TRG Tackles M&D Revenue Issues

Manufacturing and distribution (M&D) companies face unique challenges in applying the new revenue recognition standard, Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, due to the variety of revenue streams common in the industry. The Financial Accounting Standards Board (FASB) Transition Resource Group (TRG) addressed several issues at its November 2016 meeting.

Over-Time Revenue Recognition

Can an entity that recognizes revenue at a point in time under current revenue recognition guidance be required to recognize revenue over time in accordance with the new revenue standard?

Yes, entities that currently recognize revenue at a point in time should not presume continued point-in-time recognition under the new revenue guidance. Within ASU 2014-09, an entity determines *at contract inception* whether it satisfies a performance obligation over time or at a point in time. Then an entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer, which is when the customer obtains control of that good or service. 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

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—for example, 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.

In assessing alternate use, should an entity consider the completed asset or the in-production asset?

Preparers have questioned at which production stage an entity should conclude an asset has no alternate use. If an asset can be sold to a different customer throughout most of the production process, but the asset that exists at the end of production has no alternative use, does the asset have no alternate use when evaluating over-time criteria?

FASB's basis of conclusion addressed this issue—an entity should consider the characteristics of the asset that will ultimately be transferred to the customer. The standard clarifies the assessment should not be reassessed unless the contract's parties approve a contract modification.

If the asset does not have an alternative use, the entity 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.

The TRG meeting materials included an example of evaluation logic.

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 would only 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.

How and when should an entity determine whether it has an enforceable right to payment?

TRG members discussed the practical consideration in making this assessment. 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 (WIP), 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 (that is, 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.

TRG board members pointed out that if the termination clause in the above example was silent on compensation for WIP or did not include a reasonable profit margin, it might result in point-in-time revenue recognition.

Upfront Payments to Customers

How should an entity account for upfront payments to a customer? Should upfront payments be immediately recognized in income or recognized as an asset and amortized over time?

Under the new revenue standard, a payment to a customer is a reduction of transaction price, unless the payment is made in exchange for a distinct good or service. Payments to customers are common for M&D entities and can be in the form of cash, coupon, credit or voucher. Entities may make such payments to reimburse a customer for costs associated with entering into a contract, obtain a customer contract in a competitive environment or provide additional incentives to customers.

Under current guidance, there is diversity in practice, and financial statement preparers questioned whether the accounting treatment for such payments would change under the new revenue standard. Some entities analogize to a 1998 U.S. Securities and Exchange Commission speech and capitalize upfront payments in cases where the payment does not meet the definition of an asset under FASB's Conceptual Framework.

The first step in evaluating the accounting for an upfront payment is understanding the reason for the payment, the right 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 from an upfront payment.

IT Outsourcing Services Example

A service provider makes a $1 million customer payment as part of contract negotiations to provide Information Technology (IT) outsourcing services. The customer payment was negotiated because the customer will incur costs to terminate employees and dispose of equipment that is currently used in operations to be outsourced. The contract's term is five years and is cannot be canceled. The entity estimates the customer will pay a $6 million fee for five years of services. The payment to the customer is made in connection with a legally enforceable contract, i.e., the customer only receives the $1 million when it commits to the outsourcing contract.

The payment is to compensate the customer for the costs of switching to the entity's service and meets the definition of consideration payable to a customer and is not for a distinct good or service. The customer payment would reduce the transaction price to $5 million. A $1 million asset would be recognized when the payment is made at contract inception and amortized over time as the entity provides service.

Capitalization & Amortization of Incremental Cost of Obtaining a Contract

FASB's vice chairman noted this topic generated the most questions from financial statement preparers.

Which costs to obtain a contract are incremental?

Under current generally accepted accounting principles, 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. The meeting materials included several examples to highlight this change.

Example 1: Fixed Employee Salary

An employee is paid an annual salary of $100,000, 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

An entity's salesperson receives a 10 percent sales commission on each contract that he or she obtains. In addition, the following employees of the entity receive sales commissions on each signed contract negotiated by the salesperson: 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) 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 of the commissions are incremental costs 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.

How should an entity determine the amortization period for an asset recognized for the incremental costs of obtaining a customer contract?

An asset recognized for the incremental costs of obtaining a contract with a customer should be amortized on a systematic basis consistent with the transfer to the customer of the goods or services to which the asset relates. Judgment will be required, and considerations should be similar to estimating the amortization or depreciation period for intangible assets currently done today. The 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 (such as 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 a 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.

How should an entity evaluate whether the sales commission on a renewal contract is commensurate with the commission paid on the initial 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. TRG members agreed that it would be reasonable for an entity 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 to 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.

Additional Outstanding Issues

While some issues were clarified, many concerns remain for M&D companies adopting the new revenue standard. The American Institute of CPAs (AICPA) formed 16 industry task forces to help develop a new revenue recognition accounting guide with illustrative examples on the standard's application. Each task force generated a list of implementation issues and will develop recommendations to be reviewed by AICPA's Revenue Recognition Working Group (RRWG) and Financial Reporting Executive Committee (FinREC) before being referred to FASB. The table below summarizes the current status of issues relevant to manufacturers.

Manufacturing Revenue Recognition Issues List (as of December 5, 2016)		
Issue No.	Description of Implementation Issue	Status
1	**Acceptable Measures of Progress (Including Uninstalled Materials & Wasted Materials)** Review items to consider when determining what method to use when measuring progress toward completion of performance obligations satisfied over time.	Finalized to be included in the 2017 AICPA Guide Revenue Recognition
2	**Accounting for Contract Costs** Application of the guidance in FASB Accounting Standards Codification (ASC) 340 for incremental costs of obtaining a contract, costs to fulfill a contract and amortization and impairment, including precontract costs and learning or startup costs.	Finalized to be included in the 2017 AICPA Guide Revenue Recognition
3	**Variable Consideration & Constraining Estimates of Variable Consideration** Considerations for estimating the amount of variable consideration—incentive fees, award fees, economic price adjustments—contracts, the effect of subsequent modifications and how to determine the amount of estimated variable consideration to include in the transaction price.	Finalized to be included in the 2017 AICPA Guide Revenue Recognition
4	**Separation/Segmentation** Determining distinct performance obligations in contracts that design, develop, produce or deliver equipment.	Submitted to AICPA RRWG

5	**Contract Modifications, Unpriced Change Order, Claims** Cconsiderations related to contract modifications: • Evaluating existence of a contract modification • How to determine whether a contract modification is treated as a separate contract or part of the existing contract • For modifications treated as part of the existing contract, how to evaluate if the modification is treated prospectively or through a cumulative catch-up adjustment	Submitted to FinREC to be rediscussed
6	**Significant Financing Component** Considerations needed to assess whether a significant financing component exists in determining the transaction price for various types of contracts.	Finalized to be included in the 2017 AICPA Guide Revenue Recognition
7	**Allocating the Transaction Price** Allocating the transaction price to multiple performance obligations in a contract.	Finalized to be included in the 2017 AICPA Guide Revenue Recognition
8	**Effect of Contract Termination Rights & Penalties on Contract Term** Determining the term of a contract in ASC 606 when the customer has a unilateral right to cancel the contract without cause and if the existence of a specified termination payment/penalty affects the analysis.	Exposure period ended September 1, 2016

BKD will continue to monitor the revenue recognition standard process. For additional information, contact your BKD advisor.

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