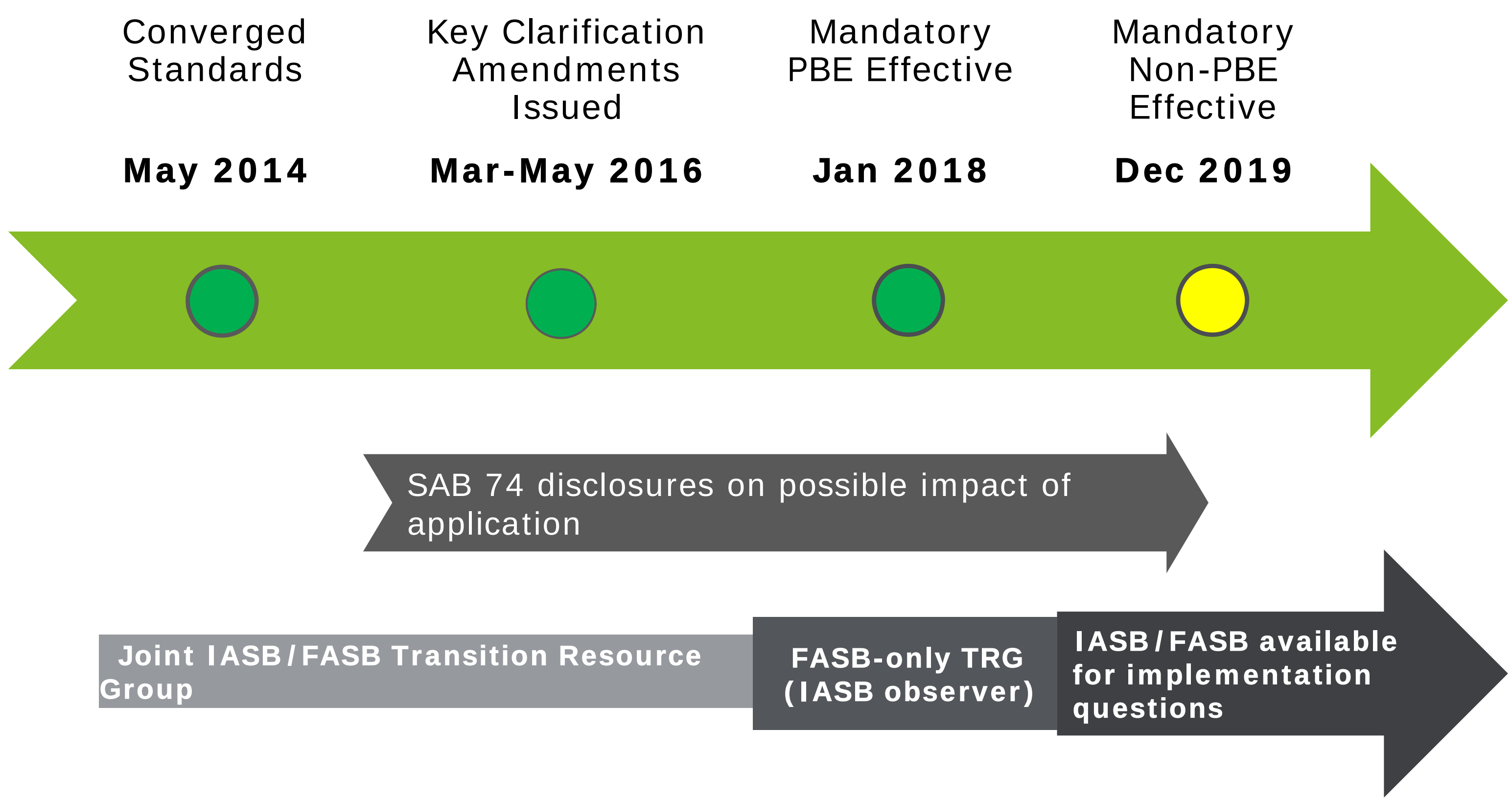
Revenue from Contracts with Customers (ASC 606)

Agenda

Section
Introduction
Revenue recognition overview
The five step model
Incremental costs to obtain a contract
Principal versus agent considerations

Revenue recognition overview

Revenue Timeline



Source: FASB

New revenue guidance
Scope

Applies to an entity's contracts with customers

Does not apply to:

- Lease contracts (ASC 840, ASC 842)
- Contracts within the scope of the insurance guidance in 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

