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REVENUE RECOGNITION

Key Insights for the manufacturing industry



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RSM's manufacturing focus



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Agenda

Topic

Industrial products industry perspective

Overview

Revenue recognition model

Contract costs

Financial statement presentation and disclosure

Transition methods

Objectives

- By the end of the course, you will be able to:
 - List what the 5 steps are in the new revenue recognition standards
 - Evaluate how your Company's revenue recognition accounting policies may be affected by the new guidance
 - Discuss plans to transition to the new revenue recognition guidance and how we can help

Industrial products industry perspective

- Today's webcast – overview of changes to come
- Spring webcast – implementation issues
- Leases.....coming

OVERVIEW

Overview – Effective Dates

Effective date of ASC 606	Calendar year end entities	June 30 year-end entities
Public entities*, quarter and year beginning...	January 1, 2018	July 1, 2018
Other entities, year ending...	December 31, 2019	June 30, 2020
Early adoption of ASC 606		
Allowed for both public entities and other entities...	As early as January 1, 2017	As early as July 1, 2017

* Public entities include PBEs, nonprofit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and (c) employee benefit plans that file or furnish financial statements to the SEC. However, the SEC staff recently announced that they would not object to those entities that are PBEs solely because their financial statements or financial information is included in a filing with the SEC pursuant to SEC rules and regulations choosing to adopt the new guidance in accordance with the effective date provided for private companies.

Core principle

Recognize revenue 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

REVENUE RECOGNITION MODEL

Key steps



STEP 1: IDENTIFY THE CONTRACT WITH A CUSTOMER

Step 1. Identify the contract with a customer

- Does a customer contract exist?
 - Defined as an agreement between two or more parties that creates enforceable rights and obligations
 - Whether rights and obligations are enforceable is a matter of law
 - Can be written, oral or implied based on the entity's usual business practices
- Does the customer contract provide the unilateral, enforceable right to each party to terminate the contract with no compensation to the other party if the contract is wholly unperformed?
 - If so, no revenue consequences related to the contract

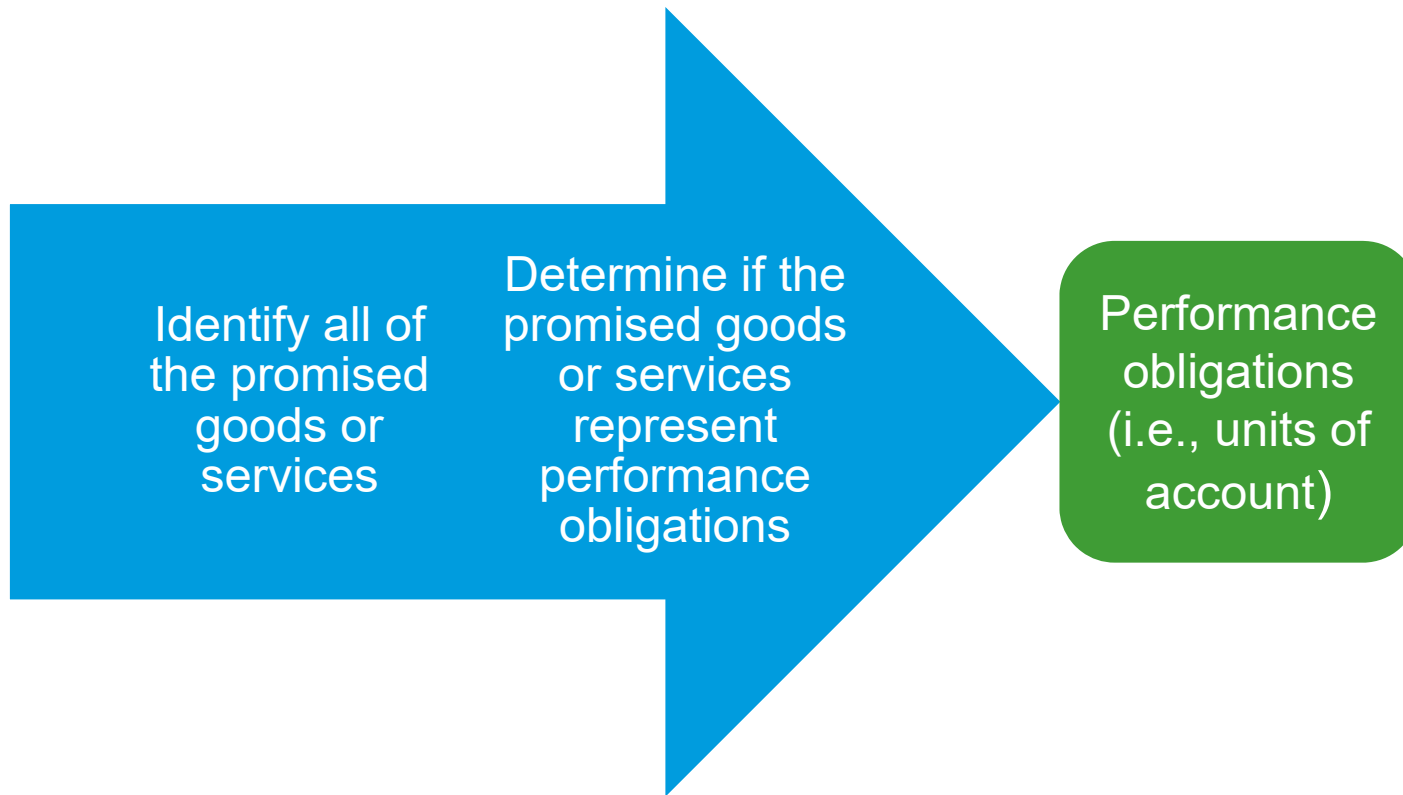
Step 1. Identify the contract with a customer

