New Revenue Recognition Standard ASC 606

Presented to ACEC/MA Accounting & Finance Forum

December 5, 2019

EFFECTIVE DATE

- Nonpublic entities
  - Annual reporting periods beginning on or after December 15, 2018
  - 2019 for calendar year-end firms
  - 2020 for fiscal year-end firms

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CORE PRINCIPLE

An entity should recognize revenue to depict the transfer of 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.

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5 STEP PROCESS

Step 1
- Identify the contract with a 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 (or as) the entity satisfies a performance obligation

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STEP 1

Identify the contract with a customer – Do we have a deal?

- A contract exists under the new standard if:
  - It is approved (written, oral, or in accordance with other customary business practices) and the parties have committed to perform their respective obligations
  - It clearly identifies what each party is giving and/or receiving
  - It has specific payment terms (or they can be easily estimated)
  - It has commercial substance (the exchange is actually worth something)
  - Collection is probable (likely to occur)
- A contract does not exist if each party has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party
- Matter of legal enforceability

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STEP 1 - RISKS AND INTERNAL CONTROL CONSIDERATIONS

Area	Risks	Internal Control Considerations
Step 1 - Identify the contract with the customer	• Revenue is/is not recognized when a contract (as defined by the new revenue standard) does not exist/does exist • Side agreements exist that are not known to accounting personnel	• Identifying contracts that meet the criteria defined in the new standard • Reassessing arrangements that do not initially meet the criteria of a contract in accordance with the new standard given that significant changes may occur in the underlying facts and circumstances • Assessing management's commitment and ability to perform under the contract • Ensuring payment terms are properly considered • Assessing the collectability criterion • Evaluating whether combined contracts meet the various criteria specified in the new standard • Evaluating contract modifications

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STEP 2

Identify the performance obligations in the contract – *Who is doing what?*

- A performance obligation is a promise to a customer to transfer:
  - A good or service (or a bundle of goods or services) that is distinct; **or**
  - A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer
- Specify each performance obligation into distinct pieces or bundles
  - **Distinct** if it is:

    (1) *Capable of being distinct* - a customer can use or benefit from an individual good or service on its own, or with other readily available resources, **and**

    (2) *Distinct within the context of the contract* - the promise to transfer goods or services is separately identifiable from other promises in the contract
  - **Not distinct** if a good or service is dependent on, or highly interrelated with, other items promised in the contract

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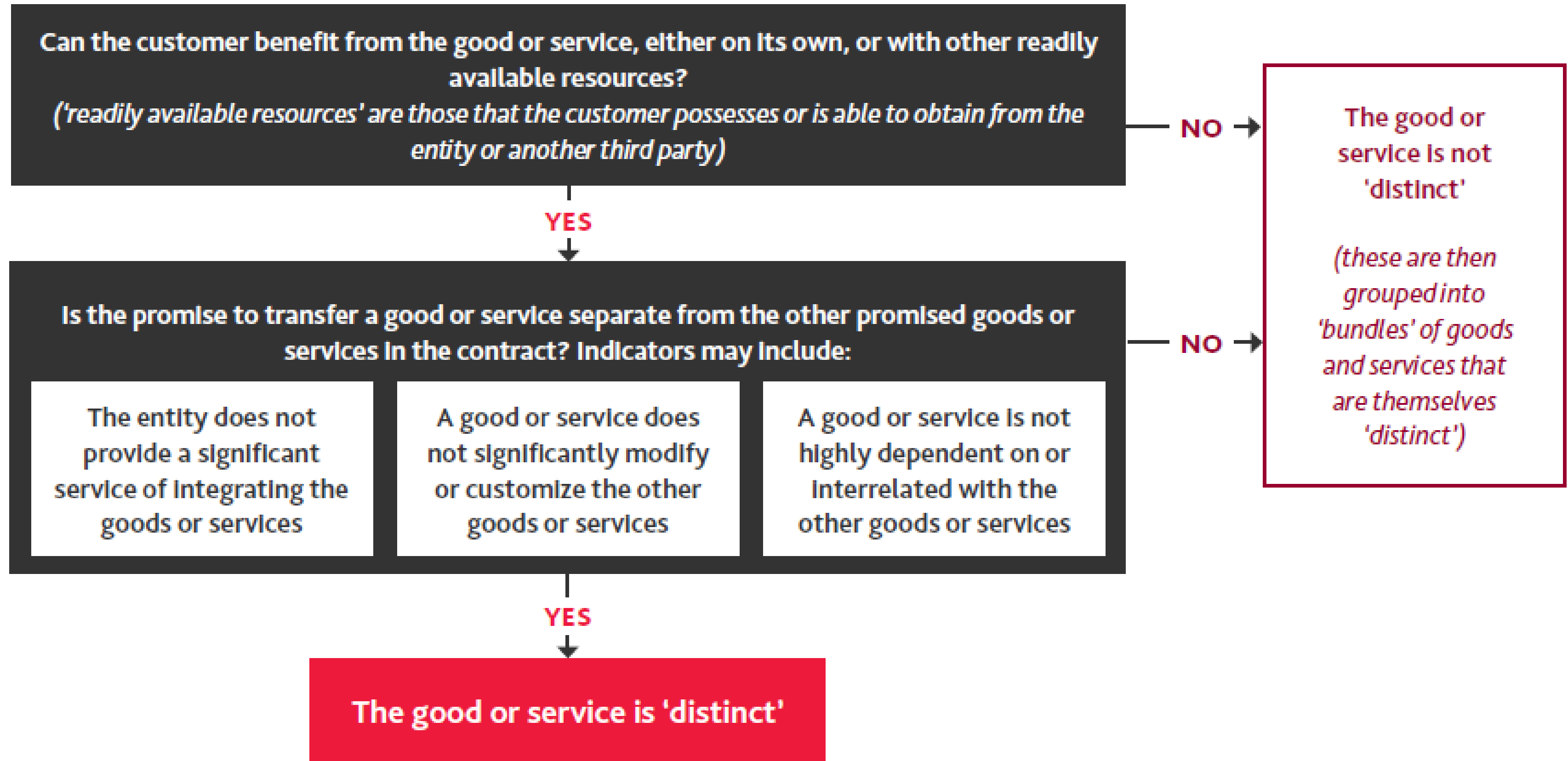
STEP 2 - DISTINCT ILLUSTRATION



