BerryDunn
Assurance, Tax, Consulting

# NEW REVENUE RECOGNITION STANDARD
# Evaluation of Customer Agreements

## STEP 1
### Identify the contract

1. **Does the Company have a contract?** The contract has to meet the following criteria:
   i. Approved by parties
   ii. Each party's rights/obligations can be identified
   iii. Payment terms are identified
   iv. Contract has commercial substance (i.e., is likely to affect the entity's cash flows)
   v. It is probable that the consideration will be collected from the customer

**PRACTICAL CONSIDERATIONS:** Approval does not have to be in writing. It can be oral or in another form, or implied by an entity's customary business practices. Probability of collecting consideration may factor in expected price concessions.

2. **Does the Company have any contracts that were entered into at or near the same time with the same customer and are the contracts interdependent based on one of the following:**
   i. The contracts are negotiated as a package with the same commercial objective
   ii. The amount of consideration paid under one contract depends on the performance under the other contract or the price of the other contract
   iii. The goods/services in the separate contracts are considered a single performance obligation

**PRACTICAL CONSIDERATIONS:** If multiple contracts meet these criteria, e.g., they are for the design and building of a single capital asset and they would be a single performance obligation had they been in a single contract, these contracts likely should be combined.

3. **Does the contract have a termination for convenience clause or other option to cancel?**

**PRACTICAL CONSIDERATIONS:** If the termination penalty is not substantive, this may indicate the contract term is less than the stated contractual period. The penalty is substantive if wind-down costs would be significant or the customer has no use from the partially completed facility. An option to cancel could also affect the conclusion as to whether control has been transferred (see step 5 below).

4. **Are there any changes to the scope or price of the contract?** If so:
   i. are additional promised goods/services distinct and
   ii. does the increase in price reflect standalone selling prices of additional goods/services?

**PRACTICAL CONSIDERATIONS:** If both conditions are met, changes should be accounted for as a separate contract, and the prospective method should be applied. If the first condition is met but not the second, the contract should be accounted for as a new contract that replaces the original contract, and the prospective method should be applied. Otherwise, the modified contract is considered a continuation of the original contract, and cumulative catch-up method should be applied.

# STEP 2

## Identify performance obligations

1. **Does the contract have promises that are capable of being distinct?** In other words, can the customer benefit from a particular promised good or service, either alone or together with other resources readily available to the customer? Items to be considered:
   i. Are distinct goods/services individual outputs or are they inputs to a combined output?
   ii. Is one promised good/service in a contract highly dependent upon, or highly interrelated with, other promised goods/services?
   iii. Does the Company provide a significant service of integrating two or more goods/services (design and construction services)?
   iv. Does the contract include a series of distinct goods/services that are substantially the same?
   v. Is a particular promised good or service distinct in the context of the contract, i.e., is the promise to provide the individual items or a combined item?

2. **Does the contract include warranty provisions?** If so, is the warranty an additional performance obligation? Items to consider:
   i. Is warranty required by law?
   ii. What is the length of the warranty coverage period as compared to the typical warranty period for that type of service?
   iii. Is the nature of tasks in line with agreed-upon specifications in the contract?

**PRACTICAL CONSIDERATION:** If the warranty is chosen by the customer rather than required by law, and provides a material benefit beyond the assurance that the product or service meets the specifications in the contract, the warranty service likely constitutes a separate performance obligation.

3. **Does an option for more goods/services create an additional performance obligation?** Items to consider:
   i. Does the entity grant the option as part of the contract?
   ii. Does the option give the customer a material right?
   iii. Would the customer have received the right without entering into the contract?

**PRACTICAL CONSIDERATION:** If all three of these are met, the option should be treated as a separate performance obligation.

4. **Does the entity charge the customer nonrefundable upfront fees, e.g., a nonrefundable deposit, setup fee, activation fee, or upgrade fee?** If so, does the upfront fee relate to a separate performance obligation?

**PRACTICAL CONSIDERATIONS:** A fee charged as compensation for an administrative task (such as a task to set up a contract) ordinarily does not result in the transfer of a distinct good/service to the customer, and thus is not a separate performance obligation.

5. **Is the performance obligation to provide a good or service, or to arrange for another entity to provide a good or service?**

**PRACTICAL CONSIDERATIONS:** If the latter, the entity is an agent, and should only record its net fee as revenue. This depends on the preponderance of the facts and circumstances, including consideration of whether the entity controls the good or service prior to transferring it to the customer, who has primary responsibility for fulfilling the performance obligations, whether the entity has inventory risk, and who sets prices.

# STEP 3

## Determine transaction price

1. Does the contract have change orders? Are they approved?

2. If the price is not approved, certain factors need to be considered to determine if the change order should be included in the transaction price:
   i. Customer's written approval of change in scope
   ii. Contract language indicating enforceable entitlement relating to change order
   iii. Documentation of change order costs that are identifiable and reasonable
   iv. Entity's favorable experience in negotiating change orders

3. Does the Company have/use standard criteria for all contracts, achievement of which would indicate that the unpriced/unapproved change orders should be included in the transaction price?

4. Does the contract have provisions for bonuses/incentives?

**PRACTICAL CONSIDERATIONS:** The existence of provisions for incentives does not necessarily mean that it should be included in the transaction price. Are there any key milestones that should be reached prior to considering if bonuses/incentives should be included in the transaction price? It may be appropriate to include it if historically these milestones indicate achievement of the incentive that is probable.

5. Does the contract include provisions for liquidated damages or other penalties?

**PRACTICAL CONSIDERATIONS:** Are there any milestones or other metrics that historically indicate avoidance of such amounts is not probable?

