Cohen & Co

A Deeper Dive into the Revenue Recognition Process

Part One: Performance Obligations

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Welcome & Introductions

Your Presenters

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Background

ASU 2014-09 Revenue From Contracts with Customers

- Core principle
  - Recognize revenue to depict **transfer** of good/service (G/S) in amount that reflects consideration expected to be **entitled** to receive in exchange for those G/S
  - Transfer based on **control**
    - Ability to direct use of and receive benefit from asset transferred
- Concept of earnings process and realization are eliminated
- New concepts
  - Transfer = Delivery
  - Entitlement = Fixed or Determinable / Collectability / Evidence of Arrangement

ASU 2014-09 Revenue From Contracts with Customers

- Customer = counterparty to a contract
  - Contracted with an entity to obtain G/S
  - G/S are an output of entity's ordinary activities
  - Consideration must be exchanged
  - If a counterparty shares in risks and benefits that result from the activity or process = not a customer
    - Example – developing an asset in a collaborative arrangement

Five Step Process

STEP ONE	STEP TWO	STEP THREE	STEP FOUR	STEP FIVE
• Identify the contract	• **Identify separate performance obligations**	• Determine the transaction price	• Allocate the transaction price to performance obligations	• Recognize revenue as or when each performance obligation is satisfied

Performance Obligations

Step 2 – Identifying the Separate Performance Obligations in the Contract

- Required to identify performance obligations (POs) in the contract
- Performance obligation is a promise to a customer to transfer:
  - Good or service (or a bundle) that is distinct; **or**
  - Series of distinct goods or services that are:
    - substantially the same **and**
    - have the same pattern of transfer to the customer
- Companies do not need to account for promised goods or services that are immaterial in the context of the contract as separate performance obligations

Step 2 – Identifying the Separate Performance Obligations in the Contract

- Promise to transfer can be written, oral or implied from:
  - Customary business practices
  - Published policies
  - Specific statements
  - Industry norms
- Setup and other administrative activities are generally not POs
- PO must be based on customer's reasonable or valid expectations

Step 2 – Identifying the Separate Performance Obligations in the Contract

- Determination of distinct is a key consideration
- Distinct function must meet both criteria:
  - G/S is capable of being distinct
    - Customer can benefit from individual G/S on its own OR
    - Customer can use good or service with other resources that are readily available to the customer
  - G/S is distinct within context of contract
    - Entity's promise to transfer G/S is separately identifiable from other promises in contract
    - Concept of separable risks

Step 2 – Identifying the Separate Performance Obligations in the Contract

- Series of distinct goods or services has the same pattern of transfer to the customer if two criteria are met:
  - Each distinct (substantially the same) good or service in the series is a performance obligation satisfied over time; and
  - Same method would be used to measure the vendor's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.
- Examples
  - Upon shipment
  - Upon delivery
  - Upon later of key delivery or license term start
  - Stand ready straight line
  - Cost to cost
  - Hours to hours
  - Other

Promised Good and Services

- Sale of goods produced by the entity – inventory of a manufacturer
- Resale of goods purchased by an entity – merchandise of a retailer
- Resale of rights to goods or services purchased by an entity – ticket resold by an entity acting as a principal
- Performing a contractually agreed upon task for a customer
- Providing a service of standing ready to provide goods or services – unspecified updates to software
- Providing a service of arranging for another party to transfer G/S
- Granting rights to G/S to be provided in the future that a customer can resell
- Constructing, manufacturing, or developing an asset on behalf of a customer
- Granting licenses
- Granting options to purchase additional G/S

Step 2 – Identifying the Separate Performance Obligations in the Contract

Can the customer benefit from the good or service, either on its own or with other readily available resources?
(readily available resources are those that the customer possesses or is able to obtain from the entity or another third party)

No → **The good or service is not "distinct"**

(these are then grouped into bundles of goods and services that are themselves distinct)

Yes ↓

Is the promise to transfer a good or service separate from the other promised goods or services in the contract? Indicators may include:

- The entity does not provide a significant service of integrating the goods or services
- A good or service does not significantly modify or customize the other goods or services
- A good or service is not highly dependent on or interrelated with the other goods or services

No → **The good or service is not "distinct"**

(these are then grouped into bundles of goods and services that are themselves distinct)

