Revenue Recognition

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The views or statements expressed herein are my own and do not necessarily reflect the views of SobelCo.

Revenue Recognition Standards

ASU – 2014-09 – Revenue From Contracts with Customers (Topic 606)

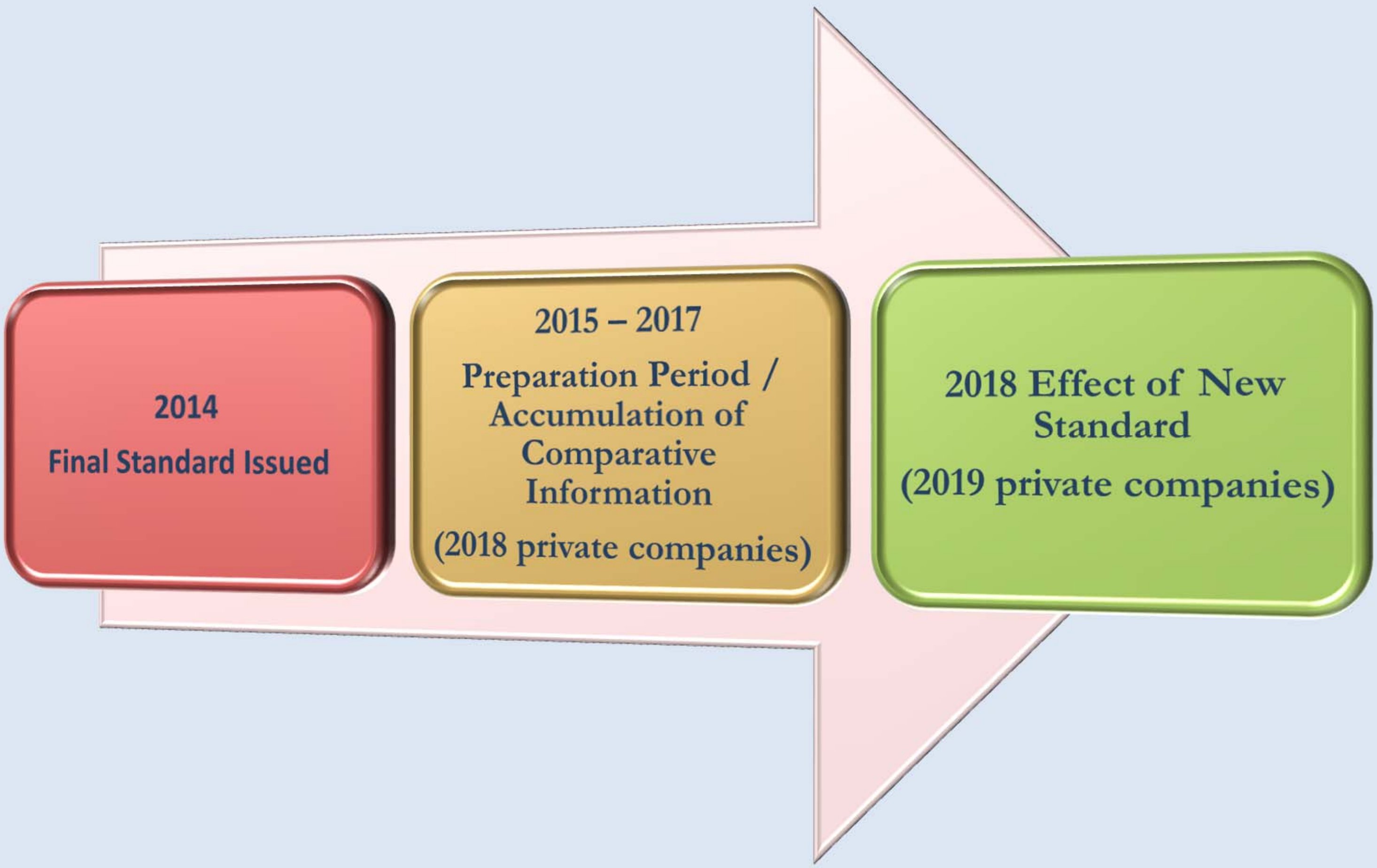
Subsequent revisions/changes:

- 2015-14 - *delayed effective date*
- 2016-08
- 2016-10
- 2016-12
- 2016-20
- 2017-13
- 2017-14

Effective Date

- Fiscal years, beginning after December 15, 2017 - Public business entities
- Fiscal years, beginning after December 15, 2018 - All other entities

