Revenue Recognition:
How It Will Change Your World

PRESENTED BY

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YEO & YEO

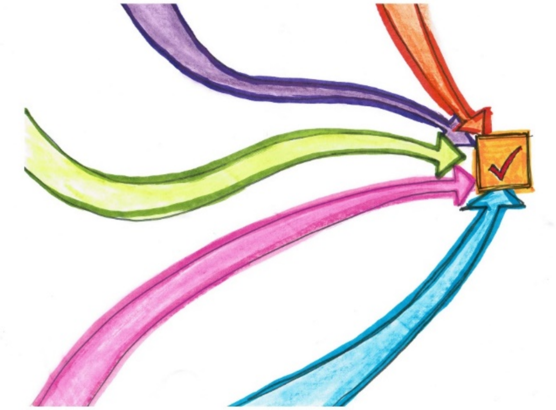
CPAs & BUSINESS CONSULTANTS

Objectives

- Discuss concerns to watch out for
- Identify the 5 steps of the new revenue recognition standard
- Discuss how the construction and manufacturing industries will be impacted by the new standard
- Go through examples for further understanding and application of new standards

Why the New Standard?

- FASB rules based
- New innovations = new rules
- Industry contracts and rules don't always align
- Convergence with IFRS



Application Date

- Nonpublic entities (FASB definition) – first annual reporting period beginning after December 15, 2018
  - **12/31/2019 year-ends**

- Comparative financials
  - 12/31/2018 year ends will need to be calculated under both old and new standards

Construction Industry

- Combining contracts
- Potentially multiple performance obligation within a single contract
- Determine transfer of control to customer:
  - input method or output method
- Change orders
- Variable consideration
- Uninstalled materials

Manufacturing Industry

- Evaluate whether revenue should be recognized:
  - over time (as productions occurs), or
  - at a point in time (when the customer obtains the goods or services)
- Determine transfer of control to the customer
- Consider volume discounts or rebates

5 Step Process

1. Identify the contract with the customer
2. Identify the performance obligations within the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognize revenue when performance obligation met

Identify the Contract

1

- Both parties approved and committed to satisfying their obligations
  - Written, oral, or implied (customary business practice)
- Commercial substance
- Each party’s rights identifiable
- Payment terms identified
  - Enforcement right of payment for performance completed to date
- Probable consideration will be collected

Multiple Contracts

- Combine multiple *legal* contracts into one *accounting* contract when:
  - Contracts are negotiated as a package with a single commercial objective
  - Consideration for one contract depends on price/performance of other contract
  - Goods/services of multiple contracts are a single performance obligation

Identify Performance Obligations

2

- (A series of) goods or services that are distinct
- Distinct
  - Customer can benefit by itself or with readily available resources
- Vendor promise must be separately identifiable

Performance Obligation

Contract Modification and Change Orders

- Change in scope or price approved by both parties
  - If additional distinct goods or services added and price increase and has stand-alone selling price
    - separate performance obligation
  - If additional distinct goods or services added but price does not have stand-alone selling price
    - terminate old performance obligation and create new
  - If no distinct goods or services added
    - adjust transaction price for current performance obligation

Incremental Costs of Obtaining Contract

2

- Incremental costs – costs incurred for contracts not yet awarded
- Setup of account, does not necessarily mean a performance obligation
- Record as asset; amortize based on likelihood of recovery
  - Practical expedient: less than one year amortization, expense when incurred
- Fulfillment
  - Surety bonds
  - Design
  - Engineering

Example A

Custom Machine

Installation

Transaction Price

3

- Consideration the entity *expects* to receive
- Excludes amounts for third parties
  - Sales tax
- Variable Consideration
  - Expected value method
  - Most likely method
- Constraint
  - Limited to amounts where it is probable a significant revenue reversal will not occur

Example B – Before Constraint

First 10 days	11-15 Days	16 + Days
5% discount	3% discount	No discount
$95	$97	$100
15%	40%	45%

- Expected value:
  - $95 * 15% +
  - $97 * 40% +
  - $100 * 45% =
  - $98.05
- Most likely:
  - $100 (45% is largest percent)

Example B – After Constraint

3

First 10 days	11-15 Days	16 + Days
5% discount	3% discount	No discount
$95	$97	$100
15%	40%	45%

