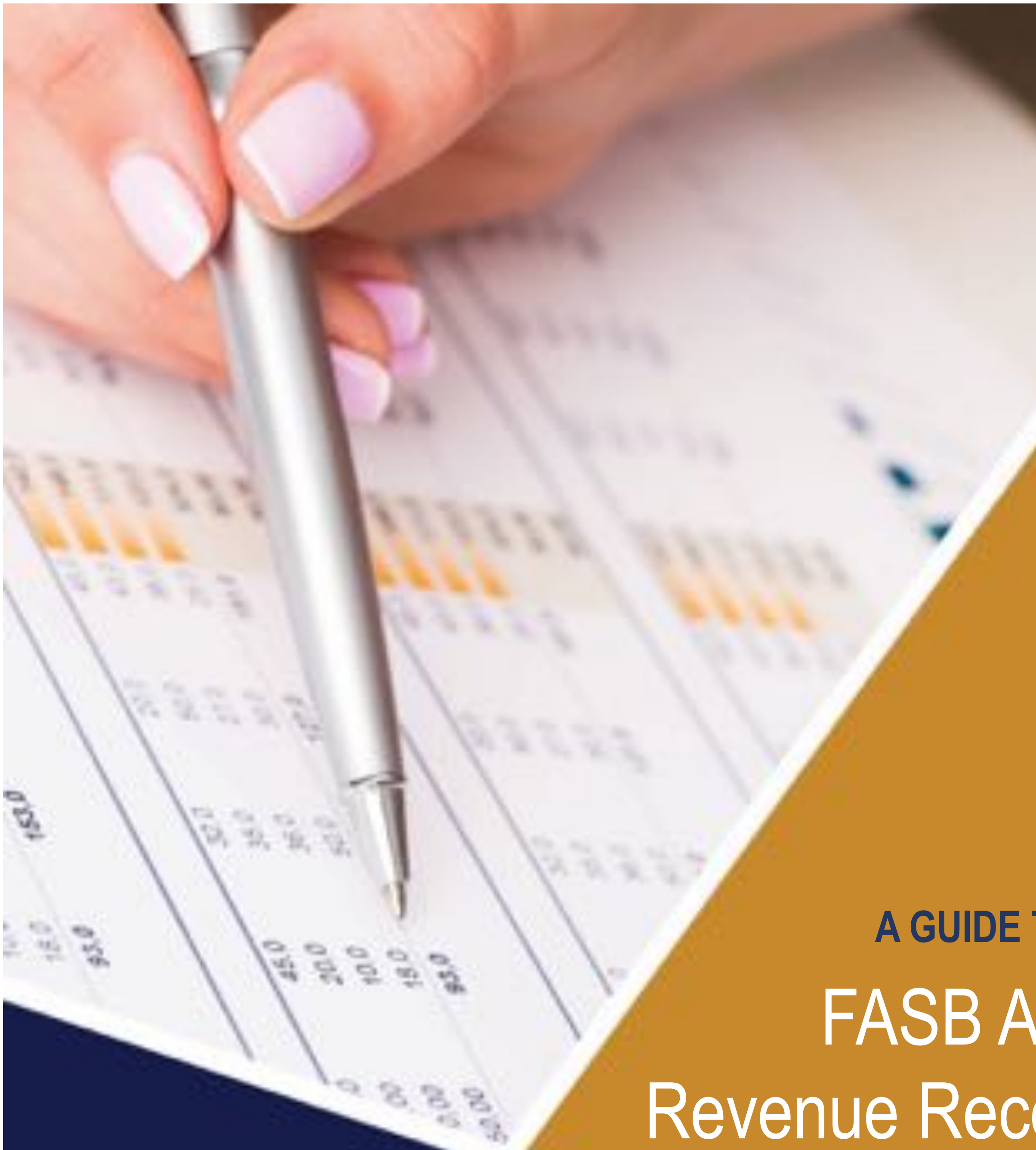

A GUIDE TO THE NEW

FASB ASC 606 Revenue Recognition

MOWERY & SCHOENFELD

What's the difference between the old model and the new model?

