

REVENUE RECOGNITION

Understanding the New Revenue Recognition Standard ASC 606

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Agenda

- Overview of ASC 606
- Review of the five-step process
- Accounting for contract costs
- Timing your transition activities
- Disclosure requirements
- Tax considerations

ASC 606-The New Standard

Rules Based



Principles Based

Removes inconsistencies and weaknesses in revenue requirements



Provides a more robust framework for addressing revenue issues



Improves comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets



Increases reliance on estimates and judgments



Provides more useful information to users of financial statements through improved disclosure requirements



The Core Principle of ASC Topic 606

Recognize revenue:

- When control of promised goods or services (performance obligations) transfers to customers
- In an amount that reflects the consideration a company expects to be entitled to in exchange for those goods and services

THE FIVE STEPS FOR REVENUE RECOGNITION



1. Identify contracts with customers



2. Identify performance obligations (promises to deliver) in each contract



3. Determine the transaction price



4. Allocate the transaction price to the performance obligations



5. Recognize revenue when or as performance obligations are satisfied

Step 1: Definition of a Contract



“A contract is an agreement between two or more parties that creates **enforceable rights** and obligations”

Criteria to have a contract:

- a. Parties **approve the contract** (in writing, orally, or in accordance with other customary business practices) and are committed to performing their obligations.

- b. The entity can **identify each party's rights** regarding the goods or services to be transferred.

Step 1: Definition of a Contract



- c. The entity can **identify the payment terms** for the goods or services to be transferred.
- d. The **contract has commercial substance** (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).
- e. It is **probable that the entity will collect** the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

Step 2: Distinct Performance Obligations

- A good or service is distinct if it is:
 - ✓ Capable of being distinct
 - ✓ Distinct within the context of the contract



Factors that suggest an item is **not** distinct within the context of the contract are:

- The seller provides a significant service of **integrating** the good or service with other goods or services promised in the contract
- The good or service significantly **modifies or customizes** another good or service promised in the contract
- The good or service is highly dependent on, or **highly interrelated** with, other goods or services promised in the contract

Warranty

- Assurance warranties are not considered separate performance obligations
 - Liability should be recognized under ASC 460
- Service warranties are generally considered separate performance obligations

Step 3: Determine Transaction Price

Includes

- Fixed consideration
- Variable consideration
- Noncash consideration

Excludes

- Collections on behalf of third parties (e.g., sales tax)
- Consideration from unexercised customer options to acquire additional goods/services
- Credit adjustments (bad debt reserves)
- Adjustments for significant financing component
- Consideration paid/payable to customer



Variable Consideration

Variable consideration represents any portion of the transaction price that can vary upward or downward

Variable consideration could be caused by:

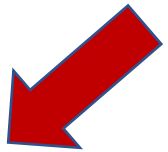
- Discounts
- Rebates
- Refunds/price protection
- Return rights
- Concessions
- Penalties
- Royalties
- Performance bonuses
- Milestones
- Profit sharing



Variable Consideration

The “Constraint”

- ❖ Include in the transaction price some or all of variable consideration only to the extent that it is **probable** that a significant **reversal** in the amount of cumulative **revenue** recognized **will not occur** when the uncertainty is subsequently resolved
- ❖ That is, include in the transaction price the maximum amount of revenue that we believe is not going to be reversed down the road



Important exception: Exclude all sales or usage royalties associated with an IP license until sale/usage occurs.

One Potential Impact: Sell-Through Method

COMPANY sells to distributors. COMPANY offers fairly generous return rights and price protection.