- The following contract existence criteria must be met to account for a contract using ASC 606's revenue model:
 - Commercial substance exists
 - Approvals have been obtained and a commitment to perform exists on the part of both parties
 - Rights of both parties are identifiable
 - Payment terms are identifiable
 - **Collection** of the amount to which the entity will be entitled is probable (i.e., likely to occur)

Once these criteria are met, reassessment is only required if there is a significant change in circumstances

**STEP 2:
IDENTIFY THE
PERFORMANCE
OBLIGATIONS IN THE
CONTRACT**

Step 2. Identify the performance obligations in the contract



Step 2. Identifying promised goods or services

- Consider both explicit and implicit promises
 - Implicit based on the entity's customary business practices, published policy or specific statement
- Some are obvious, others may not be so obvious
 - Option to purchase an additional good or service in the future at a discount
- Not all activities performed by the entity in conjunction with the customer contract provide or transfer goods or services to the customer
 - Common example is set-up activities

Step 2. Determining if promised goods or services represent performance obligations

- Is the promised good or service distinct?
 - If so, account for separately as a performance obligation (i.e., unit of account)
 - Series exception: When the promised good or service is part of a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer, the series of distinct goods or services is the performance obligation
 - If not, combine with other promised goods or services until there is a group that is distinct
- A promised good or service is distinct if it is both:
 - Capable of being distinct (obtainable elsewhere)
 - Separately identifiable from other promises in the contract (e.g., distinct within the context of the contract)

