

Revenue Recognition Under ASU 2014-09

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Agenda

- Key topics
- Current and future state of affairs
- Scope
- Core principle and key steps
- Other
- Presentation and disclosure

Key Topics

Key Topics

- **Overall model** is based on transferring control instead of transferring risks and rewards of ownership
- **Collectability** assessment is different and the revenue recognition model used when collectability is not probable could result in delayed revenue recognition (even with respect to nonrefundable cash received)
- **Multiple-element arrangements** are subject to the following new requirements:
 - For separation purposes, must apply incremental criterion focused on whether a promised good or service is separately identifiable from other promised goods or services in the contract
 - For allocation purposes, must allocate discounts and (or) variable consideration to less than all performance obligations in certain circumstances
- **Warranties** are evaluated to determine if they represent a performance obligation to which revenue is allocated
- **Variable consideration** may be recognized earlier in certain circumstances

Key Topics

- **Significant financing component** guidance is applied to both deferred and advance payments, which may result in the recognition of interest income (deferred payment) or interest expense (advanced payment)
- **Recognition of revenue over time or at a point in time** (i.e., whether control of a performance obligation's promised goods or services transfers over time or at a point in time) depends on whether one or more of three specific criteria are met
- **Balance sheet presentation** requires separate recognition of contract liabilities, accounts receivable and contract assets
- **Disclosure requirements** are significant and likely involve tracking (and disclosing) a variety of information not historically tracked or disclosed
- **Costs related to customer contracts** (e.g., costs to obtain or fulfill a customer contract) must be capitalized in certain circumstances

Current and Future State of Affairs

Effective date

Effective date of ASC 606	Calendar year end entities	June 30 year end entities
Public entities*, quarter and year beginning...	January 1, 2018	July 1, 2018
Other entities, year ending...	December 31, 2019	June 30, 2020
Early adoption of ASC 606		
Allowed for both public entities and other entities...	As early as January 1, 2017	As early as July 1, 2017

* Public entities include PBEs, not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and (c) employee benefit plans that file or furnish financial statements to the SEC.

Current and future state of affairs

- Final standards issued by FASB in May 2014
 - ASU 2014-09, Revenue from Contracts with Customers (Topic 606)
- Many changes made since issuance (clarifying changes)
 - FASB
 - Issued four final ASUs
 - More changes made than IASB
- FASB has two proposed ASUs outstanding
 - Technical corrections and improvements – to be issued Dec. 2016
 - Clarifying guidance on derecognizing nonfinancial assets - topic 610 not 606

Current and future state of affairs

Any more changes on the horizon?

- FASB's Transition Resource Group (TRG) is still meeting (**in place, but no open issues**)
- AICPA's industry-specific initiatives – **slow progress**
 - Sixteen industry task forces
 - Meeting regularly to identify and provide guidance on implementation issues
 - Objective is to help develop a revenue recognition guide
 - Many issues are out for exposure

Current and future state of affairs

AICPA Task Forces

- Aerospace and defense
- Airlines
- Asset management
- Broker-dealers
- Construction contractors
- Depository institutions
- Gaming
- Health care
- Hospitality
- Insurance
- Not-for-profit
- Oil and gas
- Power and utility
- Software
- Telecommunications
- Timeshare

