A PRACTICAL GUIDE TO REVENUE RECOGNITION

How will the new requirements under ASC 606 "Revenue from Contracts with Customers" affect your business?

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BPM

BACKGROUND

In May of 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) together issued an accounting standard (ASC 606 "Revenue from Contracts with Customers" Standard or "the Standard"), overseeing revenue from contracts with customers. Although the Standard will not be effective for public companies until 2018, in 2019 for private companies, proactive companies can adopt the Standard as early as January 1, 2017 and begin introducing new best practices.

There are two methods available to adopt the Standard. In the first method, a retrospective application is made to all periods presented, including an option for several practical expedients. The second method, a cumulative effect, requires an application to any incomplete contracts in the year of adoption. This method essentially requires two sets of books on any revenue contract that is expected to be in effect when the change is made.

ABSTRACT

The following is a summary of the new requirements under the Standard. We've outlined five steps to recognizing revenue under the Standard, which also applies to sales of non-business items such as tangible and intangible assets, as well as our practical observations and thoughts on implementation.

GETTING STARTED

***If* your business:**

- Sells bundled services and goods
- Provides refunds to customers
- Frequently issues revenue contract change orders
- Incurs costs in acquiring/fulfilling contracts
- Issues discounts, rebates or customer incentives
- Uses licenses or royalty arrangements
- Enters revenue contracts that cover multiple years
- Ties incentive compensation to revenue metrics

***Then* some of your current business practices will likely need to be revised or new processes implemented to comply with the Standard, including:**

- Customer contract design/negotiation
- Refined processes for estimating/tracking refunds
- Procedures for tracking contract modifications
- Process to estimate/track contract acquisition costs
- Modeling/tracking of multiple estimated selling prices
- Design of terms in license and royalty contracts
- Process for time valuing long-term contracts
- Employee incentive plans redesigned based on new revenue standard

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NEXT STEPS

A comprehensive gap analysis should be performed to compare what is required by the Standard to what is currently being done. The gap analysis should identify the differences in not only the accounting for revenue, but the required changes in the related revenue business processes, internal controls, and information systems that provide the needed accounting information.

To be successful, organizations will need to work in iterations across people, processes, accounting and technology systems. For example, as the accounting teams are working on the technical accounting requirements, the business owner would work on identifying the additional new business processes not already defined, while the IT teams work on portions of the systems based on new requirements that are defined to date.

GAAP GUIDANCE – FIVE STEPS

1 IDENTIFY THE CONTRACT WITH THE CUSTOMER

2 IDENTIFY THE PERFORMANCE OBLIGATION IN THE CONTRACT

3 DETERMINATION OF THE TRANSACTION PRICE

4 ALLOCATING THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS IN THE CONTRACT

5 RECOGNIZE REVENUE WHEN (OR AS) THE PERFORMANCE OBLIGATION IS SATISFIED

STEP 1: IDENTIFY THE CONTRACT WITH THE CUSTOMER

1

Contracts related to one customer can be combined and can be written, oral or implied, but must meet the following five criteria:

- Approval and commitment of the parties
- Identification of rights of the parties
- Identification of payment terms
- Commercial substance
- Collection of consideration is probable

Contract modifications will now be accounted for as either a separate contract or as part of the existing contract, depending on the nature of the modification. This can alter the status of certain revenue items, thus changing timing of revenue recognition.

Practical Observations

The new criteria are more robust than the “persuasive evidence of an arrangement” criteria used today. As a result, most companies may need to change their invoices or contracts and contracting policies to comply with the specific criteria.

Because of the focus on identifying all obligations in an arrangement, contract wording will need to be scrutinized to clarify wording that might create an unintended obligation or an obligation for which the cost of accounting is not cost beneficial.

A positive by-product of the new criteria should eliminate instances in which revenue is not recognized because of an administrative delay in getting non-substantive contract terms finalized, or in getting the exact signature timing correct, if the contract is deemed enforceable without it.

Companies that have a history of frequent contract modifications and that choose to retrospectively adopt the new standard, will need to consider past contract modifications in determining contract balances, which could be time consuming.

