Revenue Recognition: Manufacturers & Distributors Supplement

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Background & Summary

The deadline for adoption of the new revenue recognition guidance is fast approaching. For public entities,[1] implementation is required for the 2018 financial statements. All other entities will have an additional year to adopt the new standard. Certain manufacturers will see greater changes to revenue recognition than others; in general, companies that directly sell to consumers will be less affected than companies that sell through a distributor. Even if the timing of revenue recognition does not change, all entities will be subject to extensive new disclosure requirements. In addition, policies, internal controls and management's significant judgments will need to be documented or updated to reflect the new guidance. Companies that have early adopted have found that implementation took more time and effort than expected.

Shortly after the revenue standard's release, the Financial Accounting Standards Board (FASB) formed the Joint Transition Resource Group (TRG) for Revenue Recognition to aid transition to the new standard by soliciting, analyzing and discussing stakeholder issues arising from implementation of the new guidance. While the TRG members' views are nonauthoritative, manufacturers should consider them as they implement the new standard.

This industry-specific supplement to our comprehensive white paper highlights the changes from current accounting and the areas most likely to present implementation challenges for manufacturers. This paper incorporates all subsequent amendments, TRG clarifications and U.S. Securities and Exchange Commission (SEC) views gathered from official speeches.

[1] *The new revenue standard defines a public entity as any one of these:*

- *A public business entity*
- *A not-for-profit entity that has issued—or is a conduit bond obligor for—securities traded, listed or quoted on an exchange or over-the-counter market*
- *An employee benefit plan that files or furnishes financial statements to the SEC*

Changes	
Current Guidance	New Guidance
Recognition	
Revenue is not recognized until the seller has substantially accomplished what it must do under the contract terms. Risk and rewards of ownership must pass upon delivery for revenue to be recognized.	An entity would recognize revenue when (or as) control is transferred to a customer.
Disclosure	
There is limited disclosure about revenue contracts; disclosures usually relate to accounting policies and segment reporting.	A new cohesive set of disclosure requirements provide quantitative and qualitative information on revenue recognition policies and how they are applied.
Variable Consideration	
The seller's price must be fixed or determinable for revenue recognition. Variable amounts are not included in the transaction price until the variability is resolved (except for percentage of completion method). The sales price in cancellable arrangements generally is not fixed or determinable until cancellation privileges lapse.	Variable consideration will be included in the transaction price as long as it is deemed probable that a significant reversal of revenue will not occur. Revenue might be recognized sooner as a result.
Allocation of Transaction Price	
Transaction price is allocated on relative standalone selling price basis; for multiple element arrangements, the standalone selling price is determined first by vendor-specific objective evidence, then third-party evidence and finally estimated selling price.	An entity would first look to observable prices if available. Transaction price is allocated on relative standalone selling price basis. If observable prices are not available, entities would estimate standalone selling prices by using as many observable inputs as possible.
Contract Costs	
In general, an accounting policy election determines if incremental direct contract acquisition costs are capitalized or expensed.	Capitalize incremental cost of obtaining a contract, if recoverable. Fulfillment costs are capitalized only if they are expected to be recovered and both relate directly to an existing contract and generate or enhance resources that would be used to satisfy performance obligations in the future.
Repurchase Arrangements	
If a seller retains a repurchase obligation or option, or the buyer can compel the seller to repurchase, the transaction would not qualify for sale accounting; it would be treated as a financing, lease or profit-sharing arrangement.	The accounting depends on which party holds the obligation or right and the relative repurchase price to the original sales price.
Bill & Hold Arrangements	
SEC rules cover public companies.	Guidance is incorporated into generally accepted accounting principles (GAAP) for all entities; however, it is less restrictive than SEC guidance.

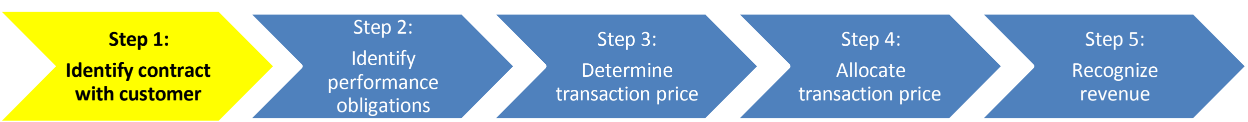
Scope

The new revenue standard applies to all contracts with customers, except those within the scope of other standards, such as lease and insurance contracts, financing arrangements, financial instruments, guarantees (other than product or service warranties) and certain nonmonetary exchanges between vendors. A contract may be partially in the new standard's scope and partially in the scope of other accounting guidance, *e.g.*, a contract for the lease of an asset and for maintenance services. If the other accounting guidance specifies how to separate or initially measure one or more parts of a contract, an entity should first apply those requirements before applying this accounting standards update (ASU).

The Revenue Recognition Model

This is the first principles-based standard to be issued by FASB, which will require greater management judgment compared to previous rules-based standards. The model's core principle is that an entity would recognize revenue in the amount reflecting the consideration to which it expects to be entitled in exchange for goods or services when (or as) it transfers control to the customer. To achieve that core principle, an entity will apply a five-step model:

- Step 1: Identify the contract(s) with a customer
- Step 2: Identify separate performance obligations
- Step 3: Determine the transaction price
- Step 4: Allocate the transaction price to the performance obligations
- Step 5: Recognize revenue when (or as) performance obligations are satisfied



Step 1 – Identify the Contract with a Customer

The new revenue standard defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations." Enforceability of rights and obligations is a matter of law and may vary between jurisdictions. Contracts with customers that are within the new standard's scope should be accounted for only when all the following criteria are met:

Recognition – Contract Criteria Not Met

The cash basis method of revenue recognition is eliminated under the new standard. If the contract requirements are not met, revenue can be recognized only when the amount an entity receives from the customer is nonrefundable and one of the following events has occurred:

- The entity has no obligation to transfer additional goods or services and substantially all of the consideration has been received.
- The contract has been terminated.[2]
- The entity has transferred control of the goods or services related to the received consideration, and the entity has stopped transferring and has no obligation to transfer additional goods and services to the customer.

Until revenue can be recognized, the consideration received from the customer should be recognized as a liability.

Commitment

FASB notes in its basis for conclusion that although both parties should be committed to performing their respective obligations under the contract, an entity and a customer would not always need to be committed to fulfilling **all** their respective rights and obligations for a contract to exist. For example, assume a belt manufacturer has a contract with a large clothing retailer to purchase a minimum quantity of belts each month. In the past, the retailer has not always purchased the minimum quantity and the manufacturer has not enforced the requirement. The manufacturer could still recognize a contract if other facts and circumstances indicated the retailer was **substantially** committed to perform.

Collectibility

Collectibility is an explicit threshold for determining whether a contract exists and must be assessed before applying the revenue recognition model. An entity must evaluate customer credit risk and conclude it is "probable" it will collect the amount of consideration due in exchange for the goods or services promised to the customer. This assessment is not based on collecting **all** the contract's promised consideration; rather, a manufacturer should consider the probability of collecting the consideration it is entitled to for the goods or services transferred to the customer, taking into account its ability to demand advance customer payments or stop providing goods or services if the customer stops paying consideration when it is due.

