

# **Company Name**

## **ASC 606 Implementation**

***Draft for XXX Management Purposes Only***

***Draft Date: XXXX***

## Instructions for use – delete upon finalization

This implementation memo is a draft document to help a company analyze and document the impact of ASC 606 on a specific revenue stream – contract manufacturing of custom equipment or tooling. This can be used for and tailored to any arrangement that includes production of equipment or other larger custom designed products, each taking a longer duration to complete (likely more than one month), that are built specifically to the customer’s specifications.

The memo is intended to be the summary of the provisions identified in contracts with customers and the overall conclusions about what the impact of the standard are. This memo will need to be tailored to the specific contracts of each company and will be complemented by the excel matrix that includes the contracts that were analyzed and the conclusions reached on those individual contracts.

The contents of this memo will need to be tailored to the Company’s situation. Text is broken down into 3 types:

*Guidance boxes – this is text that is directly from the codification or other guidance and should not be tailored unless it is not relevant and is being deleted.*

General analysis text - is the main body and documents the Company’s analysis of the factors and includes background and context. This should be tailored to fit the situation.

*Conclusion text – this text is italicized blue text and must be tailored to fit the conclusions reached and supported by the contract matrix.*

# Project Overview and Summary of Conclusions

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# Project Overview and Summary of Conclusions

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### ASC 606 Overview

Financial Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers (Topic 606)* was issued in 2014. The standard provides authoritative accounting guidance related to revenue from contracts with customers. It applies to all entities and to all contracts with customers, with the exception of the following transactions noted in ASC 606-10:

- Lease contracts within the scope of Topic 840, Leases.
- Insurance contracts within the scope of Topic 944, Financial Services-Insurance.
- Various other financial instruments that are included in the scope of topics: 310, 320, 323, 325, 405, 470, 815, 825, and 860.
- Guarantees (other than product or service warranties) within the scope of Topic 460, Guarantees.
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

***XXX – Discuss if the Company has contracts that are in the scope of the above guidance.***

***- OR -***

***The Company did not identify any contracts that were within the scope of the above guidance.***

The core principle of ASC 606 is that an entity recognizes 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.



# Project Overview and Summary of Conclusions

## Overview of Revenue from Contracts with Customers

**XXX – discuss generally the nature of revenue, revenue streams, generally how contracts are structured, if there are significant customer concentrations, etc. Anything that would be relevant in determining the approach, scope and extent of analysis required.**

*Example: The Company is a contract manufacturer of equipment such as XXXX. The majority of revenue is earned by designing, building, and shipping equipment that has been manufactured to customer specifications and shipped upon acceptance by a customer representative (depending on the contract). Certain contracts also include other services, such as installation or training. Typically, all contracts or purchase orders with a single customer are governed by global terms and conditions supplied by the customer that outline the key provisions that will impact revenue. On occasion, the contract or purchase order for the specific product line will have terms that will supersede or supplement those in the terms and conditions. In most cases, conclusions can be reached for all revenue with a given customer. In some instances, there will be multiple programs with a single customer that may have unique terms that will result in different treatment.*

*Breakdown of revenue (can be broken down by category of product, industry, etc.):*

Revenue by Stream	2017		2016	
	Stream 1 (equipment type 1)	60,000,000	92%	55,000,000
Stream 2 (equipment type 2)	5,000,000	8%	10,000,000	15%
Stream 3	500,000	1%	500,000	1%
Total revenue	65,500,000		65,500,000	

## Project Overview and Summary of Conclusions

Stream 1 by Customer					
	2017		2016		
Customer 1	15,000,000	25%	14,000,000	25%	
Customer 2	12,000,000	20%	-	0%	
Customer 3	8,000,000	13%	18,000,000	33%	
Customer 4	4,000,000	7%	4,500,000	8%	
Customer 5	2,000,000	3%	2,500,000	5%	
Others	19,000,000	32%	16,000,000	29%	
Total revenue	60,000,000		55,000,000		

### Management Approach and Results

**XXX – Discuss how the above information was used to conclude on what will be analyzed.**

#### Contract Matrix

For each separate arrangement with the customer, there are typically one to two documents that cross-reference and comprise all the terms, rights and obligations between the Company and the customer, as follows:

1. Customer Terms & Conditions – Standard terms and conditions that apply to all contracts executed by the customer, e.g., shipping and payment terms *(if applicable, customers may not have terms and conditions separate from the equipment contract or purchase order – typically depends on the type and size of customers and the related projects)*
2. Contract or Purchase Order – Could include several different forms of documents. Provides the general terms related to the specific arrangement with the customer, typically including design specifications and pricing. May also include shipping and payment terms.

Management started with the list of open contracts at December 31, 2018 in order to review and determine the impact to accounting policy as well as calculate the transition adjustment. Contracts representing XX% of revenue were selected.

If appropriate based on findings from open contracts: Based on the potential for separate performance obligations that could result in deferred revenue after the equipment is delivered, jobs that were considered closed within the last XX months of year end in excess of \$XX were also selected and analyzed to determine if there was a transition adjustment impact.

# Project Overview and Summary of Conclusions

Management reviewed the agreements and related documents that together made up a contract for XXX customers (or XXX arrangements). The Contract Matrix was utilized to capture the key documents in each agreement that form a contract. Key contract issues that were identified included the following:

- Customer
- Document type
- Effective date
- Termination date
- Step 1 – Identify the contract:
  - Documents needed to form a contract
  - Combining contracts
  - Contract modifications
- Step 2 – Identify performance obligations:
  - Equipment
  - Design
  - Research and development
  - Prototype development
  - Shipping
  - Installation services
  - Warranty provisions or service contract
  - Training services
- Step 3 – Determine the transaction price
  - Liquidating damages, performance bonuses, or penalty provisions
  - Variable pricing or pricing based on time and materials
  - Consideration paid to customers (pay to play arrangements, etc.)
  - Customer furnished materials
  - Customary business practice considerations
  - Significant financing component
- Step 4 – Allocate the transaction price to separate performance obligations
- Step 5 – Recognize revenue as or when performance obligation is satisfied
  - Termination provisions and penalties
  - Bill and hold arrangements
  - When control transfers (if point in time)

# Project Overview and Summary of Conclusions

Other terms may be present in some contracts (intellectual property rights, for example) that were considered in general but not considered relevant to the final conclusion. Consideration of those provisions are included below.

## **Approach for Customers Not Representing Top XX% of Sales**

***XXXX – If management doesn't evaluate all open contracts at the transition date, document how it was determined that conclusions reached on the analyzed contracts can be applied to the remaining population.***

*Example documentation:*

*Management considered the results of the detailed contract analysis that was performed on the customer contracts representing the top XX% of open contracts when determining its approach to the remaining population.. During the detailed contract analysis, the contracts contained very similar provisions throughout, with most containing nearly identical language. The Company does not have different sales or contract negotiation guidelines for its larger customers or projects. Accordingly, the Company would expect that language in all customer contracts to be similar, regardless of the size of the customer or project.*

*Based on the information above regarding its portfolio of customer contracts, management employed a different approach for customer contracts that did not comprise the top XX% of open contracts. Management sent a survey to the corporate controllers for each division and asked them to identify any contracts that met certain characteristics that could indicate that a change in accounting was required under ASU 2014-09. See Exhibit A for a copy of the survey that was sent to the corporate controllers.*

*The results of this survey indicated that no significant contracts were identified with characteristics indicating an accounting change was necessary.*

*-OR-*

*The results of this survey identified certain contracts with terms that would result in a different accounting treatment. As a result, all contracts with similar terms were segregated and analyzed separately.*

## **Analysis**

Management assessed the critical terms of each contract and applied the provisions of ASU 2014-09 to each contract. In addition to the standard itself, management considered information gathered from the relevant papers issued by the FASB Transition Resource Group. Management's analysis and conclusions on relevant aspects of each step of the revenue recognition model are presented on the subsequent pages in this memo.



# Project Overview and Summary of Conclusions

## Overview of Results

A contract is typically formed by 1-2 documents: Terms and Conditions and Purchase Order or contract (if separate).