Current GAAP

- Because the arrangement fee is not fixed or determinable, COMPANY uses the sell-through method to recognize revenue
- That is, revenue is recognized only when distributors sell the goods to end customers

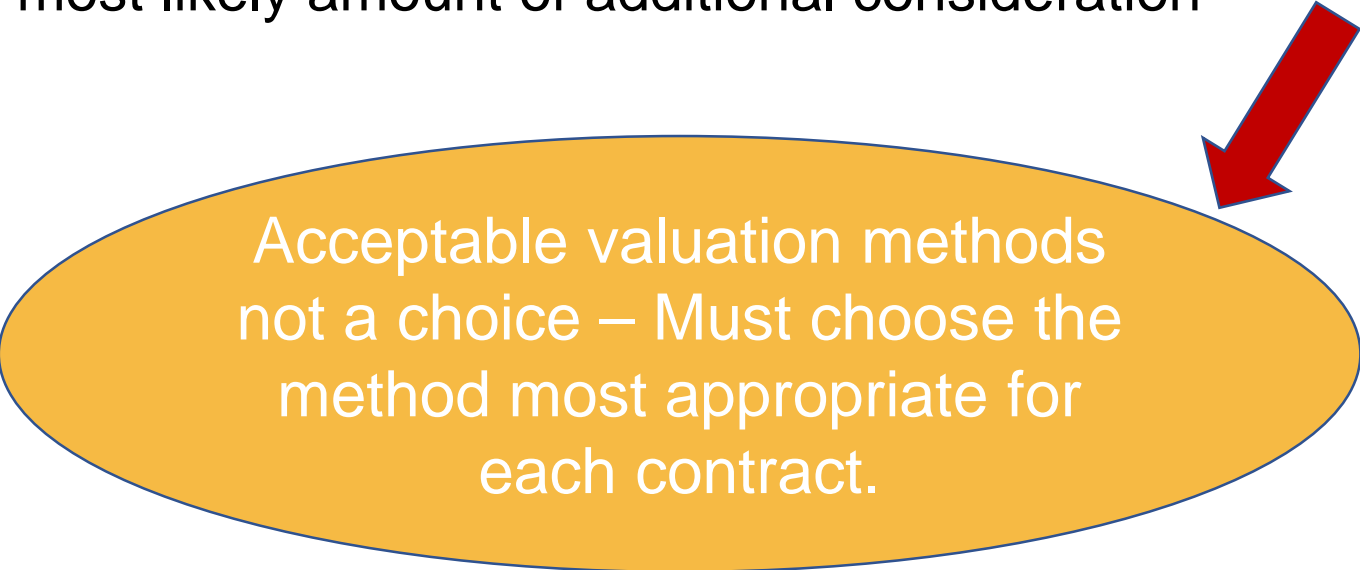
ASC 606

- COMPANY will recognize revenue when control over the goods is transferred to the distributor (likely upon shipment or delivery)
- COMPANY will include an estimate of returns and price protection in the transaction price

Variable Consideration

Valuation

- ❖ **Expected Value** – Sum of probability-weighted amounts in a range of possible amounts (large number of similar contracts)
- ❖ **Most Likely Amount** – Single most likely amount of additional consideration (achieve bonus or not)



Acceptable valuation methods not a choice – Must choose the method most appropriate for each contract.

Step 4: Allocate the Transaction Price

If applicable, allocate transaction price (Step 3) to the distinct performance obligations (Step 2) using relative standalone selling price method

- Try to “maximize observable inputs”
- If a standalone selling price is not directly observable, estimate it



Step 5: Point in Time vs. Over Time

- ❑ General Principle: Revenues must be recognized **over time** if any of the following are true:
 1. The customer simultaneously receives and consumes the benefits
 2. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls
 3. The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date

- ❑ Otherwise, recognize revenue at a **point in time**



Revenue Recognition Over Time

- Revenues measured over time are recognized as the entity makes progress toward completion
- Input or output measures are permissible
 - ✓ Should select the measure that is appropriate based on the nature of the performance obligation



One Potential Impact: Measure of Progress

COMPANY receives an order on December 1 to produce 100 custom shrouds (designed to the customer's specs). The shrouds have no alternative uses to **COMPANY** because they were designed specifically for the customer. Contractually, **COMPANY** may recover any costs incurred, plus a reasonable margin thereon, if the customer terminates the contract for any reason.

