

Cohen & Co

# A Deeper Dive into the Revenue Recognition Process

## Part Two: Variable Consideration

*PRESENTED BY:*

- › JOE DIFRANCO, CPA, MBA, MANAGER
- › TINA DZIK, CPA, MBA, DIRECTOR

January 10, 2018

# Welcome & Introductions



**Joe DiFranco, CPA, MBA**



**Tina Dzik, CPA, MBA**

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

- Identify the contract

## STEP TWO

- Identify separate performance obligations

## STEP THREE

- **Determine the transaction price**

## STEP FOUR

- Allocate the transaction price to performance obligations

## STEP FIVE

- Recognize revenue as or when each performance obligation is satisfied

## Step 3 - Determine the Transaction Price

---

- › Transaction price (TP) determined by:
  - Contract terms
  - Customary business practices
- › Determined at inception of contract and may be reassessed
- › TP = amount of consideration entity expects to be entitled to receive in exchange for transferring G/S to customer
- › Consideration may be fixed, variable or both
- › Objective = predict total amount of consideration

# Variable Consideration

# Variable Consideration

---

- › Consideration may vary based on occurrence or nonoccurrence of an event
- › May be explicitly stated in contract
- › Variable if **either** of the following exist
  - Customer has reasonable expectation that entity will **accept less** than stated in contract if:
    - Customary business practice
    - Published policy
    - Specific statements by the entity
  - Other facts and circumstances indicate intention by entity to offer **price concession**

# Variable Consideration

---

- › Two types of variable consideration:
  - Incentive and performance based fees
  - Pricing adjustments for transactions that have already been completed, which include price concessions
- › Price concessions
  - Commonly made outside initial contract terms
  - May increase chances of securing other contracts
  - Appease dissatisfied customers
  - Encourage customer to make payments

# Variable Consideration

---

## › Forms of variable consideration:

### **Unfavorable to the transaction price**

- Discounts
- Rebates
- Credits
- Refunds
- Price concessions
- Penalties
- Returns
- Allowances

### **Favorable to the transaction price**

- Incentives
- Performance bonuses
- Contingent fees

# Variable Consideration

---

- › Estimate amount of consideration to which the entity expects to better predict consideration:
  - Expected value
    - Probability weighted amounts in range of possible consideration amounts
    - Used when have a large number of contracts with similar characteristics
    - Common method of estimation for discounts, rebates and returns
  - Most likely amount
    - Single most likely amount in range of possible amounts
    - Used when contract only has two possible outcomes
    - Common method of estimation for bonuses and incentives

# Variable Consideration

---

- › Estimate amount of consideration to which the entity expects to better predict consideration
  - Apply one method consistently throughout contract
  - Must consider:
    - All information reasonably available
      - Historical
      - Current
      - Forecasted
    - Reasonable number of consideration amounts

# Variable Consideration

---

- › Constraint of variable consideration
  - Recognize variable consideration only to the extent
    - **Probable** that a **significant reversal** in amount of cumulative revenue recognized **will not occur** when uncertainty associated with variable consideration is subsequently resolved
  - Consider **likelihood and magnitude** of the revenue reversal
  - Addresses concerns that revenue could be recognized prematurely
    - Lowers risk of improper revenue recognition

# Variable Consideration

---

- › Constraint of variable consideration
  - Factors that could increase likelihood or magnitude of amount of consideration reversal include:
    - Entity's experience with similar types of contracts is limited
    - Entity's experience with similar types of contracts has limited predictive value
    - Contract has a large number and broad range of possible consideration amounts
    - Entity's practice of offering either:
      - Broad range of price concessions
      - Changing payment terms and conditions of similar contracts in similar circumstances

# Variable Consideration

---

- › Estimated transaction price reassessed and updated at end of each reporting period until uncertainty resolved
  - Includes assessment of constrained variable consideration
- › If some or all of the consideration received is expected to be refunded then refund liability must be established

# Variable Consideration

## Examples

# Example 1 – Variable Consideration and Change Order

## FACTS

- Advertising firm has a fixed contract for \$100,000 with ABC Customer to perform advertising services in 2019.
- Additional work was performed for ABC Customer in 2019 that was outside of the original contract where \$25,000 of time was incurred.
- The firm plans to bill ABC Customer \$20,000 for the additional services performed in 2020.

## ANALYSIS

- Advertising firm must consider historical experience with this customer in determining whether to include the variable consideration as revenue.
- Has the firm had success in the past of billing ABC Customer for change order work?
- Is it probable that a significant revenue reversal of the \$20,000 will not occur?
- Does the firm has an enforceable right to payment for this change order work?

