The revenue recognition transition:

Recognizing revenue as each performance obligation is satisfied

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Agenda

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1) Recognizing revenue
2) The concept of control
3) Performance obligations satisfied at a point in time
4) Performance obligations satisfied over time
5) Measuring progress toward completion
6) Conclusions and questions

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Section one

RECOGNIZING REVENUE

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ASC-606 states:

An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

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Section two

THE CONCEPT OF CONTROL

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Control passes to the customer when:

- The entity has the ability to direct the use of the asset
- Obtains the remaining economic benefits associated with the use
- This applies even when the benefits to the entity may only be momentary

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Indicators of control passing to the customer:

a) Using the asset to produce goods or provide services (including public services)
b) Using the asset to enhance the value of other assets
c) Using the asset to settle liabilities or reduce expenses
d) Selling or exchanging the asset
e) Pledging the asset to secure a loan
f) Holding the asset

The concept of control (cont.)

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The standard provides two methods for control passing to the customer:

1. **At a point in time**

2. **Over time**

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Section three

PERFORMANCE OBLIGATIONS SATISFIED AT A POINT IN TIME

Performance obligations satisfied at a point in time

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The most basic transaction, is an exchange of goods, with no other performance obligations.

When that occurs the entity transferring the promised good recognizes the related revenue.

Performance obligations satisfied at a point in time (cont.)

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Indicators that control has passed:

a) *The entity has a present right to payment for the asset—If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.*

b) *The customer has legal title to the asset—Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.*

Performance obligations satisfied at a point in time (cont.)

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Indicators that control has passed:

c) *The entity has transferred physical possession of the asset—The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs 606-10-55-66 through 55-78, 606-10-55-79 through 55-80, and 606-10-55-81 through 55-84 provide guidance on accounting for repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.*

Performance obligations satisfied at a point in time (cont.)

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Indicators that control has passed:

d) *The customer has the significant risks and rewards of ownership of the asset—The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.*

Performance obligations satisfied at a point in time (cont.)

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Indicators that control has passed:

e) *The customer has accepted the asset—The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs 606-10-55-85 through 55-88.*

Performance obligations satisfied at a point in time (cont.)

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The list is not meant to be all inclusive

- unique facts and circumstances may exist to reach the same conclusion

While most of these transactions will be straightforward, a careful analysis may be necessary.

It is possible in some scenarios that control has passed, but revenue is not recognized.

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Section four

PERFORMANCE OBLIGATIONS SATISFIED OVER TIME

Performance obligations satisfied over time

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Recognizing revenue for performance obligations which are satisfied over time adds complexity.

This practice will be common for contractors, service organization, some manufacturing, defense, and many other industries.

Performance obligations satisfied over time (cont.)

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ASC-606 provides the following criteria for this method:

a) *The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs*

b) *The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced*

c) *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*

Performance obligations satisfied over time (cont.)

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Criterion a:

- Common to many recurring service arrangements
- Usually a single performance obligation: A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Example

- Entity contracts for daily office cleanings over a period of one year. The entity recognizes revenue over time as the cleaning is provided.

Performance obligations satisfied over time (cont.)

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Criterion b:

- This criteria would be common to many construction activities
- An entity contracts to build a building on land owned by the customer.
- As the building is erected, the customer controls the asset, as it being built on its land.
- The entity recognizes revenue over time as the building is constructed.

Note: Construction industry highly affected

Performance obligations satisfied over time (cont.)

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Criterion c:

This may be the most difficult to apply as there are two important judgments required

- The entity must conclude that as it performs it is not creating an asset with an alternative use to the entity
- Must conclude that it has an enforceable right to payment for services provided to the date of termination

Performance obligations satisfied over time (cont.)

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Asset with no alternative use:

- Contractually prohibited from redirecting the use of the asset (defense contractors)
- Practical limitations on redirecting the use of the asset: design services by engineers, legal services, other professional services
- Practical limitations include the entity suffering significant economic consequences in rework or selling the asset at a loss

Note: Government contractors, professional services industries highly affected

Performance obligations satisfied over time (cont.)