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STEP 2 - RISKS AND INTERNAL CONTROL CONSIDERATIONS

Area	Risk	Internal Control Considerations
Step 2 - Identify the performance obligations	Performance obligations are not properly identified	• Identifying implied promises • Evaluating whether customer options are material rights • Evaluating whether a warranty is a performance obligation • Evaluating whether the good(s) or service(s) is/are capable of being distinct within the context of the contract or if two or more goods or services should be combined • Evaluating whether a series of goods or services should be treated as a single performance obligation

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STEP 3

Determine the transaction price – *What do you expect to be owed?*

Variable consideration	Will certain events or offers alter the price you will collect (such as discounts, incentives, credits, performance bonuses, penalties, contingencies, rebates, refunds, price concessions, etc.)?
Constraining estimates of variable consideration	Could events occur that would significantly reduce the amount of consideration received?
Significant financing component	Is the customer paying substantially before or after you deliver (time value of money impact)?
Noncash consideration	If the customer is not paying in cash, the goods or services should be measured at fair value
Consideration payable to a customer	Do you owe anything to the customer aside from the goods or services?

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STEP 3 - RISKS AND INTERNAL CONTROL CONSIDERATIONS

Area	Risk	Internal Control Considerations
Step 3 - Determine the transaction price	Management's estimates are inaccurate as a result of an inappropriate method or inappropriate significant assumptions	• Estimating the amount to which the entity expects to be entitled including variable consideration and constraining variable consideration • Reevaluating the accuracy of judgments and assumptions used in estimates for variable consideration • Determining the fair value of noncash consideration • Determining significant financing components • Determining noncash consideration • Determining consideration payable to a customer

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STEP 4

Allocate the transaction price (only if there are separate performance obligations)

- If the contract includes several separate performance obligations, revenue should be recognized as each performance obligation is completed
- If you were to sell each of these performance obligations to separate customers, what would be the standalone price?
- If a discount (or other variable consideration) relates to only one or a few (but not all) performance obligations, then the discount should be allocated to reduce the price (and revenue) of that performance obligation
- If a general discount, it should be allocated proportionately as revenue is recognized

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STEP 4 - RISKS AND INTERNAL CONTROL CONSIDERATIONS

Area	Risk	Internal Control Considerations
Step 4 - Allocate the transaction price	Management's estimates are inaccurate as a result of an inappropriate method or inappropriate significant assumptions	• Selecting an approach for determining the stand-alone selling price that maximizes the use of observable data • Estimating the stand-alone selling price • Determining the appropriate transaction price allocation including variable consideration and discounts • Reevaluating the accuracy of judgments and assumptions used in estimates for the determination of the stand-alone selling price