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

Effective date and transition

Effective date*	
US Public entities & all IFRS entities **Fiscal periods beginning after December 15, 2017 (FY'18), including interim periods therein**	**US Private entities** **Fiscal periods beginning after December 15, 2018 (FY'19), including interim periods thereafter**

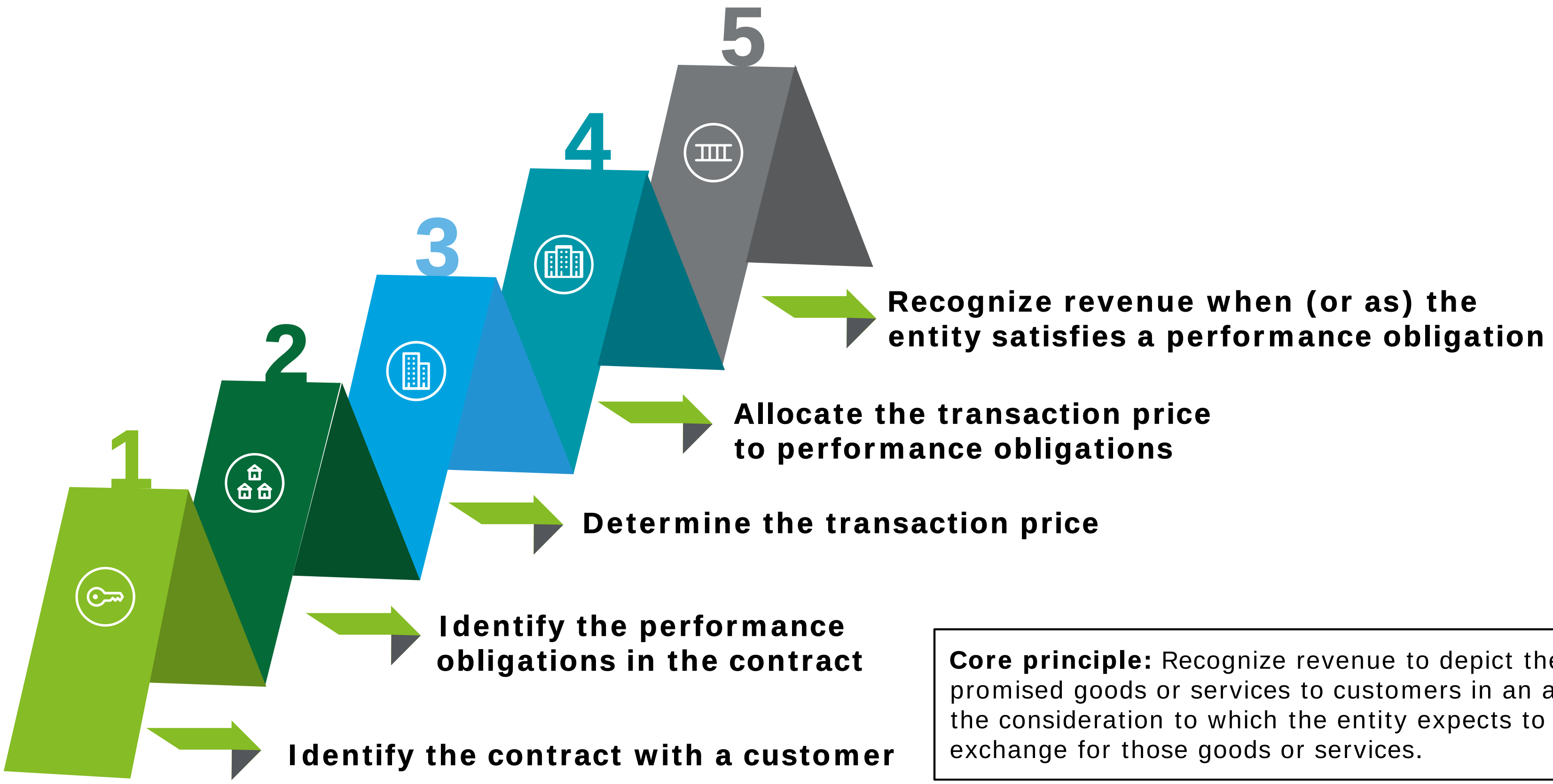
***Early adoption was permitted (FY'2017)**

Transition methods:

- Full retrospective approach (restate prior periods)
- Modified retrospective approach (cumulative catchup adjustment)

The five step model

The five-step model



Core principle: Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Step 1: Identifying the contract

Step 1 | Step 2 | Step 3 | Step 4 | Step 5

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
- 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

