

Memo No. **3**

**MEMO**

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Project	<b>Revenue Recognition</b>		
Project Stage	<b>Implementation</b>		
Issue(s)	<b>Definition of an Accounting Contract and Short Cycle Manufacturing (Right to Payment)</b>		

*The following is an excerpt from a paper that was prepared for discussion by the Private Company Council (PCC). It does not purport to represent the views of any individual members of the board or staff. Comments on the application of U.S. GAAP do not purport to set out acceptable or unacceptable application of U.S. GAAP.*

## **Memo Purpose**

1. At its April 20, 2018 meeting, the Private Company Council discussed an unsolicited comment letter the FASB received in January 2018 from the AICPA's Technical Issues Committee (TIC) requesting private company exceptions to Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and other revenue-related Updates (the revenue standard). At that meeting, PCC members asked the staff to perform additional outreach and research on one of the issues raised in the TIC comment letter, the accounting for reimbursements from customers of out-of-pocket expenses (details are included in Memo No. 2, which will be discussed at the June 25, 2018 PCC meeting).
2. At the April meeting, PCC members did not ask the staff to perform additional work on the other issues in the TIC comment letter. However, upon further discussion, PCC members and TIC members agreed that it would be helpful for the staff to provide additional educational material to aid with private companies' implementation of the guidance. Accordingly, the staff prepared this memo to provide education on the definition of a contract in Topic 606 and right to payment for short-cycle manufacturing contracts.
3. In its comment letter, TIC expressed concerns about the cost and complexity of the transition from a "realizable" notion under existing GAAP to an "enforceable rights and obligations" notion under Topic 606. Specifically, TIC's concerns relate to the portion of the guidance that describes enforceable rights and obligations as a "matter of law" (paragraph 606-10-25-2). In subsequent discussions, TIC members

have requested that the FASB provide educational materials regarding how private companies should be evaluating enforceable rights and obligations and when or if legal consultation should be considered.

4. In its comment letter, TIC also expressed concerns about application of one of the criteria for over time recognition. One of those concerns related to the cost and complexity of an entity determining whether it has an enforceable right to payment
5. This memo is organized as follows
  - (a) Definition of an Accounting Contract
    - i) Analysis of Topic 605
    - ii) Analysis of Topic 606
  - (b) Short Cycle Manufacturing (Right to Payment)
    - i) Analysis of Topic 606

## **Definition of an Accounting Contract**

### *Analysis of Topic 605*

6. Existing GAAP requires that, to be recognized, revenue should be earned and should be realized or realizable (paragraph 605-10-25-1). SEC guidance expands upon this concept by providing four criteria for revenue recognition as follows:
  - (a) Persuasive evidence of arrangement exists
  - (b) Delivery has occurred or services have been rendered
  - (c) The seller's price to the buyer is fixed or determinable
  - (d) Collectibility is reasonably assured.
7. In determining whether persuasive evidence of an arrangement exists, SEC guidance also includes an illustration to demonstrate some of the considerations. The following example is in paragraph 605-10-S99-1.

Facts: Company A has product available to ship to customers prior to the end of its current fiscal quarter. Customer Beta places an order for the product, and Company A delivers the product prior to the end of its current fiscal quarter. Company A's normal and customary business practice for this class of customer is to enter into a written sales agreement that requires the signatures of the authorized representatives of the Company and its customer to be binding. Company A prepares a written sales agreement, and its authorized representative signs the agreement before the end of the quarter. However, Customer Beta does not sign the agreement because Customer Beta is awaiting the requisite approval by its legal department. Customer Beta's purchasing department has

orally agreed to the sale and stated that it is highly likely that the contract will be approved the first week of Company A's next fiscal quarter.

Question: May Company A recognize the revenue in the current fiscal quarter for the sale of the product to Customer Beta when (1) the product is delivered by the end of its current fiscal quarter and (2) the final written sales agreement is executed by Customer Beta's authorized representative within a few days after the end of the current fiscal quarter?

Interpretive Response: Generally, the staff believes that, in view of Company A's business practice of requiring a written sales agreement for this class of customer, persuasive evidence of an arrangement would require a final agreement that has been executed by the properly authorized personnel of the customer. In the staff's view, Customer Beta's execution of the sales agreement after the end of the quarter causes the transaction to be considered a transaction of the subsequent period. Further, if an arrangement is subject to subsequent approval (e. g., by the management committee or board of directors) or execution of another agreement, revenue recognition would be inappropriate until that subsequent approval or agreement is complete.