Current GAAP

- **COMPANY** applies ASC 605-35 and measures progress toward completion using the units of delivery method
- Assuming no shrouds were completed at year-end, **COMPANY** recognizes no revenue

ASC 606

- The customer is “obtaining control” of the shrouds while they are in production
- Hence, **COMPANY** will likely recognize some revenue at year-end using the cost-to-cost method

Licenses: Point in Time vs. Over Time

- IP must be classified as either functional or symbolic

Functional IP

Significant standalone functionality:

- Software
- Biological compounds
- Drug formulas
- Films, music, TV shows

Point-in-time revenue recognition (i.e., when customer is able to use and benefit from the license)

Symbolic IP

No significant standalone functionality:

- Brands
- Trade or team names
- Logos
- Franchise rights

Over time revenue recognition (i.e., over the shorter of license period or remaining economic life of the IP)

Deferred Costs

- ASC 340-40 was updated as part of the new standard and provides guidance for the following costs related to a contract with a customer within the scope of ASC 606:
 - Incremental costs of obtaining a contract with a customer
 - Costs incurred in fulfilling a contract with a customer that are not in the scope of another Topic
- Incremental costs of obtaining a contract are those costs that would not have been incurred if the contract had not been obtained (for example, a sales commission)
 - Incremental costs of obtaining a contract with a customer are recognized as an asset if the entity expects to recover those costs
 - Practical expedient allows these to be expensed if they would be amortized over one year or less

Effective Date and Transition

- Calendar-year public companies must adopt ASC Topic 606 on January 1, 2018 (private companies one year later)
- Can elect the following transition methods:
 - Full retrospective
 - Full retrospective, with optional accommodations
 - Cumulative catch-up



Possible Reasons to Go Retro

- ✓ For companies with long-term contracts, there's not much cost/time savings using modified retrospective (or CCA)
- ✓ Allows for comparative information to be presented on the same basis



- ✓ Can work on adoption outside peak periods
- ✓ Even under cumulative catch-up approach (CCA), dual reporting is required in the year of adoption
- ✓ Under CCA, revenues can disappear!

Disappearing Revenue Example (Private Company)

Assume...

- On December 31, 2018, COMPANY sells 250 units of product to a distributor customer for \$10 million
- COMPANY grants rights of return and price protection
- Hence, under today's GAAP, COMPANY defers revenue recognition until the fee becomes fixed or determinable in 2019

Effect of Cumulative Catch-Up Adoption

- Under ASC Topic 606, COMPANY must estimate the transaction price and would recognize a lot of the revenue in 2018
- This is captured in the cumulative catch-up adjustment to opening retained earnings January 1, 2019
- Revenue disappears – It doesn't show in 2018 or 2019

Disclosures

- New rules will require:
 - ✓ Disaggregation of revenues (such as type of good or service, geography, market, type of contract, etc.)
 - ✓ Reconciliation of contract balances (assets and liabilities, description of significant changes, amounts recognized in opening liability balance, amounts recognized for performance obligations fulfilled in prior period)
 - ✓ Performance obligations (when they are satisfied, significant payment terms, nature of promised goods and services, obligation for returns, refunds, warranties, etc.)
 - ✓ Significant judgments employed in recognizing revenues

A Quick Word ... Tax Considerations

- New rules may have many tax impacts, including:
 - Do changes in accounting rules require a change in tax accounting filed on Form 3115?
 - Will new book/tax basis differences arise?
 - Will the new rules affect any transfer pricing studies previously performed?
 - Will the new rules affect the allocation of transaction price to goods and services, potentially affecting the amounts of sales and use tax to collect?



