The revenue recognition transition:

Determining the Transaction Price

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Agenda

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4) Significant financing component
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Section one

DEFINITION

Definition: Transaction price

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Transaction price

"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."

In many transactions this a straightforward concept.

A customer buys an item at retail for a stated and fixed price. But what happens if the retailer offers a discount if the customer exceeds a certain dollar amount in purchases?

Variable consideration.

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Section two

VARIABLE CONSIDERATION

Variable consideration

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Contracts often contain an element of variability:

- Discounts
- Rebates
- Credits
- Bonus or penalty clauses

Accounting for the variability can be quite complex and will require significant judgment.

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Estimations methods

The 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.

The most likely amount

> 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). ASC 606-10-32-8

Variable consideration

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The method used is not a free choice.

Rather it is driven by the facts and circumstances inherent in the contract.

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Example: Expected value method

Assume an entity enters into a contract to deliver an unspecified number of widgets to a customer for a period of two years.

The terms of the contract state the following:

- First 100 at $10;
- 101-500 at $9;
- any purchased in excess of 500 at $8 per item.

To determine the revenue to be recognized, the entity must determine the expected value of the contract, using a probability weighted approach.

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Example: Expected value method (cont.)

Units sold	Price	Probability	Weighted average units
100	10	15%	15
490	9	75%	368
610	8	10%	61
		Total	444

Based on this analysis, the entity determines the expected value of sales to be 444, which would yield the following revenue:

$1,000 (100*$10) + $3,096 (344*$9) = $4,096

This yields an average revenue of $9.23 per unit for the 444 units.

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Example: Expected value method (cont.)

The entity would thus recognize revenue at $9.23 per unit for each unit sold, recording the following journal entry, for the first 100 units:

	DR	CR
Accounts receivable	$1,000	
Revenue		$923
Contract liability		$77

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Example: Expected value method (cont.)

The entity would continue to record the revenue in the journal entry until the 101st unit was delivered, then would record for the next 344 units:

	DR	CR
Accounts receivable	$ 3,096	
Revenue		$3,173
Contract liability	$77	

The next 344 would debit $79 (due to rounding) to contract liability, thus reversing the balance.

Variable consideration

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An entity must reassess its estimate of variable consideration at each reporting period to determine if the estimate is still valid based on the then current facts and circumstances.

As in the previous example, does the entity still believe it will sell 444 units?

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Example: A change in the estimate

If the estimate changes the entity must account for the change in accordance with ASC 606 as follows:

- Assume in the previous example the entity revisits its estimate after selling 350 units and determines, based on conversations with its customer, that the total delivery will be 600 units.
- How does the entity now revise its revenue recognition pattern?

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Example: A change in the estimate (cont.)

After 350 units, the entity had recorded the following entries:

	DR	CR
Accounts receivable	$1,000	
Revenue		$923
Contract liability		$ 77
Accounts receivable	$2,250	
Revenue		$2,308
Contract liability	$ 58	

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Example: A change in the estimate (cont.)

The entity now recalculates the total estimated revenue as follows:

First 100 units	$1,000
Next 400 units	$3,600
Last 100 units	$ 800
Total	$5,400

Per unit for the run of the contract now = $9

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Example: A change in the estimate (cont.)

The entity must make the following entry, to reduce the previously recognized revenue by $.23 unit:

Revenue	$81	
Contract liability		$81

The new balance in the contract liability is now $100.

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Example: A change in the estimate (cont.)

The entity now records the sales of the following 250 units as follows:

	DR	CR
Accounts receivable	$1,350	
Revenue		$1,350

To record 150 units at $9

Accounts receivable	$800	
Revenue		$900
Contract liability	$100	

To record final 100 units at $9

Variable consideration

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This process is **significantly different than under current GAAP**, where the entity would recognize the revenue as delivered based on the invoice price.

At the end of the contract the total revenue recognized would be the same, but the **timing of the recognition could be significantly different**, based on the length of the contract and the estimates.

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Most likely amount method

This method is generally used where the variable consideration is binary in nature.

Common in situations where the entity can earn a **bonus** if the contract is completed before a certain date.

- The entity will either meet the goal or not.
- If it is probable that the entity will better the deadline, it would include the bonus amount as it recognizes the revenue.

This of course would only be relevant if the revenue will be recognized *over time* rather than at a *point in time*.

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Section three

CONSTRAINING ESTIMATES OF VARIABLE CONSIDERATION

Constraining estimates of variable consideration

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ASC 606 requires entities to estimate variable consideration when recognizing revenue.

But the estimation is subject to a constraint:

> The entity may only recognize revenue to the extent that it is **not probable** there will be a significant revenue reversal.

