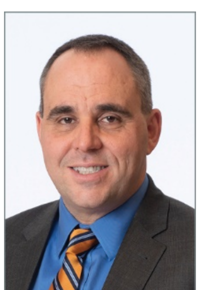
Consumer Products
Revenue Recognition ASC Topic 606

Tuesday, November 12, 2019



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Today's Agenda

Overview of ASC 606 for Consumer Products

- Background of the new standard
- Overview of the new revenue model
- Resources for successful transition
- Breakout Sessions
  - Food & Beverage and Beauty
  - Fashion and Apparel
  - Manufacturing and Distribution

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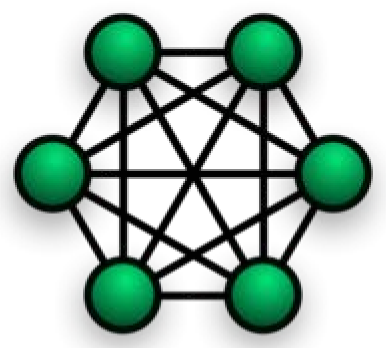
Background for Change

- ASC 605 “Legacy GAAP” had a substantial amount of industry specific rules and guidance. Occasionally contradictory between industries.
- Convergence with International Standards
- ASC 606 – Creates a uniform revenue recognition approach shared by all industries.



Core Principle of ASC Topic 605 (Legacy GAAP)

Recognize revenue when the earnings process is complete.

4 Steps for Revenue Recognition

1. Persuasive evidence of an arrangement exists
2. Delivery has occurred or services have been rendered
3. Seller's price to the buyer is fixed or determinable
4. Collectability is reasonably assured

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The ASC 606 Revenue Recognition Model

The **core principle** of the new model is that an entity would recognize revenue as it transfers a good or service to customers in an amount reflecting the consideration it expects to receive.

An entity needs to apply a five step model to achieve that core principle.

The Core Principle of ASC Topic 606

Recognize revenue when:

5 Steps for Revenue Recognition

1. Identify the contract with a customer
2. Identify the separate performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations in the contract
5. Recognize revenue when (or as) entity satisfies a performance obligation

Step 1: Identify the Contract

Identify the Contract

A contract is defined as "an agreement between two or more parties that creates **enforceable rights and obligations**." The new standard affects contracts with a customer that meet the following criteria:

1. **Approval** (in writing, orally, or in accordance with other customary business practices) and commitment of the parties;
2. Identification of the **rights** of the parties;
3. Identification of the **payment terms**;
4. Contract has **commercial substance**; and
5. Probable that the entity will **collect** the consideration to which it will be entitled in exchange for the good or service that will be transferred to the customer.

A contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party.

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Polling Question #1

EquipCo sells equipment to its customer with three years of maintenance for total consideration of $1 million, due in monthly installments over the three-year term. At contract inception, EquipCo determines that the customer does not have the ability to pay as amounts become due and therefore collection of the consideration is not probable. EquipCo intends to pursue collection and does not intend to provide a price concession.

EquipCo delivers the equipment at the inception of the contract. At the end of the first year of the contract, the customer makes a partial payment of $200,000. EquipCo continues to provide maintenance services, but concludes that collection of the remaining consideration is not probable. Can EquipCo recognize revenue for the partial payment received?

A – Yes

B – No

The Five Contractual Criteria

- If an arrangement does not meet the five criteria for a contract, a company **continues to assess** the contract to determine whether the criteria are subsequently met.

- If consideration is received, the entity shall recognize the consideration received as **revenue only** when one or more of the following events have occurred:
  - The entity has no remaining obligations to transfer goods or services and substantially all consideration received is **nonrefundable**
  - The contract has been terminated and the consideration received is **nonrefundable**
  - The entity has transferred control of the goods or services to which consideration received to date relates, they have no obligation to transfer additional goods and services, and the consideration received is **nonrefundable**.