Step 2. Shipping and handling activities

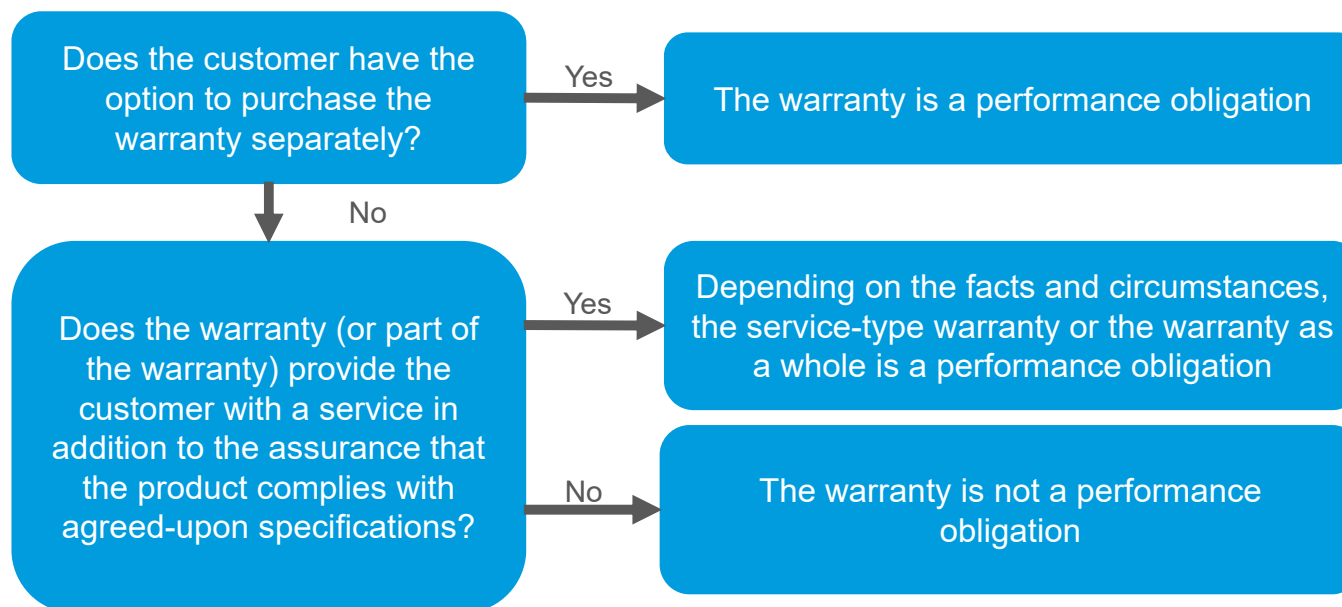
- Accounting depends on whether shipping and handling activities occur before or after the customer obtains control of the promised goods
 - Before: Fulfillment activities and not promised services
 - After: Promised services
 - **Accounting policy election:** Entity may elect to treat the promised services as fulfillment activities (i.e., no further evaluation under ASC 606)
 - If elected, the entity must accrue the costs of the shipping and handling activities when it recognizes revenue under the contract

Step 2. Warranties

- Legacy guidance – ASC 450, ASC 460 & ASC 605-20-25
 - Warranty is not separately priced
 - Revenue recognized in full at time of product delivery
 - The amount of cost estimated to fulfill any warranty obligations is accrued
 - Extended warranty is separately priced
 - Full contract price for contractual warranty is deferred
 - Warranty revenue is recognized on a straight-line basis over contract period except if related costs are incurred on other than a straight-line basis based on sufficient historical evidence