Yes ↓

The good or service is "distinct"

Step 2 – Identifying the Separate Performance Obligations in the Contract

- Distinct concept similar to stand alone value under existing GAAP
  - Does entity regularly sell G/S separately?
- If criteria not met – combine G/S with other G/S until a bundle of G/S is distinct
- Evaluate to determine if multiple G/S work together to deliver combined output

Step 2 – Identifying the Separate Performance Obligations in the Contract

- Concepts of highly interdependent or highly interrelated can be the most difficult for entities to assess
- Promised G/S are highly interdependent or highly interrelated if there is a two way dependency
  - There will be very few instances of putting promises back together
  - Significant judgment will need to be applied

Step 2 – Identifying the Separate Performance Obligations in the Contract

- When assessing dependency – consider the following:
  - Is the combined item greater than or substantively different from the sum of the promised G/S?
  - Is an entity – in substance – fulfilling a single promise to the customer?
  - Is the risk an entity assumes to fulfill its obligation to transfer a promised G/S inseparable from the risk relating to the transfer of the other promised G/S in the bundle?
    - Concept of separable risks
  - Do two or more promised goods or services each significantly affect the other?
  - Does each promised G/S significantly affect the utility of the other promised G/S to the customer?

Step 2 – Identifying the Separate Performance Obligations in the Contract

- Bundle of promised G/S = one PO if vendor provides a service of integrating them into a single item that the vendor provides to the customer
- Series of distinct G/S = one PO when:
  - Distinct G/S are substantially the same
  - Each performance obligation is satisfied over time
  - Each performance obligation has the same pattern of transfer
- Pattern of transfer consistently follows rules in Step 3 – Determine the Transaction Price

Identification of Performance Obligations and Material Rights

- Options to purchase additional G/S
  - Sales incentives
  - Customer awards
  - Contract renewal options
  - Discounts on future G/S
- Separate POs if provide material right to customer
  - Results in discount customer would not receive if not for entering into contract
  - Incremental to discounts typically given for G/S
  - Customers implicitly paying for option as part of contract

Identification of Performance Obligations and Material Rights

- Factors to determine if material right exists
  - Would a new customer pay for same G/S?
  - Availability and pricing of competitors alternatives
  - Does average customer believe fee is incentive to stay beyond stated contract term?
- Revenue recognition when
  - Future G/S are transferred
  - Option expires
- Transaction price allocated to POs
  - SSP of option reflects discount customer receives when exercising option
  - Adjusted for discount customer receives w/o exercising option
  - Adjusted for likelihood option will be exercised

Performance Obligations
Examples

Example 1 – Determining Whether Goods or Services are Distinct

FACTS

- A manufacturing entity enters into a contract to sell a customer a printer and an ink cartridge that is shipped two weeks later.
- The printer cannot print without the ink cartridge.
- Both the printer manufacturer and sellers of generic ink cartridges sell ink cartridges for the printer separately.

QUESTIONS

- There are 2 promises in this contract:
  - Printer
  - Ink cartridge
- Can the customer benefit from the goods either on their own or together with resources that are readily available?
- Which of these goods are separate performance obligations for revenue recognition?

Example 1 – Determining Whether Goods or Services are Distinct

- **ANALYSIS**
  - Both the printer and the cartridge represent distinct goods
    - Customer can benefit from the goods either on its own or together with other resources that are readily available to the customer
    - Entity's promise to transfer the good to the customer is separately identifiable from other promises in the contract
      - Customer does not need to buy the cartridge or printer from the entity in order to use the other good
      - The brand name or generic printer or cartridge could be bought from another supplier
  - Conclusion = there are two performance obligations in the contract:
    - Printer
    - Cartridge

Example 2 – Determining Whether Goods or Services are Distinct

FACTS

- Software developer enters into a contract with a customer to transfer a software license, perform an installation service, and provide unspecified software updates and technical support for a two year period.
- Entity sells all items separately.
- Software remains functional without the updates or technical support.
- Installation service is routinely performed by other entities.

QUESTIONS

- There are 4 promises in this contract:
  - License
  - Installation service
  - Software updates
  - Technical support
- Which of these goods and services are separate performance obligations for revenue recognition?
- If the installation service was customized, how would your answer change?

