ASC Topic 606: How the New Revenue Recognition Standard May Impact Manufacturers and Distributors

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Presented by: Margot Hintlian, February 14, 2019

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- More than 6,000 employees
- Offices coast to coast
- We serve nearly 6,000 privately held manufacturers and distributors

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Speaker Introductions

Margot Hintlian, CPA

CAST Project Leader, Boston, MA

Margot has more than 25 years of experience in Big 4 public accounting. She has served in roles such as assurance director, senior manager, manager, senior associate, and staff associate. Margot is adept at analyzing and applying complex accounting standards and developing strategies to address requirements. She is a trusted advisor to senior executives, with ability to effectively communicate, influence and drive consensus. In addition to her client service responsibilities, Margot served in PwC's national audit services methodologies and tools group where she developed content for fair valuation guidance and curriculum for senior associates.

Speaker Introductions

Leslie Boyd, CPA

Tax Principal, Indianapolis, IN

Leslie is a principal in CLA's Manufacturing industry group and leader of the Manufacturing industry for the Indianapolis office. Leslie has more than ten years of experience in public accounting, specializing in tax services for multi-state and multinational C corporations, S corporations, and partnerships.

Learning Objectives

At the end of this session, you will be able to:

- Recognize how ASC Topic 606 impacts Manufacturers and Distributors


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Looking ahead for the next hour:

- Planning for Revenue Recognition Implementation
- Applicability to Manufacturing & Distribution
  - Closer look at the 5 elements of revenue recognition
- Lessons learned
  - The definition of a contract
- A closer look at
  - Short-Cycle Manufacturers
  - Right of Return under Topic 606
  - Bill & Hold Transactions
- And don’t forget

Planning for Revenue Recognition Implementation

- Watch out!
  – Are you a 12/31/2018 adopter?
- January 1, 2019 opening entry
  – Focus on year 1 adoption procedures
  – Adoption methods
  – Revenue recognition policy development and tailoring disclosures

Planning for Revenue Recognition Implementation

- Are you ready?
  - Consideration of a new standard whether applicable or not needs to be assessed
  - Documentation of the assessment
  - Devil is in the detail!

Applicability to Manufacturing & Distribution

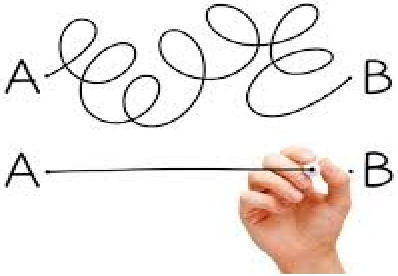
- Misconception revenue recognition is for the back office
- Front & middle offices impacted
  - Sales & marketing: impact of discounting, financing arrangements and promotions
  - Contract structure could be impacted, legal considerations

Full Retrospective Approach

- Public Companies– fiscal years beginning after 12/15/17
- Nonpublic Companies – years beginning after 12/15/18
- Permit entities to early adopt the standard as of the original effective date
- Cumulative Effect at January 1, 2018
- Dual reporting in the year prior to adoption

Modified Retrospective Approach

- Cumulative Effect at January 1, 2018 (or 2019 for private companies)
- Longer term contracts will have a longer period to review
- Existing system will need to be maintained through the year of adoption



Applicability to Manufacturing & Distribution

- Identify the contract;
- Identify the performance obligations;
- Determine the transaction price;
- Allocate the transaction price to the performance obligations in the contract; and
- Recognize revenue when (or as) the entity satisfies a performance obligation.

Identify the contract

- Contract combinations:
  - Negotiated as a package on or about the same time
  - Price dependency on performance of the other contract
  - The product or services in each of the contracts are a single performance obligation

Identify the contract

- Contract combinations – (continued)
  - Multiple contracts entered into at the same time need to be evaluated for interdependency
  - Process /controls needed to determine if evaluation has been performed
  - Judgment applied may affect 1) how performance obligations are identified, 2) how consideration is allocated, or 3) timing of revenue recognition

Identify performance obligations

- Promises to provide multiple products in a single contract
- Inconsequential deliverables such as marketing or promotional type deliverables, under current GAAP are ignored
- No exception for inconsequential obligations or marketing deliverables

Variable consideration

- Sales incentives
- Volume discounts
- Rebates
- Price concessions
- Trade in on equipment

Variable consideration

- Financing arrangements – adjusting for the time value of money
  - Upfront payments from customers
  - Deferral of payments from customers
- Other than financing considerations

Recognizing revenue

- Evaluate whether revenue should be recognized over time (as production occurs) or at a point in time (most likely when the customer obtains the goods or services),
- Measure progress toward satisfying the performance obligation over time or, if the performance obligation is satisfied at a point in time, the specific point at which control has been transferred to the customer.

Recognizing revenue

- Manufacture of a customized part(s) with no alternative use (e.g., only one customer can use the part because of its specialized nature).
- Enforceable right to payment throughout the production process and the part(s) have no alternative use.
- Manufacturer is providing a production service and is required to recognize revenue over time (as production occurs).
- Judgment in evaluating the indicators for determining when “delivery” has occurred.

Lessons learned

Has a contract been identified?

Defining a Contract

- Enforceable rights and obligations
- Current guidance describes this as a “matter of law”

Contract Criteria - Refresher

- The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.
- Each party's rights regarding the goods or services to be transferred are identified
- Payment terms for the goods or services to be transferred are identified
- The contract has commercial substance
- Probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

Do we have a contract?