Step 2. Warranties

- ASC 606



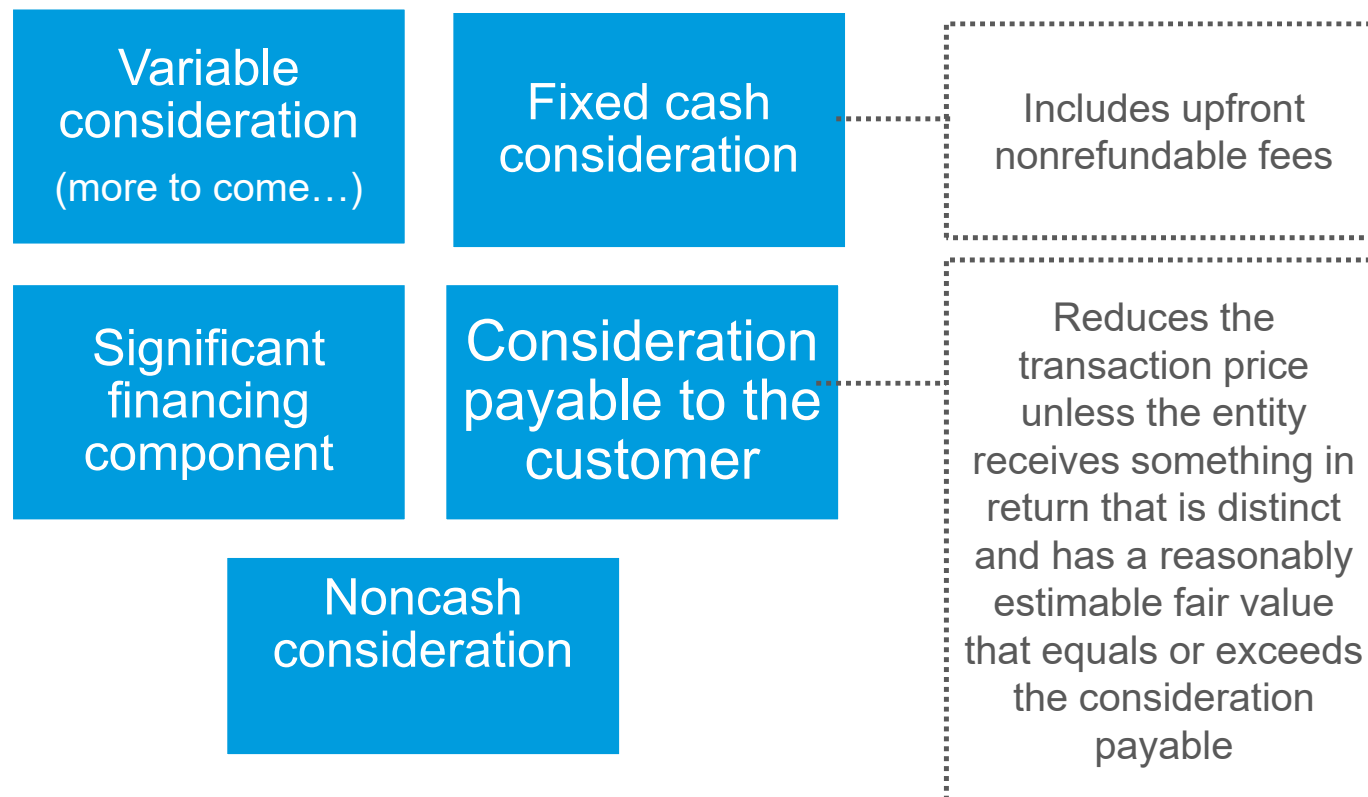
Step 2. Warranties

- In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity should consider factors such as:
 - **Whether the warranty is required by law** — If the entity is required by law to provide a warranty, it is presumptively not a performance obligation as it typically exist to protect customers from the risk of purchasing defective products
 - **The length of the warranty coverage period** — The longer the coverage period, the more likely it is that the promised warranty is a performance obligation as it is more likely to provide a service beyond the assurance that the product complies with agreed-upon specifications
 - **The nature of the tasks that the entity promises to perform** — If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications, then those tasks likely do not give rise to a performance obligation

STEP 3: DETERMINE THE TRANSACTION PRICE

Step 3. Determine the transaction price

- Transaction price may include:



Step 3. Variable consideration

- Examples
 - Bonuses
 - Price concessions
 - Refunds
 - Milestone payments
 - Penalties
 - Discounts
 - Returns
 - Volume Rebates
- Could be explicit or implicit
- Could affect whether consideration is paid at all or the amount of consideration paid
- Estimate using expected value method or most likely amount method
- Subject to the constraint on variable consideration

Step 3. Variable consideration

- Expected value method
 - Probability weighting of potential outcomes
- Most likely amount method
 - Determination of which amount within a range of defined amounts is most likely
 - Best suited for variable consideration with limited (e.g., two) outcomes
- Reassess estimate of variable consideration each reporting period until resolved
 - Use the same method used at contract inception

Step 3. Variable consideration

- To account for the transfer of products with a right of return, an entity should recognize all of the following:
 - Revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognized for the products expected to be returned)
 - A refund liability
 - An asset (and corresponding adjustment to cost of sales) for the right to recover products from customers on settling the refund liability