Probable generally means odds in excess of **75%-80%.**

Constraining estimates of variable consideration

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The standard provides the following indicators of when a revenue reversal may be probable:

- External factors
- Lengthy time period
- Limited prediction
- Broad price changes
- Broad considerations

Constraining estimates of variable consideration

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- **External factors:** The amount of consideration is highly susceptible to factors outside the entity's influence.
  - Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.
- **Lengthy time period:** The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- **Limited prediction:** The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.

Constraining estimates of variable consideration

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- **Broad price changes:** The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

- **Broad considerations:** The contract has a large number and broad range of possible consideration amounts.

Constraining estimates of variable consideration

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The concept should be applied in whenever variable consideration is a factor.

- Not an all or nothing process. There can be situations where entities will not recognize all of the variable consideration, but should recognize a lower portion of the consideration.
- As with the other estimates, the constraint shall be reassessed at each reporting period.

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Section four

SIGNIFICANT FINANCING COMPONENT

Significant financing component

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ASC 606 requires entities with contracts that exceed one year, to consider whether the pricing of the contract contains an **element of financing**.

- This could be financing provided to the customer, or the customer providing financing to the entity.

If there is a financing component, the entity must **recognize interest expense or interest income** as revenue is recognized.

Significant financing component

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Indicators of a financing component:

The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services.

The combined effect of both of the following:

- The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services
- The prevailing interest rates in the relevant market.

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Conditions that do not indicate a significant financing component:

1. The customer paid for the goods or services in advance, and the **timing of the transfer** of those goods or services is at the discretion of the customer.

2. A substantial amount of the consideration promised by the customer is **variable**, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).

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Conditions that do not indicate a significant financing component (cont.):

3. The difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 606-10-32-16) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference.
   - » For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

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Example: Product sale

An entity sells a product to a customer for $121,000 to be paid 24 months from delivery date.

- The cash selling price is $100,000.
- As such, the entity determines there is a significant financing component.
- The entity determines that the implicit discount rate is 10% and also determines it is comparable to a rate in a separate financing arrangement.

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Example: Product sale (cont.)

The entity records the transaction as follows upon delivery:

Accounts receivable	$100,000	
Revenue		$100,000

- Thereafter, it accretes interest income periodically to end with a receivable balance of $121,000 when the payment is due.
- The interest income would not be included as revenue.

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Example: Machine sale

Assume an entity enters into a contract to deliver a machine, for $50,000, in two years when the machine will be delivered to the customer.

- The entity offers payment upon delivery of $50,000 **or** payment up front of $40,000.
- Here the implicit rate is 11.8% but the entity determines the borrowing rate in a comparable transaction would be 6%.
- That rate is used to calculate the interest expense.

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Example: Machine sale (cont.)

The entity records the transaction as follows:

	DR	CR
Upon signing the contract		
Cash	$40,000	
Contract liability		$40,000
Over the contract period		
Interest expense	$4,940	
Contract liability		$4,940
Upon delivery		
Contract liability	$44,940	
Revenue		$44,940

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Example: Machine sale (cont.)

- An entity will apply this guidance by determining the discount rate at the inception of the contract based upon the current prevailing rate for a separate financing contract.
- The entity does not adjust the rate for intervening changes in interest rates.

