SolomonEdwards

A Successful Transition to ASC 606 / IFRS 15: Revenue from Contracts with Customers

SolomonEdwards' recap of the final Standard and how the latest revenue recognition rules will affect your organization.

ASC 606 / IFRS 15:

What: Impacts on revenue accounting from contracts with customers.

Who: This Standard will impact every business in some way. While the new guidance primarily affects the accounting and financial statement disclosures relating to revenue, complying with the Standard may also require companies to change operational processes, related internal controls and even business systems. Therefore, a comprehensive and proactive approach to evaluating the potential impact of the new revenue recognition Standard is essential.

When: Public organizations should apply the new revenue standard to annual reporting periods beginning after December 15, 2017. Nonpublic organizations should apply the standard to annual reporting periods beginning after December 15, 2018. Both US GAAP and IFRS set forth certain provisions for early adoption.

Why: The Standard does require either full or simplified retrospective transition, so at a minimum companies will need to be prepared to review the impact of the Standard on the fiscal year prior to formal adoption, and possibly two years prior if financial reports present three years of data (ex. Public companies).

Revenue from Contracts with Customers: Practical Considerations to Ensure a Successful Transition

This white paper summarizes the way the new revenue recognition rules require change to current practice and the critical insights that will facilitate a successful transition to the new world of accounting and financial reporting for revenue.

The Standard prescribes a five-step process for evaluating customer arrangements for determining proper revenue recognition under the guidance:

1	**Contract**	Identify the contract(s) with the customer
2	**Obligations**	Identify the separate performance obligations in the contract
3	**Price**	Determine the transaction price
4	**Allocation**	Allocate the transaction price to separate performance obligations
5	**Recognize**	Recognize revenue when, or as, each performance obligation is satisfied

Each step has several important implications, some of which are consistent with current U.S. GAAP, while others have to be considered in a new context or are entirely new. Below is a short summary of key considerations for each of the 5 steps in the new revenue recognition process.

1 Identify the contract(s) with the customer

The Standard applies to all contracts with customers except:

- Lease agreements (See relevant Standard)
- Insurance Contracts (See relevant Standard)
- Financial instruments and certain contractual rights or obligations within the scope of other Standards (Derivatives, Dividends, etc.)
- Certain nonmonetary exchanges between entities
- Certain guarantees within the scope of other Standards (other than warranties)

The Standard defines a contract very broadly, so generally all transactions with customers except those noted above are covered by the Standard.

Under current U.S. GAAP, collectability is assessed as part of validating the commercial substance of a customer arrangement. While this remains the case, additional consideration regarding the customer's ability to pay and risk of credit loss must be performed. If and when credit losses are considered to be "probable" by management, an expense for the related amount of bad debt measured in accordance with applicable financial instrument accounting guidance should be recorded.

The Standard defines a contract very broadly, so generally all transactions with a customer are covered with a few notable exceptions.

Contract Combination – multiple contracts with the same customer should now be combined if they are entered into at or near the same time, and one or more of the following is true:

- The contracts achieve a single commercial objective and are negotiated as a package.
- The price or performance of one contract influences the amount of consideration to be paid in the other contract.
- The goods or services in the separate contracts represent a single performance obligation.

Contract Modifications – the Standard sets forth a variety of considerations regarding accounting for customer contract modifications. While an in-depth discussion of those considerations is beyond the scope of this white paper, it is important to note that any subsequent modifications of key customer arrangement terms (e.g. changes in pricing, quantities or the fundamental nature and timing of performance obligations) can have a material impact on revenue recognition and should be carefully considered for proper treatment under the Standard. During the initial adoption of this Standard, reporting entities can utilize the benefit of hindsight in applying the guidance to contract modifications. This issue will become more relevant in 2017 and beyond.

2 Identify the separate performance obligations in the contract

The new Standard requires that judgment be used in determining the existence and nature of the performance obligations in each customer arrangement. The manner in which goods or services are described as either separate or bundled in a contract no longer determines how those good or services should be accounted for under the Standard. To qualify as separate performance obligations, the goods or services must be “distinct” as defined under the Standard.

A good or service is distinct if:

- The customer can benefit from the good or service either on its own or together with other readily available resources; that is, the goods or services are capable of being distinct and
- The good or service is separately identifiable from other promises in the contract; that is, the good or service is distinct within the context of the contract.

Warranties that are sold separately will generally represent a separate performance obligation, which represents a change from current GAAP that treats all warranties as cost accruals.