*Edit as necessary:*

**Performance Obligations:** *In most cases, the only performance obligation is to produce the specified equipment. The Company elected the policy election option that effectively results in always treating shipping and handling as a cost of fulfillment instead of a separate performance obligation.*

-OR-

**Performance Obligations:** *Some of the agreements reviewed include multiple performance obligations; including producing the specified equipment as well as providing installation, training, and/or warranty services that are distinct obligations. The price included in the agreement is allocated to each performance obligation based on its relative standalone selling price. The Company elected the policy election option that effectively results in always treating shipping and handling as a cost of fulfillment instead of a separate performance obligation.*

*Optional if appropriate:* **Research and Development:** *In some instances, the Company and a customer will enter into agreements where the Company will perform research and development services. Each of these arrangements will need to be analyzed individually to determine if the activity is within the scope of ASC 606 or ASC 808 Collaborative Arrangements. These arrangements are typically not entered into at or near the same time as other performance obligations and therefore it is not combined into a single contract with other arrangements.*

*Optional if appropriate:* **Prototypes:** *In some instances, the Company and a customer will enter into agreements to produce prototypes. These are a distinct performance obligation. (alternatively, if appropriate, these are a cost to fulfill the expected future performance obligations and the related costs should be capitalized and amortized in a pattern consistent with the revenue from the expected future performance obligations). These arrangements are typically not entered into at or near the same time as other performance obligations and therefore it is not combined into a single contract with other arrangements.*

*Edit as necessary:*

**Point in time vs. Overtime:** *None of the agreements reviewed had indicators indicating that revenue should be recognized over time. The equipment is manufactured at the Company's facility and either has an alternative use or did not include cancellation provisions that would result in an enforceable right to payment for performance completed to date (cost plus a margin) upon cancellation of a purchase order for a reason other than breach. Therefore, all revenue is recognized at a point in time. The appropriate point in time is based on the shipping terms (FOB dock or destination).*

- OR -

# Project Overview and Summary of Conclusions

**Point in time vs. Overtime:** *Some of the equipment is manufactured at the Customer's facility, providing the customer control of the equipment as the equipment is being built. –OR- Some of the equipment has no alternative use in its finished state and some of the agreements reviewed included cancellation provisions that would result in an enforceable right to payment for performance completed to date (cost plus a margin) upon cancellation of a purchase order for a reason other than breach. Therefore, some contracts will recognize revenue over time as the equipment is produced. The measure of progress will be total cost for parts and labor hours (edit as needed). For those contracts that do not include this provision revenue will be recognized at a point in time. The appropriate point in time is based on the shipping terms (FOB dock or destination).*

- OR -

**Point in time vs. Overtime:** *All of the equipment is manufactured at the Customer's facility, providing the customer control of the equipment as the equipment is being built. –OR- All of the agreements reviewed were for equipment that has no alternative use to the Company in its finished state AND included cancellation provisions that would result in an enforceable right to payment for performance completed to date (cost plus a margin) upon cancellation of a purchase order for a reason other than breach. Therefore, all revenue is recognized over time. The measure of progress will be total cost for parts and labor hours (edit as needed) for equipment.*

## Transition & Disclosure

**XXX – Discuss transition approach (full retrospective or modified retrospective) and any practical expedients that are adopted.**

# Detailed Analysis – Step 1

## Detailed 5 Step Analysis

### Step 1: Identification of Customer Contracts

**ASC 606-10-25-1** An entity shall account for a contract with a customer that is within the scope of this Topic only when all of the following criteria are met:

- 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 (see paragraphs 606-10-55-3A through 55-3C). In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession (see paragraph 606-10-32-7).

**ASC 606-10-25-4:** For the purpose of applying the guidance in this Topic a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties). A contract is wholly unperformed if both of the following criteria are met:

- a. The entity has not yet transferred any promised goods or services to the customer.
- b. The entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

The Company will enter into one or more arrangements with each customer. Different arrangements could be made between the different Company business units. For example, the Company could have separate arrangements with Customer A for (i) Division A to provide Equipment A and (ii) for Division B to provide Equipment B.

For each separate arrangement with the customer, there are typically one to two documents that cross-reference and comprise all the terms, rights and obligations between the Company and the customer, as follows:

1. Customer Terms & Conditions – Standard terms and conditions that apply to all contracts executed by the customer, e.g., shipping and payment terms. This may be included in the Purchase Order or Contract, depending on the customer.
2. Purchase Order or Contract – Could include several different forms of documents. Provides the general terms related to the specific arrangement with the customer, typically including design specifications and pricing. May also include shipping and payment terms.

In most cases, the individual documents will indicate which document takes precedence in the event of conflicting terms and conditions. Based on the documents reviewed, there is no set pattern as to which document will contain overriding terms. Therefore, a careful review of the documents should be performed to establish which terms are in force for each contract.

## Detailed Analysis – Step 1

The Purchase Order or Contract, which is often executed by the parties and specifies quantities and design specifications, is governed by the Customer Terms & Conditions (T&C) unless explicitly excluded or the T&Cs are included in the Contract. The combination of these two documents produces an agreement that:

- (a) commits each party to perform their respective obligations,
- (b) identifies each party's rights,
- (c) provides payment terms,
- (d) has commercial substance, and
- (e) is probable of collection.

Once the Purchase Order that specifies quantities and/or contract is issued (herein referred to solely as the Purchase Order), a contract that meets the definition under ASC 606 is formed by the combination of the Customer Terms & Conditions and Purchase Order, with respect to the obligations contained within the Purchase Order. At this time, the Company is committed to perform the obligations required by the Purchase Order, and the customer is committed to pay the stated price for them. Therefore, the combination of the Customer Terms & Conditions, if separate, and Purchase Order produces a contract. An exception to this rule exists when the Purchase Order states that specific or unspecified documents have no influence outside the Purchase Order. In that case, it may not be appropriate to consider the Customer Terms & Conditions, depending on the language in the Purchase Order. Therefore, there will be circumstances where only the Purchase Order, or the Purchase Order and the Customer Terms & Conditions, comprise the contract.

### Contract Combinations

**ASC 606-10-25-9** *An entity shall combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:*

- a. *The contracts are negotiated as a package with a single commercial objective.*
- b. *The amount of consideration to be paid in one contract depends on the price or performance of the other contract.*
- c. *The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.*

*(need to tailor accordingly)* The Company considered whether the documents representing each arrangement with the same customer should be combined and analyzed as one contract. Certain arrangements are negotiated as a package with a single commercial objective; for example, when there are two separate Purchase Orders for one right hand tool and one left hand tool that are entered into at the same time. In these cases, the contracts are combined; however, the individual items may still be separate performance obligations, depending on the results of step two.

In other cases, separate arrangements may be negotiated with the same customer, but are not negotiated as a package with a single objective. Due to differences in customer needs as previously described, they are negotiated separately. The only time the amount of consideration to be paid in one arrangement depends on the price or performance of another arrangement is when the dependent arrangement occurs in the future. When negotiating that future contract, the customer may review previous price or performance. Finally, goods or services in different arrangements do not form a single performance obligation. Therefore, it would not be appropriate to combine arrangements entered into at or near the same time because none of the criteria are met. Although criterion (b) might be met for arrangements entered into in the future, it would not be appropriate to combine those arrangements, when they exist, with current or completed arrangements due to the passage of time and circumstance between them.

# Detailed Analysis – Step 1

## Contract Modifications

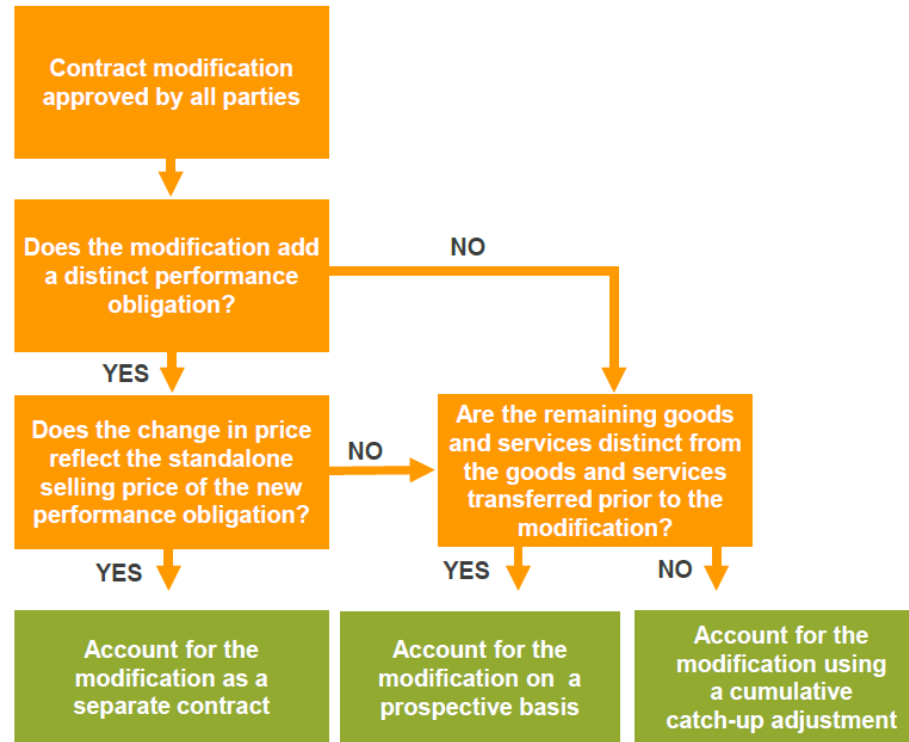
- ASC 606-10-25-12** An entity shall account for a contract modification as a separate contract if both of the following conditions are present:
- The scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 606-10-25-18 through 25-22).
  - The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the standalone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

**ASC 606-10-25-13** If a contract modification is not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (that is, the remaining promised goods or services) in whichever of the following ways is applicable:

- An entity shall account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 606-10-25-14(b)) is the sum of:
  - The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as revenue and
  - The consideration promised as part of the contract modification.
- An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (that is, the adjustment to revenue is made on a cumulative catch-up basis).
- If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph

- ASC 606-10-25-19** A good or service that is promised to a customer is distinct if both of the following criteria are met:
- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).
  - The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

## Detailed Analysis – Step 1



*(need to tailor accordingly)* In most/some cases, change orders to existing contracts in progress do not add additional distinct goods or services according to the definition per ASC 606-10-25-19, but instead modify the price or scope of the existing performance obligation. As a result, these contract modifications are accounted for as an adjustment to revenue at the date of the modification based on the entity's revised measure of progress toward completion of the performance obligation (cumulative catch-up).