## Example 2 – Variable Consideration and Contract Modification

### FACTS

- Contractor enters into a contract to expand a two-lane highway.
- Due to unforeseen weather issues, contractor incurs additional unexpected costs (spoiled materials, etc.).
- Contractor has submitted a claim to recover these costs.

### ANALYSIS

- Contractor must consider historical experience in determining whether to include the claim (variable consideration) in transaction price, considering that:
  - Contractor expects to successfully negotiate the claim.
  - It is probable that a significant revenue reversal would not occur if the claim amount is included in the transaction price.
  - The contractor has an enforceable right to payment.

## Example 3 – Variable Consideration and Incentive Payments

### FACTS

- Entity enters into a developer fee agreement with a customer for a total fee of \$500,000.
- If the project is completed within 6 months, a performance bonus of \$50,000 will be paid which is included in the \$500,000 total fee.

### ANALYSIS

- \$450,000 of the transaction price is fixed and \$50,000 is variable.
- If it is probable that a significant revenue reversal of the \$50,000 would not occur if the incentive amount is included in the transaction price, then the entire \$500,000 is deemed to be the transaction price to be recognized over the 6 month period.

## Example 4 – Variable Consideration and Returns

### FACTS

- An entity enters into a contract with a customer.
- The contract includes the sale of 100 products for \$100 each (\$10,000 consideration in total).
- The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund.
- The entity's cost of each product is \$60. The entity estimates 97 products will not be returned.

### ANALYSIS

- If the entity concludes that it is probable that a significant reversal of revenue will not occur for the 97 products, then the \$9,700 of consideration (\$5,820 of cost of sales) can be recorded on these contracts when control is transferred.
- \$300 would be recognized as a refund liability and \$180 would be recognized as a return asset.

## Example 5 – Variable Consideration and Volume Discount Incentives

### FACTS

- On January 1, 2019, an entity enters into a contract with a customer to sell a product for \$100 per unit.
- If the customer purchases more than 1,000 units in a year, the price is retrospectively reduced to \$90 per unit.
- As of March 31, 2019, 75 products were sold and entity recorded \$7,500 of revenue.
- As of June 30, 2019, the customer bought an additional 500 units of the product and now entity expects customer to reach 1,000 threshold.

### ANALYSIS

- The original three months of the contract (January 1, 2019 through March 31, 2019), entity did not expect customer to buy 1,000 units, therefore entity recorded the first 75 units at \$100 each (\$7,500).
- During the next three months of the contract (April 1, 2019 – June 30, 2019), entity should record revenue of \$44,250.
- The amount is calculated from \$45,000 (sale of 500 units x \$90) less the change in transaction price of \$750 (75 units x \$10 price reduction).
- The variable consideration is (\$5,750).

# Example 6 – Variable Consideration and Price Concessions

## FACTS

- An entity enters into a contract with a customer.
- The entity expects to transfer 1,000 products for a price of \$100 per product under the contract.
- There are production delays.
- The entity anticipates granting a \$10,000 price concession to this customer based on the production delays.
- Only 50 products have been shipped thus far.

## ANALYSIS

- The consideration in this contract is variable based on the entity's anticipation of the price concession.
- For the 50 products that have been shipped, \$4,500 would be recognized into revenue (\$5,000 of fixed less \$500 of variable consideration in the form of a price concession).

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

# What To Do Now

---

- › Review contracts with customers and document key terms and conditions in each contract
  - Performance obligations
  - Transaction pricing (variable consideration)
- › Determine and document revenue recognition under the new standard for each contract AND assess differences from current GAAP
- › The new revenue recognition rules may result in acceleration in revenue recognition of the variable consideration, in a favorable (e.g. incentive payments) or unfavorable way (e.g. volume discounts, rebates, price concessions).

# 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

# What To Do Now

---

- › 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 for our Presenters?

---



**Joe DiFranco, CPA, MBA**

216.774.1171

[jdifranco@cohencpa.com](mailto:jdifranco@cohencpa.com)



**Tina Dzik, CPA, MBA**

216.774.1125

[tdzik@cohencpa.com](mailto:tdzik@cohencpa.com)

# Thank you.

- › **Join Us For** Tax Reform Has Arrived  
Thursday, January 11, 10am – Noon EST  
[www.cohencpa.com/events](http://www.cohencpa.com/events)