THOUGHTS ON IMPLEMENTATION

✓ The new standard provides companies an opportunity to refresh their contracts and contracting processes to:

- Achieve their desired revenue model by revising obligations/terms included in contracts
- Provide additional flexibility in negotiating with customers having specific contracting needs
- Align better with other internal business processes including employee incentives

✓ Companies should revisit the past rationale followed and the frequency of modifying contracts in consideration of the potential new administrative and accounting impact of making changes.

STEP 2: IDENTIFY THE PERFORMANCE OBLIGATION IN THE CONTRACT

2

A performance obligation under the new standard is an explicit or implicit promise to deliver a good or service. The Standard does not distinguish between what is considered a "paid for good or service" and what is considered a "free good or service." Any and all activity included in the sale, regardless of whether it is included in the contract or not, must be considered to determine if it represents a performance obligation (revenue item).

The Standard includes a new practice of separating performance obligations into distinct or non-distinct items. A "distinct item" is any item that can support a sale with no further work. A "non-distinct item" is one that cannot be sold on its own, and must be combined with other items. Items included separately in the contract must be evaluated as to whether they are considered distinct in accordance with the contract. These separate items may require combination with non-distinct obligations for recognition purposes.

Under the Standard, a company should assess each arrangement where licenses are sold with other goods or services to conclude whether the license is distinct and therefore a separate performance obligation. Management will need to determine whether a license provides a right to access intellectual property, or a right to use intellectual property, since this will be the determining factor as to when revenue is recognized. Revenue recognition will also be affected if a license arrangement includes sales- or usage-based royalties.

Practical Observations

Companies will identify existing terms in their contracts, which must now be considered "performance obligations." Obligations likely will be grouped into categories such as true performance obligations, administrative obligations, legal obligations, passive obligations, etc.

The new separation criteria will change which goods and services are combined or separated for revenue recognition purposes. Such changes can cause revenue to be recognized earlier or later than at present. In addition, the split of revenue between different goods and service lines may change, which can significantly affect a company's key performance indicators.

The Standard has different criteria that will determine if revenue from a license is distinct and can be recognized up-front or non-distinct and recognized over the license period, which may be different than the company's historical approach.

If a royalty relates partly to a license of intellectual property and partly to other items, then judgment will be required to determine the predominant item to which the royalty relates.

THOUGHTS ON IMPLEMENTATION

- ✓ Should certain of these newly identified obligations become revenue drivers, companies will need to determine if the benefit of maintaining the term/ obligation in future contracts is worth the cost of the effort to establish a separate selling price, and tracking performance against that specific obligation separately.
- ✓ Companies should analyze the attributes of the distinct and non-distinct obligations in their contracts and how they can be modified to drive revenue recognition timing consistent with management's objectives. For example, if a ratable recognition model is desired, how must the description of the obligations be modified to require combining with other obligations rather than being treated as distinct?
- ✓ Management can also consider how the change in viewing the separation and recognition of different obligations can be better aligned with performance metrics and employee incentives.
- ✓ The identification of new and different obligations (revenue items) that will need to be tracked separately will require modification to existing information systems or implementation of new systems that can capture all crucial information about an item and create an audit trail.
- ✓ Companies that sell licenses/royalties will need to carefully review the new guidance and its impact on revenue recognition timing and the financial metrics of the company. Companies will have to consider revising contract terms to clearly delineate that licenses are distinct and thus separate performance obligations.

3

STEP 3:
DETERMINATION OF THE TRANSACTION PRICE

The transaction price is the amount of consideration an entity expects to be entitled to in relation to the performance obligations in the arrangement. The transaction price may include factors that make consideration variable, such as returns, discounts, rebates, price concessions, any financing received, consideration paid directly by the customer and any noncash items received. The Standard requires a company to first estimate the total amount of variable consideration from a contract, using one of the following methods:

- **Expected value:** The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be used if an entity has a large number of contracts with similar characteristics.
- **Most likely amount:** The most likely amount is the single most likely amount in a range of possible consideration amounts. It would be an appropriate estimate if the contract has only two possible outcomes.