Customary business practices and processes for documenting sales transactions vary among companies and industries. Business practices and processes may also vary within individual companies (e. g., based on the class of customer, nature of product or service, or other distinguishable factors). If a company does not have a standard or customary business practice of relying on written contracts to document a sales arrangement, it usually would be expected to have other forms of written or electronic evidence to document the transaction. For example, a company may not use written contracts but instead may rely on binding purchase orders from third parties or on-line authorizations that include the terms of the sale and that are binding on the customer. In that situation, that documentation could represent persuasive evidence of an arrangement.

The staff is aware that sometimes a customer and seller enter into "side" agreements to a master contract that effectively amend the master contract. Registrants should ensure that appropriate policies, procedures, and internal controls exist and are properly documented so as to provide reasonable assurances that sales transactions, including those affected by side agreements, are properly accounted for in accordance with GAAP and to ensure compliance with Section 13 of the Securities Exchange Act of 1934 (i. e., the Foreign Corrupt Practices Act). Side agreements could include cancellation, termination, or other provisions that affect revenue recognition. The existence of a subsequently executed side agreement may be an indicator that the original agreement was not final and revenue recognition was not appropriate.

8. Although private companies are not within the scope of the SEC's guidance, the staff understands that, in practice, many private companies apply the SEC's guidance in the absence of specific guidance in GAAP. For those companies, the transition from applying guidance about "persuasive evidence of an arrangement" is not significantly different from the notion of "enforceable rights and obligations." Private

companies that do not apply the SEC guidance typically apply the guidance in paragraph 605-10-25-1 on whether revenue is (a) realized or realizable and (b) earned.

#### *Analysis of Topic 606*

9. Step 1 of the revenue standard requires an entity to identify the contract with the customer. Guidance in paragraph 606-10-25-1 provides the following five criteria that must be met for a contract to exist:
- (a) 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.
  - (b) The entity can identify each party's rights regarding the goods or services to be transferred.
  - (c) The entity can identify the payment terms for the goods or services to be transferred.
  - (d) The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).
  - (e) It is 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.
10. Paragraph 606-10-25-2 provides the following additional guidance on identifying the contract.

A contract is an agreement between two or more parties that creates enforceable rights and obligations. **Enforceability of the rights and obligations in a contract is a matter of law.** Contracts can be written, oral, or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations. **[Emphasis added.]**

11. Because the guidance refers to enforceability of rights and obligations and refers to those notions as a matter of law, private company stakeholders have raised questions about whether legal consultation is a requirement in all cases. The staff observes that this question is in part arising because of some interpretations published by third parties on this topic. The staff would like to clarify that there is no requirement in Topic 606 that states that companies are required to consult with legal counsel for all revenue transactions.
12. Because it is not a GAAP requirement to consult with legal counsel, questions arise about specifically when private companies may want to consider consultation. The staff observes that, in some cases, it might not be clear whether a contract exists and, thus, additional work would be required (which may or may not require legal assistance, depending on the facts and circumstances); however, the staff thinks that this would be a minority population of contracts and not dissimilar from today's requirements.
13. Although the guidance notes that enforceability is a "matter of law," it is the staff's view that, in most cases, it will be obvious if the contract meets Step 1 of the five-step model. Also, the staff notes that the

guidance only requires that a contract with a customer be identified and does not require a contract to be written. That is, oral arrangements may also meet the definition of a contract (oral contracts are explicitly mentioned in paragraph 606-10-25-2). The staff notes that in cases in which a written contract does not exist, a company may need to perform additional due diligence to assert that Step 1 has been met considering the company's customary business practices. However, the staff does not think that this is a change from current practice. In the absence of a written contract today, companies have a higher hurdle to demonstrate that the revenue is realizable as compared with those arrangements with a written contract.