- An entity does not yet have a written sales agreement, but a written sales agreement is being prepared?
- An entity obtains signed contracts as its customary business practice, but the contract is not signed by both parties as of the end of the reporting period?
- Is a master service arrangement, under which the customer requests goods and services through purchase orders, a contract?
- **If a contract is subject to contingencies, ongoing negotiations or in a preliminary stage, does it qualify as a contract under Topic 606?**

Do we have a contract?

- Are side agreements contracts?
- Entity continues providing services to a customer while negotiations for a new contract occur after the expiration of an existing contract
- Entity delivers a product to a customer without a signed agreement based on a request by the customer to fill an urgent need.
- **Entity offers to provide three months of free service on a trial basis to all potential customers to encourage them to sign up for a paid subscription. At the end of the three-month trial period, a customer signs up for a noncancellable paid subscription to continue the service for an additional 12 months.**

Short Cycle Manufacturing (Right to Payment)

- Principles in the Topic 606 relate to the **transfer of control**, rather than risks and rewards under current GAAP
- Upon adoption of the standard changes may arise from recognizing revenue at a point in time to over time, and vice versa in some scenarios
- One common scenario in which this change in timing may occur is in the **contract manufacturing**

Short Cycle Manufacturing (Right to Payment)

- Company is creating a customized asset for a customer, may want to protect itself by requiring payment throughout the contract.
- Because the right to payment is assessed at the contract level, this analysis may be more complex in scenarios in which companies have non-standard terms or enter into transactions outside of their customary business practice
- In the staff’s view, a reasonable interpretation of the guidance is that when a **contract’s written terms do not specify the entity’s right to payment upon contract termination, an enforceable right to payment is presumed not to exist**

Return Rights under the Topic 606

- Entitles a customer to a full or partial refund of the amount paid or a credit against the value of previous or future purchases
- Not a separate performance obligation under the new standard, BUT it affects the estimated transaction price for transferred goods.
- Revenue is only recognized for those goods that are not expected to be returned.
- The estimate of expected returns should be calculated in the same way as other variable consideration.
- The estimate should reflect the amount that the company expects to repay or credit to its customers considering all available information.
- The **transaction price** would include amounts subject to return only if it is probable that there will not be a **significant reversal of cumulative revenue**.

Return Rights under the Topic 606

- Companies must consider whether there is some minimum amount of revenue that would not be subject to significant reversal if the estimate of returns changes.
- A company will then record a **refund liability** and an asset for its right to recover products.
- The refund liability represents the amount of consideration that the company does not expect to be entitled to because it will be refunded to customers.
- The refund liability is remeasured at each reporting date to reflect changes in the estimate, with a corresponding adjustment to revenue.

Where's My Refund?

Return Rights under the Topic 606

- The **asset** is right to receive goods back from the customer.
- Initially measured at the **carrying amount of the goods** at the time of sale, less any expected costs to recover the goods and any expected reduction in value.
- The return asset is presented separately from the refund liability.
- The amount recorded as an asset should be updated whenever the refund liability changes and for other changes in circumstances that might suggest an impairment of the asset.

Return Rights under the Topic 606 - Example

- Right of return – refund obligation and return asset
  - Game Co sells 1,000 video games to Distributor for $50 each. Distributor has the right to return the video games for a full refund for any reason within 180 days of purchase.
  - The cost of each game is $10. Game Co estimates, based on the expected value method, that 6% of sales of the video games will be returned and it is probable(US GAAP) or highly probable (IFRS) that returns will not be higher than 6%. Game Co has no further obligations after transferring control of the video games.
  - How should Game Co record this transaction?

Return Rights under the Topic 606 - Analysis

- Game Co should recognize revenue of $47,000 ($50 x 940 games) and cost of sales of $9,400 ($10 x 940 games) when control of the games transfers to Distributor.
- Game Co should also recognize an asset of $600 ($10 x 60 games) for expected returns, and a liability of $3,000 (6% of the sales price) for the refund obligation.
- The return asset will be presented and assessed for impairment separately from the refund liability.
- Game Co will need to assess the return asset for impairment, and adjust the value of the asset if it becomes impaired.

Bill and Hold Arrangements

- Determining control in a bill-and-hold arrangement in addition to the general criteria in the standard related to determining when control transfers.
- A bill-and-hold arrangement should have substance:
  - **A substantive purpose** could exist if the customer requests the bill-and-hold arrangement because it lacks the physical space to store the goods, or if goods previously ordered are not yet needed due to the customer's production schedule.
  - Must be identified as belonging to the customer
  - Cannot be used to satisfy orders for other customers
  - Ready for delivery upon the customer's request.

Bill and Hold Arrangements – All about Control!

- Consider control – redirect or determine how good are used
- Certain requirements under existing guidance that must be met for revenue to be recognized in bill-and-hold arrangements were eliminated by the new standard
  - **The new standard does not require a fixed delivery schedule to meet the bill and hold criteria**
- An entity that has transferred control of the goods and met the bill-and-hold criteria to recognize revenue should:
  - Consider custodial services in addition to selling the goods.
  - If so, the transaction price will need to be allocated between the goods and the custodial service.


Questions?

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Margot Hintlian | 617.984.8178 | margot.hintlian@CLAconnect.com

Leslie Boyd | 317.569.6329 | leslie.boyd@CLAconnect.com

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