The second independent step in the determination of transaction price is evaluating how much of the total estimated variable consideration should ultimately be included in the transaction price. Variable consideration should be included only to the extent that it's probable a significant revenue reversal won't occur ("constraint"). The guidance provides factors to consider in determining the likelihood of revenue reversal.

In addition to considering refunds as variable consideration, the new guidance requires that such estimated returns to be received must be recognized as a refund liability (the equivalent sales amount of the product estimated to be returned). In addition, they must also be recognized as a corresponding asset (the carrying amount of the product estimated to be returned, less the expected costs to recover) separate from inventory.

Contracts that include a significant financing component will require the contract price to be adjusted for the effects of the time value of money if there is more than one year between performance and payment.

Practical Observations

Estimating the amount of variable consideration to be included in the transaction price will require reviewing the terms of the customer contract, as well as past business practices of providing refunds, concessions, rebates or other credits to specific customers. **This process must include consideration of those customer incentives typically provided though not specifically included in contracts.** In addition, new processes will be needed to reevaluate and update the transaction price as necessary during each reporting period over the course of the contract, as better estimates become available.

Because of the "constraint" on inclusion of variable consideration, a company's estimation processes will need to be more refined/accurate in the future. Thus processes and infrastructure may need to be revised to ensure the accuracy of the sophisticated modeling required.

Companies that have contracts of longer duration will need to consider the potential impact of a financing component in determining transaction price.

THOUGHTS ON IMPLEMENTATION

- ✓ Due to the new modeling requirements for calculating variable consideration, companies will need to modify or implement information systems that can handle complex calculations for revenue items that may have multiple types of variable consideration. For example, one item may contain a price concession, financing and return obligation that creates variable consideration. The same item may be sold in other cases with only the return obligation. The pricing model must be flexible enough to handle multiple iterations of pricing for multiple items.
- ✓ The pricing models must be easily updated for the ongoing changes in factors driving the estimation process. Processes must also be implemented that timely validate the accuracy of the estimates. This will be key in supporting that the estimates meet the required concept of constraint.
- ✓ Additional or modified business processes and information system modifications will likely be required to comply with the recording/tracking of refund assets required by the Standard.
- ✓ A financing component will be another variable to be built into some variable pricing models.

STEP 4:
ALLOCATING THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS IN THE CONTRACT

4

The transaction price as determined in Step 3 must be allocated to each distinct or set of distinct performance obligations in the transaction. The Standard states that the allocation is to be made based on the "relative standalone selling price" of the item, i.e. when the item is sold separately. If there is not a known standalone selling price, management must estimate how the transaction price will be allocated. Standalone selling prices are not adjusted after the inception of the contract. A range of prices can be used when determining the standalone selling prices of individual goods or services, provided that the range reflects reasonable pricing of each product or service as if it were priced on a standalone basis for similar customers.

Standalone selling prices can be estimated in a number of ways. The method used should be applied consistently to similar arrangements. Suitable methods include, but are not limited to:

- Adjusted market assessment
- Expected cost plus margin
- Residual approach

In addition, consideration must be given to situations in which discounts and price concessions can be directly attributed to a distinct performance obligation and must be considered in developing the standalone selling price, rather than being allocated to all obligations in an arrangement.

Practical Observations

Thorough judgment will be involved in the estimation of the selling price. Consequently, management must develop robust documentation of the thought process in determining when prices qualify as a standalone selling price based on an observable market and when such prices have to be estimated. This will include deciding if management believes that the use of a range is appropriate in determining a standalone selling price.

Management will need to carefully consider the entity's pricing policies and practices, as well as the data used in making pricing decisions when determining the most appropriate estimation method. In addition, there may be multiple standalone selling prices for an item based on the estimation method used. For example, using the market assessment method may result in different prices for an item sold in multiple markets, based on either geographical or customer type. In addition items sold with discounts or price concessions in certain markets may result in different standalone selling prices.