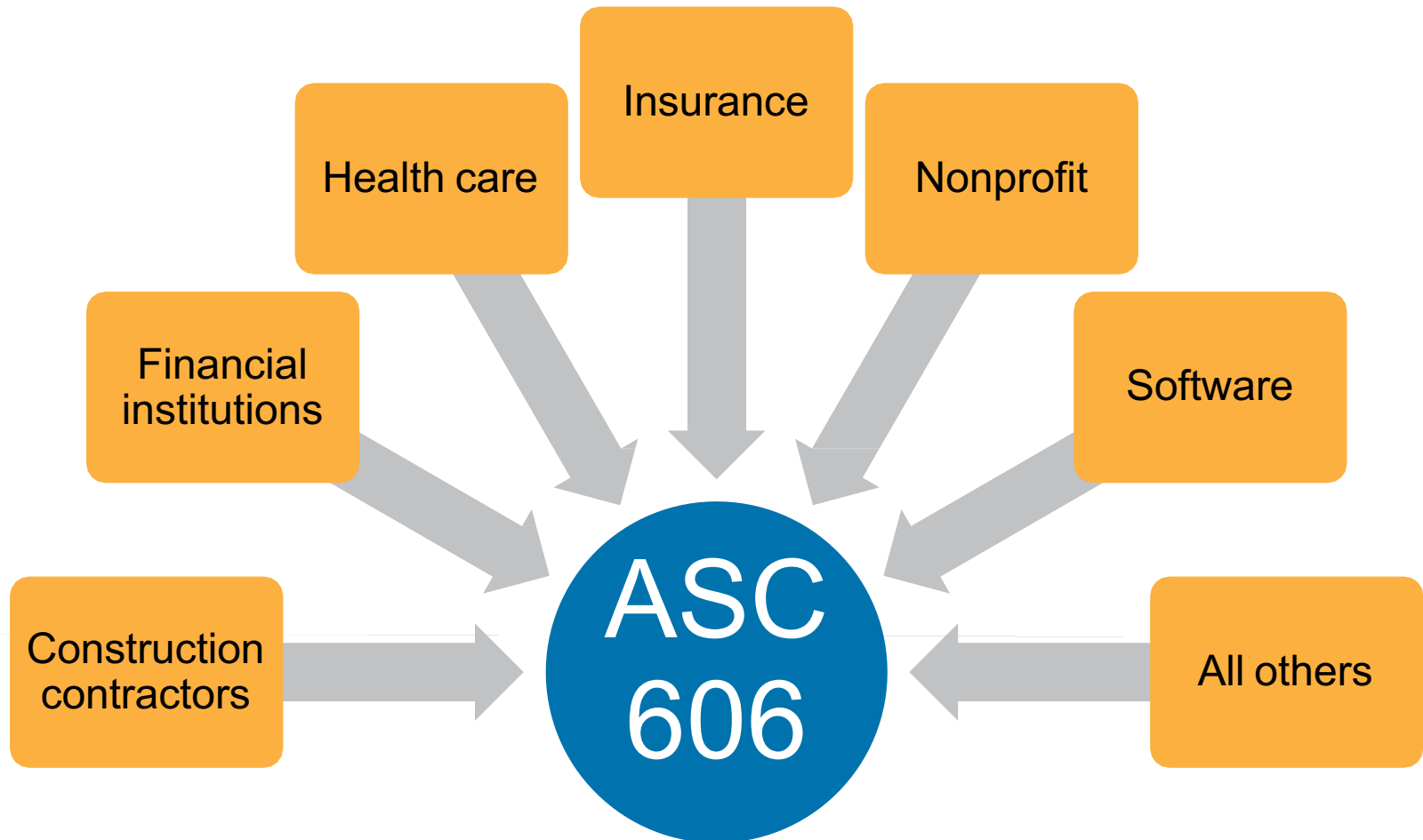
Scope

Scope

- All revenue-generating contracts with customers are within the scope of ASC 606, except for:
 - Leases
 - Contracts within the scope of ASC 944 (insurance)
 - Various contractual rights or obligations related to financial instruments
 - Guarantees other than warranties
 - Certain nonmonetary exchanges

Scope

No industries are scoped out of ASC 606!



Scope

Definition of a 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.

Core Principles and Key Steps

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.

Key steps



Step 1

Identify the Contract with a Customer

Identify the contract with a customer

- Does a customer contract exist?
 - Defined as an agreement between two or more parties that creates enforceable rights and obligations
 - Whether rights and obligations are enforceable is a matter of law
 - Can be written, oral or implied based on the entity's usual business practices

Identify the contract with a customer

- Contracts entered into at or near the same time with the same customer should be combined if any of the following criteria are met:
 - The contracts were negotiated as a package and share the same commercial objective
 - The consideration to be paid under one contract is tied to the other contract's price or performance
 - The contracts include goods and (or) services that represent a single performance obligation
- **Practical expedient:** ASC 606 may be applied to a portfolio of contracts if doing so is not reasonably expected to result in a materially different outcome
 - **Consistent with existing GAAP**
 - **Example**

Identify the contract with a customer

Example: A telecommunications company offers various combinations of handsets and usage plans to its customers under two-year noncancellable contracts.

- It offers two handset models:
 - an older model that it offers free of charge (Stand-alone selling price is \$250)
 - most recent model, which offers additional features and functionalities and for which the entity charges \$200 (stand-alone selling price is \$500)
- The entity also offers two usage plans:
 - a 400-minute (\$40 per month)
 - 800-minute plan (\$60 per month)

Identify the contract with a customer

	Product Usage	Total Transaction Price	Revenue on Handset* (% of Total Contract Revenue)	Revenue on Usage (% of Total Contract Revenue)
Customer A	Old handset, 400 minutes	\$ 960	\$198 (21%)	\$762 (\$79%)
Customer B	Old handset, 800 minutes	\$1,440	\$213 (15%)	\$1,227 (85%)
Customer C	New handset, 400 minutes	\$1,160	\$397 (34%)	\$763 (66%)
Customer D	New handset, 800 minutes	\$1,640	\$423 (26%)	\$1,217 (74%)

* In this example, the proportion of the total transaction price allocated to the handset revenue is determined by comparing the stand-alone selling price for the handset to the total of the stand-alone selling prices of the components of the contract.

Identify the contract with a customer

- The following contract existence criteria must be met to account for a contract using ASC 606's revenue model
 - Commercial substance exists (i.e., the contract is expected to change the risk, timing or amount of the entity's future cash flows)
 - Approvals have been obtained and a commitment to perform exists on the part of both parties
 - Rights of both parties are identifiable
 - Payment terms are identifiable
 - Collection of the amount to which the entity will be entitled is probable (i.e., likely to occur)
- Once met, reassessment of the contract existence criteria is only required if there is a significant change in circumstances

Identify the contract with a customer: Existing GAAP

- Revenue generally is realized or realizable and earned when all of the following criteria are met:
 - Persuasive evidence of an arrangement exists,
 - Delivery has occurred or services have been rendered,
 - The seller's price to the buyer is fixed or determinable, and
 - Collectability is reasonably assured.
- Not overly inconsistent with the new standard
 - Main differences are collectability and variable consideration


Identify the contract with a customer: Assessing collectability

- Focus is on whether it is probable that the customer has the ability and intention to pay **substantially all** of the consideration to which the entity will be entitled in exchange for the promised goods or services that **will be transferred** to the customer
 - Use of “substantially all” instead of “all”
 - Promised goods or services that “will be transferred” may not be all of the promised goods or services in the contract
- Requires judgment and consideration of all facts and circumstances, including contractual terms and the entity’s customary business practices and knowledge of its customer
- Similar to existing GAAP requirements

Identify the contract with a customer: Contract existence criteria are not met

If the customer contract does not meet all of the contract existence criteria:

- Recognize a liability for any consideration received
- Reassess the criteria each reporting period (as necessary) to determine if the criteria are subsequently met
- If the criteria continue not to be met, only recognize revenue upon the occurrence of one of three specific events



It could be some time before revenue is recognized – even for nonrefundable amounts – given the nature of these events

Identify the contract with a customer: Contract existence criteria are not met

When the contract existence criteria are not met, revenue is only recognized when the amounts received by the entity are **nonrefundable** and **one** of the following is true:

- There are no remaining performance obligations and all, or substantially all, amounts promised by the customer have been received
- The contract has been terminated
- The entity has transferred control of the goods or services to which the nonrefundable consideration relates and the entity has stopped transferring additional goods or services to the customer and is under no obligation to transfer any additional goods or services
- **Current GAAP – deposit method**

Step 2

Identify the Performance Obligations in the Contract

Identify the performance obligations in the contract

Identify all of
the promised
goods or
services

Determine if the
promised goods or
services represent
performance
obligations

Performance
obligations
(i.e., units of
account)

Identifying promised goods or services

- Consider both explicit and implicit promises
 - Implicit based on the entity's customary business practices, published policy or specific statement
- Some are obvious, others may not be so obvious
 - **Option to purchase an additional good or service in the future at a discount (example later in presentation)**
 - An implicit when-and-if-available upgrade
- Not all activities performed by the entity in conjunction with the customer contract provide or transfer goods or services to the customer
 - Common example is set-up activities

Immaterial goods or services

Goods or services that are immaterial in the context of the contract do not have to be identified for further evaluation under ASC 606.