- OR -

In most/some cases, change orders to existing contracts in progress add distinct, separate pieces of equipment or services and the price added due to the change order is equal to the standalone selling price of the additional equipment or service. As a result, these contract modifications are accounted for as a separate contract and the 5 step process is followed separately from the original contract.

- OR -

## Detailed Analysis – Step 1

In most/some cases, change orders to existing contracts in progress add separate pieces of equipment or services that are distinct from the original equipment, but the price added with the change order is not equal to the standalone selling price of the additional equipment or service. As a result, these contract modifications are accounted for as a termination of the existing contract and the creation of a new contract. The amount of consideration is the sum of the original amount of consideration included in the transaction price that has not yet been recognized as revenue and the consideration promised in the change order. This consideration is allocated to the remaining performance obligations as of the change order date.

## Detailed Analysis – Step 2

### Step 2: Identification of Performance Obligations

**606-10-25-14** At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:

- a. A good or service (or a bundle of goods or services) that is distinct
- b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see paragraph 606-10-25-15).

**606-10-25-19** A good or service that is promised to a customer is distinct if both of the following criteria are met:

- a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).
- b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

**606-10-25-21** The objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each good or service individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

- a. The entity provides a significant service of integrating goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.
- b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.
- c. The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

The following list presents all of the promises identified in the contracts reviewed. Each must be analyzed to determine whether it is distinct and should therefore be recognized as a separate performance obligation:

1. Produce equipment according to specifications
2. Design equipment to meet customer specifications
3. Research and development
4. Develop prototypes
5. Ship and handle ordered equipment
6. Installation services at customer location
7. Warranty and/or service contract
8. Provide training to customer employees
9. Intellectual property
- 10. Add any others that are identified and document consideration below**



## Detailed Analysis – Step 2

In addition to identifying the performance obligations, if more than one party is providing the good or service, the standard requires the Company to determine whether it is a principal or agent in these transactions by evaluating the nature of the promise to the customer. An entity is a principal and therefore records revenue on a gross basis if it controls a promised good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its role is to arrange for another entity to provide the goods or services. See discussion at the end of the section for any performance obligations that involve more than one entity being involved in the provision of the good or service.

### **Produce Equipment According to Specifications**

Each piece of equipment generally represents one performance obligation. However, in some circumstances, the Company is contracted to produce multiple pieces of equipment and integrate those pieces. See the Installation section below for consideration of these situations. In addition, one contract (or combination of contracts discussed in step one above) may include multiple pieces of equipment that are highly interdependent (for example, a right and left hand part of a tool that must fit together in order to be productive to the customer). *(edit accordingly) As a result, the Company has concluded that the interrelated nature of certain equipment results in separate pieces of equipment creating one performance obligation.*

- OR -

*However, the Company has concluded that although some equipment may be interrelated, each piece of equipment could be sold separately and still be used on its own. As a result, each piece of equipment is separately identifiable and considered a separate performance obligation.*

### **Research and Development (if applicable)**

In some instances, the Company and a customer will enter into agreements where the Company will perform research and development services. Each of these arrangements is analyzed individually to determine if the activity is within the scope of ASC 606 or ASC 808 Collaborative Arrangements.

**606-10-15-3** *An entity shall apply the guidance in this Topic [Revenue from contracts with customers] to a contract [...] only if the counterparty to the contract is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities.*

#### **808-10-20 Glossary - Collaborative arrangement**

*A contractual arrangement that involves a joint operating activity (see paragraph 808-10-15-7). These arrangements involve two (or more) parties that meet both of the following requirements:*

- a. They are active participants in the activity (see paragraphs 808-10-15-8 through 15-9).*
- b. They are exposed to significant risks and rewards dependent on the commercial success of the activity (see paragraphs 808-10-15-10 through 15-13).*

## Detailed Analysis – Step 2

*Tailor accordingly – In most cases, these arrangements are not entered into at or near the same time as other performance obligations and therefore the arrangement is not combined into a single contract with other arrangements. The Company is analyzing these contracts on a case by case basis to determine if the arrangement is a contract with a customer or is a collaborative arrangement. Typically, the service is considered a contract with a customer and is accounted for as follows: [insert description based on specific contract terms] – OR – Typically, the service is considered a collaborative arrangement as the arrangement involves a joint operating activity, both parties are active participants, and both parties are exposed to significant risks and rewards dependent on the commercial success of the activity.*

### **Develop Prototypes**

Promises to develop prototypes are typically considered a separate performance obligation as they result in a good (the prototype) that is distinct from other promises in the contract (equipment, etc.). In instances where no contract exists but the Company agrees to create a prototype for the customer as a demonstration prior to being awarded the work, the prototype would fall under the guidance for cost to obtain a contract:

**340-40-25-1** *An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.*

**340-40-25-2** *The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).*

**340-40-25-3** *Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.*

Because the cost of building a prototype that is created prior to being awarded the contract is not incremental to being awarded the contract (if the contract is not awarded to the Company, the cost has still been incurred), the cost should be expensed as incurred.

*Edit as appropriate: None of the contracts reviewed included prototype promises.*

- OR -

*Based on contracts reviewed, prototypes developed are considered separate performance obligations as they result in a distinct good being produced in addition to the equipment.*

- OR -

*The Company only builds prototypes prior to being awarded contracts. As a result, prototype costs are expensed as incurred.*

### **Ship and Handle Ordered Equipment**

## Detailed Analysis – Step 2

Shipping and handling activities are carried out either by the customer (the customer arranges pick up at the Company's dock) or the Company will arrange for the shipping and handling activities.

**606-10-25-18A** An entity that promises a good to a customer also might perform shipping and handling activities related to that good. If the shipping and handling activities are performed before the customer obtains control of the good (see paragraphs 606-10-25-23 through 25-30 for guidance on satisfying performance obligations), then the shipping and handling activities are not a promised service to the customer. Rather, shipping and handling are activities to fulfill the entity's promise to transfer the good.

**606-10-25-18B** If shipping and handling activities are performed after a customer obtains control of the good, then the entity may elect to account for shipping and handling as activities to fulfill the promise to transfer the good. The entity shall apply this accounting policy election consistently to similar types of transactions. An entity that makes this election would not evaluate whether shipping and handling activities are promised services to its customers. If revenue is recognized for the related good before the shipping and handling activities occur, the related costs of those shipping and handling activities shall be accrued. An entity that applies this accounting policy election shall comply with the accounting policy disclosure requirements in paragraphs 235-10-50-1 through 50-6.

*Edit as appropriate: The Company has concluded to adopt the policy election and, consequently, all shipping and handling costs will be considered a cost to fulfill the contract. If revenue is recognized before shipping, the shipping and handling costs will be accrued.*

- OR -

*In most cases, revenue is recognized at a point in time and control transfers upon delivery (see step 5) As a result, shipping and handling activities are not a separate promised service to the customer and are considered activities to fulfill the promise to transfer the good.*

- OR -

*In most cases, revenue is recognized at a point in time and control transfers prior to shipping (see step 5). The Company has concluded not to adopt the policy election for shipping and handling costs. As a result, shipping and handling activities are typically considered a separate performance obligation.*

- OR -

*In most cases, revenue is recognized over time (see step 5) and the performance obligation is completed upon completion of building the equipment (i.e. installation and/or training, if they are included in the contract, are separate performance obligations); therefore, control transfers as production progresses and full control of the equipment is fully transferred before shipment to the customer occurs. The Company has concluded not to adopt the policy election for shipping and handling costs. Therefore shipping and handling activities are typically considered a separate performance obligation.*

## Detailed Analysis – Step 2

### Installation Services

**606-10-25-21** The objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each good or service individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

- a. The entity provides a significant service of integrating goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.
- b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.
- c. The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

See guidance on determining if goods and services are distinct from ASC 606-10-55-150A through 55-150K.

Installation services could be combined with the production of equipment as a single performance obligation or could be a separately identifiable performance obligation. The result depends on the economic substance of the transaction, i.e. whether the customer is purchasing the final installed equipment (a combined output) or the equipment and installation services individually (individual inputs). One consideration is whether the equipment is functional to the customer on its own. If the customer can benefit from the equipment without the installation services, the installation services are a separate performance obligation. If the installation services include significant integration, modification, or customization of the equipment in order to provide the customer with a customized product, the installation services are part of the single performance obligation to provide the equipment.