THOUGHTS ON IMPLEMENTATION

The requirement to estimate, update and maintain a large number of different standalone selling prices, with different variables, will require an evaluation of the capabilities of a company's current data collection processes and information processing systems. To efficiently comply with the Standard may require not only changes to manual processes but also to existing technology platforms.

STEP 5:
RECOGNIZE REVENUE WHEN (OR AS) THE PERFORMANCE OBLIGATION IS SATISFIED

5

The Standard gives five indications of whether a performance obligation has been met:

- The entity has a present right to payment for the asset
- Customer has legal title to the asset
- Physical possession of the asset has transferred to the customer
- Customer has risks/rewards of ownership of the asset
- Customer has accepted the asset

A performance obligation is satisfied when the customer obtains control (control is the ability to direct the use of, and obtain substantially all of the remaining benefits from the good or service). Control can transfer over time or at a point in time. Revenue is recognized over time if any of the following three criteria are met:

- The customer simultaneously receives and consumes the benefits as the seller performs
- The seller's performance creates or enhances an asset that the customer controls as the asset is created or enhanced
- The seller's performance does not create an asset with an alternative use to the seller and the seller has an enforceable right to payment for performance completed to date

Practical Observations

Management needs to determine at contract inception, whether control of a good or service transfers to a customer over time or at a point in time.

One example of a significant change under the Standard is in sales to distributors. Many original equipment manufacturers or software developers use the sell-through method when recognizing revenue from sales to distributors. Under this method revenue isn't recognized until the product is sold through the sales channel to the end customer due to generous return rights, and price protection privileges provided to the distributor. Under the Standard, revenues are recognized upon transferring control of a good or service to the distributor. However, the amount of revenue reported may be constrained somewhat to reflect the variable pricing risk. Thus, in substance, the Standard eliminates the sell-through method of revenue recognition and instead will require greater judgment in determining the amount of revenue to recognize upon transferring control of products to a distributor.

THOUGHTS ON IMPLEMENTATION

Management should evaluate when the transfer of control occurs primarily from the customer's perspective. Considering the transaction from the customer's perspective reduces the risk that revenue is recognized for activities that do not transfer control of a good or service to the customer.

Management will also need to challenge whether the methods currently used to recognize revenue over time comply with the Standard. Companies in the construction and engineering industries may be impacted most by Step 5 of the Standard.

ADDITIONAL CONSIDERATIONS

Contract Acquisition and Fulfillment Costs

The Standard now requires that incremental contract acquisition costs be capitalized. This includes commissions, fees paid to third parties and provisioning activities. An asset is also recognized for fulfillment costs that are outside the scope of other U.S. GAAP and meet all the following criteria:

- The costs directly relate to the contract
- The costs aid in satisfying future performance obligations
- The costs are expected to be recovered

These new requirements could significantly affect companies in certain industries, such as telecommunications. While current standards allow these costs to be capitalized when certain considerations are met, **the new standard requires greater capitalization** of costs than is common in the industry.

Companies will need to evaluate all the processes used in originating and fulfilling contracts to determine the extent to which costs will need to be capitalized and amortized over future periods.

Accessible Expertise at Each Step

Our team has the extensive experience to help you better understand the complexities and nuances of the Standard and in developing your own "gap analysis." Our goal is to effectively and efficiently model the impact of needed changes to your financial reporting and business processes, internal control systems and information systems. We analyze the problems you face and deliver the solutions you need in the most holistic and cost effective ways—an approach measured by outcome rather than output.

Success Beyond Revenue Recognition

Through our tailored end-to-end solutions, we help you control exposure to risks while reaping the benefits of a strategic approach to business management. Whether it's financial, operational, regulatory or technological changes, we provide comprehensive counsel that uncovers opportunities and reduces unwanted surprises.

The pertinent objective of our Risk Assurance & Advisory Services team is to consistently deliver high quality, distinctive services to our clients. Together with our Information Technology Audit and Compliance Group, we offer accounting and advisory services that extend beyond your immediate revenue recognition needs, but rather help you achieve your long term goals.

Contact Us

Are you prepared for the new revenue recognition standard? Our advisors are here to help. Contact us today.

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