- Does not change the requirement to evaluate whether optional goods or services represent a material right to the customer
- **If elected, the entity must accrue the cost of those goods** or services that are immaterial in the context of the contract if revenue related to the contract is recognized before those goods or services are transferred to the customer
- **Example: promise to provide training manuals, simple installation process (plugin)**
- **Materiality discussion**

Shipping and handling activities

Accounting depends on whether shipping and handling activities occur before or after the customer obtains control of the promised goods

- Before (e.g., FOB destination): Fulfillment activities and not promised services
- After (e.g., FOB shipping point): Promised services
 - **Accounting policy election:** Entity may elect to treat the promised services as fulfillment activities (i.e., no further evaluation under ASC 606)
 - If elected, the entity must accrue the costs of the shipping and handling activities when it recognizes revenue under the contract
 - **Materiality discussion**

Determining if promised goods or services are performance obligations

- Is the promised good or service distinct?
 - If so, account for separately as a performance obligation (i.e., unit of account)
 - Series exception: When the promised good or service is part of a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer, the series of distinct goods or services is the performance obligation (**i.e., cleaning services**)
 - If not, combine with other promised goods or services until there is a group that is distinct
- A promised good or service is distinct if it is both:
 - Capable of being distinct
 - Separately identifiable from other promises in the contract (e.g., distinct within the context of the contract)

Capable of being distinct

A promised good or service is capable of being distinct when a customer can benefit from the promised good or service on its own or together with other readily available resources.

— Examples of situations in which a promised good or service is considered capable of being distinct:

- The entity regularly sells the good or service separately
- The customer can sell the good or service on a standalone basis for other than scrap value
- The customer can use the good or service together with a good or service that has already been transferred to it by the entity (e.g., installation service can be used with the equipment that has already been transferred to the customer)
- The customer can use the good or service together with a good or service that is readily available in the marketplace

Separately identifiable from other promises in the contract

Is the nature of the entity's promise within the context of the contract to:

- Transfer the promised good or service individually?
 - If so, the promised good or service is separately identifiable from the other promises in the contract
- Transfer a combined item or items to which the promised good or service is an input?
 - If so, the promised good or service is not separately identifiable from the other promises in the contract
- Additional factors provided to help with this determination

Separately identifiable from other promises in the contract

Indicators that the promised good or service is not separately identifiable from other promises in the contract

- The entity provides a **significant service of integrating** the various promised goods or services included in the contract into one or more combined outputs that were contracted for by the customer
 - The various promised goods or services are inputs to the combined output
 - **Example: construction of a manufacturing plant**
- One or more of the promised goods or services significantly modify or customize one or more of the other promised goods or services in the contract
 - Neither the promised modification/customization service nor the promised good or service to be modified/customized is separately identifiable
 - **Example later**

Separately identifiable from other promises in the contract

Indicators that the promised good or service is not separately identifiable from other promises in the contract

- The promised goods or services are **highly interdependent or highly interrelated** with each other, such that each of the promised goods or services in the contract is significantly affected by one or more other promised goods or services in the contract
- Example: building a house for someone

Identifying performance obligations (Situation 1)

- Software Developer (SD) enters into a contract with Customer under which it will provide the following:
 - Software license
 - Installation services
 - Routine integration of software into Customer's existing platform
 - Unspecified software updates for a two-year period
 - Technical support for a two-year period

Identifying performance obligations (Situation 1)

- SD separately sells the installation services, unspecified software updates and technical support
- Other vendors routinely perform the installation services
- The software remains highly functional without the updates or technical support

Identifying performance obligations (Situation 1)

What performance obligations should SD identify in its contract with Customer?

- A. Single performance obligation made up of all four promised goods or services
- B. Two performance obligations: (1) software and installation services and (2) unspecified updates and technical support
- C. Three performance obligations: (1) software and unspecified updates, (2) installation services and (3) technical support
- D. Four performance obligations: (1) software, (2) installation services, (3) software updates and (4) technical support

Identifying performance obligations (Situation 2)

- Same facts as Situation 1, except for those highlighted in red
- SD enters into a contract with Customer under which it will provide the following:
 - Software license
 - Installation services
 - ~~Routine integration of software into Customer's existing platform~~
 - Substantial customization of the software will be performed by SD to add significant new functionality to enable the software to interface with other customized software applications used by Customer
 - Unspecified software updates for a two-year period
 - Technical support for a two-year period

Identifying performance obligations (Situation 2)

