Implementing the new revenue guidance in the manufacturing industry

A progress check for management and audit committees

Background
As the effective date for the new revenue guidance in ASC 606, Revenue from Contracts with Customers, quickly approaches (January 1, 2018 for calendar-year public companies and January 1, 2019 for calendar-year private companies), management and audit committee members of manufacturers are faced with a number of questions as they gauge their implementation progress:

- What contract terms should we watch out for?
- What will my auditor be looking for?
- What questions should we be asking and how do we know if we are on track?

This bulletin addresses these questions and serves as a conversation prompter to help executive management and the audit committee engage with those parties involved in the implementation process.

Remember, implementing the new revenue guidance is not just an accounting exercise. The implementation process is a cross-functional exercise that requires extensive coordination between tax, sales, and IT, among others.

“Even those manufacturers with little dollar impact have expended significant effort to successfully implement the new revenue guidance and ensure the implementation effort is adequately documented and supported for the external auditors.”

Jeff French, National Managing Partner Consumer & Industrial Products
Contract terms to watch out for

If your contracts with customers include the following terms and provisions, you will need extra time to analyze and document accounting considerations.

**Volume rebates or price steps-downs**
One of the most significant implementation challenges manufacturing companies may encounter is accounting for “material rights” in their contracts. Manufacturing companies often provide customers with an option to acquire additional goods or services for free or at a discount. For example, a company sells the first 1,000 units to a customer at $100 per unit, but any purchases in excess of 1,000 units are invoiced at $90 per unit. The accounting for volume discounts depends upon whether the volume discount results in retrospective price adjustments or only in prospective price changes. Retrospective volume discounts are treated as variable consideration, while prospective volume discounts must be evaluated to determine if they constitute a “material right.”

Under ASC 606, a company must identify a “material right” as a separate performance obligation if the option provides a material benefit to the customer that the customer would not have received without entering into that contract. The guidance does not specify what constitutes a material right, but does provide as an example “a discount that is incremental to the range of discounts typically given for the goods or services to a particular class of customer in a geographical area or market.”

A manufacturing company needs to carefully evaluate its contract terms to determine if any discounted pricing or rebates constitute material rights that need to be accounted for as separate performance obligations.

This means that a company needs to determine the stand-alone selling price of the material right, defer the corresponding amount of revenue associated with the right, and recognize that revenue only when the option is exercised or expires. Manufacturing companies are finding it especially challenging to calculate the stand-alone selling price of material rights.

In some contracts, the pricing decreases in future years, regardless of the number of units purchased in the prior year. These price step-downs will generally be considered a material right because the lower price in future years is an incremental discount that the customer would not receive without previously entering into the contract in the prior year. But, in some situations, the decreased price may be due to expected increased efficiencies in the company’s processes and may reflect the expected stand-alone selling price. This means the option would not provide the customer with a material right. The determination will require management to exercise significant judgment.

If a manufacturer believes the pricing step-downs in its multiyear contracts are related to increased efficiencies, it needs to accumulate sufficient data to support this assertion. This may require assembling and analyzing significant amounts of historical data and cost projections — all of which need to be evaluated by the manufacturing company’s auditors to support management’s assertion.

Additionally, there may be situations in which only a portion of the pricing step-down is related to expected efficiencies. In these cases the company may still need to evaluate as a material right the portion of the discount that cannot be supported as a decrease in stand-alone selling price.
Minimum purchase commitments
We have learned that some manufacturers have adopted methods to recognize revenue over a period of time when they believe a customer will not meet contractual minimums by a prescribed date. Under ASC 606, the manufacturer does not have an enforceable right to payment and cannot recognize any revenue related to the minimum commitment until (a) a purchase order is executed by the customer, or (b) the prescribed date in the contract when the manufacturer is entitled to minimum spend. In other words, revenue may be recognized later under ASC 606.

Modifications
Contract modifications are an area of change for many manufacturing companies because legacy GAAP does not include an overall framework for accounting for contract modifications. As a result, manufacturers may not have a robust system in place to identify, track, and account for contract modifications. Because ASC 606 provides prescriptive guidance on how to account for modifications, companies need to follow the new prescriptive accounting treatment and may need to update their systems and controls.