Determining the transaction price is more complex if the arrangement involves variable consideration, a significant financing component, noncash consideration or consideration payable to a customer by the seller.

3 Determine the transaction price

The transaction price is the amount of consideration that an entity expects to be entitled to in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of a third party such as sales taxes, third party agent commissions, etc. Determining the transaction price is more complex if the arrangement involves any of the following:

Variable Consideration

- Variable consideration is a complex topic within the Standard and one that requires the exercise of significant judgment. The transaction price might include elements of consideration that are variable or contingent on the outcome of future events, including but not limited to discounts, refunds, rebates, credits, incentives, performance bonuses, concessions or royalties.
- Variable consideration should be estimated using one of the following approaches that best fits the fact pattern:
  - *Expected value* - represents the sum of probability-weighted amounts for various possible outcomes.
  - *The most likely amount* - represents the most likely amount in a range of possible amounts.
  - The approach used is not a policy choice. Management should use the approach that it expects will best predict the amount of consideration on a contract-by-contract basis.

Significant Financing Component

- If the payment terms are less than one year the entity can usually disregard the effect that the time value of money may have on the transaction price.
- In evaluating the existence of a significant financing component the entity should consider:
  - Whether the amount of consideration would significantly differ if the

- customer paid cash when the goods or services were transferred.
- The length of time between when the entity transfers the goods or services to the customer and when the customer pays for them, and the interest rate in the contract and prevailing interest rates in the market.

Noncash Consideration

When a customer contract includes noncash consideration, the fair value of that noncash consideration will be used to determine the transaction price. An entity will measure the consideration indirectly by reference to the standalone selling price of the goods or services promised in the arrangement if it cannot reasonably estimate the fair value of the noncash consideration. Some customer arrangements may require a customer to contribute goods or services to the seller as consideration. Management must evaluate the point at which it gains control of those contributed goods or services to determine the timing for recognition of such noncash consideration.

Consideration Payable to a Customer by the Seller

- Consideration paid (or expected to be paid) to a customer generally results in a reduction of the transaction price unless the payment is made in exchange for a distinct good or service that the customer transfers to the entity. The same definition of “distinct” utilized in determining performance obligations should be used in evaluating the accounting for consideration paid to a customer.
- Consideration paid by a seller to a customer that is a payment for a “distinct” good or service will generally not impact the transaction price, as it will be accounted for in the same manner that regular purchases from other suppliers are treated. However, when the consideration paid for “distinct” goods or services received from a customer is greater than the fair value of those goods or services, any excess consideration paid to the customer will indeed be recorded as a reduction of the transaction price. Such a reduction will be recognized in either the period the entity recognizes revenue for the transfer of the promised goods or services, or the period the entity pays the consideration, whichever is later.

The transaction price is allocated to the separate performance obligations in a contract based on the relative standalone selling prices of the goods or services promised.

4 Allocate the Transaction Price to Separate Performance Obligations

The transaction price is allocated to the separate performance obligations in a contract based on the relative standalone selling prices of the goods or services promised. This allocation is made at contract inception and not adjusted based upon subsequent changes in the standalone selling prices of those goods or services.

In situations where the seller does not offer its goods and services separately with their own standalone selling prices, then management will need to estimate the selling price of goods or services. This is another one of many areas in the new revenue recognition guidance where significant management judgment is required. Possible estimation methods include:

- Expected cost plus an appropriate margin
- Market prices for similar goods and services

- Residual approach, in limited circumstances

Discounts and variable consideration will generally be allocated proportionately to all of the performance obligations in the contract; however, some circumstances may require that discounts and variable consideration can be allocated specifically to one or more separate performance obligations. The guidance highlights the following criteria to be used for this purpose:

- The entity regularly sells each distinct good or on a standalone basis.
- The entity regularly sells, on a standalone basis, a bundle of some of those goods or services at a discount to the standalone selling prices of those goods or services.
- The discount attributable to the bundle of goods or services is substantially the same as the discount in the contract.

5 Recognize revenue when/as each performance obligation is satisfied

An entity will recognize revenue when (or over time as) a good or service is transferred to the customer and the customer obtains control of that good or service.

An entity will recognize revenue when (or over time as) a good or service is transferred to the customer and the customer obtains control of that good or service. Control of an asset is defined as an entity's ability to direct the use of and obtain substantially all of the remaining benefits (that is, the potential cash inflows or savings in outflows) from the asset. Directing use of an asset refers to a customer's right to deploy that asset, to allow another entity to deploy that asset in its activities, or to restrict another entity from deploying that asset. At the inception of a contract, management must evaluate whether control passes to the customer at either a point in time or over a period of time.