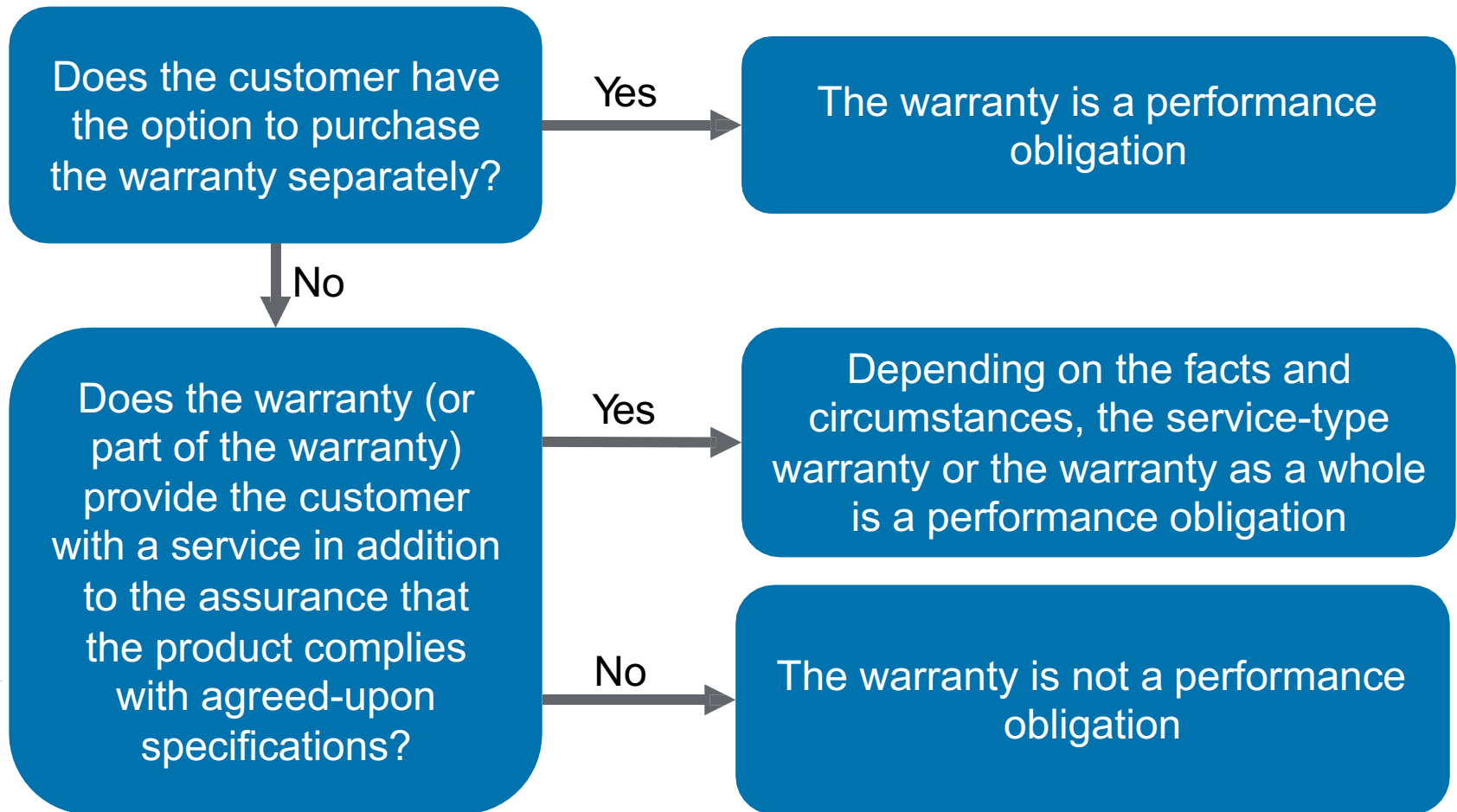
- SD separately sells the installation services, unspecified software updates and technical support
- Other vendors **routinely can** perform the installation services
- The software remains highly functional without the updates or technical support

Identifying performance obligations (Situation 2)

What performance obligations should SD identify in its contract with Customer?

- A. Single performance obligation made up of all four promised goods or services
- B. Two performance obligations: (1) software and installation services and (2) unspecified updates and technical support
- C. Three performance obligations: (1) software and installation services, (2) unspecified updates and (3) technical support
- D. Four performance obligations: (1) software, (2) installation services, (3) software updates and (4) technical support

Warranties



Warranties

In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity should consider factors such as:

- Whether the warranty is required by law - If the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is **not a performance obligation** because such requirements typically exist to protect customers from the risk of purchasing defective products
- The length of the warranty coverage period – **The longer the coverage period, the more likely it is that the promised warranty** is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications
- **Is it more than just assurance against defects?**

Existing GAAP - Warranties

Account for warranty separately as a revenue source only if sold separately

Options for additional goods or services

- Examples include:
 - An option to purchase additional goods or services in the future at a discount
 - Award credits in customer loyalty programs that can be accumulated and used to obtain additional goods or services in the future
 - A contract renewal right that can be exercised in the future

Options for additional goods or services

- An option is a performance obligation for accounting purposes **if it provides a material right to the customer that the customer would not have received without entering into the contract**
 - An option provides a material right if, for example, it provides a discount that is incremental to the range of discounts typically given to others that are similarly situated
 - Determining the standalone selling price of an option that is a performance obligation can be quite difficult
 - **We will discuss how to account for this later**