Timeline


2014
Final Standard Issued
2015 – 2017
Preparation Period / Accumulation of Comparative Information
(2018 private companies)
2018 Effect of New Standard
(2019 private companies)

Transactions Scoped out of ASC 606

- Lease contracts under Topic 840
- Insurance contracts under Topic 944
- Financial instruments and other contractual rights under:
  - Topic 310 Receivables
  - Topic 320, 323, 325 Investment Topics
  - Topic 450 Liabilities
  - Topic 815 Derivatives and Hedging
  - Topic 825 Financial Instruments
  - Topic 860 Transfers and Servicing
- Guarantees Topic 460
- Nonmonetary exchanges between entities in the same line of business to facilitate customers or potential customers

Some Key Glossary Definitions under Topic 606

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

Some Key Glossary Definitions under Topic 606

Contract - An agreement between 2 or more parties that creates enforceable rights and obligations. Contracts may be oral or written or implied by an entity's customary business practices.

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.

Some Key Glossary Definitions under Topic 606

Performance Obligation - A promise in a contract with a customer to transfer to the ***customer*** either:

a) A good or service (or a bundle of goods or services) that is ***distinct***

b) A series of ***distinct*** goods or services that are substantially the same and that have the same pattern of transferred to the ***customer***

Some Key Glossary Definitions under Topic 606

Transaction Price - The amount of consideration to which an entity ***expects to be entitled*** in exchange for transferring promised goods or services to a ***customer***, excluding the amounts collected on behalf of 3rd parties.

Standalone Selling Price - The price at which an entity would sell a promised good or service separately to a ***customer***.

Some Key Glossary Definitions under Topic 606

***Contract Asset* -** An entity's right to consideration in exchange for GOS that the entity has transferred to a customer when that right is conditioned on something other than the passage of time

Contract Liability - An entity's obligation to transfer GOS to a ***customer*** for which the entity has received consideration (or the amount is due) from the ***customer***.

Common Phrases

Control – The ability to direct the use of and obtain substantially all of the remaining benefits from an asset. Also includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset ("defensive control").

Over Time (ratable) – Entity transfers control of a good or service over time.

Point in Time – Performance obligations are satisfied at a point in time when a customer obtains control of a promised asset at a point in time.

The Core Principle of ASC Topic 606

- **Recognize revenue when:**
  - Promised goods or services are transferred to customers
  - In an amount that reflects the consideration a company expects to be entitled to in exchange for those goods and services

- **Recognized when you transfer control**

5 Steps for Revenue Recognition

1. Identify the contract with a customer
2. Identify the separate performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations in the contract
5. Recognize revenue when (or as) entity satisfies a performance obligation

Step 1: Definition of a Contract

- "A contract is an agreement between two or more parties that creates **enforceable rights** and obligations"
- Criteria to have a contract:

a. The parties to the contract have **approved the contact** (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.

b. The entity can **identify each party's rights** regarding the goods or services to be transferred.

c. The entity can **identify the payment terms** for the goods or services to be transferred.

d. The **contract has commercial substance** (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).

e. It is **probable that 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.

Step 2: Distinct Performance Obligations

- In summary, a good or service is *distinct** if:
  - The good or service is capable of being distinct,
  - Nature of the promises within the contract are for individual goods and services, and not for a combined item, **and**
  - Does the buyer infer the good or service as separate

Factors that suggest an item is **not** distinct within the context of the contract are:

- The seller provides a significant service of **integrating** the good or service with other goods or services promised in the contract
- The good or service significantly **modifies or customizes** another good or service promised in the contract
- The good or service is highly dependent on, or **highly interrelated** with, other goods or services promised in the contract

****Distinct: sold on own; can benefit from item***

GOS Not Distinct/Not Material

- GOS that are not distinct are bundled with other GOS in the contract until a bundle of GOS that is distinct is created. That bundle of GOS is a single performance obligation
- Entity is not required to separately account for promised GOS that are immaterial in the context of the contract

Step 3: Determine Transaction Price

Includes	Excludes
• Fixed consideration • Variable consideration • Noncash consideration	• Collections on behalf of 3rd parties (e.g., sales tax) • Consideration from <u>unexercised</u> customer options to acquire additional goods/services • Credit adjustments (bad debt reserves) • Adjustments for significant financing component • Consideration paid/payable to customer

Variable Consideration

- **Variable Consideration** represents any portion of the transaction price that can vary upwards or downwards

- Variable consideration could be caused by:

- Discounts
- Rebates
- Refunds/Price Protection
- Return rights
- Concessions
- Penalties

- Royalties
- Performance bonuses
- Milestones
- Profit sharing
- Contract modifications

The “Constraint”

- Include in the transaction price some or all of variable consideration only to the extent that it is **probable** that a significant reversal in the amount of cumulative **revenue** recognized will not occur when the uncertainty is subsequently resolved

- That is, include in the transaction price only that revenue that we feel pretty good is not going to be reversed down the road

- Important exception: Exclude all sales or usage royalties associated with an IP license until sale/usage occurs.