Step 3. Example – Payment terms

- ABC offers payment terms of 2/10, net 30 to its customers
- Assume a \$1,000 invoice price
- If the customer pays within 10 days, the customer will receive a 2% discount on the total invoice price
- ABC has the data available to support that the discount is taken in 20% of similar transactions
- The expected value method was used to estimate the variable consideration of \$996 ($\$1,000 \times 80\%$) + ($\$980 \times 20\%$)
- The Company will also need to consider the variable consideration constraint

Step 3. Example - Volume rebates

- ABC has a contract to deliver fidget spinners to its customer
- Annual volume rebates are offered as follows
 - 0% for sales less than 1,000,000 units
 - 5% for sales between 1,000,000 and 3,000,000 units
 - 10% for sales over 3,000,000 units
- Based on industry and customer-specific experience, management believes the most likely rebate will be 5%
- The Company will record revenue for 95% of the amount received and defer 5% of the amount received as the goods are delivered to the customer
- Each reporting period the estimate is reviewed with cumulative adjustments recorded at that time
 - Changes from the initial estimate will impact the period in which the cumulative adjustment is recorded

STEP 4: ALLOCATE THE TRANSACTION PRICE

Step 4. Allocate the transaction price

- Overall approach is to allocate transaction price using a relative standalone selling price (SSP) model
- Steps in allocating the transaction price
 - Estimate the SSP of each performance obligation
 - Determine whether any discounts or variable consideration should be allocated to one or more, but less than all, performance obligations
 - Allocate the transaction price

Step 4. Standalone selling prices

- SSP is the amount the entity charges (or would charge) when the goods or services are sold on their own to a customer
- Determined only at contract inception
- Best evidence is the directly observable price charged by the entity when they sell the goods or services separately in similar circumstances to similar customers
 - If it exists, it must be used
- If a directly observable price does not exist, must estimate a standalone selling price
 - Maximize observable inputs
 - Consider all reasonably available and relevant information

Step 4. Allocation example

- ABC sells air conditioners which includes a service type warranty to its customer for a total of \$1,000
- How should the transaction price be allocated?

Allocation of transaction price (rounded)	SSP	% of SSP	Allocation of Transaction Price (\$1,000)
Air Conditioner (\$1,000 SSP)	\$1,000	91%	\$910
Warranty (\$100 SSP)	<u>100</u>	<u>9%</u>	<u>90</u>
Total	\$1,100		\$1,000

STEP 5: RECOGNIZE REVENUE

Step 5. Recognize revenue

- Recognize the transaction price allocated to a performance obligation when (or as) it is satisfied
 - Performance obligation is satisfied when (or as) control of the underlying distinct good or service (or distinct bundle of goods or services) transfers to the customer
 - Control has transferred when the customer has the ability to direct the use of the good or service AND receive substantially all of the related remaining benefits
- Is control transferred over time or at a point in time?

Step 5. Performance obligations satisfied over time

- A performance obligation is considered satisfied over time if any one of these criteria are met:
 - The customer simultaneously receives and consumes benefits as the entity performs
 - Could another entity step in and fulfill the remaining performance obligation without having to substantially reperform the work already performed by the entity?
 - The entity's performance creates or enhances an asset that the customer controls as it is created or enhanced
 - The entity's performance does not create an asset with an alternative use to the entity and there is an enforceable right to payment for performance completed to date

Step 5. Performance obligations satisfied over time

- Identify a single method by which to measure progress toward complete satisfaction of the performance obligation, which should be:
 - A reasonable and reliable method
 - If one cannot be identified, recognize revenue to the extent of costs incurred only if the costs are expected to be recovered and only until a reasonable and reliable method can be identified
 - Consistent with how control of the underlying goods or services are transferred to the customer

Step 5. Performance obligations satisfied at a point in time

- If a performance obligation is not satisfied over time, it is satisfied at a point in time
 - Recognize revenue when the customer obtains control over the underlying good or service
 - Indicators that control has transferred include:
 - The entity has a present right to payment for the distinct good or service
 - One or more of the following have transferred/passed to the customer
 - Legal title to the distinct good or service
 - Physical possession of the distinct good or service
 - Significant risks and rewards of ownership
 - The customer has accepted the distinct good or service