Step 3

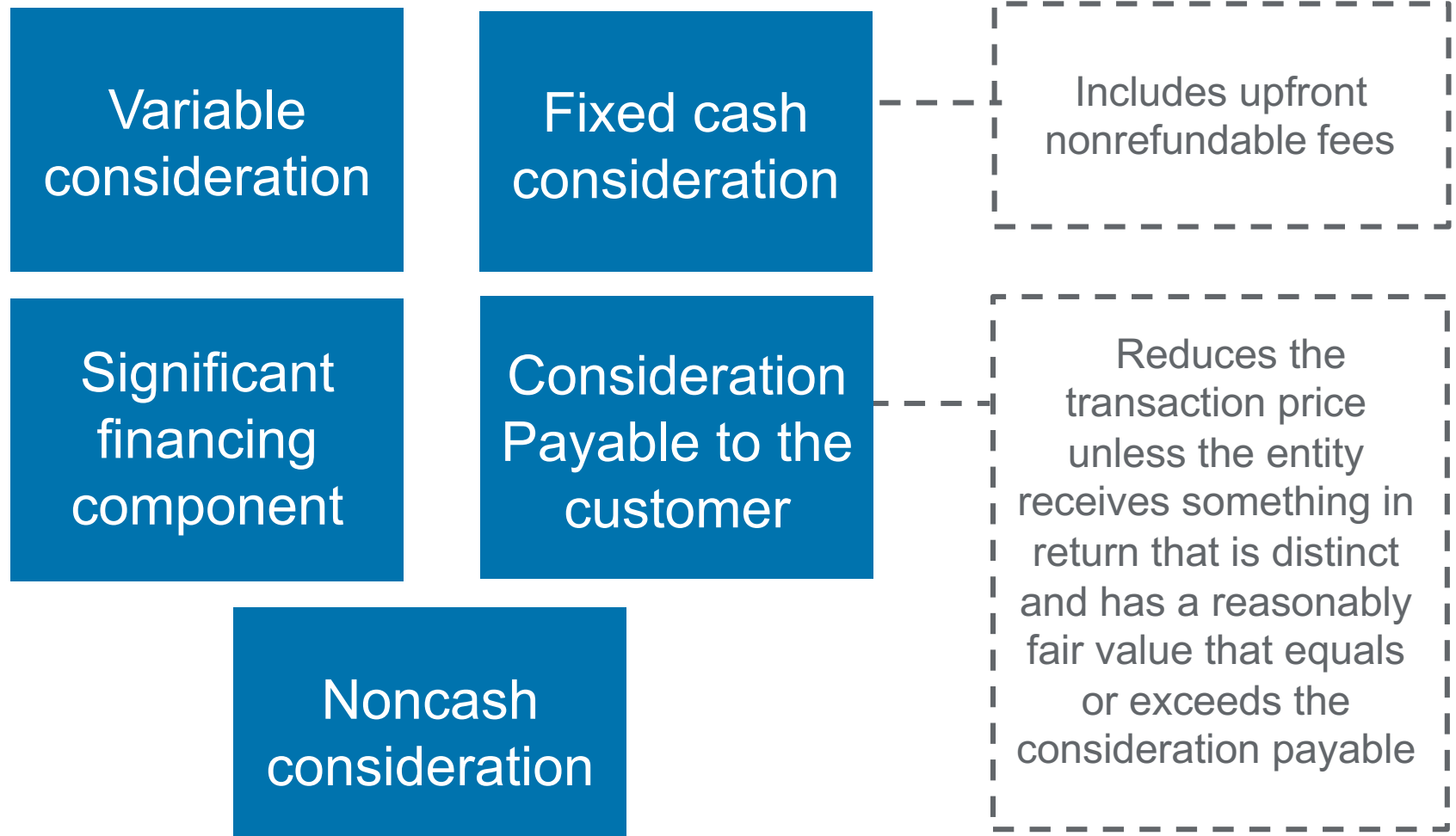
Determine the Transaction Price

Determine the Transaction Price

- 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
 - “Entitled” notion is what results in no consideration being given to the customer’s credit risk
 - Estimate is reassessed each reporting period until all performance obligations have been satisfied
 - **Accounting policy election: An entity may elect to exclude sales and similar taxes collected from customers from the transaction price**
 - If an entity does not make this election, it must apply ASC 606’s principal vs. agent guidance to determine whether such taxes should be included in the transaction price

Determine the Transaction Price

Transaction price may include:



Determining the Transaction Price (Existing GAAP)

Revenue and profit are generally recognized at the time of sale provided that:

- The amount of revenue is measurable, i.e., the collectability of the sales price is reasonably assured or the amount uncollectible can be estimated
- The earning process is complete or virtually complete, i.e., the seller is not obligated to perform significant activities after the sale in order to earn the revenue or if the seller is obligated to perform some activities after the sale, the cost of performing those activities can be estimated on a reasonable basis.

Determining the Transaction Price (Existing GAAP)

Basic Contract Price: Construction Example

- Estimated revenue from a contract is the total amount that a contractor expects to realize from the contract
- Determined primarily by the terms of the contract and basic contract price
- Contract price may be relatively fixed or **highly variable** and subject to a great deal of uncertainty, depending on type of contract
- Total amount of revenue that ultimately will be realized is subject to a variety of changing circumstances and accordingly may not be known with certainty until the parties to the contract have fully performed their obligations
- Determination of total estimated value requires careful consideration and exercise of judgement in assessing the probability of future outcomes

Raytheon's Revenue Recognition Policy

- Revenues, including estimated fees or profits, are recorded as costs are incurred
- Due to the nature or work required to be performed on many of Raytheon's contracts, the estimation of total revenue and cost at completion is complex and subject to many variables
- Incentive and award fees generally awarded at the discretion of the customer or upon achievement of certain program milestones or cost targets
- **Incentive and award fees, as well as penalties related to contract performance, are considered in estimating profit rates**

Variable consideration

- Examples

- Bonuses

- Price concessions

- Refunds

- Milestone payments

- Penalties

- Discounts

- Returns

- Rebates

- Could be explicit or implicit

- Could affect whether consideration is paid at all or the amount of consideration paid

Variable consideration

- Overall accounting model
 - Estimate the amount of consideration the entity expects to be entitled to using whichever one of the following methods better predicts that amount:
 - Expected value method
 - Most likely amount method
 - Include the estimate in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur
- **Referred to as the variable consideration constraint**

Variable consideration

- Expected value method
 - Probability weighting of potential outcomes
- Most likely amount method
 - Determination of which amount within a range of defined amounts is most likely
 - Best suited for variable consideration with limited (e.g., two) outcomes
- Reassess estimate of variable consideration each reporting period until resolved
 - Use the same method used at contract inception

Example: Volume discounts/rebates

- Widget Manufacturer (WM) enters into a contract to sell widgets to Customer for one year
- The pricing of the widgets depends on how many widgets Customer buys during the year
 - 1,000 or fewer widgets = \$100 per widget
 - More than 1,000 widgets = \$90 per widget (including first thousand purchased)

Example: Volume discounts/rebates

- WM estimates the transaction price to be \$100 per widget using the most likely amount method (i.e., it expects Customer to buy fewer than 1,000 widgets)
- WM applies the **variable consideration constraint** to the transaction price of \$100 per widget
 - If it is probable that Customer will buy fewer than 1,000 widgets, then it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur
 - Transaction price remains \$100 per widget
 - If it is less than probable that Customer will buy fewer than 1,000 widgets, then it is not probable that a significant reversal in the amount of cumulative revenue recognized will not occur
 - Transaction price reduced to \$90 per widget
- Not inconsistent with existing GAAP

Example: Variable consideration

- Building Builder (BB) enters into a contract to construct a building for Customer
 - For ease of illustration, assume the contract includes a single performance obligation
- BB commits to turning legal title of the building over to Customer no later than June 30, 20X4
- Customer agrees to pay \$10 million for the building

Example: Variable consideration

To incent BB to turn control of the building over to it sooner, Customer agrees to pay BB an additional \$250,000 for each week before June 30, 20X4 that BB turns control of the building over to Customer; however, the total incentive payment cannot exceed \$500,000.

Example: Variable consideration

Delivery occurs...	Incentive payment	Probability	Probability-weighted average
On June 30th or less than one week before	\$0	20%	\$0
At least one week before, but less than two weeks before, June 30th	\$250,000	20%	50,000
Two weeks or more before June 30th	\$500,000	60%	300,000
Variable consideration estimated using the expected value method			\$350,000
Variable consideration estimated using the most likely amount method			\$500,000

Example: Variable consideration

What is the amount of variable consideration BB should include in the transaction price at contract inception?