*Edit as appropriate – Because the Company does not sell its installation services separately and the equipment that requires installation is not functional for the customer until installation, the installation services provided by the Company should not be accounted for as a separate performance obligation.*

- OR -

*Based on review of a sample of contracts, there are some contracts where installation services are a distinct performance obligation and some contracts where the services are not distinct from the related equipment. The Company reviews the specific terms, circumstances, and design specifications for each contract. If the equipment is functional for the customer without installation and/or if installation services could be performed by a separate vendor, the installation services are accounted for as a separate performance obligation.*

*NOTE – additional documentation of factors considered should be included.*

### Design Services

## Detailed Analysis – Step 2

Similar to installation services, design services could be combined with the production of equipment as a single performance obligation or could be a separately identifiable performance obligation. The result depends on the economic substance of the transaction, i.e. whether the customer is purchasing the final equipment designed by the Company to meet their specifications (a combined output) or the equipment and design services individually (individual inputs). The Company should consider whether the customer could benefit from the design services or the equipment production on their own (in other words, consider whether the customer could take the design provided by the Company and provide that design to another vendor to produce the equipment or, vice versa, whether the customer could obtain design services from another vendor and provide that to the Company to produce the equipment).

*Edit as appropriate – Because the Company does not sell its design services separately and the equipment that requires design could not be designed and produced by two separate vendors, the design services provided by the Company should not be accounted for as a separate performance obligation.*

- OR -

*Based on review of a sample of contracts, there are some contracts where design services are a distinct performance obligation and some contracts where the services are not distinct from the related equipment. The Company reviews the specific terms, circumstances, and design specifications for each contract. If the design service could be offered as a standalone service by the Company or by another vendor, the design services are accounted for as a separate performance obligation.*

### **Training Services**

Training services could be combined with the production of equipment as a single performance obligation or could be a separately identifiable performance obligation based on the nature of the training. The result depends on the economic substance of the transaction, i.e. whether the customer is purchasing the final equipment and employee training (a combined output) or the equipment and training services individually (individual inputs). The Company should consider whether the customer could benefit from the equipment on its own without the training provided.

*Edit as appropriate – In most cases, training is separately identifiable from the related equipment and/or is offered to customers as a separate service to add on to their purchase. Although the training is related to the equipment, the training services provided by the Company are not so interdependent that the Company could not provide the equipment and training separately. Additionally, the customer obtains control of and can obtain the economic benefit from the equipment prior to the training.*

- OR -

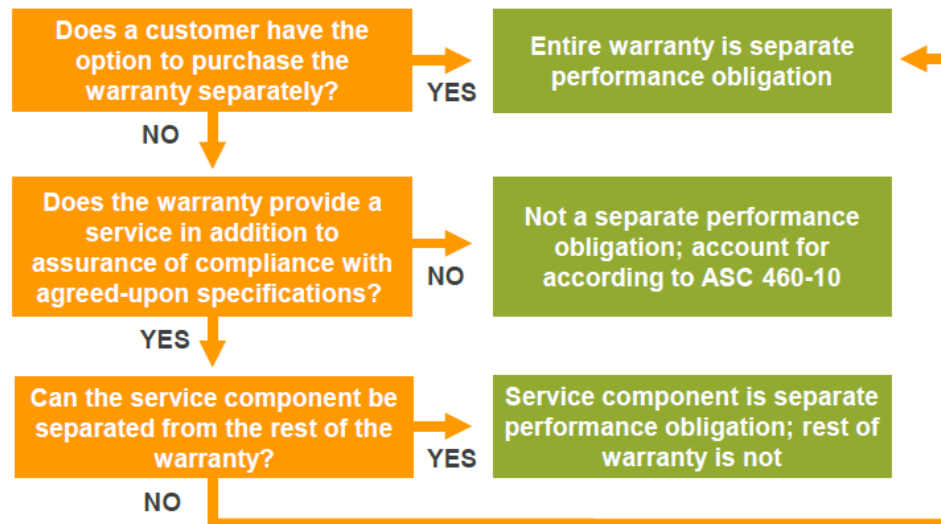
*Based on review of a sample of contracts, there are some contracts where design services are a distinct performance obligation and some contracts where the services are not distinct from the related equipment. The Company reviews the specific terms and circumstances for each contract. Due to the unique nature of some of the Company's produced equipment, the training and equipment are highly interrelated (the customer can not utilize the equipment until being trained by the Company) and are accounted for as a single performance obligation. NOTE – this will likely be a rare conclusion.*

## Detailed Analysis – Step 2

### Warranty and/or Service Contract

**606-10-55-31** - If a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, an entity should account for the promised warranty as a performance obligation in accordance with paragraphs 606-10-25-14 through 25-22 and allocate a portion of the transaction price to that performance obligation in accordance with paragraphs 606-10-32-28 through 32-41.

**606-10-55-32** - If a customer does not have the option to purchase a warranty separately, an entity should account for the warranty in accordance with the guidance on product warranties in Subtopic 460-10 on guarantees, unless the promised warranty, or a part of the promised warranty, provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.



Warranty obligations are treated either as a separate performance obligation or as a cost of fulfillment. A warranty could be considered a distinct service if the customer has the option to purchase a warranty or service contract separately from another vendor or from the Company. If the warranty is a separate performance obligation, a portion of the transaction price will be allocated in Step 4 and deferred, to be recognized over the warranty period. If the customer does not have the option to purchase a warranty or service contract separately and the warranty only provides assurance that the equipment complies with agreed-upon specifications, the warranty is not a separate performance obligation. If the warranty is not a separate performance obligation, then it is accounted for under other GAAP, specifically ASC 460.

## Detailed Analysis – Step 2

*Edit as appropriate – Because the Company does not sell its product warranties separately, and because no service is provided other than to assure that the equipment complies with agreed-upon specifications, the warranty provided by the Company should not be accounted for as a separate performance obligation.*

*- OR -*

*Due to the nature of the Company's equipment and terms of the warranty (including free or reduced cost repairs for normal wear and tear and/or inspections and/or routine maintenance), repairs or other services may be required over the warranty period even if the equipment complies with agreed-upon specifications. As a result, a portion of the warranties are accounted for as separate performance obligations.*

*- OR –*

*Because the Company offers its customers the option to purchase a warranty separately, warranties are accounted for as separate performance obligations.*

### **Intellectual Property (IP)**

Some contract manufacturing agreements refer to intellectual property. This takes two forms: (1) the customer will supply IP that the Company will use in the production of equipment or (2) the agreement indicates that any IP owned, licensed and/or developed by the Company connected to the equipment will be licensed to the customer.

The first type (customer supplied IP) would not constitute a performance obligation. It is possible that this could be considered variable consideration under ASC 606-10-32-24:

**606-10-32-24** *If a customer contributes goods or services (for example, materials, equipment, or labor) to facilitate an entity's fulfillment of the contract, the entity shall assess whether it obtains control of those contributed goods or services. If so, the entity shall account for the contributed goods or services as noncash consideration received from the customer.*

However, the Company does not obtain control of intellectual property that is provided by the customer. The Company is only permitted to use the IP in the production of the customer's goods. Therefore, this would not be considered variable consideration.

The second type (Company owned/licensed IP) also would not be considered a performance obligation. An example of contract language is as follows:

*"To the extent any Intellectual Property Rights owned by or licensed to Seller is embodied in, or is otherwise necessary for the intended use of, any Buyer's Property, Seller hereby grants to Buyer a fully paid, irrevocable, non-exclusive, worldwide, perpetual to the maximum extent permitted by law, royalty-free license, with the right to grant sublicenses as necessary for any use of Buyer's Property, to use such Intellectual Property Rights."*

The nature of the promise to the customer is not to develop IP, but rather to produce equipment. This clause covers the eventuality that IP owned by the Seller (Company) is needed for the product to be used as intended. It was also considered if IP is customarily developed and transferred to the customer, and therefore could be identified as a performance obligation because it is the Company's customary business practice. As this is a very rare occurrence, it is not seen as an implied promise and therefore not customary business practice. Rather, in the event that IP is needed for the equipment to function as intended, the IP would be considered highly

## Detailed Analysis – Step 2

integrated and therefore not distinct from the promise to produce equipment. Additionally, it is relevant to note that the clause typically refers to the IP being “royalty-free”. While the fact that a promise has no stated price or a stated price of zero does not mean it is not a performance obligation, in this case it was concluded that the lack of a stated price provides evidence to support that the IP is not a distinct performance obligation.



## Detailed Analysis – Step 2

### Principal vs. Agent Considerations

**606-10-55-36** When another party is involved in providing goods or services to a customer, the entity should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by the other party (that is, the entity is an agent). An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer (see paragraphs 606-10-25-19 through 25-22). If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others.

**606-10-55-36A** To determine the nature of its promise (as described in paragraph 606-10-55-36), the entity should:

- a. Identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party [see paragraph 606-10-25-18])
- b. Assess whether it controls (as described in paragraph 606-10-25-25) each specified good or service before that good or service is transferred to the customer.

**606-10-55-37** An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

**606-10-55-37A** When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

- a. A good or another asset from the other party that it then transfers to the customer.
- b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.
- c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer. For example, if an entity provides a significant service of integrating goods or services (see paragraph 606-10-25-21(a)) provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which include goods or services from other parties) and directs their use to create the combined output that is the specified good or service.