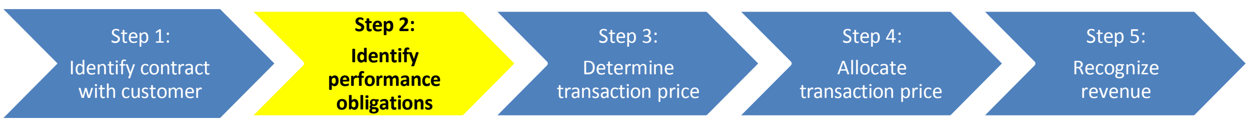
Contract Modifications

A contract modification occurs when both parties approve a change in a contract's scope and/or price that creates new enforceable rights and obligations or changes existing ones. Similar to a contract, a contract modification can be written, oral or implied by customary business practices. Contract claims—such as additional consideration for customer-caused delays, changes or errors in specifications—would be accounted for in a similar manner to contract modifications. For claims expected to be settled through adjudication or arbitration, recognition would be delayed until the uncertainty of the settlement amount is resolved due to the revenue constraint (see Step 3). Unsettled claims and unpriced change orders would be accounted for similar to a modification only if the work's scope has been approved and the entity can estimate the change in the transaction price.

[2] *ASU 2016-12 defines contract termination as when an entity is allowed to stop (based on the contract or by law) and has stopped transferring goods or services to the customer. The contract does not need to be legally terminated and the entity does not need to stop pursuing collection for the contract to be considered terminated for purposes of recognizing the cash collected as revenue.*

Accounting for contract modifications is dependent on the type of modification as noted below:

Contract Modifications	
Type of Modification	Accounting Treatment
• Additional goods or services are distinct • At standalone prices	Separate contract
• Remaining services are distinct • Not at standalone prices	Termination of existing contract and creation of a new contract
• Remaining services are not distinct • Form part of a single partially complete performance obligation	Part of the existing contract



Step 2 – Identify Separate Performance Obligations

Once an entity has identified a contract with a customer, the next step is to identify separate performance obligations within that contract. A performance obligation is a promise to transfer a distinct good or service—or a series of distinct goods or services that are substantially the same and have the same pattern of transfer—to a customer. The promise may be oral, written or implied by customary business practices. To be considered distinct, a promised good or service must be both:

- Capable of being distinct, i.e., the customer can benefit from the good or service on its own or with other readily available resources
- Distinct within the context of the contract, *i.e.*, the good or service is separately identifiable from other promises in the contract; the following indicators would be used to evaluate if a good or service is distinct within the contract's context:
    - Significant integration services are not provided
    - The customer was able to purchase—or not purchase—the good or service without significantly affecting other promised goods or services in the contract
    - The good or service does not significantly modify or customize another good or service promised in the contract

A manufacturer would determine whether the nature of its promise in the contract is to transfer each of the goods or services or whether the promise is to transfer a combined item (or items) to which the promised goods and/or services are inputs.

Example – Design & Manufacture

An entity agrees to design an experimental product for a customer and manufacture 10 prototype units. The product's specifications include functionality that has yet to be approved. The entity will need to revise the product's design during construction and testing; as a result, the entity expects that most or all of the units may require rework. The customer may not be able to choose whether to purchase only the design services or the manufacturing services without significantly affecting the other; the risk of providing the design service is inseparable from the manufacturing service. Therefore, in the context of this contract, the performance obligations are not distinct.

Series Provision

The series provision is a new concept that does not exist in current GAAP. It **requires** goods or services to be accounted for as a single performance obligation in certain instances, even though the underlying goods or services are distinct. A series of distinct goods or series should be accounted for as a single performance obligation if they are substantially the same, have the same pattern of transfer and both of the following criteria are met:

- Each distinct good or service in the series represents a performance obligation that will be satisfied over time (Step 5).
- The entity would measure its progress toward satisfaction of the performance obligation using the same measure of progress for each distinct good or service in the series.

Entities will need to determine whether a single performance obligation is created in this manner to appropriately allocate variable consideration (Step 4) and apply the guidance on contract modification and changes in transaction price. This provision prevents an entity from having to allocate the transaction price on a relative standalone selling price basis to each increment of a distinct service in repetitive service contracts.

TRG members agreed that a series of distinct goods or services need not be consecutively transferred. The series guidance also must be applied even when there is a gap or overlap in an entity's transfer of goods or services if the other criteria are met.

Example A

A manufacturer has contracted to produce 1,000 units per month for a two-year period. The service will be performed evenly over the two-year period with no breaks in production. The units produced are substantially the same and manufactured to customer specifications. There are no significant upfront costs to develop the production process. Assume that its service of producing each unit is a distinct service and the service is accounted for as a performance obligation satisfied over time because the units are manufactured to customer specifications (no alternative use to the entity). If the contract were to be canceled, the entity has an enforceable right to payment (cost plus a reasonable profit margin).

Example B

Assume the same facts as the example above, except the entity does not plan to perform evenly over the two-year service period—the manufacturer could produce 2,000 units in some months and zero units in other months.

TRG Conclusion

Under both examples, the manufacturing service provided would be a single performance obligation. While an entity may consider the pattern of performance in determining the measure of progress toward satisfying a performance obligation, the pattern of performance is not an explicit criteria for the application of the series provision. TRG members agreed a consecutive performance pattern is not determinative in concluding if the series provision applies. FASB did not intend for the series provision to only apply to consecutive performance.

Immaterial Items

FASB did not expect entities to identify significantly more performance obligations than the deliverables identified under current guidance. A subsequent amendment permits entities to disregard promises that are deemed to be immaterial in the context of the contract. Such items would not be required to be aggregated and assessed for materiality at the entity level for auditing purposes. If the revenue related to a performance obligation that includes goods or services that are immaterial in the context of the contract is recognized before those immaterial goods or services are transferred to the customer, a manufacturer would accrue the related costs to transfer those goods or services.

Shipping & Handling

Under existing guidance, many entities do not account for shipping provided along with the sale of their goods as an additional deliverable. To reduce the cost and complexity of applying the new standard, a subsequent amendment allows entities to elect to account for the cost of shipping and handling performed after control of a good has been transferred to the customer as a fulfillment cost, *i.e.*, an expense. Without such an election, a manufacturer that has free on board shipping point arrangements might conclude the shipping is a performance obligation to be required to allocate a portion of the transaction price to the shipping service and recognize it when (or as) the shipping occurs.

SEC Insights

At the 2017 American Institute of CPAs (AICPA) conference, an official from the SEC's Office of the Chief Accountant (OCA) addressed the expense classification for shipping and handling costs, which is not addressed in the ASU. Entities will need to apply reasonable judgment in determining the appropriate classification for those shipping and handling activities that are accounted for as activities to fulfill the promise to transfer the good. The SEC would ***not*** *object to classification of these expenses within cost of sales* ***or*** *if an entity continued to apply its previous classification policy for these costs, which could potentially be outside cost of sales. However, registrants should consider disclosure for significant shipping and handling charges reported outside of cost of sales, including the amount and line item on the income statement where they are reported.*

Material Rights

Manufacturers frequently offer customer options to acquire additional goods or services for free or at a discounted rate. Examples include sales incentives, customer reward credits, contract renewal options or other discounts on future goods or services. Such options would constitute a separate performance obligation only if the option gives the customer a material right it would not receive without entering into that contract. This topic generated many implementation questions. TRG members generally agreed on the following:

- Entities should consider accumulating incentive programs, *e.g.*, loyalty rewards, when determining whether an option represented a material right.
- The material right evaluation should consider both qualitative and quantitative factors.
- It would be reasonable for an entity to apply the guidance on contract modifications to the exercise of a material right, which also may be treated as a continuation of the existing contract. The decision will require management's judgment based on the facts and circumstances of each arrangement.
- Material rights also should be evaluated to determine if a significant financing component exists. TRG members noted if the customer can choose when to exercise the option, there likely is not a significant financing component.
- The period over which a nonrefundable upfront fee will be recognized depends on whether the fee provides the customer with a material right to future contract renewals. If the entity concludes the upfront fee does not provide a material right, the fee would be recognized over the contract term.
- Usage-based fees will require judgment.