- A. \$0
- B. \$250,000
- C. \$350,000
- D. \$500,000

Variable consideration

Include the estimate in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur.

Right of return or refund

- Right of return or refund is treated as variable consideration
 - Must estimate the amount of returns or refunds, likely using the expected value method
 - Does not include product exchanges when they are:
 - For the same type, quality, condition and price
 - Due to defects
- Estimated amount of returns or refunds:
 - Reduces transaction price
 - Recorded as a refund liability

Right of return or refund

- For product sales, recognize:
 - An asset for the right to returned inventory
 - Former carrying amount of the product less the expected costs to recover those products (includes expected decreases in the value of the returned product)
 - A corresponding adjustment to cost of sales for estimated returns

Example: Right of return

- Retailer sells 1,000 sweaters at a price of \$200 each
 - For ease of illustration, assume the customers pay in cash
- Retailer allows its customers to return merchandise for any reason within 60 days and receive a cash refund
- Using the variable consideration guidance, Retailer estimates that \$20,000 of the \$200,000 collected for the sweaters will be refunded (i.e., 100 of the sweaters are expected to be returned)

Example: Right of return

- Retailer's carrying amount of the sweaters is \$50
- Retailer expects costs to recover the sweaters of \$10 each
- Facts:

Retail price of sweater	\$200
Cost of sweater	\$50
Cost to recover returned sweater	\$10

Example: Right of return

	Debit	Credit
Cash (1,000 sweaters at \$200 each)	\$200,000	
Cost of sales (\$50,000 cost of sweaters sold less \$4,000 asset for right to returned inventory) (900 x \$50) + (100 x \$10)	46,000	
Right to returned inventory (100 returned sweaters at \$40 each)	4,000	
Revenue (\$200,000 received less \$20,000 of expected returns)		\$180,000
Inventory (1,000 sweaters at \$50 each)		50,000
Refund liability (100 returned sweaters at \$200 each)		20,000

Net Income Effect - \$134,000

Existing GAAP: Right of return

Recording Right of Return	Debit	Credit
Cash	\$200,000	
Cost of goods sold	45,000	
Expense (recovery cost)	1,000	
Sales		\$180,000
Liability		16,000
Inventory		50,000

Net Income Effect - \$134,000

Significant financing component

With limited exceptions, significant, implicit or explicit financing components that benefit either the entity or the customer are reflected in the transaction price.

- Can occur with both advance and deferred payment terms
 - Deferred payments decrease the transaction price and result in the recognition of interest income over a period of time
 - Advance payments increase the transaction price and result in the recognition of interest expense over a period of time

Significant financing component

Practical expedient: A significant financing component may be ignored in estimating the transaction price if the difference between the following is expected to be one year or less at contract inception.

- **Entity's transfer of goods or services**
- **Customer's payment for goods or services**
- **What is your revenue cycle? Less than a year?**
Use practical expedient

Step 4

Allocate the Transaction Price

Allocate the Transaction Price

- If there are multiple obligations
- Overall approach is to allocate transaction price using a relative standalone selling price model
- Steps in allocating the transaction price
 - Estimate the standalone selling prices of each performance obligation
 - Determine whether any discounts or variable consideration should be allocated to one or more, but less than all, performance obligations
 - Allocate the transaction price
- Existing GAAP addresses these issues also

Standalone selling prices

- A standalone selling price is the amount the entity charges (or would charge) when the goods or services are sold on their own to a customer
- Determined only at contract inception
- Best evidence is the directly observable price charged by the entity when they sell the goods or services separately in similar circumstances to similar customers
 - If it exists, it must be used

Standalone selling prices

- If a directly observable price does not exist, must estimate a standalone selling price
 - Maximize observable inputs
 - Consider all reasonably available and relevant information

Estimating a standalone selling price

- Three approaches discussed in ASC 606
 - Adjusted market assessment approach - What is the price in the market?
 - Expected cost plus a margin approach - Cost plus appropriate margin
 - Residual approach; however, may only be used when:
 - One or more, but not all, of the performance obligations have underlying goods or services for which the standalone selling price(s) is highly variable or uncertain due to specific factors
 - The standalone selling prices for the goods or services in the other performance obligations are observable

Allocating discounts and variable consideration

In general, proportionately allocate discounts and variable consideration in a customer contract by using the relative standalone selling price model

- However, if certain criteria are met, a discount or variable consideration must be allocated to one or more, but not all, performance obligations
 - Separate criteria to evaluate for discounts vs. variable consideration

Example: Allocating the transaction price

- Tool Wholesaler (TW) sells a drill to Good Customer (GC) for \$500 and gives GC a 40% discount voucher for any future purchases up to \$500 in the next 30 days
- TW regularly sells the drill to other customers for \$500
- TW intends to offer a 10% discount on all sales during the next 30 days as part of a seasonal promotion
 - GC cannot use the 10% discount in addition to its 40% discount voucher
- TW estimates the following based on experience it has had in the past when giving GC and other good customers discount vouchers:
 - An 80% likelihood that a customer will redeem the voucher and purchase, on average, \$250 of additional products

Example: Allocating the transaction price

- TW concludes that the incremental 30% discount provided to GC is a material right that GC would not have received without buying the drill
- TW concludes there are two performance obligations
 - Drill
 - Discount voucher
- TW estimates the standalone selling price of the voucher as \$60
 - \$250 purchase of additional products x 30% incremental discount x 80% likelihood the voucher will be redeemed

Example: Allocating the transaction price

- TW allocates the transaction price to the drill and discount voucher as follows:

Performance obligation (PO)	Standalone selling price (SSP)	SSP of each PO to total SSPs	Allocation of transaction price (\$500) to each PO
Drill	\$500	89%	\$445
Discount voucher	60	11%	55
	\$560	100%	\$500

- TW recognizes \$445 as revenue when control of the drill transfers to GC
- TW recognizes the \$55 allocated to the discount voucher when it is redeemed or it expires