**606-10-55-37B** When (or as) an entity that is a principal satisfies a performance obligation, the entity recognizes revenue in the gross amount of consideration to which it expects to be entitled in exchange for the specified good or service transferred

## Detailed Analysis – Step 2

**606-10-55-38** An entity is an agent if the entity's performance obligation is to arrange for the provision of the specified good or service by another party. An entity that is an agent does not control the specified good or service provided by another party before that good or service is transferred to the customer. When (or as) an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

**606-10-55-39** Indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal [see paragraph 606-10-55-37]) include, but are not limited to, the following:

- a. The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.
- b. The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return). For example, if the entity obtains, or commits to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.
- c. The entity has discretion in establishing the price for the specified good or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers

**606-10-55-39A** The indicators in paragraph 606-10-55-39 may be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts

Principal (gross) or agent (net) revenue recognition is only a consideration when more than one entity is involved in providing the good or service to the customer.

*Edit as appropriate: Based on the nature of the contracts, it is not expected that the Company acts as an agent in their transactions. Generally speaking, customers contract with the Company for all aspects of the manufacture of the equipment and the Company is responsible for design, procurement, and inventory risk, and is responsible for negotiating the price with the customer. None of the contracts reviewed had indicators that the Company was an agent.*

- OR -

*In most cases, it is not expected that the Company acts as an agent in their transactions. Generally speaking, customers contract with the Company for all aspects of the manufacture of the equipment and the Company is responsible for design, procurement, and inventory risk, and is responsible for negotiating the price with the customer. However, in certain cases, the Company contracts with a*

## Detailed Analysis – Step 2

*third party to install equipment locally at a customer location. In these situations, the Company still typically has primary responsibility to deliver the installed equipment to the customer based on the contract terms and the Company establishes the price that the customer will pay. As a result, the Company is still the principal in the transaction and therefore recognizes revenue and costs at gross amounts.*

*- OR -*

*In most cases, it is not expected that the Company acts as an agent in their transactions. Generally speaking, customers contract with the Company for all aspects of the manufacture of the equipment and the Company is responsible for design, procurement, and inventory risk, and is responsible for negotiating the price with the customer. However, in certain cases, the Company contracts with a third party to install equipment locally at a customer location. In these situations, the Company typically transfers inventory risk to the local installer and the local installer is responsible for the acceptable performance of the installation services. The Company sets its price for installation charged to the customer based on the price established by the local installer. Based on these factors, contracting with local installers typically results in the Company acting as an agent for installation services. Therefore, revenue is recognized net of costs in these cases.*

## Detailed Analysis – Step 3

### Step 3: Determine Transaction Price

**606-10-32-2** *An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.*

The following list presents all of the identified components of the transaction price in the contracts reviewed and/or those common in the Company's contracts. Each must be analyzed to determine the amount that is appropriate to include in the calculation of the transaction price of a contract:

1. Price per piece of equipment per purchase order
2. Performance bonuses, penalty provisions, or other variable pricing
3. Time and materials arrangements
4. Pay-to-play fees (consideration paid to the customer)
5. Customer supplied material
6. Customary business practice considerations
7. Significant financing components
8. *Others as identified*

## Detailed Analysis – Step 3

### Performance Bonuses, Liquidating Damages, Penalty Provisions, or Other Variable Pricing

**606-10-32-5** *If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.*

**606-10-32-8** *An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:*

- a. *The expected value - The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.*
- b. *The most likely amount - The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).*

**606-10-32-11** *An entity shall include in the transaction price some or all of an amount of variable consideration...only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.*

**606-10-32-12** *Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:*

- a. *The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.*
- b. *The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.*
- c. *The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.*
- d. *The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.*
- e. *The contract has a large number and broad range of possible consideration amounts.*

Some contracts for long-term projects such as equipment manufacturing contain performance bonuses for meeting, or penalties for missing, certain target dates or other forms of variable pricing. 606-10-32-8 provides two methods for estimating the variable price. The Company should choose the method that it expects best predicts the amount of consideration to which the entity will be entitled to receive based on the terms of the contract.

After estimating the price, the Company must constrain the price to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. The significance of the reversal should be assessed at the contract level (which would include any separate performance obligations and any additional fixed consideration included in the contract).

## Detailed Analysis – Step 3

*Edit as appropriate: None of the contracts reviewed included performance bonuses or variable pricing, except for time and materials arrangements addressed below.*

*-OR-*

*Certain contracts reviewed included performance bonuses (or penalty provisions) if the Company does/does not meet agreed upon deadlines. The Company will use either the expected value or the most likely amount methods of estimating the transaction price, depending on the circumstance and range of possibilities.*

### **Time and Materials Arrangements**

**606-10-55-18** *As a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice.*

Some contracts for custom equipment do not specify a price, but state that the price will be based on the time and materials to produce the equipment. 606-10-55-18 provides a practical expedient for these situations when billings reflect the value of the good or service transferred to the customer. There is no requirement that the "value to the customer" must equal the stand-alone selling price; however, the Company must consider whether the stated prices reflect something other than the value to the customer. For example, if billings at the beginning of the contract are higher in order to provide more liquidity to the Company and not based on the amount of work performed, the practical expedient should not be used.

*Edit as appropriate – Based on the nature of the Company's time and materials contracts, use of the practical expedient will generally be appropriate as the Company bills the customer based on value provided up to the billing date.*

## Detailed Analysis – Step 3

### **Consideration Payable to Customers (Pay-to-play)**

**606-10-32-25** Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes equity instruments (liability or equity classified) granted in conjunction with selling goods or services (for example, shares, share options, or other equity instruments). An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 606-10-25-18 through 25-22) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 606-10-32-5 through 32-13.

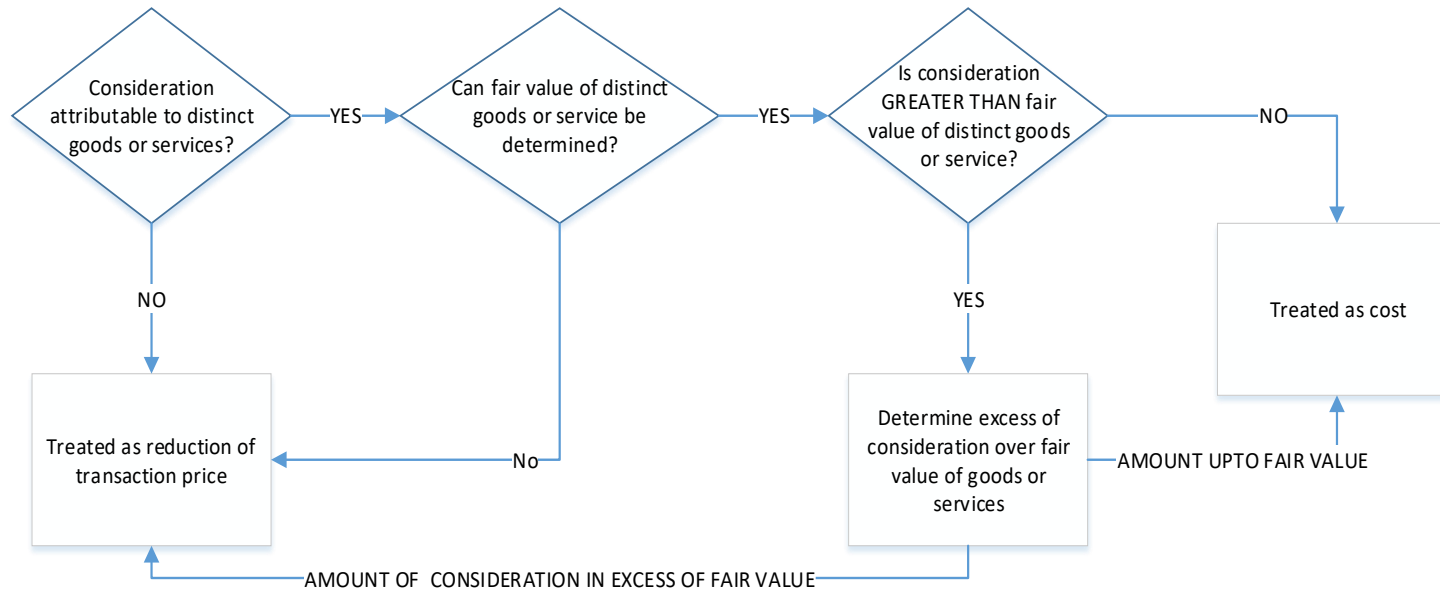
**606-10-32-26** If consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity shall account for such an excess as a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price.

**606-10-32-27** Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognize the reduction of revenue when (or as) the later of either of the following events occurs:

- a. The entity recognizes revenue for the transfer of the related goods or services to the customer.
- b. The entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices

## Detailed Analysis – Step 3

The requirements are illustrated in the flowchart below:



Pay-to-play arrangements are not attributable to distinct goods and services received from the customer. The result of the pay-to-play arrangement is the ability to receive more contracts from the customer. This is not a distinct good or service. Therefore, when the payment is reflected in income it should be classified as a reduction of revenue.