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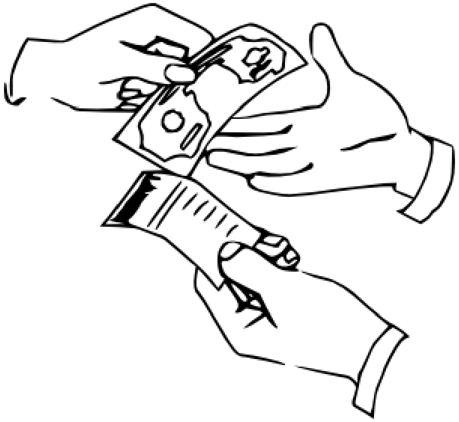
Collectability

- Under the new standard, a company must be able to assess at **project inception** that it is **probable** that they will **collect substantially all of the consideration** to which the company is entitled in exchange for the promised goods or services that will be transferred to the customer.

- The Board used the term **"substantially all"** because a contract may represent a substantive transaction, even if it is not probable the entity will collect 100% of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.



Master Service Agreements (MSAs)

- Consumer Product Companies frequently enter into agreements that serve as frameworks for additional arrangements. MSAs may only establish basic terms and conditions with customers and may require purchase orders to be submitted which include the specific goods and services that will be provided. In these cases, **enforceable rights and obligations of the parties may not be included in the MSAs alone**, thus not meet the definition of a contract.

- The individual **purchase order** would need to be evaluated along with the **MSA** in order to determine if criteria for a contract has been met. Also, Individual MSAs need to be evaluated to determine if the MSAs alone create enforceable rights and obligations

Contract Modifications

- A change to an existing contract is a modification. A contract modification could **change the scope of the contract, the price of the contract, or both**. A contract modification exists when the parties to the contract approve the modification.

- Contract modifications are accounted for as either a **separate contract** or as **part of the existing contract**, depending on the nature of the modification

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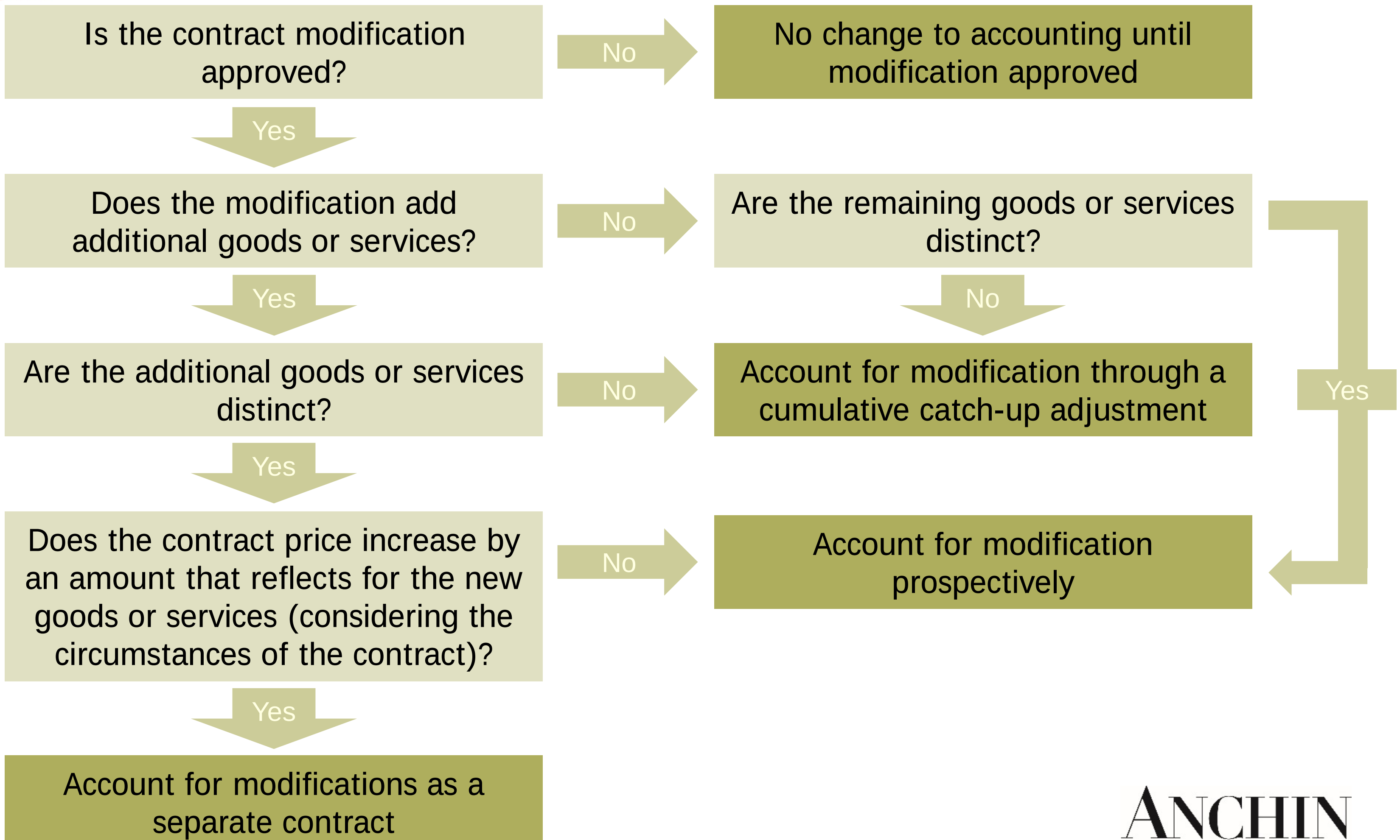
Contract Modifications