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STEP 5

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

- Revenue is recognized one of two ways: Over time or at a point in time

- Transfer of control of a good or service occurs over time and **revenue is recognized over time**, if **one** of the following are met:
  - Customer receives and consumes benefits as performed
  - Creation of an asset that customer controls as asset is created or enhanced
  - Performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment

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STEP 5 - RISKS AND INTERNAL CONTROL CONSIDERATIONS

Area	Risk	Internal Control Considerations
Step 5 - Recognize revenue when (or as) performance obligations are satisfied	Revenue is recognized before the performance obligation is satisfied	• Determining whether performance obligations are satisfied at a point in time or over time • Identifying when control transfers to the customer for a performance obligation satisfied at a point in time • Measuring progress toward complete satisfaction of a performance obligation that is satisfied over time (i.e., the input and output methods)

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OTHER CONSIDERATIONS

Warranties

- Warranties that the customer has the option to purchase separately give rise to a separate performance obligation. A portion of the transaction price is allocated to that separate performance obligation at contract inception.
- A warranty is accounted for as a cost accrual if a customer does not have the option to purchase it separately, unless the promised warranty, or a part of the promised warranty, provides the customer with a distinct service in addition to the assurance that the product complies with agreed-upon specifications.
- A company might provide a warranty that calls for a service to be provided to the customer (for example, maintenance) in addition to a promise that the company's past performance was as specified in the contract. The company will account for the service component of the warranty as a separate performance obligation in these circumstances. If a company promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the company should account for both of the warranties together as a single performance obligation.

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OTHER CONSIDERATIONS

Contract Costs

- All costs related to satisfied performance obligations and costs related to inefficiencies (i.e., abnormal costs of materials, labor, or other costs to fulfill) are expensed as incurred.
- Incremental costs of obtaining a contract are costs that the company would not have incurred if the contract had not been obtained and are recognized as an asset if they are expected to be recovered. As a practical expedient, such costs may be expensed as incurred if the amortization period of the asset that the company otherwise would have recognized is one year or less.
- Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained (for example, certain bid costs) are recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.
- Direct costs of fulfilling a contract are capitalized under the revenue standards if not within the scope of other standards and if they relate directly to a contract, generate or enhance resources that will be used to satisfy future performance obligations and are expected to be recovered.
- Capitalized costs are amortized as control of the goods or services to which the asset relates is transferred to the customer, which may include goods or services to be provided under specific anticipated contracts (for example, a contract renewal).

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OTHER CONSIDERATIONS

Contract Assets and Liabilities

- The company should present either a contract asset or a receivable, depending on the nature of the company's right for its performance, if a company recognizes revenue before the customer pays consideration.
- A contract asset is a company's right to payment in exchange for goods or services that the company has transferred to a customer when that right is conditioned on something other than the passage of time (e.g., the company's future performance).
- A receivable is a company's right to payment that is unconditional.
- If a customer makes a payment or an amount of payment is due before a company has satisfied its performance obligations, the company should present that amount as a contract liability. A contract liability is a company's obligation to transfer goods or services to a customer for which the company has received payment from the customer.

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OTHER CONSIDERATIONS

Loss Contracts

- The loss contract test is performed at the contract level, however an entity may make an accounting policy election to perform the test for loss contracts at either the contract or performance obligation level.

Principal versus Agent Considerations

- Whether an entity is a principal or agent in a transaction is determined whether the entity controls the specified good or service before it is transferred to the customer. There are three indicators of when an entity controls the specified good or service and is therefore a principal. These indicators focus on whether –
  - The entity is responsible for fulfilling the promise to provide the good or service to the customer,
  - The entity has inventory risk before the specified good or service has been transferred to the customer, **and**
  - The entity has discretion in establishing the price for the specified good or service

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OTHER CONSIDERATIONS - RISKS AND INTERNAL CONTROL CONSIDERATIONS

Area	Risks	Internal Control Considerations
Licensing	Licensing revenue is improperly recognized	• Determining whether the license is distinct • Identifying the nature of the license (functional vs. symbolic) • Determining whether obligations to provide updates to or maintenance of licensed intellectual property are distinct • Accounting for sales- or usage-based royalties
Contract costs	Costs incurred with obtaining or fulfilling a contract are inappropriately capitalized	• Evaluating whether the cost of obtaining or fulfilling a contract may be capitalized on the basis of the criteria of the new standard • Amortizing capitalized contract costs