Distribution Networks

In distribution networks, manufacturers commonly transfer control of a product to unrelated third-party intermediaries such as dealers or retailers. The manufacturer also may promise other goods or services as sales incentives to encourage sale of products that have become part of the intermediary's inventory. In some cases, those promises are made at contract inception. However, promises can be added later in response to changing market conditions; this is common in the automotive industry. If the promise to transfer additional goods or services to a dealer is made in the original contract, the promised goods or services would be treated as a single performance obligation. If the promise to transfer additional goods or services was made after the transfer of control of the product to the intermediary, the promise would be treated as a separate performance obligation.

Warranties

Manufacturers will have to distinguish between warranties—those representing assurance of a product's performance and those representing a separate performance obligation. A warranty that can be purchased separately should be accounted for as a separate performance obligation because the entity promises a service to the customer in addition to the product. For bundled sales, the transaction price would be allocated to the two performance obligations based on the relative standalone selling prices of the product and warranty. If no separate purchase option exists, the entity would apply the cost-accrual guidance in Accounting Standards Codification (ASC) 460, *Guarantees*, unless the warranty provides an additional service to the customer in addition to the assurance that the product complies with agreed-upon specifications. If an entity promises both assurance and service-type warranties but cannot reasonably account for them separately, it would account for both together as a single performance obligation.

A manufacturer should consider the following factors in determining whether a warranty provides a customer with an additional service:

- Legal requirement – If the intention is to protect the customer from purchasing a defective product, it likely does not represent a separate performance obligation
- Warranty term – The shorter the coverage period, the less likely a warranty is a separate performance obligation
- Tasks to be performed under the warranty – If an entity must perform certain tasks to provide assurance to the customer that the product complies with agreed-upon specifications, those services would not likely constitute a separate performance obligation, *e.g.*, return shipping service for a defective product

Step 3 – Determine the Transaction Price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. To determine the transaction price, an entity would consider the contract terms, its customary business practices and the effects of the time value of money, noncash consideration and consideration payable to the customer. Consideration may include fixed and/or variable amounts. Customer credit risk would not be reflected in determining the transaction price.

Transaction Price				
Total amount of consideration to which an entity expects to be entitled				
Variable consideration	Constraining estimates of variable consideration	Significant financing component	Noncash consideration	Consideration payable to a customer

Variable Consideration & Constraining Estimates

Variable consideration is anything that causes the amount of consideration to vary and could result from volume discounts, rebates, price concessions, refunds, performance bonuses, contingencies, royalties or penalties. An estimate, including some or all of the variable consideration, could be included in the transaction price if it is "probable" the amount would not result in a significant revenue reversal. This constraint also would apply to a fixed-price contract if an entity's entitlement is contingent on the occurrence or nonoccurrence of a future event, *e.g.*, performance bonuses or sales with a right of return. Management's estimate of the transaction price will be reassessed each reporting period, and the transaction price should be updated for any changes in circumstances throughout the period. The estimate would assume an entity delivers all the promised goods or services and the customer does not cancel, renew or modify the contract.

This assessment will require significant judgment. Manufacturers should consider the following indicators, any of which increase the likelihood or magnitude of a revenue reversal:

- The amount of consideration is highly susceptible to factors outside the entity's influence
- Resolution of uncertainty about the amount of consideration is not expected for a long period of time
- The entity has limited experience with similar types of contracts
- The entity has a practice of offering a broad range of price concessions or changing the payment terms and conditions in similar circumstances for similar contracts
- The contract has a large number and broad range of possible consideration amounts

Entities are required to estimate the transaction price using one of the approaches below, depending on which is expected to most accurately predict the consideration to which the entity will be entitled:

- Expected value – the sum of probability-weighted amounts in a range of possible consideration amounts; an expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics
- Most likely amount – the single most likely amount in a range of possible consideration amounts, *i.e.*, the single most likely outcome of the contract; the most likely amount may be an appropriate estimate of the amount of variable consideration if the contract only has two possible outcomes, *e.g.*, an entity achieves or doesn't achieve a performance bonus

The same method should be used throughout the contract's life to update the estimated transaction price at each reporting date.

TRG members clarified the variable consideration constraint should be applied at the contract level as it is the unit of account for determining the transaction price. In some cases, it may be difficult to determine if an entity has implicitly offered a price concession or accepted the customer's risk of default on the contractually agreed consideration; the TRG provided the following indicators of a price concession:

- Customary business practice of providing discounts or accepting as payment less than the contractually stated price
- Customer has a valid expectation the manufacturer will accept less than the contractually stated price
- Entity transfers the goods to the customer when historical experience indicates that it is probably not the manufacturer who will collect the billed amount

Example – Price Concessions

A manufacturer, ABC Co., enters into a contract with a distributor and transfers 1,000 units at contract inception for the contractual price of $100 per unit. Payment is due when the distributor sells the product to the end customer, usually within 90 days. ABC anticipates granting a price concession to the distributor to move the product through the distribution chain.

Variable Consideration Not Constrained

ABC has significant experience selling this product. Current market information suggests a 20 percent price reduction will be sufficient to move the products through the distribution chain. ABC has not granted a price concession significantly greater than 20 percent in many years. Using the expected value method, which ABC expects will best predict the amount of consideration to which it will be entitled, ABC estimates the transaction price to be $80,000 ($80 x 1,000 units). ABC determines it has significant previous experience with this product and current market information supports its estimate. Despite some uncertainty resulting from factors outside its influence, based on its current market estimates, ABC expects the price to be resolved within a short time frame. ABC concludes it is probable a significant reversal in the cumulative amount of revenue recognized, i.e., $80,000, will not occur when the uncertainty is resolved and recognizes $80,000 as revenue when the products are transferred to the distributor.

Variable Consideration Constrained

ABC has significant experience selling this product. However, the product has a high risk of obsolescence and ABC is experiencing high volatility in its pricing. ABC historically granted a broad range of price concessions ranging from 20 percent to 60 percent. Current market information suggests a 15 to 50 percent price reduction will be sufficient to move the products through the distribution chain. ABC uses the expected value method, which it expects will best predict the amount of consideration to which it will be entitled, and estimates a 40 percent discount resulting in a variable consideration estimate of $60,000 ($60 x 1,000 units). The amount of consideration is highly susceptible to factors outside the manufacturer's influence, e.g., risk of obsolescence, and ABC may need to offer further discounts. ABC cannot recognize its $60,000 revenue estimate since it cannot conclude a significant reversal of cumulative revenue recognized will not occur. However, ABC could conclude a significant reversal of cumulative revenue would not occur if a 50 percent discount was used. Therefore, ABC would recognize revenue of $50,000 when the goods are transferred and would reassess the estimate of the transaction price at each reporting date until the uncertainty is resolved.

Performance Bonuses

Entities currently do not recognize performance bonuses until they are earned. Under the new model, an entity would estimate and include in the transaction price the most predictive amount of a performance bonus that would not be subject to risk of significant reversal. Some entities might recognize revenue earlier than current practice if they have predictive experience. If an entity does not have predictive experience relative to the entire transaction price but does have it up to a certain amount, the "floor" amount would be used to determine the transaction price.

Example – Volume Rebate

ShredCo, an office equipment manufacturer, enters into a one-year arrangement to distribute paper shredders with OPR, a national office products retailer. ShredCo agrees to provide OPR a volume rebate of 5 percent if annual purchases exceed $5 million and 10 percent if annual purchases exceed $10 million. The rebate will be applied in the form of a credit against outstanding accounts receivable from OPR in February of each year based on prior-year purchases. In exchange for the volume rebates, OPR will exclusively purchase all of its paper shredders from ShredCo. The consideration in the contract is variable.