- $98.05 > $95 and $97
  - $98.05 < $100
- % of amounts less than $98.05
  - 15% + 40% = 55%
  - Probable amount will be less than $98.05
- % of amounts less than $97
  - 15%; not probable amount will be less than $97
  - Constrained amount for expected value

Allocating Transaction Price

- Stand-alone selling prices
  - Allocate proportionately
    - No stand-alone selling price
      - Adjusted market assessment (what would they pay)
      - Expected cost plus margin
      - Residual approach (only if sold to different customers for wide range of prices or not yet sold separately)
- Discount
  - Typically proportionate
    - If regularly sold stand-alone, and regularly sell in discounted bundle, and the bundle discount approximates this discount, then can allocate proportionate to just bundle

Example C

Machine

Installation

Warranty

Example C

4

Product:	Performance Obligations:	Transaction Price:	Recognition:	Date:
Press	1) Build Press	$ 250.00	Shipped	6/30/20X1
	2) Install Press	100.00	Installed	1/1/20X2
	3) 5 Year Warranty	50.00	Over time	Exp: 6/30/20X6
		$ 400.00		

	Revenue	Costs	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Obligation 1:	$ 250.00	$ 200.00	$ 250.00	$ -	$ -	$ -	$ -	$ -
Obligation 2:	100.00	80.00	-	100.00	-	-	-	-
Obligation 3:	50.00	20.00	5.00	10.00	10.00	10.00	10.00	5.00
	$ 400.00	**$ 300.00**	$ 255.00	$ 110.00	$ 10.00	$ 10.00	$ 10.00	$ 5.00

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Income Statement						
Revenue	$ 255.00	$ 110.00	$ 10.00	$ 10.00	$ 10.00	$ 5.00
Costs	200.00	80.00	-	-	-	-
Warranty expense	-	-	-	20.00	-	-
Net Income	**$ 55.00**	**$ 30.00**	**$ 10.00**	**$ (10.00)**	**$ 10.00**	**$ 5.00**
Balance Sheet						
A: Cash	$ 200.00	$ 120.00	$ 120.00	$ 100.00	$ 100.00	$ 100.00
L: Deferred revenue	145.00	35.00	25.00	15.00	5.00	-
L: Accrued Warranty	-	-	-	-	-	-
E: Equity	$ 55.00	$ 85.00	$ 95.00	$ 85.00	$ 95.00	$ 100.00

Recognizing Revenue

- Satisfied at a point in time, or
- Satisfied over time
  - Customer simultaneously receives and consumes benefit
  - Performance creates/enhances asset the customer controls OR
  - Does not create an asset with alternative uses to the seller

Recognizing Revenue Over Time

- Output methods
  - Milestones
  - Time elapsed
  - Units produced
  - Units delivered
- Input methods
  - Resources consumed
  - Labor hours expended
  - Costs incurred
  - Time elapsed

Example D1

Product:	Performance Obligations:	Transaction Price:	Recognition:	Date:
100 Widgets	1) Create widgets	$ 6,000.00	Shipped 1	6/30/20X1
		-	Shipped 49	9/30/20X1
"Outputs"		-	Shipped 50	3/31/20X2
		$ 6,000.00		

5

Revenue	Costs		6/30/20X1	12/31/20X1	12/31/20X2	12/31/20X3	12/31/20X4	12/31/20X5
			1 Unit Shipped	49 Units Shipped	50 Units Shipped			
6,000.00		**Revenues**	60.00	2,940.00	3,000.00	-	-	-
-	5,000.00	**Expenses**	2,000.00	1,500.00	1,500.00	-	-	-
$ 6,000.00	**$ 5,000.00**	Billed Customer	$ 3,000.00	$ 1,500.00	$ 1,500.00	$ -	$ -	$ -

Income Statement						
Revenue	$ 60.00	$ 2,940.00	$ 3,000.00	$ -	$ -	$ -
Costs	2,000.00	1,500.00	1,500.00	-	-	-
Net Income	**$ (1,940.00)**	**$ 1,440.00**	**$ 1,500.00**	**$ -**	**$ -**	**$ -**

Balance Sheet * Ignoring Inventory						
A: Cash	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00
L: Billings in Excess	2,940.00	1,500.00	-	-	-	-
E: Equity	$ (1,940.00)	$ (500.00)	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00