A contract will not be in the scope if:

- The contract is wholly unperformed

and

- Each party can unilaterally terminate the contract without compensation

Collectibility threshold

Exercise: Step 1

Facts

- Entity X licenses intellectual property (IP) to Customer Y in exchange for a usage-based royalty. At contract inception, January 1, 20X8, the contract meets all the criteria in paragraph 606-10-25-1 and the entity recognizes revenue when the customer's subsequent usage occurs in accordance with paragraph 606-10-55-65.
- Entity X collects royalties quarterly and collected the first and second quarter royalties within the agreed-upon period.
- In July 20X8 the Customer Y's industry is disrupted by a new product that significantly reduces the popularity of the Customer Y's product. Customer Y continues to use the license. However, during the third quarter, Customer Y was only able to pay $5 million of the total $10 million royalties due. For the fourth quarter, Entity X collected no payments on the $8 million fourth quarter royalties due from Customer Y.
- In January 20X9 Entity X learns that Customer Y has lost access to credit and its major customers and thus Customer Y's ability to pay significantly deteriorates.

Question

- When (if ever) is Entity X required to reassess the collectibility of the consideration due from the customer in accordance with the criteria in ASC 606-10-25-1?
- If Entity X determines that the collectability of the consideration due from the customer is no longer probable, how should Entity X account for revenue previously recognized under the contract? How Should Entity X account for future amounts collected?

Step 2: Identifying performance obligations

Step 1 | Step 2 | Step 3 | Step 4 | Step 5

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**

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 THE CONTRACT

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

YES

Account for as a performance obligation

NO

Combine two or more promised goods or services and reevaluate

Performance obligations
Points to consider

- Repetitive services that have the same pattern of transfer (series guidance)
- Discounts for future goods or services (material rights)
- Immaterial promises
- Warranty-type arrangements

Step 3: Determining transaction price

Step 1 | Step 2 | Step 3 | Step 4 | Step 5

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
  - 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

Transaction price does NOT include…

- Effects of customer credit risk

Exercise: Step 3

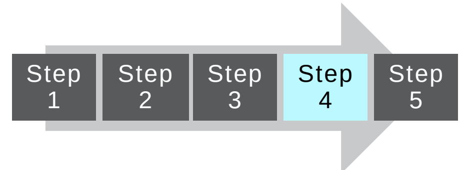
Facts

- On 1/1/X8, Entity C enters into a contract with a customer to provide asset management services for five years.
- C receives a 2 percent quarterly management fee based on the client's assets under management at the end of each quarter. In addition, the C receives a performance-based incentive fee of 20 percent of the fund's return in excess of the return of an observable market index over the 5-year period.
- C accounts for the services as a single performance obligation because it is providing a series of distinct services that are substantially the same and have the same pattern of transfer.

Question

- At contract inception, what potential factors should Entity C consider when estimating (and potentially constraining) the amount of variable consideration to be included in the transaction price of its contract with this customer?
- Should Entity C subsequently adjust its initial estimate of variable consideration after contract inception?

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

Exercise: Step 4

Facts

- Entity A enters into a contract to sell License A, Service B, and Service C for $70.
- Entity A has concluded that each good/service is a distinct performance obligation with the following stand-alone selling prices:
  - License A: $40 (no observable sales)
  - Service B: $25 (observable sales)
  - Service C: $20 (observable sales)
- Entity A regularly sells License A and Service B in a bundle for $50 (i.e., Entity A regularly provides a $15 discount when bundling License A and Service B, as compared to selling them separately).

Question

- How should Entity A allocate the $70 contract price to the performance obligations in the contract?

Exercise: Step 4

Facts

- Stand-alone selling prices:
  - License A: $40 (no observable sales)
  - Service B: $25 (observable sales)
  - Service C: $20 (observable sales)
- Entity A regularly sells License A and Service B in a bundle for $50

How should Entity A allocate the $70 contract price to the performance obligations in the contract?

In this scenario, there is no incremental discount for providing Service C under the contract as opposed to bundling License A and Service B without Service C, as illustrated below:

$ 65	SSP of A and B individually	$ 85	SSP of A, B and C individually
$ 50	Observe price of Bundle A+B	$ 70	Contract price of purchase A, B and C
$ 15	Discount for purchasing bundle A+B	$ 15	Discount for purchasing A, B, and C together

$ - Incremental Discount for purchasing C (in addition to Bundle A+B)

Because the $15 discount in this contract is equal to the regular discount provided for a bundle of License A and Service B, the discount should be attributed entirely to the bundle (i.e., License A and Service B) and not to Service C. This will result in $50 being allocated to the bundle of License A and Service B. If necessary, then $50 of consideration (inclusive of the discount of $15) should be allocated between License A and Service B based on their respective relative stand-alone selling prices (i.e., $30.77 to License A and $19.23 to Service B). The remaining $20 of the transaction price will be allocated to Service C.