First Quarter

ShredCo has significant experience with OPR's purchasing patterns and reasonably estimates the volume of purchases at $6 million during the year. During the first quarter, $1 million in shredders are sold. ShredCo concludes it has significant experience with this product and OPR's purchasing pattern. ShredCo concludes that at $100 per unit, it is probable a significant reversal in the cumulative amount of revenue recognized, i.e., $100 per unit, will occur when the uncertainty is resolved. ShredCo would recognize $950,000 in revenue in the first quarter reflecting the volume rebate.

Second Quarter

OPR acquires another office supplies retailer and as a result, ShredCo estimates OPR's total purchases will exceed $15 million for the year. OPR purchases $1 million of shredders in the second quarter.

In light of the acquisition, ShredCo estimates OPR's purchases will exceed the threshold for the maximum rebate of 10 percent and will be required to retrospectively reduce the price per unit to $90. Therefore, OPR's second quarter revenues would be $850,000 to $900,000 for the shredders sold in the second quarter (reflecting a 10 percent discount) and an adjustment of $(50,000) for the change in transaction price for the units sold in the first quarter.

Example – Right Return

A manufacturer sells 100 widgets for $100 each. The customary practice is to allow a customer to return an unsold widget within 30 days and receive a full refund. The cost to produce each widget is $60. The cost to recover the widget is immaterial and the returned widget can be resold at a profit. Previous predictive experience indicates roughly three widgets will be returned. Upon transfer of the widgets, the manufacturer would not recognize revenue for the three widgets it expects to be returned.

New Model

	Debit	*Credit*
Accounts receivable	*$10,000*	
Revenue (97 x $100)		*$9,700*
Refund liability (3 x $100)		*$300*
Cost of sales (97 x $60)	*$5,820*	
Right to recover products (3 x $60)	*$180*	
Inventory (100 x $60)		*$6,000*

The new model for sales with a right of return is largely consistent with current U.S. GAAP. However, currently there is diversity in balance sheet presentation for expected returns. Entities now will be required to show on the balance sheet a liability for the refund obligation and an asset for the right to recover the product. Entities also will be required to subject the asset recognized to impairment testing.

Significant Financing Component

Contract terms may explicitly or implicitly provide the entity or the customer with favorable financing terms. A contract that has a financing component includes, conceptually, two transactions—one for the sale and one for the financing. If the financing component is significant, the transaction price should be adjusted to reflect the time value of money as though the customer had paid cash at the time of transfer.

To determine if the financing component is significant, an entity would consider the effect of the following:

- Whether the consideration would substantially differ if the customer promptly paid cash under typical credit terms
- The expected length of time between delivery of goods or services and receipt of payment
- The prevailing interest rates in the relevant market

As a practical expedient, an entity would not reflect the time value of money if—at contract inception—it expects the period between customer payment and the transfer of goods or services will be one year or less. This also would apply to contracts with an overall duration greater than one year if the period between performance and the corresponding payment for that performance is one year or less. An entity must disclose if this practical expedient is elected.

The transaction price adjustment for the time value of money would use the discount rate implied in a separate financing transaction between the entity and customer at contract inception, reflecting the borrower's (customer's) credit risk and any collateral or security provided. The rate may be calculated by discounting the nominal amount of the promised consideration to the cash selling price of the good or service. The rate cannot be adjusted for changes in circumstances or interest rates after contract inception.

The effects of financing would be presented separately from revenue as interest expense or interest income in the statement of comprehensive income. An entity would not be precluded from presenting interest income recognized from contracts with a significant financing component as revenue, provided the entity generates interest income in the normal course of business similar to a financial services entity.

The standard highlights three circumstances that would **not** result in a significant financing component:

- If the difference stems from a reason other than financing to either the customer or manufacturer, and the difference is proportional to the reason for the difference
- If an entity pays in advance for goods or services,and if the timing of the transfer of goods or services is at the customer's discretion, *e.g.*, a prepayment to secure supplies
- If a substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies based on the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity, *e.g.*, a sales-based royalty

Manufacturers with long-term arrangements where payment and performance are far apart will be most affected. Determining whether a contract contains a significant financing component will require judgment.

Noncash Consideration

If a customer consideration is promised in a form other than cash, the noncash consideration should be measured at fair value at contract inception to determine the transaction price. If a reasonable estimate of fair value of the noncash consideration cannot be made, the entity would use the estimated selling price of the promised goods or services, similar to current accounting standards.

Consideration Payable to a Customer

Consideration payable to a customer includes amounts an entity pays or expects to pay to a customer in the form of cash or noncash items, *e.g.*, additional goods, coupons or vouchers, which the customer can apply against amounts owed to the entity. This also could include a customer's customer, *e.g.*, a manufacturer may sell a product to a dealer or distributor and subsequently pay a customer of that dealer. An entity would evaluate the consideration to determine if the amount represents a reduction of the transaction price, a payment for distinct goods or services or a combination of the two. An entity would reduce the transaction price by the amount it owes the customer, unless the consideration owed is in exchange for distinct goods or services transferred from the customer to the entity.

If the consideration owed to the customer is payment for distinct goods or services from the customer to the entity, the entity would account for the purchase of these goods or services similarly to purchases from suppliers. If the amount of consideration owed to the customer exceeds the fair value of those goods or services, the entity would reduce the transaction price by the excess amount. If the entity cannot estimate the fair value of the goods or services it receives from the customer, it would reduce the transaction price by the total consideration owed to the customer.

An entity would recognize the revenue reduction associated with adjusting the transaction price for consideration payable to a customer at the later of the following dates:

- When the entity recognizes revenue for the transfer of goods or services to the customer
- When the entity pays or promises to pay the consideration to the customer (this could be implied by customary business practices)

Upfront Payments to Potential Customers or on Anticipated Contracts

Under current guidance, there is diversity in practice about the treatment of payments to potential customers and payments that relate to both current and anticipated contracts. Financial statement preparers questioned whether the accounting treatment for such payments would change under the new revenue standard. TRG members agreed the determination of asset versus expense is **not** an accounting policy election. Entities must understand the reason for the payment, the rights and obligations resulting from the payment, the nature of the promise and any other relevant facts and circumstances. An entity should be clear on whether and how it expects to obtain future benefit as a result of an upfront payment. A payment to a customer related to anticipated contracts could meet the "asset" definition. An entity's decision on which approach is appropriate may be a significant judgment in determining the transaction price that would require disclosure.

Gross Versus Net Revenue – Amounts Billed to Customers

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. Any party—not just the customer—can pay the amount, *e.g.*, payments received from a manufacturer as a result of coupons or rebates.

Presentation of Sales Taxes

A subsequent amendment allows entities to make an accounting policy election to present sales taxes collected from customers on a net basis. The standard as originally issued would have **required** some taxes collected on behalf of third parties to be excluded from the transaction price. Entities would have had to evaluate taxes collected in multiple jurisdictions to determine if a tax is levied on the entity or customer. An entity not making this accounting policy election would apply the new revenue standard as originally issued in determining if those taxes should be included in the transaction price.

