New Standards for Revenue Recognition

Presented by JAK
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Agenda

Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*

- Implementaion
- Overview of the new 5 step process
- Impact on financial statements
- Considerations for 3rd party users
- Wrap up and questions

New Revenue Recognition Standard

Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers,* will be effective for non-public entities for periods beginning after December 15, 2018.

Core Principal: Recognize revenue to depict the transfer of promised goods or services in an amount that reflects the consideration expected.

Excluded items: Leases, insurance, financial instruments, guarantees, non monetary transactions

Implementation

How do we transition?

The FASB allows entities to:

1. Apply retrospectively to each prior period, or
2. Apply retrospectively with the cumulative effect shown as an adjustment to retained earnings
   - No comparability reflected in the income statement
   - Recognition of revenue utilizing different methods
   - Beginning retained earnings will not agree to prior issued financial statements

Expect single year financials for 2019

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Implementation

- Potential change in timing of revenue recognition
- Capitalization of some upfront costs
- Presentation changes on the financial statements
- Potential impact on common ratios
- Management judgements and estimates will require evaluation for reasonableness

5 Steps of Revenue Recognition

1. Identify the contract(s) with the customer
2. Identify the performance obligations
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognize revenue when performance obligations are satisfied

Significant judgement required in all steps!

Step 1–Identify the Contract(s)

Definition: Agreement between parties that creates enforceable rights and obligations

A contract must meet these criteria:

1. Approval and commitment
2. Rights
3. Payment terms
4. Commercial substance
5. Probable collection of payment

If a contract does NOT meet these criteria, revenue is recognized essentially on a cash basis.

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Step 2-Identify Performance Obligations

Definition: A promise with a customer to transfer a distinct good or service

- If distinct, you have separate performance obligations.
  - There can be multiple performance obligations within one contract.
- If not distinct, combine goods and services until the bundle becomes distinct.

Step 3–Determine the Transaction Price

Definition: Amount of consideration expected to be entitled to from a contract

- Evaluated at each reporting date
- Various methods available
  - Most Likely Value or Expected Value
- Must reflect variable consideration
  - Incentives, penalties, discounts, rebates, refunds, price concessions, products with right of return, etc.

Step 3–Determine the Transaction Price

Variable Consideration

- May result in items previously reported as costs now being netted in revenues.
  - Penalties, rebates, etc.
- Will likely result in odd contract prices that don't agree to the value stated in the contract.
- Evaluation is necessary to determine whether variable consideration should be allocated to specific performance obligations.

Step 4-Allocate the Transaction Price

- The transaction price is allocated to separate performance obligations in proportion to the **standalone selling price** of the promised goods and services.

- Various methods available
  - Adjusted Market or Expected Cost Plus Margin
  - A combination of methods may be used within a single contract for each performance obligation.

Step 5–Recognize Revenue When (or as) Performance Obligations are Satisfied

- Revenue is recognized as each performance obligation is satisfied by transferring goods or services to the customer
  - At a point of time (default assumption)
  - Over a period of time (% complete)

- Various methods available
  - Input (Costs incurred or machine hours)
  - Output (Achieved milestones or units produced)
  - If progress cannot be reasonably estimated, recognize at break-even until estimation is possible.

Step 5–Recognize Revenue When (or as) Performance Obligations are Satisfied

- A good or service is deemed to be transferred when customer obtains <u>control</u>

Control of an asset refers to the ability to:

- Direct the use
- Receive substantially all of the remaining benefits
- Prevent other entities from directing the use and receiving the benefits

Step 5–Recognize Revenue When (or as) Performance Obligations are Satisfied

- Satisfied over time if any of these apply:
  - The customer simultaneously receives and consumes the benefit, or
  - The performance creates or enhances an asset that the customer controls, or
  - The entity's performance does not create an asset with alternative use to the entity and the entity has an <u>enforceable right to payment</u> for performance completed to date.
    - **This language needs to be included in the contract**

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Contract Modifications

Definition: Approved change in the scope or the price of a contract that is enforceable

- Does the modification create a separate performance obligation?
  - Yes = separately account for modification
  - No = reevaluate the entire contract
    - Performance obligations
    - Allocation of transaction price

Impact on Financial Statements

Contract Assets – *An entity's right to payment for goods or services already transferred to a customer if that right to payment is conditional on something other than the passage of time.*

Includes existing account balances

- Costs in Excess of Billings
- Unbilled Receivables

Includes new account balances

- Incremental Costs to Obtain a Contract
- Costs to Fulfill a Contract
- Variable Consideration Adjustments

Impact on Financial Statements

Contract Assets – New Account Balances

- Incremental costs to obtain a contract
  - Costs that would not have been incurred if the contract were not obtained
  - Example: sales commission
- Costs to fulfill a contract
  - Costs incurred after the contract is obtained, but before goods or services are transferred
  - Examples: set-up costs, mobilization, bond premiums

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Impact on Financial Statements

Contract Liabilities – *An entity's obligation to transfer goods or services to a customer.*

- Billings in Excess of Costs
- Accrued warranty costs
- Customer deposits
- Refundable consideration

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Impact on Financial Statements

Disclosure requirements are expanded to provide clear information concerning:

1. The entity’s contracts with its customers
2. Significant judgments and changes in judgments
3. Any assets recognized from the costs to obtain or fulfill a contract with a customer

Considerations for Users

- Its all about timing! In the end, the same amount of profit is recognized.

- Ratios – Consider adjusting benchmarks
  - New current asset items on balance sheet
  - Some costs will be expensed over time rather than when incurred (effect on % complete calculations)
  - Some shifts between costs of good sold and revenue
  - Some revenue might be counted twice or not counted at all in the year of transition

Considerations for Users

- Common Ratios
  - Current ratio (current assets / current liabilities)
  - Working capital (current assets – current liabilities)
  - Gross profit percentage (gross profit / revenues)
  - Inventory turnover (COGS / average inventory)
  - Accounts receivable turnover (revenues / average receivables)
  - Bonding capacity (multiple of equity or working capital)

Revenue Recognition Summary

- Considerable estimation and judgement in the revenue recognition process
  - How will this be evaluated?

- Financial statement presentation changes
  - How does this change your process?

- Ratio metrics may need to be adjusted
  - Will agreements need to be amended?

Be proactive in discussing the changes with your clients and the impact on your business with them!

Use JAK as Your Resource!

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