	Debit	Credit
Cash or AR	\$500	
Revenue		\$445
Voucher liability		55

Step 5

Recognize Revenue

Recognize Revenue

Recognize the transaction price allocated to a performance obligation when (or as) it is **satisfied**

- Performance obligation is **satisfied** when (or as) **control** of the underlying distinct good or service (or distinct bundle of goods or services) **transfers** to the customer
 - **Control has transferred** when the customer has the ability to direct the use of the good or service and receive substantially all of the related remaining benefits

Recognize Revenue

KEY QUESTION:

Is a performance obligation satisfied (and control of the underlying good or service transferred) **over time or at a point in time?**

Performance obligations satisfied over time

A performance obligation is considered satisfied over time if any **one** of these criteria are met:

- The customer simultaneously receives and consumes benefits as the entity performs
 - Could another entity step in and fulfill the remaining performance obligation without having to substantially reperform the work already performed by the entity?
- The entity's performance creates or enhances an asset that the customer controls as it is created or enhanced
- The entity's performance does not create an asset with an alternative use to the entity and there is an enforceable right to payment for performance completed to date
- Construction industry!

Performance obligations satisfied over time

Identify a single method by which to measure progress toward complete satisfaction of the performance obligation, which should be:

- A reasonable and reliable method
 - If one cannot be identified, recognize revenue to the extent of costs incurred only if the costs are expected to be recovered and only until a reasonable and reliable method can be identified
- Consistent with how control of the underlying goods or services are transferred to the customer
- Construction industry!
 - Percentage completion
 - Cost to cost

Performance obligations satisfied at a point in time

- If a performance obligation is not satisfied over time, it is satisfied at a point in time
 - Recognize revenue when the customer obtains control over the underlying good or service
 - Indicators that control has transferred include:
 - The entity has a present right to payment for the distinct good or service
 - One or more of the following have transferred/passed to the customer
 - Legal title to the distinct good or service
 - Physical possession of the distinct good or service
 - Significant risks and rewards of ownership
 - The customer has accepted the distinct good or service
 - Example: widgets

Other Topics Related to Key Steps

Principal vs. Agent

- Two key steps:
 - Identify the specified goods or services being provided to the customer
 - Is the ticket aggregator providing the right to fly or the flying service (i.e., flight)?
 - Determine whether the entity obtains control of those specified goods or services before transferring control to the customer
 - If there is more than one specified good or service being provided to the customer, need to determine whether they are distinct (Step 2)
 - Apply incremental principal vs. agent guidance to each distinct specified good or service (or distinct group of specified goods or services)

Principal vs. Agent

Indicators under ASC 605-45-45	Comparable indicator under ASC 606
Primary obligor (strong indicator)	Primary responsibility for fulfillment; however, no relative strength provided
Inventory risk (unmitigated inventory risk is a strong indicator)	Inventory risk; however, no relative strength provided
Latitude in establishing price	Discretion in setting prices
Makes changes to the product or performs part of the service	No comparable indicator, but considered in the control analysis
Discretion in supplier selection	No comparable indicator
Involved in the determination of product or service specifications	No comparable indicator
Physical loss inventory risk after customer order or during shipping	Inventory risk
Credit risk	No comparable indicator

Does not look particularly different from existing GAAP

Contract Costs

Contract Costs

	Costs to fulfill a contract	Costs to obtain a contract
Applicability	Guidance only applies when the contract is within the scope of ASC 606 and if the costs are not within the scope of other ASC Topics	
Example	Setup costs	Commission
Capitalization criteria	<p>Capitalize costs if all of the following criteria are met:</p> <ul style="list-style-type: none"> • Directly relate to the contract or an anticipated contract • Generate or enhance resources that will be used to satisfy performance obligations in the future • Are expected to be recovered 	<p>Capitalize incremental costs if they are expected to be recovered</p> <p>Capitalize costs that are not incremental only if they are explicitly chargeable to the customer regardless of whether the contract is obtained</p>

Contract Costs

	Costs to fulfill a contract	Costs to obtain a contract
Practical expedient	<ul style="list-style-type: none"> • None 	Expense if amortization period would otherwise have been one year or less
Amortization	<ul style="list-style-type: none"> • Method should be consistent with how the related goods or services are transferred to the customer • Depending on the facts and circumstances, it may be appropriate to use an amortization period longer than the initial contract period 	
Impairment	<ul style="list-style-type: none"> • Compare the carrying amount to an amount that considers the revenue and costs that remain to be recognized under the contract* 	

*Proposed ASU would include revenue and costs related to expected contract renewals and extensions with the same customer and make other clarifications to the impairment guidance

- **Materiality Discussion**

Presentation and Disclosure

Balance Sheet Presentation

- Entity recognizes a contract asset or contract liability by comparing its performance under the contract (i.e., transferring control of performance obligations) to Customer's performance under the contract (i.e., making payments)
 - Contract asset
 - Entity's performance > Customer's performance
 - Contract liability
 - Entity's performance < Customer's performance
 - Titles are not prescriptive
 - However, it must be clear by the title that a contract asset is not a receivable
- Receivables are only recognized for the unconditional right to receive consideration
 - Recognized separate from other assets

Example: Balance sheet presentation

- EquipCo sells three pieces of equipment (Q, R and S) to Customer
- Total arrangement consideration is \$1.9 million
- All of the contract existence criteria are met
- Each piece of equipment is distinct

Example: Balance sheet presentation

- Customer is obligated to make specific payments for each piece of equipment as it is delivered
 - Customer has 30 days after delivery to make payment
- Customer does not have the right of return
- Control of the equipment transfers to Customer upon delivery

Example: Balance sheet presentation

Equipment	Standalone selling price	Allocated consideration	Delivery date	Amount due on delivery date
Q	\$1,000,000	\$950,000	12/15/20X1	\$700,000
R	250,000	237,500	12/28/20X1	600,000
S	750,000	712,500	1/10/20X2	600,000
Total	\$2,000,000	\$1,900,000		\$1,900,000

	12/15/20X1	12/28/20X1	Through 12/31/20X1	1/10/20X2
	Debit (Credit)			
Accounts receivable	\$700,000	\$600,000	\$1,300,000	\$600,000
Contract asset *	250,000	(250,000)	-	-
Contract liability		(112,500)	(112,500)	112,500
Revenue	(950,000)	(237,500)	(1,187,500)	(712,500)