The timing of the recognition of consideration is enumerated in ASC 606-10-32-27, which requires that payments cannot be recognized as a reduction in revenue until revenue for the transfer of goods or services has been made. Until recognized as a reduction of transaction price (in accordance with the latter of a. or b. in the guidance), any amount paid will be treated as an asset. ASC 606 is silent on the pattern that should be followed to reduce revenue, but an analogy can be made with ASC 340 which requires that costs to acquire contracts should be amortized following a method that reflects benefit expected to be derived from the payment (for example, over the term of the supply agreement or some other appropriate method). Accordingly, payments made to a customer under a pay-to-play provision will be capitalized as an asset and recognized as a reduction of revenue as the revenue is recognized. The asset will be considered for recoverability on a periodic basis and written down in the event that it is estimated to no longer be recoverable.

*Edit as appropriate: **Conclusion:** None of the contracts reviewed included pay-to-play provisions. Additionally, the Company does not enter into pay-to-play arrangements frequently. –OR- Some pay-to-play provisions and/or arrangements were noted. These will be tracked on an arrangement by arrangement basis, capitalized as a contract asset upon payment and amortized as the related equipment revenue is recognized (either over time or at a point in time).*



## Detailed Analysis – Step 3

### Customer Furnished Material

**606-10-32-21** To determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the estimated fair value of the noncash consideration at contract inception (that is, the date at which the criteria in paragraph 606-10-25-1 are met).

**606-10-32-24** If a customer contributes goods or services (for example, materials, equipment, or labor) to facilitate an entity's fulfillment of the contract, the entity shall assess whether it obtains control of those contributed goods or services. If so, the entity shall account for the contributed goods or services as noncash consideration received from the customer.

Some contracts may contain language that indicate it is possible for the customer to provide material or other supplies to the Company. The determination of if customer furnished materials represents noncash consideration depends on if the Company obtains control of the material. If the contract contains provisions that restrict the use of any supplied materials to use only on or in the customer's good or service, then the Company does not obtain control as the good can only be used as directed by the Customer. If the customer supplied materials can be used for anything, then the Company obtains control and the fair value of the supplied good must be included in the determination of consideration.

*Edit as appropriate: **Conclusion:** In the contracts reviewed, for those that included this language, it was noted that the agreement specifically restricted the use of customer furnished materials (if any) to use only in the production of equipment for the customer. Because the Company does not have the right to divert the supplied material to another use, it is concluded that the Company does not obtain control of the customer furnished materials and therefore it is not considered non-cash consideration and not included in the determination of the transaction price. – OR – Some contracts provide customer furnished materials to the Company and allow the Company to use them for whatever purpose they want so long as the Company uses a comparable grade of good in their equipment. For these contracts, the fair value of the customer supplied material is estimated and included in the transaction price.*

### Customary Business Practice Considerations

**606-10-32-7** The variability relating to the consideration promised by a customer may be explicitly stated in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:

- a. The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry, or customer this offer may be referred to as a discount, rebate, refund, or credit.
- b. Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer

## Detailed Analysis – Step 3

In addition to the stated terms in the agreement, the contract price can be impacted by customary business practices of the business. If the Company has a history of accepting less than the stated or agreed upon price for a good or service, then this creates variability that must be factored into the transaction price at the time that revenue is recognized.

*Edit as appropriate: While not written, certain customers expect and the Company has historically agreed to retroactive price adjustments at the end of a certain period of time (e.g. annually). Although nothing is written, the Company's past practice of agreeing to these retroactive price adjustment creates variability and the best estimate of the amount to be ultimately refunded should be deducted from the transaction price as the related revenue is recognized. – OR – The Company does not have a history of retroactive price adjustments other than those written in the contracts. No other business practices, published policies, or specific statements that the Company will accept an amount of consideration less than the price stated in the contract exists.*

## Detailed Analysis – Step 3

### Significant Financing Components

**606-10-32-15** *In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.*

**606-10-32-16** *The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (that is, the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:*

- a. *The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services*
- b. *The combined effect of both of the following:*
  1. *The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services*
  2. *The prevailing interest rates in the relevant market.*

**606-10-32-17** *Notwithstanding the assessment in paragraph 606-10-32-16, a contract with a customer would not have a significant financing component if any of the following factors exist:*

- a. *The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.*
- b. *A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).*
- c. *The difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 606-10-32-16) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.*

**606-10-32-18** *As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.*

## Detailed Analysis – Step 3

**606-10-32-19** To meet the objective in paragraph 606-10-32-16 when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

**606-10-32-20** An entity shall present the effects of financing (interest income or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income (statement of activities). Interest income or interest expense is recognized only to the extent that a contract asset (or receivable) or a contract liability is recognized in accounting for a contract with a customer. In accounting for the effects of the time value of money, an entity also shall consider the subsequent measurement guidance in Subtopic 835-30, specifically the guidance in paragraphs 835-30-45-1A through 45-3 on presentation of the discount and premium in the financial statements and the guidance in paragraphs 835-30-55-2 through 55-3 on the application of the interest method.

Equipment manufacturing contracts could include a financing component. Determination of whether a financing component exists depends on whether there is a difference between the cash selling price and the promised consideration per the contract that is due to the timing of payment.

*Edit as appropriate: There is not typically a difference between the cash selling price and the promised consideration per the contract. In addition, the period between when the entity produces the equipment to the customer and when the customer pays for the equipment is typically less than one year. The Company would elect the practical expedient for any of these situations. As a result, the transaction price does not need to be adjusted for significant financing components.*

*- OR -*

*The Company provides financing to its customers for certain long-term projects due to the significance of the individual project. The Company has not elected the practical expedient for timing differences less than one year OR the length of time between when the entity transfers the equipment to the customer and when the customer pays is typically more than one year. As a result, the transaction price is discounted and interest income is recorded as revenue from contracts with customers is recognized.*

## Detailed Analysis – Step 4

### Step 4: Allocation of Transaction Price to Each Performance Obligation

**606-10-32-28** *The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.*

**606-10-32-29** *To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis in accordance with paragraphs 606-10-32-31 through 32-35, except as specified in paragraphs 606-10-32-36 through 32-38 (for allocating discounts) and paragraphs 606-10-32-39 through 32-41 (for allocating consideration that includes variable amounts).*

**606-10-32-30** *Paragraphs 606-10-32-31 through 32-41 do not apply if a contract has only one performance obligation. However, paragraphs 606-10-32-39 through 32-41 may apply if an entity promises to transfer a series of distinct goods or services identified as a single performance obligation in accordance with paragraph 606-10-25-14(b) and the promised consideration includes variable amounts.*

**606-10-32-31** *To allocate the transaction price to each performance obligation on a relative standalone selling price basis, an entity shall determine the standalone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those standalone selling prices.*

**606-10-32-32** *The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the standalone selling price of that good or service.*

#### **Equipment Only**

If each purchase order is a separate contract for accounting purposes, the total transaction price is the sum of the extended amount for each separate item on the purchase order. Equipment produced by the Company is unique to each customer, created using customer-specific designs. Because the equipment of one customer would not fit the needs of a different customer, there is no market for that equipment other than the customer ordering that equipment. Therefore, the standalone selling price of the equipment is the price per the Purchase Order. As a result, the price of the equipment as stated in each Purchase Order should be the transaction price allocated to that Purchase Order. An exception does exist when the Purchase Order contains discounts, as discussed below.

*Edit as appropriate: In most cases, as each purchase order is for one or few pieces of equipment, each purchase order embodies a stand alone contract and each piece of equipment results is a single performance obligation. As previously discussed, each purchase order would likely not be combined with other contracts. Therefore, allocation of the transaction price is typically based on the price for each piece of equipment per the purchase order.*

#### **Equipment and Other Services**

## Detailed Analysis – Step 4

If multiple separate performance obligations have been identified in step 2 (for example, equipment production and installation services as two separate performance obligations), the transaction price should be allocated to the performance obligations based on the relative standalone selling prices of each performance obligation. In most cases, equipment produced by the Company is unique to each customer, created using customer-specific designs. Because the equipment of one customer would not fit the needs of a different customer, there is no market for that equipment other than the customer ordering that equipment. Therefore, the standalone selling price of the equipment is the price per the Purchase Order. For other services, the Company should determine the standalone selling price of those services based on selling prices in similar circumstances to similar customers. The total transaction price is then allocated based on these relative standalone selling prices.

*Edit as appropriate: In most cases, the prices per the purchase order are quoted based on the standalone selling price for each performance obligation. As a result, the transaction price can be allocated based on the prices per the customer and project-specific purchase order. Occasionally, discounts are given to the customer on additional services such as installation, as discussed below.*

### **Discounts**

**606-10-32-36** A customer receives a discount for purchasing a bundle of goods or services if the sum of the standalone selling prices of those promised goods or services in the contract exceeds the promised consideration in a contract. Except when an entity has observable evidence in accordance with paragraph 606-10-32-37 that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract. The proportionate allocation of the discount in those circumstances is a consequence of the entity allocating the transaction price to each performance obligation on the basis of the relative standalone selling prices of the underlying distinct goods or services.