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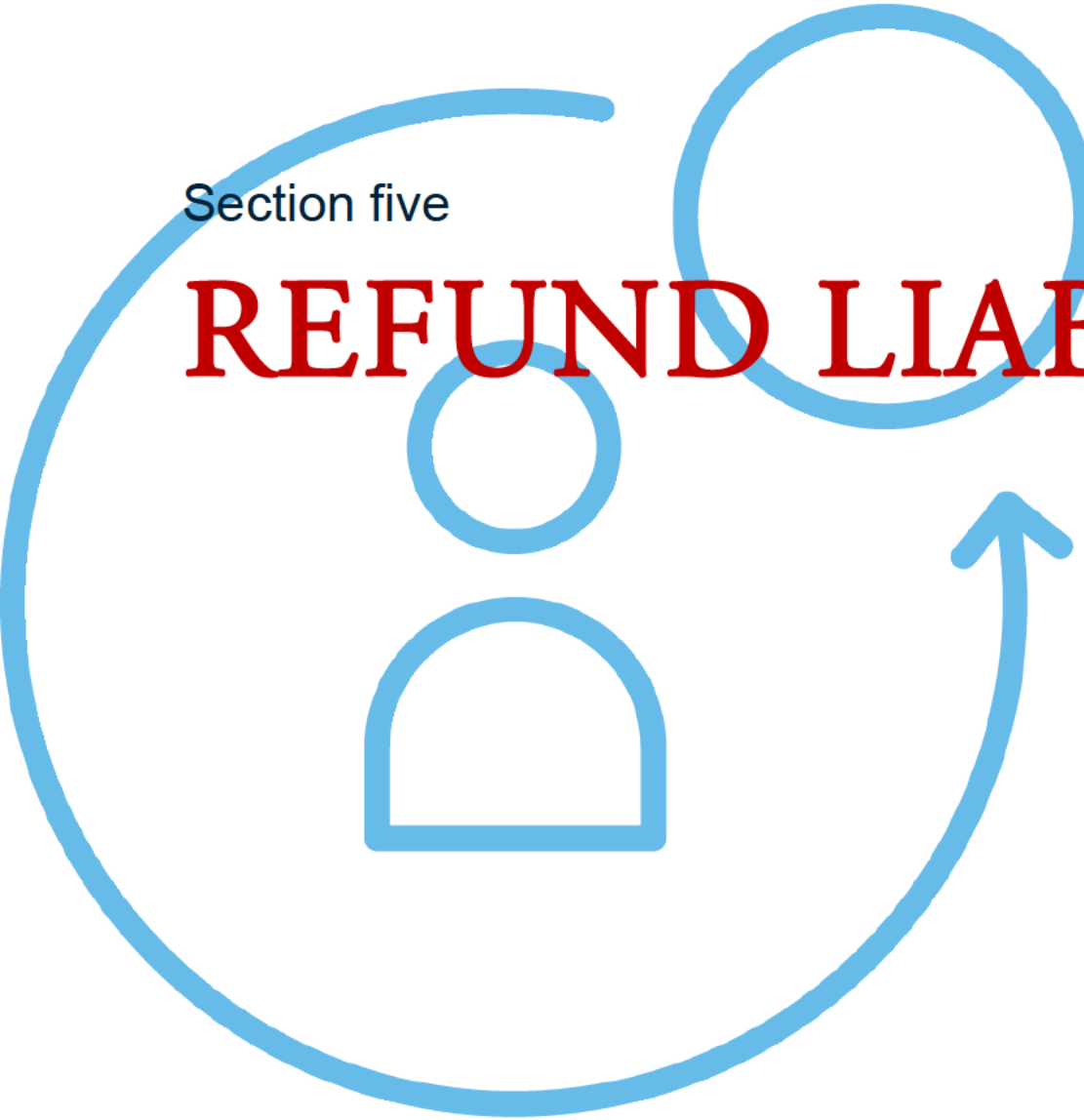
Section five

REFUND LIABILITIES



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Another form of variable consideration is the right of return.

- An entity must determine whether goods are likely to be returned and reduce its initial revenue estimate.
- In these situations, an entity may apply a portfolio method for estimating a return liability, as long as the results would not be materially different from applying to individual contracts.

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Example: Consumer products sales

An entity sells consumer products and has a reliable history of the returns it can expect from such sales.

- During its seasonal busy season an entity sells 10,000 units at a price of $100 per.
- The units may be returned in 30 days for a full refund and the returned units can be resold.
- History indicates an return rate of 5%.
- The cost of the unit is $80.

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Example: Consumer products sales (cont.)

After the sale, the entity would record the following entry to account for returns:

Revenue	$50,000	
Refund liability		$50,000
Inventory to be returned	$40,000	
Cost of good sold		$40,000

> The entity would reduce the value of the inventory to be returned for any expected additional handling costs.

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Section six

OTHER MATTERS

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Non-cash consideration

Some contracts call for consideration to be in a form other than cash, such as equity in the customer.

- ASC 606 requires such consideration to estimated at the fair value of the consideration at the contract inception.
- Variable consideration does not include the variability inherent in the fair value of non-cash consideration.

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Consideration payable to a customer

Consideration payable to the customer reduces the transaction price.

- This can be in the form of coupons, vouchers, etc. for future purchases.
- The entity must estimate whether the customer will make use of the consideration and record a liability to be reassessed at each reporting period.
- Consideration payable in exchange for goods and services shall be accounted for as with other purchases. Unless the amount is in excess of the fair value, if so any difference is a reduction of revenue.

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Section seven

CONCLUSION AND QUESTIONS

Conclusion

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- Determining the transaction price can be quite complex when there is an element of variability in the contract.
- These assessments historically have not been required. In some cases, revenue will be accelerated. In other cases, perhaps delayed.
- These estimates will require significant application of judgment.
- Entities will need to establish and control processes to make and support such judgments.

Thank you!

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Questions?

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