Example D2

5

Product:	Performance Obligations:	Transaction Price:	Recognition:	Date:
100 Widgets	1) Create widgets	$ 6,000.00	Shipped 1	6/30/20X1
		-	Shipped 49	9/30/20X1
"Inputs"		-	Shipped 50	3/31/20X2
		$ 6,000.00		

Revenue	Costs		6/30/20X1	12/31/20X1	12/31/20X2	12/31/20X3	12/31/20X4	12/31/20X5
			1 Unit Shipped	49 Units Shipped	50 Units Shipped			
6,000.00		**Revenues**	60.00	2,940.00	3,000.00	-	-	-
-	5,000.00	**Expenses**	2,000.00	1,500.00	1,500.00	-	-	-
$ 6,000.00	**$ 5,000.00**	Billed Customer	$ 3,000.00	$ 1,500.00	$ 1,500.00	$ -	$ -	$ -
		Cost To Date	$ 2,000.00	$ 3,500.00	$ 5,000.00			
		Total Costs	5,000.00	5,000.00	5,000.00			
		% Complete	40.00%	70.00%	100.00%			

Income Statement	6/30/20X1	12/31/20X1	12/31/20X2	12/31/20X3	12/31/20X4	12/31/20X5
Revenue	$ 2,400.00	$ 1,800.00	$ 1,800.00	$ -	$ -	$ -
Costs	2,000.00	1,500.00	1,500.00	-	-	-
Net Income	**$ 400.00**	**$ 300.00**	**$ 300.00**	**$ -**	**$ -**	**$ -**

Balance Sheet * Ignoring Inventory	6/30/20X1	12/31/20X1	12/31/20X2	12/31/20X3	12/31/20X4	12/31/20X5
A: Cash	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00
L: Billings in Excess	600.00	300.00	-	-	-	-
E: Equity	$ 400.00	$ 700.00	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00

Concerns

- Discounts (bonus / penalty incentive) for early payment?
- Explicit right of return – refund liability?
- Warranty – performance obligation?
- Option to purchase additional goods/services – material right?
- Nonrefundable up front fees – performance obligation?
- Change orders?
- Uninstalled materials?
- Variable consideration?

Manufacturing Industry

- Evaluate whether revenue should be recognized over time (as productions occurs), or at a point in time (usually when the customer obtains the goods or services)
- Determine transfer of control to the customer
- Consider volume discounts, rebates or price concessions
- Manufacturing highly customized part for a customer
  - Contractual restrictions of redirecting that part?
  - Enforceable right for payment for performance completed to date?
    - Determine implications of canceled orders

Construction Industry

- Potentially multiple performance obligation
- Determine transfer of control to customer
- Proper treatment of change orders / variable / uninstalled materials
- Constructing hospital
  - Overall management as well as goods/services: engineering, site clearance, foundation, etc.
    - Capable of being distinct
    - Not distinct because significant integration
  - One performance obligation
  - If use input method of cost, no real change

Tax Implications

- Change in financial accounting methods may result in a change in tax accounting methods

- Consider:
  - Increase or decrease book-tax differences?
    - Timing of taxable revenues
  - Necessity of filing Form 3115 “Application for Change in Accounting Method”
  - Contract acquisition and fulfillment costs capitalization

To Do List – Contact Yeo & Yeo

- Walk through 5 step process on normal contracts and transactions
  - For all types of contracts
- Compare to existing revenue recognition
- Accounting system review
  - Change how we record in system, or
  - Adjust revenues at year end
  - Track performance obligations separately on W.I.P. Schedule
- Train sales department
- Consider internal control changes

Example E1:
Contract Review Tool

Contract Abstract Analysis Tool

Prepared for you by:

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CICPAC
CPAS WHO KNOW CONSTRUCTION

A. Does the agreement meet the definition of a contract as defined under ASC 606 (RRG. pg. 5)?

The five criteria to be met are as follows:

1. Approval and commitment of parties (legally enforceable) ☐
2. Identification of the rights of the parties regarding goods or services ☐
3. Identification of the payment terms ☐
4. Commercial substance ☐
5. Collection of payment is probable ☐

If not, which criteria was not met and why.