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Enforceable right to payment:

- The entity must consider contract terms and legal issues
- There is not a requirement for full payment but the entity must be entitled to compensation for cost incurred plus a reasonable profit margin

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Reasonable profit margin

The standard states:

a) A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party)

b) A reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

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Example

An entity contracts to build a specialized machine.

- The payment terms call for 10% upfront, regular progress payments totaling 50% through construction, and 40% upon delivery and acceptance.
- The payments are non-refundable.
- Although the payments are non-refundable, they do not, at all times, represent an amount to compensate the entity for performance to date.
- The entity must recognize revenue at a point in time, upon delivery and acceptance by the customer.

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Section five

MEASURING PROGRESS TOWARD COMPLETION

Measuring progress toward completion

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An entity must measure progress toward completion in a manner that:

"…depict an entity's performance in transferring control of goods or services promised to the customer…"

> To do so, the entity uses an input method or an output method; this is not a free choice, the method should be one that best meets the objective.

Measuring progress toward completion (cont.)

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Input methods are familiar to contractors that have historically used such measures related to contract revenue.

Output measures would be appropriate where there is observable evidence of performance, such as in the cleaning service above. The entity would measure progress as each day of cleaning is performed.

Measuring progress toward completion (cont.)

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The method used should be reasonable.

- If the entity does not have a reliable estimate of costs to complete a project, it may need to defer recognition until more reliable information is available.

Measuring progress toward completion (cont.)

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Common output methods

- units produced
- milestones reached
- performance surveys
- etc.

The method should be reasonable.

- An entity using an output measure of units delivered, may ignore progress toward completion reflected in WIP or finished goods not yet delivered, but per the contract in the control of the customer.

Measuring progress toward completion (cont.)

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Due to inherent limitations in the use of the input method, ASC-606 provides indicators for when an input measure may need to be adjusted:

a) When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation.

For example, an entity would not recognize revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract (for example, the costs of unexpected amounts of wasted materials, labor, or other resources that were incurred to satisfy the performance obligation).

Measuring progress toward completion (cont.)

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b) When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation.

In those circumstances, the best depiction of the entity's performance may be to adjust the input method to recognize revenue only to the extent of that cost incurred.

For example, a faithful depiction of an entity's performance might be to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:

1. The good is not distinct.
2. The customer is expected to obtain control of the good significantly before receiving services related to the good.
3. The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.
4. The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal in accordance with paragraphs 606-10-55-36 through 55-40).

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Example

A common example is the construction industry when dealing with uninstalled materials.

- The cost of the material will ultimately be part of the overall cost
- The timing of the purchase does not drive revenue recognition
- It does not faithfully represent progress towards completion

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Example (cont.)

An entity agrees to a building renovation, including installing new elevators:

Transaction price	$5,000,000
Expected costs:	
Elevators	$1,500,000
Other costs	$2,500,000
Total cost	$4,000,000

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Example (cont.)

The entity purchases the elevators, six months before they will be installed. After three months the entity has incurred $500,000 in costs.

- Progress towards completion = 500,000/2,500,000 = 20%
- Revenue recognized = 20%*3,500,000 (5-1.5) = $700,000+$1,500,000 = $2,200,000
- Cost of goods = $500,000 + $1,500,000 = $2,000,000
- Gross profit = $200,000

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Section six

CONCLUSIONS AND QUESTIONS

Conclusions

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As with the previous four elements, determining which method to use for revenue recognition will require the **exercise of estimates and judgment**.

Adequate processes and ICFR should be part of an entity's transition plan, in order to properly apply the element and support the judgments inherent in its financial reporting.

Thank you!

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Questions?

Philip Santarelli, CPA

Partner Emeritus

215 557 2290

philip.santarelli@bakertilly.com

Disclosure

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