Bill-and-hold transactions

Current bill-and-hold criteria	Comparable guidance in ASC 606
1. The risks of ownership pass to the buyer	Transfer of control indicators
2. The customer makes a fixed commitment to purchase the goods, preferably in writing	Step 1 (which does not require the parties' rights and obligations to be documented in writing)
3. The buyer requires the transaction be on a bill-and-hold basis and has a substantial business purpose for doing so	The reason for the bill-and-hold must be substantive (e.g., the customer initiated the arrangement)
4. There is a fixed schedule for delivery of the goods that is reasonable and consistent with the buyer's business purpose	None
Continued...	

Bill-and-hold transactions

Current bill-and-hold criteria	Comparable guidance in ASC 606
5. The seller does not retain any specific performance obligations such that the earning process is not complete	Steps 2 and 5
6. The ordered goods are segregated from the seller's inventory and are not available to fill other orders	<ul style="list-style-type: none">• The products must be separately identified as the customer's products• The products must not be able to be used by the entity or redirected to another customer
7. The product is complete and ready for shipment	The products must be ready for physical transfer to the customer

CONTRACT COSTS

Other considerations - Contract costs

	Costs to fulfill a contract	Costs to obtain a contract
Applicability	Guidance only applies when the contract is within the scope of ASC 606 and if the costs are not within the scope of other ASC Topics	
Example	Setup costs	Commission
Capitalization criteria	<p>Capitalize costs if all of the following criteria are met:</p> <ul style="list-style-type: none"> • Directly relate to the contract or an anticipated contract • Generate or enhance resources that will be used to satisfy performance obligations in the future • Expected to be recovered 	<ul style="list-style-type: none"> • Capitalize incremental costs if they are expected to be recovered • Capitalize costs that are not incremental only if they are explicitly chargeable to the customer regardless of whether the contract is obtained

Other considerations - Contract costs

	Costs to fulfill a contract	Costs to obtain a contract
Practical expedient	<ul style="list-style-type: none"> None 	Expense if amortization period would otherwise have been one year or less
Amortization	<ul style="list-style-type: none"> Method should be consistent with how the related goods or services are transferred to the customer Depending on the facts and circumstances, it may be appropriate to use an amortization period longer than the initial contract period 	
Impairment	<ul style="list-style-type: none"> Compare the carrying amount to an amount that considers the revenue and costs that remain to be recognized under the contract including expected contract renewals and extensions with the same customer 	

FINANCIAL STATEMENT PRESENTATION & DISCLOSURE

Balance sheet presentation

- Entity recognizes a contract asset or contract liability by comparing its performance under the contract (i.e., transferring control of performance obligations) to customer's performance under the contract (i.e., making payments)
 - Contract asset
 - Entity's performance > Customer's performance (payment)
 - Contract liability
 - Entity's performance < Customer's performance (payment)
 - Titles are not prescriptive
 - However, it must be clear by the title that a contract asset is not a receivable
- Receivables are only recognized for the unconditional right to receive consideration
 - Recognized separate from other assets

Disclosures

- Objective is to help financial statement users understand the nature, amount, timing and uncertainty of the related revenue and cash flows
- Detailed quantitative and qualitative information about the following must be disclosed:
 - Disaggregated revenue
 - Contract assets, contract liabilities and receivables
 - Performance obligations in general and the transaction price allocated to the remaining performance obligations at the end of the reporting period
 - Significant judgments related to when performance obligations are satisfied and used to estimate and allocate the transaction price
 - Capitalized customer contract costs

TRANSITION METHODS

Transition methods

- Entities may choose to apply one of the following transition methods:
 - Full retrospective application of ASC 606 to all periods presented
 - One or more of four practical expedients may be elected
 - Modified retrospective application as of the date of initial application of ASC 606
 - Recognition of a cumulative effect adjustment as of the date of initial application (i.e., prior periods are not adjusted)
 - One practical expedient may be elected
 - Disclose the effects on each line item in the financial statements of applying the new guidance in the period of adoption