**606-10-32-37** An entity shall allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

- a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis.
- b. The entity also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle.
- c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

**606-10-32-38** If a discount is allocated entirely to one or more performance obligations in the contract in accordance with paragraph 606-10-32-37, an entity shall allocate the discount before using the residual approach to estimate the standalone selling price of a good or service in accordance with paragraph 606-10-32-34(c).

Consideration must be given to the contracts and performance obligations that exist and are impacted by the discount.

## Detailed Analysis – Step 4

*Edit as appropriate – Equipment only: In most cases, each purchase order is for one piece of equipment or a few pieces and the discounts are granted to the customer proportionately to each piece of equipment; as a result, the discount can be allocated among the performance obligations proportionately.*

*Edit as appropriate – Equipment and services: Occasionally, discounts on additional services such as installation are provided to customers as an incentive to purchase both equipment and services. However, the Company does not regularly sell installation or other services on a standalone basis without related equipment. As a result, the criteria to allocate the discount entirely to one performance obligation are not met and the discount is allocated proportionately to all performance obligations in the contract.*

- OR -

*Occasionally, discounts on additional services such as installation are provided to customers as an incentive to purchase both equipment and services. Because the Company regularly sells installation (or design, training, etc.) as a service on a standalone basis to customers that are not simultaneously buying equipment and also regularly sells equipment on a standalone basis, there is observable evidence of the standalone selling price of the service and the equipment. However, there are not typically bundles within the contract that are regularly sold on a standalone basis. As a result, it is unlikely that a discount will be allocated entirely to one or more performance obligations and therefore should be allocated proportionately to all performance obligations.*

- OR -

*Occasionally, discounts on additional services such as installation and design are provided to customers as an incentive to purchase both equipment and services. Because the Company regularly sells installation and design (or training, etc.) as services on a standalone basis to customers that are not simultaneously buying equipment and also regularly sells equipment on a standalone basis, there is observable evidence of the standalone selling prices of the services and the equipment. Installation and design services are also regularly sold on a standalone basis as a bundle with a discount for purchasing this bundle. Equipment is not normally discounted. As a result, when the discount on a contract for equipment, design, and installation services is similar to the typical discount on the design and installation service bundle, the discount will be allocated specifically to the design and installation services. In all other cases, the discount will be allocated proportionately.*

## Detailed Analysis – Step 5

### Step 5: Recognize Revenue Allocated to Each Performance Obligation

**606-10-25-23** An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

**606-10-25-24** For each performance obligation identified in accordance with paragraphs 606-10-25-14 through 25-22, an entity shall determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 606-10-25-27 through 25-29) or satisfies the performance obligation at a point in time (in accordance with paragraph 606-10-25-30). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

**606-10-25-27** An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met:

- a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs 606-10-55-5 through 55-6).
- 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 (see paragraph 606-10-55-7).
- c. The entity's performance does not create an asset with an alternative use to the entity (see paragraph 606-10-25-28), and the entity has an enforceable right to payment for performance completed to date (see paragraph 606-10-25-29).

**606-10-55-11** An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract were to be terminated.

**606-10-25-29** An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 606-10-25-27(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. Paragraphs 606-10-55-11 through 55-15 provide guidance for assessing the existence and enforceability of a right to payment and whether an entity's right to payment would entitle the entity to be paid for its performance completed to date.

The following are all of the separate performance obligations identified in Step 2. Each must be analyzed to determine whether revenue should be recognized over time or at a point in time:

1. Supply equipment as required
2. Install equipment at customer location
3. Provide ongoing service under warranty or service contract
4. *Others if identified*



## Detailed Analysis – Step 5

### Consideration of Over Time Criteria:

**Equipment (produced at Company's location):** If another entity stepped in to fulfill the Company's equipment production obligations without the benefit of Company's work in process, it would need to re-perform whatever work the Company had already done. Therefore, criterion (a) to recognize revenue over time is not met. The Company has physical possession of the equipment and makes all design decisions for the equipment, therefore the Company controls the equipment as it is created, so criterion (b) also is not met. With respect to criterion (c), an entity should consider both contractual restrictions and physical limitations when considering whether the equipment has an alternative use. In addition, the consideration of the "alternative use" of the asset should be based on the characteristics of the asset that will ultimately be transferred to the customer (i.e. the final product, not based on the status of the work in process at the time of cancellation) per BC136 of ASU 2014-09. *(Tailor accordingly) The equipment does not have an alternative use to the Company, as it is both customer- and program-specific and the cost to modify for another customer would result in significant economic loss. In addition to the practical limitations of being able to use the equipment for another purpose, the Company is contractually restricted from doing anything else with the equipment. Therefore, if the Company has the enforceable right to payment for performance completed to date in fulfilling the equipment and installation performance obligations (see discussion below on considerations of reasonable profit margin), revenue should be recognized over time. Otherwise, revenue should be recognized at a point in time.-OR- The equipment is typically designed based on the Company's base design with very minimal customization for the customer. As a result, the equipment in process can likely be used for another customer with little rework required as an alternative if the contract is terminated. Therefore, criterion (c) is not met and revenue should be recognized at a point in time.*

Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:

- a. A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party)
- b. A reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts."

Some contracts may contain provisions that require the Customer to provide notice to the supplier before they can terminate the contract for convenience. If the required notice is sufficient to allow the Company to complete any conversion of work in process to finished equipment AND the customer is required to purchase all finished equipment at the contractually stated price, then it could be concluded that the Company has a contractual right to payment for performance throughout the duration of the contract.

Discussion in the Implementation Guidance and Illustrations section of ASC 606 make it clear that the consideration of the "right to consideration for performance" is a contractual and legal question and is typically not impacted by the Company's history of enforcement of their rights. The Company's decision to waive their rights to consideration is a separate decision and is accounted for when and if that decision is made.

## Detailed Analysis – Step 5

**606-10-55-13** *In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).*

**606-10-55-14** *In assessing the existence and enforceability of a right to payment for performance completed to date, an entity should consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether:*

- a. Legislation, administrative practice, or legal precedent confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer.*
- b. Relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect.*
- c. An entity's customary business practices of choosing not to enforce a right to payment has resulted in the right being rendered unenforceable in that legal environment. However, notwithstanding that an entity may choose to waive its right to payment in similar contracts, an entity would continue to have a right to payment to date if, in the contract with the customer, its right to payment for performance to date remains enforceable.*

**606-10-55-15** *The payment schedule specified in a contract does not necessarily indicate whether an entity has an enforceable right to payment for performance completed to date. Although the payment schedule in a contract specifies the timing and amount of consideration that is payable by a customer, the payment schedule might not necessarily provide evidence of the entity's right to payment for performance completed to date. This is because, for example, the contract could specify that the consideration received from the customer is refundable for reasons other than the entity failing to perform as promised in the contract.*

The consideration of if the contractual terms or lack thereof and the legal framework that governs contract law in the jurisdiction need to be carefully considered to determine if an enforceable right to payment exists.

### Termination Provisions and Penalties:

#### Edit as appropriate:

*All of the contracts reviewed included provisions allowing the customer to cancel a purchase order for convenience and the provisions require the customer to pay cost only on any incomplete work in process. Therefore, revenue on all equipment will be recognized at a point in time based on the shipping terms. Future agreements with Customers will be evaluated on a case by case basis to determine if any individual new contracts will require a different accounting treatment.*

## Detailed Analysis – Step 5

-OR-

*All of the contracts reviewed included provisions allowing the customer to cancel a purchase order for convenience, however some included provisions that require the customer to pay either a proportionate amount of the purchase price based on the amount complete or allow for the conversion process to be complete on any incomplete work in process. Therefore, each customer relationship that has different terms will be evaluated to determine the appropriate treatment and all future agreements with Customers will be evaluated on a case by case basis to determine the proper treatment.*

-OR-

*None of the contracts reviewed included provisions allowing the customer to cancel a purchase order for convenience. Therefore, if the Customer terminates an order for convenience the Customer is in Breach and under most legal jurisdictions in the United States the Company would be entitled to complete performance under the contract and would be entitled to payment for work performed and revenue will be recognized over time. Future agreements with Customers will be evaluated on a case by case basis to determine if any individual new contracts will require a different accounting treatment.*

-AND / OR –

*Some of the reviewed contracts had provisions that would allow for cost plus a margin on work in process OR the contract clearly requires the customer to supply sufficient notice of cancellation that the Company can complete the conversion process on any ordered equipment. These contracts will be recognized as revenue (and cost of sales) as the equipment is produced instead of upon shipment or delivery.*

**Equipment (produced at customer's location – if applicable):** Due to the nature of the Company's product and manufacturing process, the equipment can be created on-site at the customer location in some cases. Based on the terms of the contracts reviewed, the customer owns the work-in-process, monitors the building of the equipment, and makes design decisions throughout this process. As a result, the Company's performance creates an asset that the customer controls as it is created. Therefore, criterion (b) to recognize revenue over time is met.