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ADOPTION METHODS

- **Full Retrospective** – Recast all comparative periods presented in the post-adoption financial statements. Practical expedients include:
  - For completed contracts, an entity need not restate contracts that begin and end within the same annual reporting period
  - For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods
  - For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue
- **Modified Retrospective / Cumulative Effect** – Cumulative-effect adjustment to retained earnings in the period of adoption for prior periods' effects. With this election, an entity should disclose:
  - The amount by which each financial statement line item is affected in the current reporting period by the application of the revenue recognition standard as compared to the guidance that was in effect before the change
  - An explanation of the reasons for significant changes

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ADOPTION METHODS - RISKS AND INTERNAL CONTROL CONSIDERATIONS

Area	Risks	Internal Control Considerations
Adoption period	• All material revenue streams and contract types are not identified • Accounting conclusions are not accurate or complete • The recording of the adoption of the revenue standard is not accurate or complete • IT logic for reports and journal entries is not accurate	• Identifying and evaluating all material contract types • Identifying the complete population of contracts to evaluate • Evaluating whether the data used to record adjustments to the financial statements is accurate and complete • Documenting and reviewing accounting conclusions and revised accounting policies • Reviewing the application of the transition method elected • Identifying, developing, and implementing new system requirements, including logic of reports

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DISCLOSURE REQUIREMENTS

- The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of the financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers
- To meet this objective, the standard includes the following disclosure requirements:
  - Disaggregation of revenue
  - Contract balances
  - Performance obligations
  - Significant judgments and estimates
  - Contract costs
  - Accounting policies
  - Effective date and transition

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DISCLOSURE REQUIREMENTS APPLICABLE TO CS

Category	Disclosure Requirements
Contracts with customers	Revenue recognized from contracts with customers, which the company must disclose separately from its other source(s) of revenue Any impairment losses recognized on any receivables or contract assets arising from a company's contracts with customers, which the company must disclose separately from impairment losses on other contracts
Disaggregation of revenue	Quantitative disclosures about revenue, disaggregated based on the timing of transfer of goods or services (e.g., revenue recognized at a point in time and revenue recognized over time) in the financial statements Qualitative information about how economic factors such as the type of customer, the geographical location of customers and the type of contract affect the nature, amount, timing and uncertainty of revenue and cash flows
Contract balances	The opening and closing balances of contract assets, contract liabilities and receivables from contracts with customers if this information is not otherwise separately presented or disclosed

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DISCLOSURE REQUIREMENTS APPLICABLE TO CS

Category	Disclosure Requirements
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, (5) warranties, and (6) revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (e.g., changes in transaction price)
Significant judgments and estimates	The methods used to recognize revenue for performance obligations that are satisfied over time (e.g., a description of the output method, a description of the input method, how those methods are applied) Qualitative information about the methods, inputs and assumptions used for assessing whether an estimate of variable consideration is constrained

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DISCLOSURE REQUIREMENTS - RISKS AND INTERNAL CONTROL CONSIDERATIONS

Area	Risks	Internal Control Considerations
Presentation and disclosure	• Contract assets and liabilities are not presented appropriately • Footnote disclosures are not accurate, complete, or understandable	• Evaluating whether to present contract assets and liabilities as current or noncurrent • Determining the level of aggregation or disaggregation of the disclosures • Reviewing the accuracy and completeness of contract disclosures • Reviewing the disclosures of significant judgments and estimates

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LESSONS LEARNED FROM PUBLIC COMPANIES' EXPERIENCES

Training outside of accounting

- All employees involved in revenue-producing transactions can benefit from understanding the standard's changes and their effect on the business.
- Sales, finance, legal, IT, and tax personnel can work together to determine how the standard affects operations.

Budgeting and financial close process

- Be aware of how changes to the timing of revenue recognition may affect year-on-year comparisons and current and year-end projected results (including effects on projected commissions and bonuses).
- Revisit the financial close process to identify and address any ramifications (e.g., process changes and new data needs).

Governance and legal

- Boards, audit committees, and banks will expect detailed plans that address adoption and its effect on revenue trends.
- Consider planning, timelines, added internal and external costs and headcount, and adequacy of management systems.
- Contracts may have provisions that need to be revisited in light of ASC 606.

Compensation plans

- Boards, management, and human resources should consider ways to adapt performance compensation programs to accommodate changes in revenue calculations that are likely to affect bonus plans and other performance-based compensation arrangements.

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THANK YOU

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