Step 4 – Allocate the Transaction Price to the Separate Performance Obligations

An entity would allocate the transaction price to performance obligations based on the relative standalone selling price of separate performance obligations. The best evidence of standalone selling price would be the observable price for which the entity sells goods or services separately. In the absence of separately observable sales, the standalone selling price would be estimated by using observable inputs and considering all information reasonably available to the entity. The objective would be to allocate the transaction price to each performance obligation in an amount that represents the consideration the entity expects to receive for its goods or services. Several approaches could be used to estimate the standalone selling price of a good or service, including but not limited to the following:

- Adjusted market assessment – An entity would evaluate the market and estimate the price customers would pay; competitors' price information might be used and adjusted for an entity's cost and margins
- Cost plus margin – An entity would forecast its expected cost to provide goods or services and add an appropriate margin to the estimated selling price
- Residual value – An entity would subtract the sum of observable standalone selling prices for other goods and services promised in the contract from the total transaction price to find an estimated selling price for a performance obligation; the residual value approach would be appropriate only if selling price is highly variable or uncertain, *e.g.*, intellectual property where there is little incremental cost, a new product where price has not been set or the product has not been previously sold

The use of the residual value approach is more limited within the ASU than under current accounting guidelines; the residual method becomes an estimation technique rather than an allocation methodology.

Variable Consideration

Variable consideration may be attributable to the entire contract or a specific part of it. Variable consideration (and any subsequent changes) would be entirely allocated to a distinct good or service only if both the following criteria are met:

- The variable payment specifically relates to either of the following:
  - The entity's efforts to transfer that distinct good or service
  - A specific outcome of transferring that distinct good or service

- Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the general allocation principle that the transaction price should be allocated to each separate performance obligation in an amount depicting the consideration amount to which the entity expects to be entitled in exchange for satisfying each separate performance obligation, considering all the contract's performance obligations and payment terms.

An entity can allocate variable consideration to more than one distinct good or service in the contract.

Allocating Discounts

Discounts for a bundle of goods or services would be allocated to all performance obligations unless **all** of the following criteria are met, in which case the entire discount would be allocated to one or more (but not all) separate performance obligations:

- The entity regularly sells each good or service, or each bundle of goods or services, in the contract on a standalone basis
- The entity regularly sells on a standalone basis a bundle of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle
- The discount attributable to each bundle of goods or services described above is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation(s) to which the entire discount in the contract belongs

Changes in Transaction Price

If the transaction price changes after contract inception, an entity would allocate the change to separate performance obligations in the same way it allocates the transaction price at contract inception. Any change in the transaction price allocated to a satisfied performance obligation would be recognized either as revenue or a reduction in revenue in the period the change occurs. An entity would allocate a change in transaction price to a single distinct good or service, or group of goods or services, using the variable consideration criteria.

Step 1: Identify contracts with customer → Step 2: Identify performance obligations → Step 3: Determine transaction price → Step 4: Allocate transaction price → **Step 5: Recognize revenue**

Step 5 – Recognize Revenue When (or as) Performance Obligations Are Satisfied

An entity would recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. An asset is transferred when the customer obtains control—a departure from the current risk and rewards criteria. Revenue can be recognized over time or at a point in time and is determined at the performance unit level at contract inception. Assessing whether a transaction meets the criteria to recognize revenue over time will be a key accounting judgment.

Performance Obligations Satisfied over Time

Over-time recognition is appropriate when **any** of these criteria are met:

- The customer simultaneously receives and consumes the performance obligations benefits
- The entity's performance creates or enhances an asset
- The performance does not create an asset with alternate use **and** the entity has an enforceable right to payment

Alternate Use

To determine if an asset has an alternative use, the entity considers at contract inception the effects of contractual and practical limitations on its ability to readily direct the asset to another customer. An asset would not have an alternative use if an entity is prohibited from transferring the asset to another customer or would incur significant costs to do so. A manufacturer should consider the characteristics of the asset that will ultimately be transferred to the customer. The assessment should not be reassessed unless the contract's parties approve a contract modification. If the asset does not have an alternative use, a manufacturer would not automatically be required to recognize revenue over time. A manufacturer also must meet the second half of the criteria related to an enforceable right to payment.

> ***Example***
>
> *An entity enters into a contract with a customer to build equipment. The entity builds custom equipment for various customers. The customization of the equipment occurs when the manufacturing process is approximately 75 percent complete. In other words, for approximately 75 percent of the manufacturing process, the in-process asset could be redirected to fulfill another customer's equipment order (assuming there is no contractual restriction to do so). However, the equipment cannot be sold in its completed state to another customer without incurring a significant economic loss. The equipment's design specifications are unique to the customer, and the entity only would be able to sell the completed equipment at a significant loss.*
>
> *The entity would evaluate at contract inception whether there is any contractual restriction or practical limitation on its ability to readily direct the completed asset for another use. Because the entity cannot sell the completed equipment to another customer without incurring a significant economic loss, the entity has a practical limitation on its ability to direct the completed equipment and, therefore, the asset does not have an alternative use. However, before concluding revenue should be recognized over time, an entity must evaluate whether it has an enforceable right to payment.*

Enforceable Right to Payment

An entity has an enforceable right to payment for performance to date if an entity is allowed to recover cost plus margin on goods and services transferred to date. The right to payment should be enforceable and management should consider contractual terms and any legislation or legal precedent that could override those contractual terms. The right to payment for performance completed to date does not need to be for a fixed amount.

To be an enforceable right, the termination must include a reasonable profit margin on its performance completed to date at all times throughout the contract's duration. A termination provision that only compensates for cost would not meet the required criteria. Many contract terms have clear termination provisions related to finished goods, but may be silent on work in progress, and the timing of revenue recognition might be different as a result.

Application of the guidance will require judgment. An entity should consider whether it has an enforceable right to payment related to its performance completed to date. If the entity's performance obligation is to customize its standard goods for a customer, an entity would evaluate whether it has an enforceable right to payment at the point that it begins to satisfy the performance obligation to customize the goods for the customer.

Example

For each of the last five years, an entity has received an order from a customer for 300 custom ice cream machines with unique specifications. In anticipation of this year's order, the entity starts producing machines before there is a contract between the parties in the current year. The entity and the customer later enter into a contract that meets all criteria in Step 1 of the new revenue standard for 300 units. The entity has a practical limitation on its ability to direct the equipment in its completed state because it could not do so without incurring a significant economic loss. The entity has an enforceable right to payment beginning when the contract is executed. Assume each machine is distinct.

At contract inception, the entity has completed 50 units (in inventory awaiting shipment to the customer), 10 units in production and has not begun manufacturing 240 units.

Production began prior to contract inception; therefore, the entity cannot recognize revenue until a contract exists. At contract inception, the entity would assess the nature of its promise to the customer and identify the performance obligation. Each machine is distinct; however, the entity considers whether the arrangement is a series of distinct goods. One of the two criteria to be a series is that the performance obligation is satisfied over time. There is no alternative use for the machines, and there is an enforceable right to payment at contract inception. The entity concludes it will recognize revenue over time.

The second criterion to be a series is that the same method would be used to measure progress toward complete satisfaction to transfer each distinct good to the customer. The 300 units are identical, so the entity concludes it would use the same measure of progress for each distinct unit. Because both criteria for a series are met, the entity concludes the arrangement for 300 machines should be accounted for as a series of goods and services.

At contract inception, the entity would record a cumulative catch-up adjustment for progress made as of contract inception toward complete satisfaction of the performance obligation, i.e., the series comprising 300 units, considering the 50 completed and 10 in-process units. The entity would continue to recognize revenue over time as progress is made on finishing the 10 units and manufacturing the 240 units.

Measuring Progress Toward Satisfaction of a Performance Obligation

Revenue can be recognized over time only if an entity can reasonably measure its progress toward completion. An entity would be permitted to recognize revenue to the extent of costs incurred until it is reasonably able to measure its progress or the performance obligation becomes onerous, *e.g.*, during a contract's early stages. An entity can use either output or input methods to measure progress, but it would be required to consistently apply that method to similar performance obligations in similar circumstances.

The new model focuses on recognition of revenue rather than recognition of margin.

FASB declined to include guidance for normal expected wasted materials and the accounting for abnormal wasted materials. Manufacturers will need to use judgment to adjust a cost-to-cost calculation for costs that do not contribute to the progress in the contract.