Did the agreement include a termination provision where either party has a unilateral right to terminate the contract without compensation? If yes, the contract is not within the scope of ASC 606. ◯ Yes ◯ No

If the contract does not meet all criteria under ASC 606, STOP, no further evaluation necessary. Revenue would not be recognized until the consideration has been received, it is nonrefundable, and no performance obligations remain.

B. Did the Company enter into other contracts at or near the same time with the same customer? If so, explain.

If the answer to one or more of the following is "yes", the contracts are Required to be combined:

1. Are the contracts negotiated in one package?
2. Does the payment of one contract depend on the other?
3. Are the goods/services promised considered one performance obligation?

When the contracts are combined for reporting purposes, revenue is recognized at the combined contract level and only one contract asset/liability will be reported on the combined contract level (RRG. pg. 5).

[2018-11-07 Revenue Recognition Tool.pdf]

Implementation

- Early Adoption
  - Have 12/31/16 Revenue Figures available, calculated under the old and new method
    - 2018 FS: Make AJE to RE as of 1/1/17, add restated over 2017
    - 2018 FS: Recognize revenues under new method for 2017 and 2018
- Standard Adoption
  - Have 12/31/17 Revenue Figures available, calculated under the old and new method
    - 2018 FS: Record and keep (for next year) 12/31/17 and 12/31/18 Revenue Figures
    - 2018 FS: No change, recognize revenues under old method for 2017 and 2018
    - 2019 FS: Make AJE to RE as of 1/1/18, add restated over 2018
    - 2019 FS: Recognize revenues under new method for 2018 and 2019
- Single Year Presentation
  - Have 12/31/18 Revenue Figures available, calculated under the old and new method
    - 2018 FS: Record and keep (for next year) 12/31/18 Revenue Figures
    - 2018 FS: No change, recognize revenues under old method for 2017 and 2018
    - 2019 FS: Make AJE to RE as of 1/1/19, only present 2019 FS
    - 2019 FS: Recognize revenues under new method for 2019

Who?

Example F1: Disclosures – All

Note 1 - Revenue from Contracts with Customers

The following summarizes revenue by type for the year ended December 31, 2018:

Revenue from Contracts with customers	$	500,000
Rental income		200,000
Interest revenue		10,000
Other revenue		2,000
Total revenue	$	712,000

The following summarizes bad debt expense for the year ended December 31, 2018:

Impairment loss on contracts with customers	$	1,000
Impairment loss on rental income		500
Total bad debt expense	$	1,500

The revenue from contracts with customers for the year ended December 31, 2018 consists of:

Revenue earned at a point in time	$	400,000
Revenue earned over time		100,000
Total revenue	$	500,000

Example F1: Disclosures – All

Note 1 - Revenue from Contracts with Customers, cont.

Revenue earned over time consists of Federal government contracts for customized widgets where the government has a unilateral right to cancel. The Federal budget impacts whether the contract is continued or canceled. Because the unilateral right to cancel includes a requirement for the Federal government to pay all costs incurred to termination, plus other costs not recovered at termination, and an allowance for profit, the performance obligation for those custom widgets is satisfied over the period of time of the contract. The Federal government is billed as customized widgets are shipped, and the receivable is due on receipt. The transaction price is allocated to the performance obligations based on the stand-alone selling price of the widgets. Revenue is recognized on a cost-to-cost basis over the period of the contract.

Revenue earned at a point in time consists of various types of widgets provided to local manufacturers throughout the state of Michigan. Generally, widgets are purchased on account as needed and therefore the revenues and cash flows related to these programs are not subject to the same amount of uncertainty as Federal government contracts. The performance obligation is typically satisfied when the widget is shipped to the customer. There is variable consideration for the widgets depending on when they pay (early payment discount), however, the variable consideration is not constrained. The transaction price is calculated using the expected value method based on historical experience for each price. Because the majority of widgets are paid timely, there is no constraint.

Example F1: Disclosures – All

Note 1 - Revenue from Contracts with Customers, cont.

The following summarizes contract assets and contract liabilities as of:

	January 1, 2018	December 31, 2018
Accounts receivable	$ 58,000	$ 62,000
Unbilled receivable	3,000	2,500
Total contract assets	$ 61,000	$ 64,500
Deferred revenue	$ 20,000	$ 24,000
Total contract liabilities	$ 20,000	$ 24,000

Obligations for returns/refunds are $5,000 at December 31, 2018 and are included in the balance sheet in accrued expenses based on historical experience of how widgets will be returned due to defect.