THE OLD MODEL

Recognizes revenue when a company "earns" it.

This model has lead to similar companies arriving at different revenue recognition for similar services or goods, making it difficult to compare companies or compare certain goods and services.

In addition, US GAAP currently has over 200 pronouncements about how to recognize revenue, leading to inconsistencies.

THE NEW STANDARD

Recognizes revenue as companies fulfill their promises to provide goods or service to their customers.

In addition to being compliant to GAAP, the new revenue recognition standard will provide many benefits to owners/operators and investors.

- Provides owners and operators with a clearer picture of the business – with better insight into which parts of a contract are most profitable.
- Supplies consistency across industries and companies, making it easier to compares goods and services.
- Makes comparison and consideration simpler for investors or interested parties since the revenue is based on the same standards as all other companies.

ASC 606 5-STEP PROCESS

This process requires revenue to be be recognized to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services :

Identify customer contracts

A contract is defined as an agreement between two or more parties that creates enforceable rights and obligations. Every sale in which goods or services are exchanged is a contract.

Identify performance obligations

A contractual agreement with a customer to transfer distinct goods or services is identified as a performance obligation. Some contracts may only have one obligation, and others may have more than one bundled or sold together.

Determine the transaction price

The transaction price is the amount a company is entitled to receive from the customer for performance of the contract.

Allocate the transaction price

The transaction price should be allocated based on the relative standalone selling price of each performance obligation.

Recognize revenue when the obligation is met

The obligation is considered met when the customer obtains control. For some transactions, this means recognizing revenue for different obligations at different times. This may be satisfied over time or at a point in time.

STEP ONE
Identify the contract with the customer

What is a contract?

A contract is defined as an agreement between two or more parties that creates enforceable rights and obligations. In order to meet revenue recognition requirements, a contract must be written, verbal or implied; and it must meet the following criteria:

- The parties of the contract have approved the contract and are committed to perform their respective obligations.
- The entity can identify each party's rights regarding the goods or services.
- The entity can identify the payment terms.
- The contract has commercial substance.
- It is probable the consideration will be collected in exchange for the goods or services that will be transferred to the customer.

If a contract does not meet the above criteria, revenue should be not be recognized until at least one of the following occurs:

- All performance obligations in the contract have been satisfied, and substantially all of the promised consideration has been met.
- The contract has been terminated.
- The entity has transferred control of the goods or services to the extent that the consideration has been received and that the entity has no additional obligation to transfer more goods or services.

STEP TWO
Identify the performance obligation

FASB ASC 606 requires an entity to identify the distinct goods or services promised in a contract. Each distinct good or service should be accounted for separately. This may include customer options to acquire additional free or discounted goods; warranties; or non-refundable, up-front fees. If the option provides a material right that the customer would have not received without entering into the contract, the option creates a separate performance obligation.

How do I identify when a good is distinct?

The customer can benefit from the good or service on its own with other readily available resources

or

The good or service is separately identifiable from other promises in the contract

STEP THREE

Determine the transaction price

The transaction price is based on the amount a company is entitled to receive from the customer for performance of the contract. In other words, this is the price of the contract.

STEP FOUR

Allocate the transaction price to each performance obligation

Once a company has identified the total price of a contract, as well as all of the individual performance obligations, it is time to allocate that price to each performance obligation. Transaction prices should be allocated on the basis of standalone selling prices. The ASU states the "best evidence of stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers." If a standalone price does not exist, the it can be estimated using market prices, inputs plus a reasonable margin, or the residual approach.

In the event a contract includes a discount for bundled services, discounts should be allocated proportionally to all performance obligations in the contract, unless the following criterial are met:

- The entity regularly sells each distinct good or service on a standalone basis.
- The entity also regularly sells a bundle of some of the distinct goods or service at a discount on a standalone basis.
- The discount attributable to each bundle of goods or services described above is substantially the same as the discount in the contract.

Example

How to reconcile the standalone model and bundled discounts:

An entity enters into a contract for the sale of Product A and upgraded services for a total of $100. As part of the contract, the entity gave a $20 discount on the combined contract of the two performance obligations.