Step 5: Recognizing revenue

Step 1 | Step 2 | Step 3 | Step 4 | Step 5

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:

606-10-25-27(a) The customer receives and consumes the benefit as the entity performs (e.g., cleaning service)

or

606-10-25-27(b) Performance creates or enhances a customer controlled asset (e.g., home addition)

or

606-10-25-27(c) Performance does not create an asset with an **alternative use** and the entity has an **enforceable right to payment** for performance completed to date

Measure progress toward completion using input/output methods

Step 5: Recognizing revenue

Revenue recognition over time

606-10-25-27(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.

- Analysis of this criteria involves a two-part assessment:
  1. Alternative use
     - Contractual restrictions (must be substantive), **or** practical restrictions
     - Generally applicable to customized and/or specialized assets
  2. Enforceable right to payment
     - Cost incurred **and** reasonable profit margin (not necessarily full profit margin if contract were fulfilled as promised)
     - Can exist through contractual terms or legislative conditions
       - **Example:** Except as otherwise provided in this Agreement, in the event this Agreement is terminated for a reason other than the Company's bankruptcy, insolvency or dissolution, the Customer shall pay the actual costs to date for direct labor and materials plus ten percent to cover indirect fees, overhead and profit.

Incremental costs to obtain a contract

Incremental costs to obtain a contract

ASC 340-40-25-1 An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.

- "Incremental costs" are those costs that would not be incurred if the contract was not obtained.
  - Common example: Sales commissions
  - One way to analyze – Would the cost have been incurred if the customer (or the entity) decided that it would not enter into the contract just as the parties were about to the sign the contract?
- Practical expedient to expense as incurred if amortization period is one year or less
- Capitalization is not a policy election (i.e., if costs meet capitalization criteria and practical expedient does not apply, capitalization is required)

Exercise: Costs to obtain a contract

Facts

Entity A incurs the following costs related to a new contract with a customer obtained by Salesperson B:

1. $7,000 in commissions to Salesperson B upon contract signing
2. $3,000 in commissions to Salesperson B one year after contract signing, if he/she is still employed with A
3. $3,000 in commissions to Salesperson B's **manager** upon contract signing
4. $200 in 401(k) matching related to commissions paid to Salesperson B and his/her manager upon contract signing
5. $1,000 in legal fees to draft the contract
6. $500 in expenses for Salesperson B to travel to the customer's location to execute the contract

Question

1. Which costs should be capitalized as incremental costs to obtain a contract?

Principal versus agent considerations

Principal-versus-agent considerations
Application of the control principle

An entity that is a principal obtains control of any one of the following:

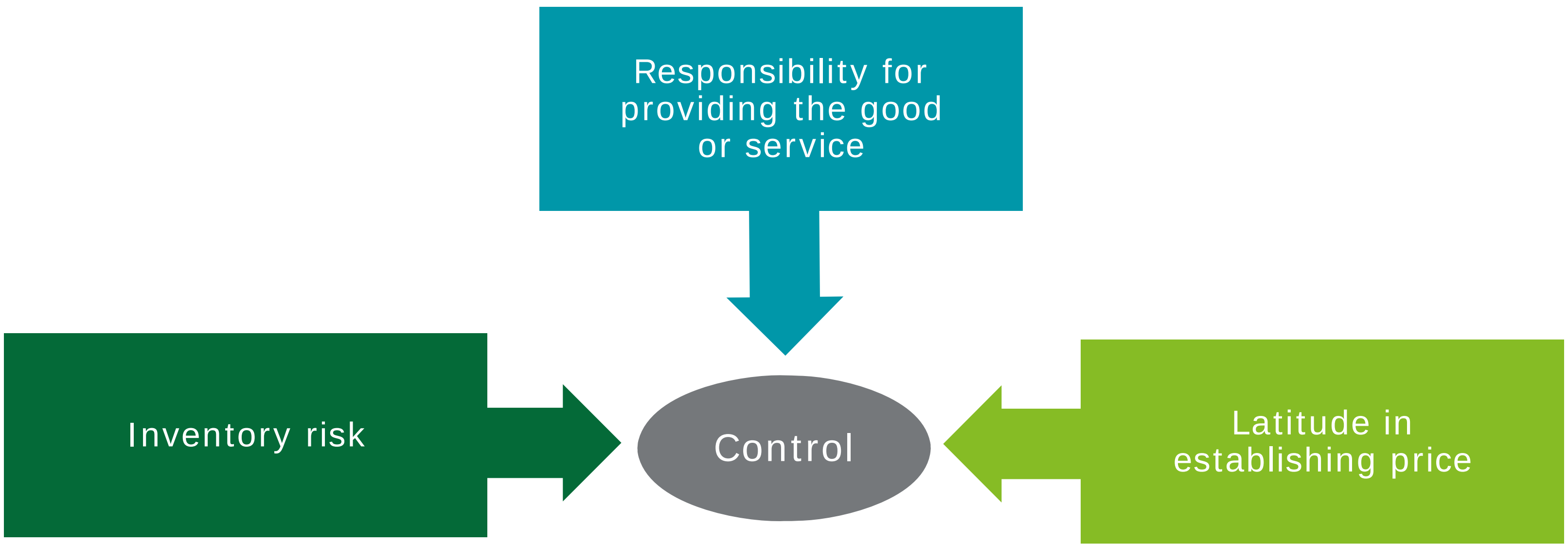
a. A good or another asset that it then transfers to the customer