Customized goods
If a manufacturer produces a customized good and has an enforceable right to payment for its work completed to date, the guidance requires the manufacturer to recognize revenue as it performs the work, that is, over time during the manufacturing process.

The logic behind this guidance is that if a manufacturer creates an asset with no alternative use, it is effectively creating an asset at the customer’s discretion and likely wants to be economically protected in the event the customer terminates the contract. When a customer is obligated to pay for performance completed to date, the customer obtains the benefits as the company performs, and the manufacturer is required to recognize revenue over time.

At the crossroads: Changing from point in time to over time revenue recognition
Some manufacturers that produce customized goods will experience a change in their revenue recognition pattern—that is, revenue recognition may be accelerated. ASC 606 provides implementation guidance on how to determine if the asset has “no alternative use” and if the manufacturer has “an enforceable right to payment for performance completed to date.”
**Bill-and-hold arrangements**
A manufacturing company that make sales on a bill-and-hold basis may experience a significant change in accounting. The criteria to recognize revenue for sales on a bill-and-hold basis under ASC 606 have changed – most notably, there is no longer a requirement for the arrangement to have a fixed delivery schedule. As a result, a manufacturer that concluded it does not meet the bill-and-hold criteria under legacy GAAP may conclude that it does meet the criteria under ASC 606 if only a fixed delivery schedule was missing. The result is that revenue recognition may be accelerated under ASC 606.

**Contract costs**
The standard introduces guidance for costs incurred from a contract with a customer (codified in ASC 340-40). A manufacturer generally must capitalize both of the following costs:
- Incremental costs of obtaining a contract with a customer if the company expects to recover those costs
- Fulfillment costs if the costs relate directly to a contract (or anticipated contract); generate or enhance resources of the company; and are expected to be recovered

The manufacturer cannot elect whether to capitalize or expense costs under ASC 606. If the capitalization criteria are met, a manufacturer must capitalize the costs. The only exception is a practical expedient that allows the company to expense incremental costs of obtaining a contract if the amortization period is one year or less.

**Disclosures**
The new guidance introduces extensive new disclosure requirements that companies must carefully evaluate to determine if they are capturing all of the necessary data to meet the overall disclosure objective. Even those manufacturers with little dollar impact will experience a significant change in disclosures.
What will my auditor be looking for?

Risk Assessment
Your auditor’s determination of complexity factors and assessment of risks for your company will influence the nature and extent of audit testing surrounding management’s implementation plan, the cumulative effect adjustment, and auditing transactions in the period of adoption. To make the determination about complexity factors and risk assessment, the audit team will consider

- Historical control findings in the revenue cycle and how management responded to those findings
- Tone at the top, especially with regard to emphasis on accounting principles
- Other pervasive control findings, such as those in connection with IT general controls (ITGCs)

Management’s implementation plan and documentation
Management’s implementation plan encompasses many activities — scoping, accounting assessment, solutions development, and other activities. Auditors will obtain an understanding of this plan by asking management questions, examining process narratives, and performing walkthroughs of relevant controls. Auditors will also review management’s accounting policy documentation to determine if the policies are in accordance with ASC 606 and to validate that the company’s accounting complies with the stated policy. For ICFR audits, the auditor will also test the operating effectiveness of the controls.

Management is expected to have a variety of key processes implemented to identify revenue streams and relevant contract features to support their accounting policy conclusions. Auditors need to understand how management selected contracts to validate the contract features identified during initial scoping when 100 percent of revenue transactions are not examined.