Step 4: Allocate the Transaction Price

- **Next step**: Allocate the transaction price (Step 3) to the distinct performance obligations (Step 2) using a relative **standalone selling price** methodology

- Sources for standalone selling prices:
  1. Observable prices for the same or similar products and services
  2. Internal pricing models

Step 4 – Allocating Transaction Price to Performance Obligations

- If standalone selling price is not directly observable will need to estimate using one of the following approaches:
  1. Adjusted market assessment approach
  2. Expected cost plus a margin approach
  3. Residual approach (only if prices are highly variable or price has not been established
- Variable consideration can be allocated to one performance obligation only if both of following:
  1. Terms related specifically to satisfying one PO AND
  2. Subsequent changes in transaction price allocated on same basis determined at contract inception

Step 5: Point in Time vs. Over Time

- **General Principle:** Revenues must be recognized **over time** <u>if any of the following are true:</u>

  1. The customer simultaneously receives and consumes the benefits
  2. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls
  3. 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

- Otherwise, recognize revenue at a **point in time**

- Revenues measured over time are recognized as the entity makes progress towards completion

- Appropriate methods of measuring progress include output methods and input methods.

Step 5: Point in Time vs. Over Time

Output Methods – recognizes revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract, and include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or units delivered.

Input methods – recognize revenue on the basis of the entity's efforts or inputs in satisfying a performance obligation, for example, costs incurred, relative to the total expected inputs to satisfy that performance obligation.
If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for an entity to recognize revenue on a straight-line basis. Entities that currently record revenue based on achievement of milestones should assure that such milestones represent actual performance on the contract. If not, the entity would need to change to another input or output method.

Step 5: Point in Time vs. Over Time

General Principle: Revenues must to be recognized as **point in time** an entity should also consider the following indicators of the transfer of control:

1. The entity has a present right to payment for the asset
2. The customer has legal title to the asset
3. The entity has transferred physical possession of the asset
4. The customer has the significant risks and rewards of ownership of the asset
5. The customer has accepted the asset

Rights of Return

- A <u>right of return</u> is not a separate performance obligation, but it affects the estimated transaction price for transferred goods.
- Revenue is only recognized for those goods that are <u>not expected</u> to be returned.
- The estimate of expected returns should be calculated in the same way as other variable consideration. The estimate should reflect the amount that the entity expects to repay or credit customers

Other

Gross -v- Net

For each performance obligation within each contract, the entity must determine whether it is a principal in the transaction or whether it is the agent. As a principal, the entity takes control of the good or service which it sells and would record revenue gross, along with related cost of sales. However, if the entity does not take control of the underlying good or service, it is essentially acting as an agent in the transaction. As such, it would record only its agent fee as revenue in the transaction.

Other

Contract Costs

Incremental costs of obtaining a contract with a customer should be recognized as an asset if the entity expects to recover those costs. However, as a practical expedient, such costs may be expensed as incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

Costs should be capitalized if all of the following are met:

1. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify
2. The costs generate or enhance resources of the entity that will be used in satisfying or in continuing to satisfy performance obligations in the future
3. The costs are expected to be recovered.

Need to be reviewed for impairment

Disclosures

ASC 606 requires significant enhancement to disclosures, quantitative and qualitative, including:

- Disaggregation of revenue (over time -v- point in time)
- Contract balances and significant changes
- Information about performance obligations
- Remaining performance obligations
- Significant judgements, including input/output considerations
- Contract assets/liabilities
- Practical expedients

Disclosures

Performance Obligations disclosure should include:

1. When the company typically satisfies its performance obligations (e.g., at shipment, at delivery, as services rendered, etc.)
2. Significant payment terms
   - Terms, significant financing components, whether variable consideration is involved and constrained
3. Nature of goods/services to be transferred
   - Highlight performance obligations where company acts as agent
4. Return and refund obligations
5. Warranty obligations