Courtesy of PWC ASC 606 Guide

Challenges in Applying Step 1

- Use of side agreements
- Contract combinations
- Not using standard contracts / Using the customers contract.
- Termination clauses
- Sometimes necessary to get legal counsel involvement.
- Contracts with multiple parties
- Collaboration agreements

Step 2: Identify Separate Performance Obligations

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Performance Obligations

- Drives the basis of revenue recognition

- At **contract inception,** an entity shall assess the goods or services promised in a contract with a customer and shall identify as a **performance obligation** each **promise to transfer to the customer** either:
  a) A good or service (or a bundle of goods or services) that is **distinct**
  b) A **series of distinct** goods or services that are substantially the same and that have the same pattern of transfer to the customer

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Distinct - Defined

A good or service that is promised to a customer is **distinct** if both the following criteria are met:

A. The Customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (Capable of being distinct)

B. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (Distinct within the contract)

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Performance Obligations - Issues

- A contract with a customer also may include **promises that are implied** by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a reasonable expectation of the customer that the entity will transfer a good or service to the customer.

- An entity is not required to assess whether promised goods or services are **performance obligations** if they are **immaterial** in the context of the contract with the customer.

- An entity needs to evaluate whether customer options for additional goods or services are **material rights** that should be accounted for as performance obligations.

Options to Purchase additional Goods & Services – Material Rights

- Customer options are additional performance obligations in an arrangement if they provide the customer with a **material right** that it would not otherwise receive without entering into the arrangement. The customer is purchasing two things in the arrangement: the good or service originally purchased and the right to a free or discounted good or service in the future. The customer is effectively paying in advance for future goods or services.

- Refunds, rebates, and other obligations to pay cash to a customer are not customer options. They affect measurement of the transaction price.

Performance Obligations Issues Cont.

- Promised goods or services **do not include activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer.**
  - For example, a services provider may need to perform various administrative tasks to set up a contract.

- The contract must be legally enforceable to be within the scope of the revenue model, **all of the promises (explicit or implicit) don't have to be legally enforceable** to be considered when determining the entity's performance obligations.

- Some items commonly considered to be **marketing incentives or incidental goods** or services under legacy GAAP have to be evaluated under the standard to determine whether they represent promised goods and services in the contract.

Polling Question #2

ABC enters into an agreement to sell 10,000 flux capacitors over a 2-year period to a customer. This type of product has not been developed previously. Accordingly, the customer agrees to pay ABC "non-recurring engineering" or NRE payments to cover ABC's development cost. After development, ABC will retain all intellectual property rights to the product and can sell variations of it to other customers. How many performance obligations are in this contract?

a. 1
b. 2
c. 10,000
d. 10,001

Step 3: Determining the Contract Price

Determining the Contract Price

- An entity shall consider the terms of the contract and its customary business practices to 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, **excluding amounts collected on behalf of third parties** (for example, some sales taxes). The consideration promised in a contract with a customer **may include fixed amounts, variable amounts, or both.**

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Forms of Variable Consideration

- Price Concessions
- Prompt Pay Discounts
- Volume Discounts
- Rebates/Refunds
- Performance Bonuses & Penalties
- Price Protection and Price Matching

Fixed or Variable???