Transition adjustments and SAB 74 disclosures
Management’s cumulative effect adjustment is not yet recorded, so it’s not subject to audit until the period when the company adopts the new standard. But management’s quantitative SAB 74 disclosures are expected to be very similar to the company’s eventual cumulative effect adjustment journal entry. Because the SEC staff expects SAB 74 disclosures to evolve and eventually include quantitative data, the auditors may test the adjustment during fieldwork prior to adoption to obtain audit evidence to support management’s SAB 74 disclosures. Remember, auditors must perform substantive procedures to test the relevant assertions of significant financial statement disclosures. This includes SAB 74 disclosures that assert that the impact of the standard is not expected to be material to the financial statements.
The new guidance requires management to either restate prior-period financial statements (full retrospective method) or provide disclosures of significant changes by financial statement line item (modified retrospective method). Management must have controls and processes in place for both prior-period restatement and disclosures of significant changes. Auditors must obtain an understanding of those controls and test them accordingly. The testing approach will vary by company. Some companies have a highly automated approach where the auditor can utilize their IT specialists to validate that the changes made to the system are appropriate and perhaps trace contracts through the new system. While some companies have fully automated the process to collect new data, others are utilizing spreadsheets or other short-term manual processes until an automated solution is put in place. Auditors may identify the short-term manual processes as a risk related to initial adoption and may need to perform additional work around the manual processes.

Keep in mind that the auditors may or may not be able to utilize samples that were selected for testing transactions under legacy GAAP. For example, it is unlikely that the number of transactions tested for the cumulative effect adjustment and for substantive testing under ASC 605 are the same.

**Extensive new disclosures**
The extensive new disclosures required by ASC 606 may require companies to update data, systems, processes, and controls used to develop disclosures.

ICFR auditors will obtain an understanding of the company’s ITGCs that are important to the effective operation of automated controls, as well as management review controls.

**First quarter interim review in the period of adoption**
Auditors are required to understand significant changes in management’s system of internal control and to question management and perform analytical procedures to provide a basis for communicating whether they are aware of material modifications that should be made so that the financial statements comply with GAAP. If the auditors completed sufficient procedures around management’s implementation plan, they only need to verify, via inquiry, that there have been no changes in management’s implementation plan.

The SEC staff has indicated that incremental disclosure of changes in internal control within Forms 10-Q and 10-K in the period prior to adoption would be useful for investors. The first quarter in the period of adoption is the last opportunity for companies to present such information.

**Indicators that management is behind and a control finding may need to be evaluated**
Determining whether a company is significantly behind is a matter of judgment. The following indicators may, however, lead the auditor to conclude that management is behind or failing to execute their implementation plan:

- Incomplete or inappropriate SAB 74 disclosures
- Inability of management to articulate the details of their implementation plan or progress toward implementing that plan
- Lack of a detailed implementation plan and timeline
- Evidence that key deadlines from the timeline have been missed and that there are no plans to catch up or not enough time to do so
- Poor tone at the top, including lack of involvement from those charged with governance
What questions should we be asking?

By now, the audit committee and management should have a clear understanding of the implementation plan and who owns which steps within the plan.

Are we on track?
For calendar-year public companies, the audit committee and management can gauge whether the company is on-track by asking if the company has:

- Completed scoping and contract review activities to identify contract terms that may impact accounting
- Developed accounting policies to document accounting conclusions under the new guidance
- Determined the adoption approach and started to develop an approach to determine the cumulative effect adjustment
- Begun work to understand changes in business processes and the control environment
- Identified the appropriate resources to implement the necessary changes

Other questions to ask
Audit committee members may also want to ask management if they have:

- Identified any concerns with the implementation plan
- Evaluated competence across the organization and of outsourced service providers, and remediated any shortcomings identified
- Communicated implementation status and the impact of the new guidance on stakeholders (investors, internal auditors, external auditors, IT vendors)
- Established a regular cadence of meetings among external auditors, any external consultants, and staff
- Worked cross-functionally to understand the impact of the new standard across the business (forecasting, employee benefits, tax, sales teams)
- Identified disclosure gaps that require system updates or changes, and initiated the process to close those gaps
- Disclosed what the company knows in the SAB 74 footnote in accordance with SEC staff announcements

Ultimately, an open and frequent dialogue between the audit committee, management, and other affected parties, including the external auditors, is critical for a successful implementation of the new revenue guidance.
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