Transition method pros and cons

	Full retrospective	Modified retrospective
Pros	<ul style="list-style-type: none"> Provides for greatest comparability 	<ul style="list-style-type: none"> Generally viewed as being less time consuming
Cons	<ul style="list-style-type: none"> Comparability is somewhat hindered to the extent any practical expedients are elected Generally viewed as being more time consuming, particularly when: <ul style="list-style-type: none"> One or more comparative periods are presented There is a large population of multiyear contracts 	<ul style="list-style-type: none"> Comparability is hindered to the extent one or more comparative periods are presented Required to provide revenue information based on what revenue would have been in the year of adoption under legacy U.S. GAAP <ul style="list-style-type: none"> Requires dual bookkeeping in year of adoption

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Information about the new guidance in ASC 606

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which added Topic 606 to the FASB's Accounting Standards Codification (ASC) and will replace almost all pre-existing revenue recognition guidance in legacy generally accepted accounting principles (GAAP) with a robust framework for addressing how an entity should account for its revenue. Implementation by calendar year-end public entities must occur no later than January 1, 2018 and by other calendar year-end entities no later than the year ending December 31, 2019.

This resource center provides access to high-level and detailed information about the new revenue recognition guidance. Check back often as additional information will be added in the near future.

RESOURCES

WHITE PAPER
[Revenue recognition: Overview of ASC 606](#)
An overview of the new guidance in ASC 606 (as amended) and highlights of the fundamental changes ASC 606 will bring.

WHITE PAPER
[Revenue recognition: A whole new world](#)
A white paper that details new guidance in ASC 606, including scope, core principle, key steps, transition methods and effective dates.

Need help implementing the new revenue recognition standard?
Let the professionals at RSM help guide your company through the challenges of implementing 606.

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Additional audit content
[Financial Reporting Resource Center: Revenue recognition](#)

Non-audit client additional resources
[Migrating to Advanced Revenue Management \(ARM\) – are you ready?](#)
[Leveraging NetSuite for ASC 606 adoption webcast](#)

www.rsmus.com/revrec

- Look for a spring webcast to dive into implementation matters

Application of ASC 606

- Even if the accounting treatment does not change for a specific entity, the processes for making this determination will change due to the new guidance
- Internal controls will need to be updated to address the new guidance and resulting processes
- Financial statement disclosures will increase and often require that additional data be captured



QUESTIONS AND ANSWERS?

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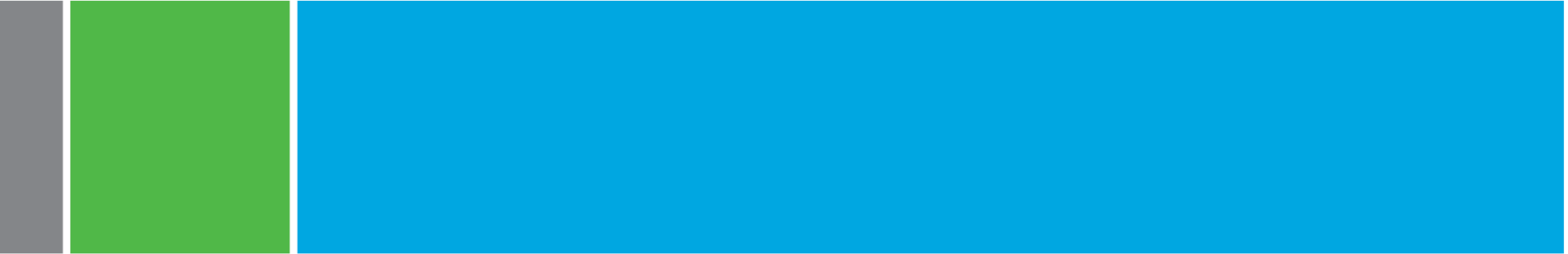
Revenue recognition: Key insights for the manufacturing industry

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