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LEASE ACCOUNTING

Understanding the New Lease Standard ASC 842

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Lease Accounting

- At **inception** of the contract, determine if it is or contains a lease
 - A contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment for a period of time in exchange for consideration
 - ‘Period of time’ may be defined as the amount of use rather than a calendar period
- Contract specifies the use of an identified asset
 - Such as a truck’s VIN, a specific copier, or specific facilities premises
 - Supplier does not have right to substitute
- Customer controls the use of the identified asset
 - Right to obtain the economic benefits from use of the asset
 - Right to direct the use of the asset

Lease Accounting

- Scope exceptions—the rules to not apply to:
 - Leases of intangible assets,
 - Leases of biological assets (such as timber),
 - Leases of inventory,
 - Leases of assets under construction.
- No scope exceptions for small-ticket leases

Lease Accounting - Lessees

- Under ASC 842, nearly every lease will be recognized on the balance sheet
 - Lease obligation & corresponding right-of-use (ROU) asset
- Off-balance sheet financing no longer available for operating leases
 - Exception, when the transaction doesn't qualify as a lease
 - Short-term leases
- Distinction between finance leases and operating leases
 - Different P&L/Cash Flow recognition and presentation requirements
 - Classification criteria not as defined as the old rules

Lease Accounting - Lessees

- Finance Leases
 - Declining expense recognition pattern (greater cost in earlier periods)
 - Interest expense on lease liability presented as interest expense
 - Amortization of ROU asset presented with deprec/amort
 - Principal payments within financing cash flows
 - Interest and variable lease payments within operating cash flows
- Operating Leases
 - Straight line expense recognition
 - Presentation in single income statement caption
 - Payments within operating cash flows

Lease Accounting - Lessees

- A **finance lease** has any of the following criteria:
 - Transfers ownership to the lessee by the end of the term
 - Grants the lessee an option to purchase the asset that the lessee is reasonably certain to exercise
 - The lease term is for the major part (>75%) of the remaining economic life of the asset (although disregarded if lease inception is at or near the end of the asset's economic life(<25%))
 - The PV of the sum of lease payments (and any guaranteed residual) equals or exceeds substantially all (>90%) of the fair value of the asset
 - The assets is so specialized that it is expected to have no use to the lessor at the end of the term
- If none of these criteria are present, classify as an **operating lease**

Lease Accounting - Lessees

- Finance leases
 - Liability/ROU asset recorded at PV of lease payments not yet paid
 - Discounted at rate implicit in the lease. If not readily determinable, then use the incremental borrowing rate.
 - With each payment, the liability is reduced, along with an element of interest expense recognized under the effective interest method
 - The ROU asset is amortized straight line over the lease term. (It is subject to impairment)
 - (LHI are amortized over the shorter of their useful life or the lease term)

Lease Accounting - Lessees

- Operating Leases
 - Liability/ROU asset recorded at PV of lease payments not yet paid
 - Discounted at rate implicit in the lease. If not readily determinable, then use the incremental borrowing rate.
 - Lease liability subsequently adjusted (upward) for interest accreted and (downward) for payments made.
 - ROU asset reduced by the difference between the straight line expense and interest accreted on the lease liability
 - ***The impact is effectively that the lease expense is recognized straight line—Undiscounted lease payments (& direct costs) / lease term***
 - (LHI are amortized over the shorter of their useful life or the lease term)

Lease Accounting - Lessees

- Variable lease payments
 - Accounted for income or expense in the period determined, except:
 - Payments dependent upon an index or rate should be included in lease payments, measured using the index or rate at lease inception (without consideration of estimated future changes in the index or rate)
- Short term leases
 - Term of 12 months or less (and no purchase option reasonably certain of exercise)
 - May elect to not recognize assets/liabilities from Short Term leases, instead expense payments on Straight Line basis over the term
- Other guidance
 - Purchase options
 - Termination penalties
 - Reassessment/Re-measurement

Lease Accounting – Other

- Related Party—
 - In practice, related party leases:
 - May not have stated non-cancellable terms (effectively month-to-month)
 - May have payment terms dependent upon cash availability
 - Should still be classified and accounted for solely on the basis of legally enforceable terms and conditions
 - Should not evaluate the economic substance of the leases in determining accounting treatment—Accounting and classification for RP leases should be the same as for unrelated parties

Lease Accounting – Other

- Other situations—
 - Sale-Leaseback
 - Build-to-Suit
- Effective date: Fiscal years beginning after Dec 15, 2019 for non-public entities
- Modified retrospective transition: recognize and measure leases as of the beginning of the earliest period presented
- May elect various practical expedients upon adoption



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