* Unbilled receivable – existing GAAP addresses

Disclosures

- Objective is to help financial statement users understand the nature, amount, timing and uncertainty of the related revenue and cash flows
- Annual and interim disclosures required of public entities
 - Less on an interim basis, but mostly quantitative in nature
- More disclosures required of public business entities (PBEs) and certain nonprofit entities and employee benefit plans
 - However, disclosures for all others are still significant

Transition

Transition methods

Entities may choose to apply one of the following transition methods:

- Full retrospective application of ASC 606 to all periods presented
 - Several practical expedients provided
- Modified retrospective application as of the date of initial application of ASC 606

Full retrospective transition method

Full retrospective application to all periods presented

- Practical expedients
 - One or more of the four provided may be elected
 - Consistent application of each one elected to all contracts in all reporting periods presented is required
 - If one or more are elected, incremental disclosures are required
- With limited exceptions, the disclosures in ASC 250 related to a change in accounting principle are required

Modified retrospective transition method

Recognition of a cumulative effect adjustment as of the date of initial application

- **Prior periods are not adjusted**
- Date of initial application is the first day in the period of adoption
 - **January 1, 2019 for a calendar year end nonpublic entity that does not early adopt – adjustment basically at December 31, 2019**
- ASC 606 may be applied to either: (a) all contracts at the date of initial application or (b) only contracts not completed at the date of initial application
 - Must disclose which approach was taken

Transition method pros and cons

	Full retrospective	Modified retrospective
Pros	<ul style="list-style-type: none">• Provides for greatest comparability	<ul style="list-style-type: none">• Generally viewed as being less time consuming
Cons	<ul style="list-style-type: none">• Comparability is somewhat hindered to the extent any practical expedients are elected• Generally viewed as being more time consuming, particularly when:<ul style="list-style-type: none">- One or more comparative periods are presented- There is a large population of multiyear contracts	<ul style="list-style-type: none">• Comparability is hindered to the extent one or more comparative periods are presented• Required to provide revenue information based on what revenue would have been in the year of adoption under legacy U.S. GAAP<ul style="list-style-type: none">- Requires dual bookkeeping in year of adoption

Practical Expedients

A Life Line!

Summary of disclosure requirements

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities
Disaggregation of revenue	Disaggregate revenue into categories that depict how revenue and cash flows are affected by economic factors	Yes!
	Sufficient information to understand the relationship between disaggregated revenue and each disclosed segment's revenue information	Yes!

Summary of disclosure requirements

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities
Contract balances	Opening and closing balances (receivable, contract assets and contract liabilities)	No
	Amount of revenue recognized from beginning contract liability balance	Yes!
	Amount of revenue recognized from performance obligations satisfied in prior periods (i.e., changes in transaction price estimates)	Yes!
	Explanation of significant changes in contract balances (using qualitative and quantitative information)	Yes!

Summary of disclosure requirements

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities
Performance obligations (including remaining performance obligations)	Qualitative information about (1) when performance obligations are typically satisfied, (2) significant payment terms, (3) the nature of goods or services promised, (4) obligations for returns or refunds and (5) warranties	No
	Transaction price allocated to the remaining performance obligations: <ul style="list-style-type: none"> • Disclosure of quantitative amounts • Quantitative or qualitative explanation of when remaining performance obligation amounts will be recognized as revenue 	Yes!

Summary of disclosure requirements

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities
Significant judgements and estimates	<p>Qualitative information about determining the timing of:</p> <ul style="list-style-type: none"> • Performance obligations satisfied over time (i.e., methods of measuring progress, why methods are representative of the transfer of goods or services, judgments used in the evaluation of when a customer obtains control of goods or services • Performance obligations satisfied at a point in time – specifically, the significant judgements used in the evaluation of when a customer obtains control 	Yes!

Summary of disclosure requirements

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities
Significant judgements and estimates (continued)	<p>Qualitative and quantitative information about:</p> <ul style="list-style-type: none"> • Determining the transaction price (i.e. estimating variable consideration, adjusting for the time value of money, noncash consideration) • Constraining estimates of variable consideration • Allocating the transaction price, including estimating stand-alone selling prices and allocating discounts and variable consideration • Measuring obligations for returns, refunds and other similar obligations 	Yes!

Summary of disclosure requirements

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities
Contract costs	Qualitative information about: <ul style="list-style-type: none"> • Judgements made in determining the amount of costs incurred to obtain or fulfill a contract • The method the entity uses to determine the amortization for each reporting period 	Yes!
	Quantitative information about: <ul style="list-style-type: none"> • The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract, by main category of asset • The amount of amortization and any impairment losses recognized in the reporting period 	Yes!

Summary of disclosure requirements

Category	Disclosure Requirements	Practical Expedient Available to Nonpublic Entities
Practical expedients	Disclosure of practical expedients used	No

Accounting - practical expedients or policy election

- *Significant financing component (ASC 606-10-32-18)*: An entity does not need to adjust the promised amount of consideration for the effects of a significant financing component if it expects, at contract inception, that the period between the entity's transfer of a promised good or service to a customer and the customer's payment for that good or services will be one year or less
- *Sales taxes (ASC 606-10-32-2A)*: An entity may elect to exclude from its transaction price any amounts collected from customers for all sales (and other similar) taxes – **policy election**

Accounting - practical expedients

- *Costs of obtaining a contract (ASC 340-40-25-4):* An entity “may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less”
- *Shipping and handling (ASC 606-10-25-18B):* An entity may elect to account for shipping and handling activities that occur after control of the related good transfers as fulfillment activities instead of assessing such activities as performance obligations – **policy election**

Accounting - practical expedients

- *Portfolio approach (ASC 606-10-10-4):* An entity may apply the new revenue standard to a portfolio of contracts (or performance obligations) with similar characteristics if it reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio

Accounting - practical expedients

- *Right to invoice (ASC 606-10-55-18):* For performance obligations satisfied over time, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance complete to date (for example, a service contract in which an entity bills a fixed amount for each hour of services provided), the entity may recognize revenue in the amount to which the entity has a right to invoice

Thank you for joining us!