Is the consideration expected to be received under the present contract fixed or variable?

Fixed

Variable

Estimate the amount using either the **expected value** or **most likely amount** method for each type of variable consideration.

Constrain the estimate to an amount for which a significant revenue reversal is not probable.

Include the amount in the transaction price.

Courtesy of EY ASC 606 Guide

Two Methods to Determine the Amount of Variable Consideration

1. **Expected value method** – 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.

2. **Most likely amount** — The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, 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 has **only two possible outcomes** (for example, an entity either achieves a performance bonus or does not).

Expected Value Method

Entity A enters into contracts with customers to construct commercial buildings. The contracts include similar terms and conditions and contain a fixed fee plus variable consideration for a performance bonus related to the timing of Entity A's completion of the construction.

Based on Entity A's historical experience, the expected bonus amounts and associated probabilities for achieving each bonus are as follows:

Bonus Amount	Probability of Outcome
$ 0	25%
$100,000	50%
$150,000	25%

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Expected Value Method – cont.

Entity A determines that using the expected value method would better predict the amount of consideration to which it will be entitled because it has a large number of contracts that have characteristics that are similar to the new contract. Under the expected value method, Entity A estimates variable consideration of $87,500 as follows:

Bonus amount (a)	Probability of outcome (b)	Expected value amount (a * b)
$ —	25%	$ —
$ 100,000	50%	$ 50,000
$ 150,000	25%	$ 37,500
	Total	$ 87,500

Constraining Estimates of Variable Consideration

- An entity shall include in the transaction price some or all of an amount of **variable consideration estimated**, only to the extent that it is **<u>probable</u> that a significant reversal in the amount of cumulative revenue recognized will not occur** when the uncertainty associated with the variable consideration is subsequently resolved

- At the end of each reporting period, an entity shall update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period

Other Challenges

- Right of Return
- Refund Liabilities
- Significant Financing Component
- Nonrefundable up-front fees
- Consideration payable to a customer

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Polling Question #3

- We will now pause for a brief polling question, which webinar attendees must answer to earn CPE credit.

- In-person attendees, if you would like CPE credit, please make sure you have signed the sign-in sheet.

Step 4: Allocate the Transaction Price to Separate Performance Obligations

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ALLOCATE THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS

- Once the separate performance obligations are identified and the transaction price has been determined, the standard requires an entity to allocate the transaction price to the performance obligations in proportion to their **standalone selling prices**

- When allocating on a relative standalone selling price basis, **any discount within the contract generally is allocated proportionately to all of the performance obligations in the contract**.

DETERMINING STAND ALONE SELLING PRICE

Is the standalone selling price directly observable?

Yes

Use the observable price.

No

Estimate the standalone selling price by maximizing the use of observable inputs. Possible estimation approaches include:

- Adjusted market assessment approach
- Expected cost plus a margin approach
- Residual approach (in limited circumstances)
- Other reasonable estimation approaches that maximize observable inputs

Courtesy of EY ASC 606 Guide

ALLOCATING TRANSACTION PRICE EXAMPLE

Marine sells boats and provides mooring facilities for its customers. Marine sells the boats on a standalone basis for $29,000 – $32,000 each and provides mooring facilities for $5,000 per year. Marine concludes that the goods and services are distinct and accounts for them as separate performance obligations.

Marine enters into a contract to sell a boat and one year of mooring services to a customer. The stated contract prices for the boat and the mooring services are $31,000 and $1,500, respectively.

How should Marine allocate the total transaction price of $32,500 to each performance obligation?