The seller will recognize revenue over time if any of the following criteria are met:

- The customer concurrently receives and consumes the benefits provided by the entity's performance as the entity performs.
- The entity's performance creates or enhances a customer-controlled asset.
- The entity's performance does not create an asset with an alternative use and the entity has a right to payment for performance completed to date.

Revenue is recognized at the point in time control transfers if the criteria above are not met.

For a performance obligation satisfied over time, the objective is to recognize revenue in a manner that represents the transfer of control of the promised goods or services to the customer. Methods for measuring that progress include:

- Output methods, such as units produced or delivered, contract milestones, or other completion measurements
- Input methods, such as costs incurred, labor hours expended, time lapsed, or machine hours used

Other Practical Application Considerations

Contract Costs

An entity should recognize an asset for the incremental costs incurred to obtain a contract if management expects to recover those costs. Incremental costs of obtaining a contract are costs the entity would not have incurred if the contract had not been obtained (for example, sales commissions). Costs that the entity would have incurred if the contract had not been obtained, such as facilities costs and sales force salaries are not capitalized. An entity can elect to expense the cost of obtaining a contract if the amortization period would be one year or less. Management should also consider if these costs could be recorded under a separate standard in U.S. GAAP such as the inventory, fixed asset or intangible assets standards.

Principal or Agent

A full discussion of the requirements that apply to accounting for a revenue arrangement as a principal or as an agent is beyond the scope of this white paper; however, it should be noted that the Standard does provide some relevant guidance that impacts whether an entity is operating in one role or the other. This determination can have a material outcome on recognized revenue and should be assessed under each customer contract's specific fact pattern.

Licenses

Licenses are specific to the rights granted and vary from software, to patents, to other intellectual property (collectively IP). Management will need to assess if the license is distinct, based upon the guidance in step 2, and then determine if the access to the IP is delivered at a point in time or if it is dynamic and subject to change during the license period, as this will be a key consideration on when revenue is recognized. There is separate application guidance available as part of the Standard for various types of IP.

Disclosure Requirements

The financial statement disclosure requirements of the new revenue Standard are voluminous and will most certainly impact all new adopters even if the application of the new recognition criteria do not result in material changes to a company's revenue accounting. A number of the items below will require new footnotes or significant modifications to existing ones:

- The method of retrospective analysis chosen for adoption: Full Retrospective or Simplified Transition Method
- The disaggregation of revenue into primary categories that depict the nature, amount, timing and uncertainty of revenue and cash flows
- A tabular reconciliation of the movements of the assets recognized from the costs to obtain or fulfill a contract with a customer
- An analysis of the entity's remaining performance obligations including the nature of the goods and services to be provided, timing of satisfaction and significant payment terms
- Information on costs to obtain or fulfill contracts including closing balances and the method used to determine period amortization
- Significant judgments and changes in judgments that affect the determination of the amount and timing of revenue from contracts with customers

SolomonEdwards' accounting and finance consultants and team of experts are available to ensure your transition to the new world of reporting revenue is successful.

Contact your local SolomonEdwards office for more on converged regulatory standards that affect today's complex finance and accounting requirements.

Atlanta **P** 404.497.4141 | Chicago **P** 312.466.0101 | Houston **P** 713.960.8880 | New York **P** 212.545.9500

Philadelphia **P** 610.902.0440 | San Francisco **P** 415.391.1038 | Washington, D.C. **P** 703.738.9600

www.SolomonEdwards.com

About SolomonEdwards

SolomonEdwards is a national professional services firm focused on strategy execution. We create success for our clients by providing extensive experience, deep subject matter expertise and adaptability within ever-changing business dynamics. Through our business consulting division we execute on custom solutions to solve clients' critical business issues related to business transformation, accounting and finance, governance and regulatory compliance and mergers and acquisitions.

Our Accounting & Finance Advisory services help companies to balance the high demands placed on accounting and finance departments with effective and efficient controls and processes. From general ledger transaction processing and business process improvement, to plant and cost accounting, financial reporting and financial system assessment and optimization, our advisors ensure your team is fully aligned and operating at the most efficient levels possible.

Our Transaction & Regulatory Advisory Services practice works closely with private equity firms, portfolio company clients as well as corporate buyers and sellers executing mergers and acquisitions. We partner to meet their unique business objectives along the full cycle of a deal.

SolomonEdwards®