Control Transferred at a Point in Time

Performance obligations that do not meet any of the three criteria for being satisfied over time should be accounted for at a point in time when (or as) control is transferred to a customer. When control over an asset is transferred at a single point in time, an entity would recognize revenue by evaluating when the customer obtains control. An entity would use judgment in determining when control has been transferred, considering the following indicators:

- The entity has a present right to payment
- The customer has legal title
- The customer has physical possession
- The customer has the significant risks and rewards of ownership
- The customer has accepted the asset

Clauses that allow the customer to cancel a contract or require an entity to take remedial action if a good or service does not meet agreed-upon specifications must be evaluated to determine if a customer has obtained control. For goods delivered for trial or evaluation, control of the product is not transferred until the customer accepts the product or the trial period lapses.

Manufacturers that currently recognize revenue at a point in time should not presume continued point-in-time recognition under the new revenue guidance. Meeting materials from a previous TRG meeting illustrated a transaction that might be accounted for at a point in time today but would be accounted for over time under the new revenue standard:

A manufacturer produces goods designed to a customer's specifications. Because the goods are designed to unique specification, the entity concludes its performance does not create an asset with alternative use to the entity. The entity also has an enforceable right to payment for performance completed to date. Therefore, revenue will be recognized over time.

This does not imply all entities that produce customized goods should conclude they will recognize revenue over time, *e.g.*, if the entity does not have a right to payment.

Entities will need to perform an assessment of their specific facts and circumstances under the new guidance to conclude whether revenue should be recognized over time or at a point in time. This is a contract-by-contract assessment; variances in contract terms could result in recognizing revenue at a point in time for some contracts and over time for others, even when the products promised in the contracts are similar.

Additional Items

Contract Costs

In conjunction with the new standard's release, FASB also amended ASC 340, *Other Assets and Deferred Costs*. Outside of guidance on accounting for long-term construction contracts and certain industry-specific guidance, GAAP previously did not address the accounting for the cost of obtaining and fulfilling customer contracts; an accounting policy election determined whether such costs were capitalized or expensed. Only SEC registrants were required to disclose their policy for capitalized costs.

Under the ASU, entities likely would capitalize more contract costs than under existing U.S. GAAP. An entity that currently elects to expense eligible contract costs might be required to capitalize those costs. For example, sales commissions expensed as paid would be capitalized if the costs are recoverable. Management's decision process on the transition strategy should consider costs incurred for contracts not completed upon adoption of the standard.

Contract Acquisition Costs

Entities incur a variety of costs in delivering products or performing services for revenue generation, *e.g.*, customer acquisition, setup and fulfillment costs. These costs are usually incurred before revenue is recognized.

Under current GAAP, costs must be direct and incremental to be capitalized. Under the new standard, costs must only be incremental and companies may be required to capitalize more commissions.

An entity would capitalize incremental costs of obtaining a contract if the costs are recoverable. Incremental costs are those that would not have been incurred if the contract had not been obtained, *e.g.*, sales commissions. Costs an entity incurs regardless of whether it obtains a contract would be expensed as incurred. As a practical expedient, an entity can expense these incremental costs if the amortization period of those costs would be one year or less, *i.e.*, the contract term or earnings process is not greater than a year. An entity must disclose if this practical expedient is elected.

Under cost-based input methods, contract acquisition costs should not be included in the measure of progress to completion because they do not depict the transfer of control of goods or services to the customer. Rather than being used to dertmine the pattern of revenue recognition, capitalized costs of obtaining a contract are amortized in accourdance with the expected pattern of transfter of goods or services.

Example 1: Fixed Employee Salary

An employee is paid a $100,000 annual salary, based upon the employee's prior-year signed contracts and current year's projected signed contracts. The employee's salary will not change based on the current year's actual signed contracts; however, salary in future years likely will be affected by the current year's actual signed contracts.

What amount, if any, should be recorded as an asset for incremental costs to obtain a contract during the year?

Do not capitalize any portion of the employee's salary as an incremental cost to obtain a contract. The costs are not incremental costs to any contract because the costs would have been incurred regardless of the employee's signed contracts in the current year. The costs associated with the employee's salary are not incremental costs that result from obtaining a specific revenue contract. Whether the employee sells 100, 10 or no contracts, the employee is still only entitled to a fixed salary.

Example 2: Some Costs Are Incremental

Employees receive a 5 percent sales commission when they obtain a customer contract. An employee begins negotiating a contract with a prospective customer, and the entity incurs $5,000 of legal and travel costs in trying to obtain the contract.

The customer ultimately enters into a $500,000 contract and as a result, the employee receives a $25,000 sales commission.

What amount should the entity capitalize as an incremental cost to obtain the contract?

The entity only should capitalize $25,000 for the sales commission. That is the only cost that is an incremental cost to obtain the contract because the entity would not have incurred the cost if the contract was not obtained. While the entity incurs other costs necessary to facilitate a sale (such as legal and travel), those costs would have been incurred even if the customer decided not to execute the contract.

Example 3: Timing of Commission Payments

An entity pays an employee a 4 percent sales commission on all of the employee's signed contracts with customers. For cash flow management, the entity pays the employee half of the commission (2 percent of the total contract value) upon the sale's completion and the remaining half (2 percent of the total contract value) in six months. The employee is entitled to the unpaid commission, even if the employee is no longer employed by the entity when payment is due. An employee makes a $50,000 sale at the beginning of the first year.

What amount should the entity capitalize as an incremental cost to obtain the contract?

Capitalize the entire commission ($2,000). The commission is an incremental cost that specifically relates to the signed contract, and the employee is entitled to the unpaid commission. The payment's timing does not affect whether the costs would have been incurred if the contract had not been obtained.

However, additional factors might affect the payment of a commission to an employee. For example, an entity could require that an employee sell additional services to the customer to receive the second half of the commission. Or, an entity could make the second payment contingent upon the customer completing a favorable satisfaction survey about its first six months of working with the entity. An entity will need to assess its specific compensation plans to determine the appropriate accounting for incremental costs of obtaining a contract.

Example 4: Commissions Paid to Different Levels of Employees

A manufacturer's salesperson receives a 10 percent sales commission on each contract that he or she obtains. In addition, the employee's sales commissions on each signed contract negotiated by the salesperson are 5 percent to the manager and 3 percent to the regional manager.

Which commissions are incremental costs of obtaining a contract?

All of the commissions are incremental because the commissions would not have been incurred if the contract had not been obtained. The new revenue standard does not differentiate based on the function or title of the employee who receives the commission. It is the entity that decides which employee(s) is/are directly entitled to a commission for entering into a contract.

It is possible that several commission payments are incremental costs of obtaining the same contract; however, companies should ensure that each commission is an incremental cost of obtaining a contract with a customer, rather than variable compensation, e.g., a bonus, based on a number of factors—one of which is related to sales.

Consider an employee who receives a discretionary annual bonus based on the entity achieving sales growth targets, minimum profitability levels and progress toward various strategic goals. Although one of the factors involves sales, the bonus is not an incremental cost of obtaining a contract because there are other factors involved in determining the annual bonus. Therefore, the annual bonus should not be capitalized as a cost to obtain a contract.

Contract Fulfillment Costs

If the costs incurred in fulfilling a contract are not within the scope of other guidance, *e.g.*, inventory, property, plant and equipment or capitalized software, an entity would recognize an asset only if the costs meet all the following criteria:

- Directly relate to a contract or a specific anticipated contract, *e.g.*, direct labor or materials
- Generate or enhance resources that would be used to satisfy performance obligations in the future
- Are expected to be recovered

Certain costs are expensed as incurred, *e.g.*, most general and administrative costs and the cost of wasted materials and labor not reflected in the contract price. If an entity cannot distinguish the fulfillment costs that relate to future performance obligations from the costs that relate to past performance obligations, the entity would expense these costs as incurred.