ALLOCATING TRANSACTION PRICE - EXAMPLE

Analysis

The contract price for the boat ($31,000) falls within the range Marine established for standalone selling prices; therefore, Marine could use the stated contract price for the boat as the standalone selling price in the allocation:

Boat:	$27,986	($32,500 × ($31,000 / $36,000))
Mooring services:	$4,514	($32,500 × ($5,000 / $36,000))

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Polling Question #4

- We will now pause for a brief polling question, which webinar attendees must answer to earn CPE credit.

- In-person attendees, if you would like CPE credit, please make sure you have signed the sign-in sheet.

Step 5: Recognize Revenue as Performance Obligations are Satisfied

Satisfaction of Performance Obligations

- An entity recognizes revenue only when it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is considered to be transferred when the **customer obtains control**.
- The standard defines control as an entity's ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset.
- Control should be assessed primarily from the **customer's perspective.**

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Control Transfers Over Time

Does the customer simultaneously receive and consume the benefits provided by the entity's performance as the entity performs?

Yes → The entity transfers control of a good or service over time (and recognizes revenue over time).

No ↓

Does the entity's performance create or enhance an asset that the customer controls as the asset is created or enhanced?

Yes → The entity transfers control of a good or service over time (and recognizes revenue over time).

No ↓

Does the entity performance create an asset with no alternative use to the entity AND the entity has enforceable right to payment for performance completed to date?

Yes → The entity transfers control of a good or service over time (and recognizes revenue over time).

No ↓

The entity transfers control of a good or service at a point in time (and recognizes revenue at a point in time).

Courtesy of EY ASC 606 Guide

Transition Methods & Disclosure

Transition Methods

- Entities that elect the **Modified Retrospective Method** will apply the guidance retrospectively only to the most current period presented in the financial statements. To do so, the entity recognizes the cumulative effect of initially applying the standard as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets) at the date of initial application.
- Entities electing **Full Retrospective** adoption must apply the standard to each period presented in the financial statements in accordance with the accounting changes guidance in ASC 250-10-45-5 through 45-10, subject to the practical expedients.

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Transition Methods - Continued

- This means entities have to apply the standard as if it had been in effect since the inception of all their contracts with customers presented in the financial statements.
- That is, an entity electing the full retrospective method must transition all of its contracts with customers to the standard (subject to the practical expedients described below), not just those contracts that are not considered completed as of the beginning of the earliest period presented under the standard at the date of initial application.

Summary of the Transition Methods

Retrospective method

- Recognize the cumulative effect of ASC 606 at the start of the earliest period presented (e.g., 1/1/18)
- Restate comparative periods
- Practical expedients available

Cumulative effect method

- Recognize the cumulative effect of applying the new standard at the date of initial application (e.g., 1/1/19)
- No restatement of the comparative periods presented
- In the year of adoption, disclose the revenues under ASC 605
- Practical expedients available

Disclosures

An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative information is required about:

1. Contracts with customers including revenue and impairments recognized, disaggregation of revenue, and information about contract balances and performance obligations (including the transaction price allocated to the remaining performance obligations);
2. Significant judgments and changes in judgments - determining the timing of satisfaction of performance obligations (over time or at a point in time), and determining the transaction price and amounts allocated to performance obligations; and
3. Assets recognized from the costs to obtain or fulfill a contract.

Revenue Recognition Readiness

- **Critical to have sufficient documentation.**
- **Contact your Anchin contact to obtain an AICPA documentation tool.**

Resources For ASC 606

https://www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition.html

https://www.aicpa.org/interestareas/centerforplainenglishaccounting.html

https://www.ey.com/ul/en/accountinglink/current-topics-revenue-recognition

https://www.pwc.com/us/en/cfodirect/publications/accounting-guides.html

https://www2.deloitte.com/us/en/pages/audit/articles/a-roadmap-to-applying-the-new-revenue-recognition-standard.html

https://frv.kpmg.us/reference-library/2017/handbook-revenue-recognition.html

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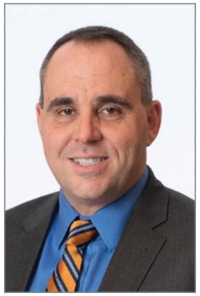
Thank you!



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