There is a 100% satisfaction guaranteed warranty on the widgets. A liability of $2,000 is included in accrued expenses for this warranty based on historical experience.

There were no changes in judgments related to revenue recognition for the year ended December 31, 2018.

The Company uses the practical expedient to record revenue as if there is no significant financing component when the receivable is due within one year.

Example G1: Disclosures – Early Adoption

Note 2 - Change in Accounting Principle

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, to clarify the principles of recognizing revenue, create common revenue recognition guidance, and improve disclosures. Accordingly, the Company has elected to implement this standard using a full retrospective adjustment of the prior year financial statements. Retained earnings increased $10,000 on January 1, 2017 as a result of this change.

The Company has elected to use the following practical expedients, which are not material to the restated information: 1) not restating contracts that began and were completed in the same annual reporting period; 2) for contracts with variable consideration, the transaction price used was that at the completion of the contract; and 3) contracts modified before the beginning of the earliest reporting period presented were not retrospectively restated for the modification.

	December 31, 2017 As originally reported	**December 31, 2017 As restated**	**Difference**
Accounts receivable	60,000	45,000	15,000
Unbilled receivable	3,500	-	3,500
Deferred revenue	15,000	8,500	(6,500)
Retained earnings	45,000	68,000	23,000
Total revenue	710,000	675,000	(35,000)

Example G2: Disclosures – Standard Adoption

Note 2 - Change in Accounting Principle

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, to clarify the principles of recognizing revenue, create common revenue recognition guidance, and improve disclosures. Accordingly, the Company has elected to implement this standard using a full retrospective adjustment of the prior year financial statements. Retained earnings increased $10,000 on January 1, 2018 as a result of this change.

The Company has elected to use the following practical expedients, which are not material to the restated information: 1) not restating contracts that began and were completed in the same annual reporting period; 2) for contracts with variable consideration, the transaction price used was that at the completion of the contract; and 3) contracts modified before the beginning of the earliest reporting period presented were not retrospectively restated for the modification.

	December 31, 2018 As originally reported	**December 31, 2018 As restated**	**Difference**
Accounts receivable	60,000	45,000	15,000
Unbilled receivable	3,500	-	3,500
Deferred revenue	15,000	8,500	(6,500)
Retained earnings	45,000	68,000	23,000
Total revenue	710,000	675,000	(35,000)

Example G3: Disclosures – Single Year Presentation

- Option 1

Note 2 - Change in Accounting Principle

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, to clarify the principles of recognizing revenue, create common revenue recognition guidance, and improve disclosures. Accordingly, the Company has elected to implement this standard using a full retrospective adjustment of the prior year financial statements. Retained earnings increased $10,000 on January 1, 2019 as a result of this change.

The Company has elected to use the following practical expedients, which are not material to the restated information: 1) not restating contracts that began and were completed in the same annual reporting period; 2) for contracts with variable consideration, the transaction price used was that at the completion of the contract; and 3) contracts modified before the beginning of the earliest reporting period presented were not retrospectively restated for the modification.

Example G3:
Disclosures – Single Year Presentation

- Option 2

Note 2 - Change in Accounting Principle

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, to clarify the principles of recognizing revenue, create common revenue recognition guidance, and improve disclosures. Accordingly, the Company has elected to implement this standard using a modified retrospective adjustment of the prior year financial statements. The initial application was applied to only contracts that were not completed at January 1, 2019, the date of initial application.

The Company has elected to use the practical expedient, which is not material to the restated information so that contracts modified before the beginning of the earliest reporting period presented were not retrospectively restated for the modification.

The amounts reported in the December 31, 2019 financial statements under the new standard versus the previous standard would be:

	As reported	Amounts that would have been reported without the adoption of ASU 2014-09	Difference
Accounts receivable	58,000	40,000	18,000
Unbilled receivable	3,000	-	3,000
Deferred revenue	20,000	9,000	(11,000)
Retained earnings	50,000	102,000	52,000
Total revenue	712,000	650,000	(62,000)

The reasons for these changes relate to the timing of recognizing the Federal government contract revenue by a cost to cost measure over a period of time, rather than strictly at a point in time.

Questions?

CONNECT with Us:

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Thank you!

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