Learning Curve

A learning curve is the effect of efficiencies over time when an entity's production costs decline in relation to the number of times an entity produces a particular unit. A manufacturer with a single performance obligation to deliver a specified number of units—which meets the requirements to be recognized over time—would select the method of progress that results in the entity recognizing more revenue and expense for the early units produced relative to later units, *e.g.*, cost-to-cost method. The effect is appropriate because the great value of the manufacturer's performance is in the early part of the contract. If the contract does not give rise to a single performance obligation satisfied over time, a manufacturer should apply the guidance of other standards, *e.g.*, inventory.

Judgment will be needed to determine whether design costs and bidding expenses incurred as part of contract negotiations represent a cost of fulfilling the contract or cost of obtaining a contract.

SEC Insights

At a December 2017 AICPA conference, a representative from the SEC's OCA highlighted a pre-filing consultation on the treatment of a preproduction arrangement for the design of a specialized good that the registrant anticipated manufacturing and selling to a customer. In this case, the registrant concluded that the design activities did not transfer control of a good or service and, therefore, were not a performance obligation under ASC 606. The registrant concluded that the periodic information provided to the customer related to the design activities was not detailed enough to enable the customer to avoid having to reperform the design work, for example, if the design efforts were not successful or if the counterparty selected another manufacturer for the specialized good. The registrant determined the preproduction design activities should be accounted for as research and development expenses and that payment received should be accounted for as an advance for the specialized good's future sale. The OCA did not object to this accounting based on the specific facts and circumstances. The OCA also did not object to the registrant applying the ASC 606 transition guidance rather than the guidance in ASC 250 on changes in accounting principles.

*Other registrants have historically considered preproduction as a nonrevenue arrangement that could be accounted for as an advance payment for future sales or as a contra expense under a cost reimbursement model. The OCA would **not** object if registrants continued to apply their historical nonrevenue models to pre-production arrangements. Registrants that historically applied a nonrevenue model and are considering either applying a revenue model under ASC 606 or making changes to their historical nonrevenue model, including any change to the historical timing or payment presentation in the income statement, should consult with the SEC.*

Amortization & Impairment

Capitalized costs to obtain and fulfill contracts would be amortized on a systematic basis consistent with the pattern of the transfer of goods or services to which the asset relates. As a practical expedient, if the amortization period would be one year or less, an entity may elect to expense the costs. The asset may be amortized over more than one contract when the asset relates to goods or services that will be provided under an anticipated contract that the entity can specifically identify, *e.g.*, renewal options.

TRG meeting materials provided some factors to consider when estimating the amortization period of an asset arising from the incremental costs of obtaining a customer contract:

- **Identify the contract(s) to which the commission relates.** An entity must determine whether the capitalized incremental costs, *e.g.*, sales commissions, relate to goods or services that only will be transferred as a part of the initial contract or if the costs also relate to goods or services that will be transferred as part of a specific anticipated contract(s).
- **Determine whether a commission on a renewal contract is commensurate with the commission on the initial contract.** For commissions on renewal contracts, an entity must first determine if the "renewal" commission is commensurate with the "initial" commission. If commensurate, the asset would be amortized over the initial contract term, *i.e.*, the commission from the initial contract does not relate to the renewal contract. If not commensurate, the entity should assess the period to which the asset relates, potentially including specific anticipated contract(s).
- **Evaluate facts and circumstances to determine an appropriate amortization period.** TRG members think using an amortization period equal to the average customer term is a reasonable application of the new revenue standard unless facts and circumstances indicate otherwise.

Amortizing the asset over a longer period than the initial contract would not be appropriate in situations in which an entity pays a commission on a renewal contract that is commensurate with the commission paid on the initial contract. In that case, the acquisition costs from the initial contract do not relate to the subsequent contract.

The level of effort to obtain a contract or renewal should **not** be a factor in determining whether the commission paid on a contract renewal is commensurate with the initial commission. It would be reasonable for a manufacturer to conclude that a renewal commission is commensurate with an initial commission if the two commissions are reasonably proportionate to the respective contract value, *i.e.*, 5 percent of the contract value is paid for both the initial and the renewal contract. It might be less difficult to obtain a renewal than secure an initial contract, *e.g.*, if there are barriers to the customer changing suppliers or it is costly or difficult to establish new customer relationships.

In some circumstances, if the renewal commission is less than the initial commission, it might still be commensurate with the initial commission. This will depend on the specific facts and circumstances and, therefore, judgment might be required.

An impairment loss would be recognized if the carrying value of the capitalized costs exceeds its recoverable amount. The recoverable amount equals the remaining consideration to which the entity expects to be entitled, minus costs directly related to those goods or services. Contract renewals and extensions should be considered when measuring the remaining amount of consideration that the entity expects to receive. In assessing impairment, an entity should include both the amount of consideration it has already received—but not recognized as revenue—and the amount the entity expects to receive for goods and services to which the asset relates. Reversals of these impairments would not be permitted.

Repurchase Arrangements

The new revenue recognition model is based on control criteria versus a risk-and-reward model under current guidance. The existence of a repurchase agreement in a contract affects the customer's ability to control the assets and affects the accounting and timing of revenue recognition. Under the new model, the accounting for repurchase arrangements depends on which party holds the obligation or right and the relative purchase price as compared to the original selling price, as indicated in the table below.

Repurchase agreement type	Repurchase price (RP) versus original sales price (SP)	Significant economic incentive to exercise	Accounting
Call option/forward	RP < SP	n/a	Lease – see ASC Topic 840
Call option/forward	RP ≥ SP	n/a	Financing
Put option	RP < SP	Yes	Lease – see ASC Topic 840
Put option	RP < SP	No	Sale with right of return
Put option	RP ≥ SP and RP > expected market value	Yes	Financing
Put option	RP ≥ SP and RP < expected market value	No	Sale with right of return

Sale Leasebacks

A call option that is part of a sale leaseback agreement would be treated as a financing arrangement if the repurchase amount is less than the original sales price. A put option with a repurchase price less than the original sales price that is included in a sale leaseback transaction would be accounted for as a financing arrangement if the customer has a significant economic incentive to exercise the put.

Bill-and-Hold Arrangements

Bill-and-hold arrangements occur when an entity bills a customer for a product but retains physical possession until a future point in time, *e.g.*, due to a customer's space availability or delay in the production schedule. For these arrangements, the following conditions must be met for an entity to conclude control has been transferred to a customer and revenue recognized:

- The reason for the bill-and-hold arrangement must be substantive
- The product must be identified separately as belonging to the customer
- The product currently must be ready for physical transfer to the customer
- The entity cannot use the product or direct it to another customer

Some of the transaction price would be allocated to the custodial service of storing the goods if such services are a separate performance obligation. There is no explicit requirement for a bill-and-hold arrangement to be at the customer's request, although the reason for the arrangement must be substantive.

Some private companies may need to change their accounting for transactions involving bill-and-hold arrangements. The standard incorporates much of the SEC staff guidance not previously included in U.S. GAAP. Many nonpublic entities already apply this bill-and-hold guidance, but today it is only required for SEC registants.

The criteria for determining whether a bill-and-hold transaction qualifies for revenue recognition under the new standard are similar to—but somewhat less detailed than—today's criteria in Staff Accounting Bulletin (SAB) Topic 13. SAB Topic 13 requires that the customer requests that the entity retain the completed product and that the arrangement include a fixed delivery schedule are not considerations under the standard. Most bill-and-hold transactions that qualify for revenue recognition under today's guidance also will qualify under the new standard.