14. At this point, the revenue standard was issued over four years ago, and the staff observed that there is a multitude of third-party resources that stakeholders can leverage on this topic (for example, the AICPA Revenue Recognition Guide and Big 4 Publications). The staff has not received questions from public company stakeholders on this topic and therefore thinks that the existing interpretive examples that exist are effective in helping companies apply the guidance. Accordingly, the staff has summarized some types of contracts in which determining whether a contract exists may be more difficult and in which third-party interpretations are readily available. Please note that this is a summary of third-party publications and is not intended to be an exhaustive list and is not intended to imply that these scenarios require legal consultation:

- (a) An entity does not yet have a written sales agreement, but a written sales agreement is being prepared
- (b) 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
- (c) Is a master service arrangement, under which the customer requests goods and services through purchase orders, a contract?
- (d) If a contract is subject to contingencies, ongoing negotiations or in a preliminary stage, does it qualify as a contract under Topic 606?
- (e) Does the form of an entity's contracts and evidence of approval have to be consistent across customers?
- (f) Are side agreements contracts?
- (g) Entity continues providing services to a customer while negotiations for a new contract occur after the expiration of an existing contract
- (h) Entity delivers a product to a customer without a signed agreement based on a request by the customer to fill an urgent need.
- (i) 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.

(j) Oral contract where a customer agrees to the terms and makes payment at the same time over the phone

15. TIC had provided the FASB staff with examples of common scenarios where it viewed identifying the contract may be difficult for private companies. The staff observes that several of those scenarios are included in the list above (for example, oral contracts, customary business practices).
16. Furthermore, some TIC members had concerns that the guidance would require companies to wait for cash collection to recognize revenue when the definition of a contract is not met at inception. The staff thinks it's important to keep in mind that if an entity determines it does not meet the definition of a contract at inception, the guidance requires that the entity continue to reassess the contract to determine if the definition is subsequently met (606-10-25-6). Therefore, failure of Step 1, identifying the contract, at inception does not necessarily mean that revenue would be deferred until receipt of payment because it could meet Step 1 at a date after inception but prior to payment.

### **Short Cycle Manufacturing (Right to Payment)**

#### *Analysis of Topic 606*

17. Under the guidance in the revenue standard, an entity recognizes revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. An entity will need to determine whether control transfers and, in turn, whether revenue is recognized at a point in time or over time.
18. Step 5 of the revenue standard requires that an entity recognizes revenue over time if any one of the following criteria in paragraph 606-10-25-27 is met. If none of the criteria below is met, then an entity recognizes revenue at a point in time:
- (a) The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs
  - (b) The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced
  - (c) The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.
19. Because the principles in the revenue standard relate to the transfer of control, rather than risks and rewards under current GAAP, there will be cases in which an entity has a change upon adoption of the standard 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 industry, which is not to say that all contracts in this industry are affected. However, in this industry it is

common that the goods are customized and are customer-specific. Therefore, there are cases in which the third over-time criterion is met, when there is also a right to payment for the goods. The TRG provided education on this topic in November 2016 ([TRG Memo 56](#)). In its comment letter TIC noted that private companies may not have internal controls over contracting, including the ability to obtain legal determinations for contracts. Therefore, it may be difficult for private companies to determine if they have a right to payment for performance completed to date.

20. Consistent with the discussion earlier in this memo on the definition of a contract, the staff would like to clarify that there is no requirement in Topic 606 that states that companies are required to consult with legal counsel for all revenue transactions. In that regard, the staff thinks it is helpful for companies to consider the Boards' reasoning for including right to payment in the criterion. The following is an excerpt from the basis for conclusions to Update 2014-09:

BC142. The Boards decided that there is a link between the assessment of control and the factors of no alternative use and a "right to payment." This is because if an asset that an entity is creating has no alternative use to the entity, the entity is effectively constructing an asset at the direction of the customer. **Consequently, the entity will want to be economically protected from the risk of the customer terminating the contract and leaving the entity with no asset or an asset that has little value to the entity.** That protection will be established by requiring that if the contract is terminated, the customer must pay for the entity's performance completed to date. This is consistent with other exchange contracts in which a customer typically would be obliged to pay only if it has received control of goods or services in the exchange. Consequently, the fact that the customer is obliged to pay for the entity's performance (or, in other words, is unable to avoid paying for that performance) suggests that the customer has obtained the benefits from the entity's performance. **[Emphasis added.]**

21. As noted in the basis excerpt above, the general notion is that if a company is creating a customized asset for a customer, then it will want to protect itself by requiring payment throughout the contract. The staff thinks that this analysis will typically be straightforward and should not require exhaustive analysis in most cases. 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 that regard, the staff thinks that the discussion on this topic is very similar to the discussion on definition of a contract
22. The staff understands that questions have arisen about how to handle contracts in circumstances in which the entity creates a good with no alternative use and the contract with its customer does not specify by its written terms the entity's right to payment upon contract termination. Some stakeholders have asked whether it was the Board's intent that companies analyze every law in every jurisdiction to determine whether there is recoverability. 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.