6. **Does the contract have claims?**

7. **Does the contract have any other variable consideration?**

8. **How many different outcomes are possible from including the variable consideration into the transaction price?** Options:
   i. Use the most likely amount method to estimate the amount
   ii. Use the expected value method (probability based method) to estimate the amount

9. **If included in the transaction price, is it probable that the significant reversal of the variable consideration will not occur?** (70-80% likelihood or higher is likely the appropriate threshold here) Factors to consider in assessing the likelihood and magnitude:
   i. Is the amount of consideration highly susceptible to factors outside the entity's influence?
   ii. How long is the period during which the uncertainty is expected to be resolved?
   iii. Is the entity's experience with similar types of contracts limited? Or does that experience have limited predictive value?
   iv. Does the entity have a practice of either offering a broad range of price concessions or changing the payment terms and conditions?
   v. Does the contract have a large number and broad range of possible consideration amounts?

10. **Does the entity bill customers for shipping and handling or out-of-pocket expenses?**

11. **Does the entity charge a mark-up on the reimbursable expenses?** Or does the entity collect the reimbursement on behalf of a third-party without mark-up?

**PRACTICAL CONSIDERATIONS:** If the entity charges a mark-up on reimbursable expenses, it should include gross amounts to variable consideration.

# STEP 4

## Allocate transaction price

1. **If there is more than one performance obligation in the contract, which method should be used to determine each obligation's standalone selling price, which is used to allocate the transaction price to the performance obligations?** Allowable methods:
   i. Directly observable standalone selling price
   ii. Adjusted market
   iii. Expected cost plus margin
   iv. Residual approach

2. **Does the contract identify a discount?** A discount is specific to a performance obligation if all of the following is true:
   i. The entity regularly sells each distinct item in the contract separately to customers,
   ii. The entity also regularly sells some of the items together at a discount, and
   iii. The discount when those select items are sold together at a discount is basically the same as the discount in the contract. Based on observable evidence, the entity is able to identify the specific performance obligation (or multiple performance obligations) that the entire discount pertains to.

   If one or more of these conditions is not met, the discount should be allocated based on the allocation of standalone selling prices of the various performance obligations.

# STEP 5

## Recognize revenue: Measure progress towards completion

1. **Does the performance obligation fall into one of the following categories?** If so, it is satisfied over time:
   i. The customer both receives and consumes the benefits of the entity's performance as the entity performs
   ii. The entity's performance either creates an asset that the customer controls as the asset is created or enhances an asset that customer controls as the asset is enhanced
   iii. The entity's performance creates an asset for which it has no alternative use, and the entity has a right to be paid for its performance to date

2. **Does the entity not have an enforceable right to payment for the work completed to date?** If not, performance obligation is satisfied at a point in time.

3. Does the entity provide homogeneous goods/services in the contract?

**PRACTICAL CONSIDERATIONS:** If homogeneous goods/services are provided, units-of-delivery method might be appropriate for revenue recognition, but need to consider work-in-process. When work-in-process is material, using units-of-delivery method might not be appropriate if work-in-process is controlled by the customer because the entity would not recognize the revenue on those units that might not have been delivered or before the production is complete.

4. Does the entity have the right to payment for all goods/services completed to date?

**PRACTICAL CONSIDERATIONS:** If the entity has the right to invoice the customer for all of the entity's performance to date, the entity might be able to recognize revenue equal to the invoiced amount. This method might not be appropriate if the contract includes variable consideration.

5. Does the entity have stand-ready contracts, e.g., maintenance, extended warranty services, software updates, energy?

**PRACTICAL CONSIDERATIONS:** When the entity has stand-ready contracts, it might be appropriate to recognize revenue for that performance obligation on the straight-line basis because the customer benefits evenly from the assurance that a service is available when and as needed.

6. If using cost-to-cost method, did the entity incur significant waste or defective materials, or are there significant uninstalled materials?

**PRACTICAL CONSIDERATIONS:** If the entity incurs significant waste or uninstalled materials, including those costs in total costs might not faithfully depict the entity's performance towards completion; therefore, those costs should be excluded from contract costs. Waste is significant if the entity incurs costs that are beyond the contingencies that are included in the original project forecast.

7. Does the contract involve licenses? If so, does the customer have the right to use the license, or to access the license?

**PRACTICAL CONSIDERATIONS:** For licenses with significant standalone functionality, revenue is typically recognized at a point in time; otherwise, revenue is typically recognized over the period of the license.

## Right to return goods

1. Does the Company expect the customer to return certain goods?

**PRACTICAL CONSIDERATIONS:** The Entity has to recognize both a refund liability and an asset that represents the Entity's right to the good it expects the customer to return.

## Contract costs

1. Does the Company incur any incremental costs of obtaining a contract (sales commission, costs incurred during the proposal, negotiation and design phases)?

**PRACTICAL CONSIDERATIONS:** If recovery is expected and the costs would not have been incurred if the contract had not been obtained, such costs should be recognized as an asset and amortized to costs of revenues over the performance of the contract. Otherwise, they should be expensed as incurred, unless they are capitalizable under other GAAP.

2. Does the Company incur costs to fulfill a contract (bond and insurance premiums, set-up costs, mobilization costs)? These costs must meet the following criteria:
   i. The costs are directly related to an existing, or specific anticipated, contract
   ii. The costs generate or enhance resources that will be used in satisfying the performance obligation
   iii. The costs are expected to be recovered

**PRACTICAL CONSIDERATIONS:** If recovery is expected, such costs should be recognized as an asset and amortized to costs of revenues over the performance of the contract.