On August 18, 2017, the SEC issued an SAB stating that registrants should no longer refer to the bill-and-hold criteria in Accounting and Auditing Enforcement Release No. 108 upon the registrants' adoption of ASC Topic 606, Revenue From Contracts With Customers. Until adoption of ASC 606, it should continue referring to the existing guidance.

Consignment Sales

In a common consignment arrangement, the seller delivers goods to a customer but retains title to the goods shipped. A consignee will not take title or pay for the goods until the consignee sells them to a third party or consumes them in production. An entity should not recognize revenue for products held on consignment. Indicators of a consignment arrangement include:

- The seller controls the product until a specified event, *e.g.*, a sale to an end customer
- The entity is able to require the product's return or transfer
- The dealer does not have an unconditional obligation to pay for the product

The timing of revenue recognition could change for some entities because current guidance focuses on the transfer of risks and rewards rather than the transfer of control. The transfer of risks and rewards is an indicator of whether control has transferred under the new revenue standard, but additional indicators also will need to be considered.

Example – Consignment Sale

ABC has developed a new type of cold-rolled steel sheet and provides 50 rolls to part manufacturer XYZ on a consignment basis. XYZ pays a deposit upon receipt of the rolls; title transfers to XYZ and payment is due only upon consumption of the rolls in manufacturing. Each month both parties agree on the amount consumed by XYZ. XYZ can return—and ABC can demand back—any unused product at any time. Control transfers upon consumption of the rolls in the manufacturing process, as title has transferred and payment is due only at that point. If the entity did not retain the right to demand return of the inventory, that might suggest that control transferred to the manufacturer upon receiving the shipment.

Some manufacturers recognize revenue using a "sell-through" approach, whereby revenue is not recognized until the product is sold to the end customer due to consignment or because the selling price is not known until the product is sold to the end customer. Entities using a sell-through approach may be able to recognize revenue upon shipment to the distributor/consignee if it is probable a significant revenue reversal will not occur. If the distributor has control, including the right—but not the obligation—to return the product to the manufacturer at its discretion, and the distributor does not have a significant economic incentive to exercise the return right, control transfers when the product is delivered to the distributor.

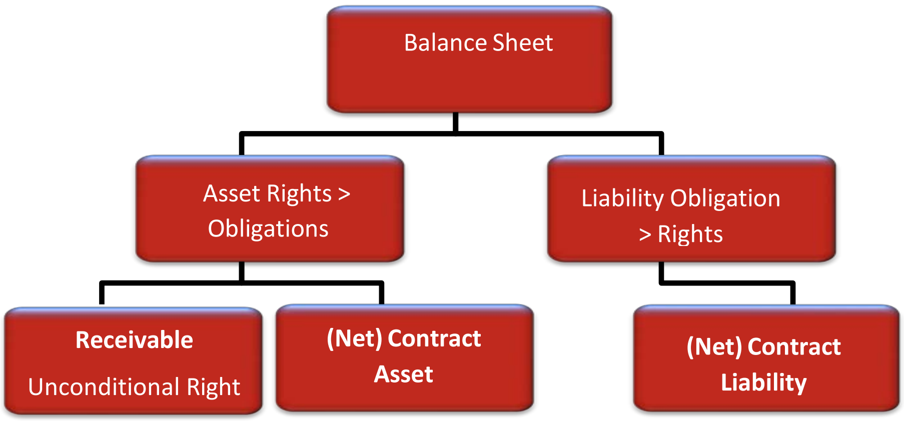
Presentation & Disclosure

Presentation

An entity would present a contract in its statement of financial position as a contract liability, contract asset or receivable, depending on the relationship between the entity's performance and customer's performance at the reporting date. A contract liability exists if the customer has paid consideration or if payment is due as of the reporting date but the entity has not yet satisfied the performance obligation. If an entity has transferred goods or services as of the reporting date but the customer has not yet paid, the entity would recognize either a contract asset or receivable. An unconditional right to consideration is presented as a receivable. If an entity's right to consideration is conditioned on something other than the passage of time, an entity would recognize a contract asset. FASB felt the distinction between a contract asset and receivable provided financial statement users with relevant information about an entity's risk exposure.

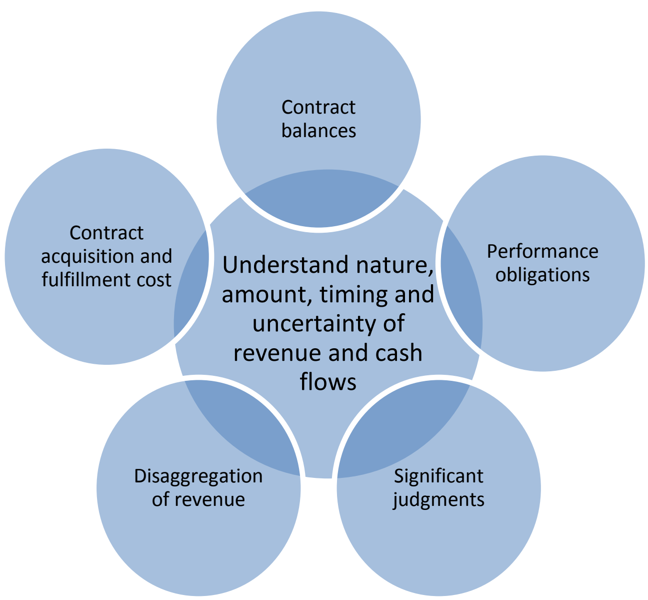
While both asset categories are subject to credit risk, a contract asset also is subject to other risks such as performance risk.

TRG members clarified that contract assets and liabilities are presented at the contract level and not the performance obligation level. Contract assets and liabilities are offset for contracts that are combined under the guidance. Balances other than contract assets and liabilities, *e.g.*, trade receivables and deferred costs, are only offset if permitted by other GAAP. Contract assets and liabilities related to contracts not combined under the guidance in the revenue standard are only offset if allowed by other GAAP.



Disclosure

BKD has prepared a separate white paper on the new required disclosures that is applicable for all industries. Companies that have early adopted the standard have found this area to be more challenging than initially anticipated. The standard provides significant relief for nonpublic entities.



Backlog

For some manufacturers, the biggest change will be the required information about remaining performance obligations versus current supplemental information on backlog. This information is typically provided outside of the financial statements in management's discussion and analysis. Industry practice dictates how backlog information is calculated and disclosed and can vary widely.

Under the new rules, manufacturers must disclose information about customer promises that are incomplete or partially complete. The disclosures include the transaction amount allocated to the unsatisfied performance obligations and either a numerical or narrative explanation about when the revenue from the unfinished tasks can be recorded. No disclosure is required under a practical expedient available if the promises are part of a contract of a year or less **or** if the business has the right to customer payments for an amount that directly corresponds with the value to the customer. Disclosure relief also is provided under a second practical expedient for sales-based or usage-based royalties for licenses of intellectual property and variable consideration allocated to a series of distinct goods or services. If a business uses either of the disclosure exemptions, it will still have to include qualitative or descriptive information about the nature of the performance obligation, the length of time left in the contract and the amount excluded from the numerical disclosure of the transaction price allocated to the remaining obligation.

Depending on current practice, the new requirements may significantly change the backlog information. In addition, while a company may currently have formal processes for calculating backlog information, it may need to enhance these processes and add internal controls because the disclosures will be included in the financial statements notes and subject to audit.

BKD has prepared a library of **BKD Thoughtware®** on revenue recognition issues. Visit our Hot Topics page to learn more. If you have questions about the revenue recognition rules, contact your BKD advisor.

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