Example 2 – Determining Whether Goods or Services are Distinct

- **ANALYSIS**
  - Based on the facts, each of the G/S appears to be distinct:
    - Customer can benefit from each of the goods and services on their own or
    - Together with other goods and services that are readily available
  - Each G/S also appears to be separately identifiable from the other promises
    - Installation service does not significantly modify or customize the software itself and, as such, the software and installation service are separate outputs promised by the entity instead of inputs used to produce a combined output
  - Conclusion = all inputs appear to be separate performance obligations
    - If the installation was significantly customized, the software and installation would not be separately identifiable and therefore they would be considered one performance obligation

Example 3 – Explicit and Implicit Promises in a Contract

FACTS	QUESTIONS
• Manufacturer sells a product to a distributor • Distributor resells product to end customer • Manufacturer promises to provide maintenance services for no additional consideration to any party that purchases product from the distributor • Manufacturer outsources performance of the maintenance services to the distributor • Manufacturer pays the distributor an agreed upon amount for providing those services on entity's behalf • Manufacturer not obligated to pay distributor if end customer does not use the maintenance services	• Is the promise of maintenance services a performance obligation? • Should the manufacturer allocate a portion of the transaction price to the promise to provide maintenance services? • If the manufacturer has historically provided the maintenance services for no additional consideration and does not explicitly promise the maintenance during contract negotiations, is the promise a performance obligation?

Example 3 –Explicit and Implicit Promises in a Contract

- **ANALYSIS**
  - Question 1 – Explicit Promise
    - Promise of maintenance services is a promise to transfer services in the future
    - Promise of maintenance services is part of the negotiated exchange between the entity and distributor
    - Conclusion – promise represents a performance obligation regardless whether the manufacturer, distributor or a third party performs the service
      - Portion of the transaction price is allocated to the promise to provide maintenance services
  - Question 2 – Implicit Promise
    - Manufacturer has customary business practice of deciding at inception that implicit promise to provide maintenance services exists as part of contract negotiations
    - Past practices create valid expectations of customers (both distributor and end user) that services will be provided
    - Conclusion – promise of maintenance services is a performance obligation

Example 4 – Material Rights and Customer Loyalty Programs

FACTS

- An entity has a customer loyalty program where each point is redeemable for a $1 discount on future purchases.
- During a reporting period, $100,000 of product was purchased and 9,500 points were earned.

QUESTIONS

- How much revenue should be recognized in this reporting period?
- How much should be reflected in contract liability?

Example 4 – Material Rights and Customer Loyalty Programs

› **ANALYSIS**

- Of the $100,000 of product sold, $91,324 should be recognized as revenue ($100,000 x $100,000/$109,500) and $8,676 should be recognized as a contract liability ($100,000 x $9,500/$100,000)
- As points are redeemed, revenue is recognized and the contract liability is reduced

Look Ahead & Takeaways

What To Do Now

- Review contracts with customers and determine approach
  - Homogeneous contracts
    - Apply new revenue recognition standard similarly to all contracts
  - Significant variation – apply new revenue recognition using a contract by contract approach
    - Attempt to identify similarities between contracts
- Determine and document revenue recognition under the new standard for each contract and assess differences from current GAAP

What To Do Now

- Identify and document key terms and conditions in each contract
  - Evaluate promises in each contract
  - Evaluate distinct promises that are determined to be performance obligations
  - Evaluate performance obligations satisfied over time or at a point in time
  - Evaluate the pattern of control transfer/measure of progress
  - Evaluate the types of consideration included in the contract when determining transaction pricing
  - Determine stand alone selling prices for each performance obligation
  - Evaluate variable consideration
  - Determine the pattern of revenue recognition

What To Do Now

- Develop implementation plan
  - Accounting system evaluation
  - Accounting policies and procedures
  - Internal control assessment
  - Tax reporting requirements
  - Internal communications to all stakeholders
  - Training
  - New financial reporting disclosures
- Determine the new standard's effects on all areas of the organization and assess whether any revisions need to be made
  - Existing contracts with customers
  - Loan agreements
  - Compensation
  - Any other agreements

Questions?

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Future Events

- Tax Reform Has Arrived: How Will It Impact You & Your Business?
  - Thursday, January 11, 10am – Noon EST
  - www.cohencpa.com/events

Thank you.

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