The standalone selling price of Product A is $72 and the upgrade is $48. In order to get to the contract price of $100, you would allocate 60% of the total (or $60) to Product A revenue, and 40% of the total (or $40) to the upgrade.

	Standalone Selling Price		Allocated Transaction Price
Product A	$ 72.00	*60% of total*	$ 60.00
Upgrade	48.00	*40% of total*	40.00
Total	**$ 120.00**		**$ 100.00**

STEP FIVE

Recognize Revenue

The entity recognizes revenue when the performance obligation is satisfied and when the customer obtains control of the good or service. Control can transfer over time or at a point in time. In order for control to be transferred over time, one of the following must be met:

- The customer simultaneously receives and consumes the benefits provided by the entity as the entity performs its obligation.
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use, and the entity has an enforceable right to payment of the performance completed to date.

Special Considerations

Warranties

An entity should determine if the warranty provides additional services or only validates that the good or service adheres to its description. If no additional services are included, the warranty should be accounted for as a product warranty. If the warranty includes additional service, it should be accounted for as a performance obligation.

Rights of Return

An entity should estimate returns if the right of return exists. This is not a separate performance obligation. Recognize a refund liability for refunds expected to be provided to customers. Recognize an asset (and corresponding adjustment to cost of sales) for the right to recover goods from the customer.

Costs of Obtaining a Contract

An entity recognizes an asset for the incremental costs of obtaining a contract that is expected to be recovered. These assets include costs that relate to a contract and would not have been incurred if the contract was not obtained. An example of this would be commission, which is applicable to a contract with a period spanning over one year. Commissions are expected to be recovered through future fees and services.

Contract Modifications

Contract modifications such as change orders need to be addressed as a separate contract, modification to the existing contract, or termination and creation of a new contract.

- **Separate contract**: Additional goods or services are distinct and can be based upon stand-alone prices.
- **Modification to existing contract**: Services are not distinct, and prices are to be allocated among new contract terms.
- **Termination and creation of new contract**: Remaining services are not distinct and not at standalone prices. An example of this would be additional products are sold at a discount due to minor defects in the first shipment.

Other Considerations

There are a number of other considerations and unique situations in which guidance may be necessary, including but not limited to the following:

- Rebate programs or volume discounts
- Subscription renewals
- Nonrefundable upfront fees
- Significant financing or noncash consideration

Tax Reporting Implications

The impact of these financial reporting changes on the company's tax reporting also needs to be evaluated. In most cases, companies will be required to file an Application for Change in Accounting Method (IRS Form 3115) to reflect the changes in recognizing revenue on its income tax filings, starting with the 2019 tax year.

Software Contract Company Example

MARK BUYS A

1-Year Software Subscription

FOR

$100 per month

INCLUDES

Initial setup, ongoing software licensing, and as-needed service

Let's Break it Down

1. IDENTIFY CUSTOMER CONTRACTS

The signed customer agreement in which the company agrees to provide the software subscription package in exchange for a set fee per month, meets the criteria of a customer contract.

2. IDENTIFY PERFORMANCE OBLIGATIONS

In our example, the software company has three distinct obligations – the initial setup, software licensing, and as-needed service.

3. DETERMINE THE TRANSACTION PRICE

Our company determined the transaction price for the subscription is $100 per month or $1,200 per year.

4. ALLOCATE THE TRANSACTION PRICE

We have identified the specific performance obligations in step two and total transaction price in step three. Now, we need to determine how much estimate the value of each individual obligation based on standalone market value.

Setup	$200
Software ($50 per month)	$600
Service	$400
Total Annual Price	**$1,200**

5. RECOGNIZE REVENUE WHEN THE OBLIGATION IS MET

For our software company, the revenue allocated to our setup fees would need to be recognized once the software is operational, the software license would be recognized each month, and the service recognized as it is used or based on some standard use model.

REACH OUT

By the end of 2019, we will provide guidance and support as you update your contracts and accounting processes to ensure all clients are prepared and compliant.

If you have any questions, give our assurance team members a call and we will help you navigate the revenue recognition changes as they relate to your company and individual transactions.

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