b. A right to service to be performed by a third party, which gives it the ability to direct the third party to provide the service on the entity's behalf

c. A good or service from the other party that it then integrates with other goods or services in providing the specified good or service to the customer

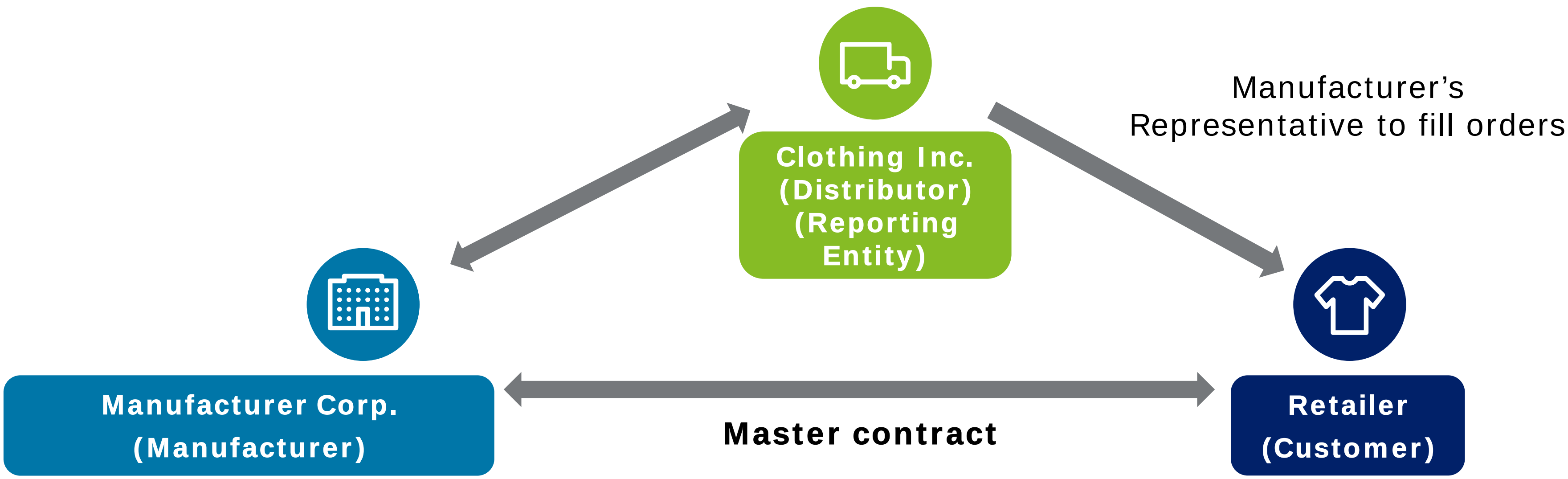
Principal-versus-agent considerations

Application of the control principle



Exercise: Principal versus agent

Question: Is Clothing Inc. the principal or the agent?



Potential Points to Consider
- Who handles product issues that the Retailer raises?
- Who has front-end and back-end inventory risk?
- Who determines the price that the Retailer pays?

Questions?