**Other Services (if applicable):** For the Company's installation (or training, design, warranty) services, the customer typically receives and consumes the benefits of the services as the entity performs. For example, if the Company had completed 50% of the installation process and the contract was cancelled, a separate vendor would likely not have to start over but could use the work completed by the Company so far to complete the service. Therefore, criterion (a) to recognize revenue over time is met. *(Tailor accordingly) The customer is able to receive the benefit from the installation/training/design/warranty services as they are performed. As a result, revenue from these services is recognized over time.*

## Detailed Analysis – Step 5

### Measure of Progress if Over Time

**606-10-25-31** For each performance obligation satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity shall recognize revenue over time by measuring the progress toward complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation).

**606-10-55-16** Methods that can be used to measure an entity's progress toward complete satisfaction of a performance obligation satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29 include the following:

- a. Output methods (see paragraphs 606-10-55-17 through 55-19)
- b. Input methods (see paragraphs 606-10-55-20 through 55-21).

**606-10-55-17** Output methods recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract. Output methods include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or units delivered. When an entity evaluates whether to apply an output method to measure its progress, the entity should consider whether the output selected would faithfully depict the entity's performance toward complete satisfaction of the performance obligation. An output method would not provide a faithful depiction of the entity's performance if the output selected would fail to measure some of the goods or services for which control has transferred to the customer. For example, output methods based on units produced or units delivered would not faithfully depict an entity's performance in satisfying a performance obligation if, at the end of the reporting period, the entity's performance has produced work in process or finished goods controlled by the customer that are not included in the measurement of the output.

**606-10-55-20** Input methods recognize revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labor hours expended, costs incurred, time elapsed, or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognize revenue on a straight-line basis.

## Detailed Analysis – Step 5

**606-10-55-21** A shortcoming of input methods is that there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a customer. Therefore, an entity should exclude from an input method the effects of any inputs that, in accordance with the objective of measuring progress in paragraph 606-10-25-31, do not depict the entity's performance in transferring control of goods or services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances:

- a. When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation. For example, an entity would not recognize revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract (for example, the costs of unexpected amounts of wasted materials, labor, or other resources that were incurred to satisfy the performance obligation).
- b. When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity's performance may be to adjust the input method to recognize revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity's performance might be to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:
  1. The good is not distinct.
  2. The customer is expected to obtain control of the good significantly before receiving services related to the good.
  3. The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.
  4. The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal in accordance with paragraphs 606-10-55-36 through 55-40).

*Edit as Appropriate: **Equipment:** For the equipment performance obligation, a significant amount of the cost is in raw materials. Acquisition of the raw materials isn't an accurate measure of the Company's progress. Therefore, another input measure will be used. For the Company, labor hours best reflects the progress. Revenue will be recognized in proportion to the number of labor hours expected to date to the estimate of total labor hours expected for the build.*

-OR-

*Raw materials are typically added to the equipment relatively consistently over the production period. Therefore, the Company has determined that total costs incurred best reflects the Company's progress. Revenue will be recognized based on total costs incurred in proportion to the total costs expected for the total build. If raw materials are procured and accumulated at the beginning of the project, these amounts are recorded as contract fulfillment costs and not used to record revenue when procured since the accumulation of the materials is not indicative of progress toward satisfying the performance obligation. The contract fulfillment cost asset should be amortized on a systematic basis in proportion to the construction costs incurred.*

-OR-

*Raw materials are typically added to the equipment relatively consistently over the production period, except for one significant material required to be procured upfront (for example, a block of steel that makes up a significant portion of the cost of the project and is required to be procured before most of the work is performed). The Company has determined that total costs incurred best reflects the*

## Detailed Analysis – Step 5

*Company's progress, except for the procurement of the significant material at the beginning of the project. Revenue will be recognized based on total costs incurred in proportion to the total costs expected for the total build, except for the cost of the material at the beginning of the project. For the significant material procured and accumulated at the beginning of the project, revenue will only be recognized to the extent of cost with no margin as reflected in the implementation guidance, Example 19 at ASC 606-10-55-187 through 192. See below for example guidance followed.*

## Detailed Analysis – Step 5

**606-10-55-187** In November 20X2, an entity contracts with a customer to refurbish a 3-story building and install new elevators for total consideration of \$5 million. The promised refurbishment service, including the installation of elevators, is a single performance obligation satisfied over time. Total expected costs are \$4 million, including \$1.5 million for the elevators. The entity determines that it acts as a principal in accordance with paragraphs 606-10-55-36 through 55-40 because it obtains control of the elevators before they are transferred to the customer.

**606-10-55-188** A summary of the transaction price and expected costs is as follows:

Transaction price	5,000,000
Expected costs:	
Elevators	1,500,000
Other costs	<u>2,500,000</u>
Total expected costs	4,000,000

**606-10-55-189** The entity uses an input method based on costs incurred to measure its progress toward complete satisfaction of the performance obligation. The entity assesses whether the costs incurred to procure the elevators are proportionate to the entity's progress in satisfying the performance obligation in accordance with paragraph 606-10-55-21. The customer obtains control of the elevators when they are delivered to the site in December 20X2, although the elevators will not be installed until June 20X3. The costs to procure the elevators (\$1.5 million) are significant relative to the total expected costs to completely satisfy the performance obligation (\$4 million). The entity is not involved in designing or manufacturing the elevators.

**606-10-55-190** The entity concludes that including the costs to procure the elevators in the measure of progress would overstate the extent of the entity's performance. Consequently, in accordance with paragraph 606-10-55-21, the entity adjusts its measure of progress to exclude the costs to procure the elevators from the measure of costs incurred and from the transaction price. The entity recognizes revenue for the transfer of the elevators in an amount equal to the costs to procure the elevators (that is, at a zero margin).

**606-10-55-191** As of December 31, 20X2, the entity observes that:

- Other costs incurred (excluding elevators) are \$500,000.
- Performance is 20% complete (that is,  $\$500,000 \div \$2,500,000$ ).

**606-10-55-192** Consequently, at December 31, 20X2, the entity recognizes the following:

Revenue	2,200,000 <sup>(a)</sup>
Costs of goods sold	<u>2,000,000</u> <sup>(b)</sup>
Profit	200,000

<sup>(a)</sup>Revenue recognized is calculated as  $(20\% \times \$3,500,000) + \$1,500,000$ . (\$3,500,000 is \$5,000,000 transaction price - \$1,500,000 costs of elevators.)

<sup>(b)</sup>Cost of goods sold is \$500,000 of costs incurred + \$1,500,000 costs of elevators.

## Detailed Analysis – Step 5

*Edit as Appropriate: **Installation:** The input measure of costs -OR- labor hours -OR- labor costs incurred best reflects that transfer. For installation performance obligations recognized over time, the Company recognizes a contract asset in lieu of inventory given that the Company does not control any work in process or finished goods. Raw materials, unless the material was acquired specifically for the customer's installation and the customer is obligated to acquire the raw materials in the event that the arrangement is terminated, is still recorded as inventory because control of the raw materials has not transferred until installation is complete.*

*Edit as Appropriate: **Warranty:** The Company's warranty obligations that are distinct performance obligations are typically for a specified period of time, provide an unlimited amount of service, and customers typically utilize the services throughout the term of the contract. As a result, a time-based measure of progress best reflects the Company's performance in satisfying warranty obligations and warranty revenue is recognized on a straight-line basis over the service period.*

*Edit as Appropriate: **Warranty:** The Company's service-type warranty obligations that are distinct performance obligations are typically for 3 years. The Company has agreed to "stand ready" to provide the service when and as the customer requests for a fixed fee. Based on historic experience, the Company performs little to no maintenance in the first year of the warranty, 25% in the 2<sup>nd</sup> year and 75% in the third year. Management has concluded that the timing of when it performs the service is the best indication and will recognize revenue accordingly. Management will review and update the estimates of when the services are performed annually.*



## Detailed Analysis – Step 5

### Timing of Recognition if Point in Time

**606-10-25-30** *If a performance obligation is not satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the guidance on control in paragraphs 606-10-25-23 through 25-26. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:*

- a. *The entity has a present right to payment for the asset—If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.*
- b. *The customer has legal title to the asset—Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer’s failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.*
- c. *The entity has transferred physical possession of the asset—The customer’s physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs 606-10-55-66 through 55-78, 606-10-55-79 through 55-80, and 606-10-55-81 through 55-84 provide guidance on accounting for repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.*
- d. *The customer has the significant risks and rewards of ownership of the asset—The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.*
- e. *The customer has accepted the asset—The customer’s acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs 606-10-55-85 through 55-88.*

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**606-10-55-85** In accordance with paragraph 606-10-25-30(e), a customer's acceptance of an asset may indicate that the customer has obtained control of the asset. Customer acceptance clauses allow a customer to cancel a contract or require an entity to take remedial action if a good or service does not meet agreed-upon specifications. An entity should consider such clauses when evaluating when a customer obtains control of a good or service.

**606-10-55-86** If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. For example, if the customer acceptance clause is based on meeting specified size and weight characteristics, an entity would be able to determine whether those criteria have been met before receiving confirmation of the customer's acceptance. The entity's experience with contracts for similar goods or services may provide evidence that a good or service provided to the customer is in accordance with the agreed-upon specifications in the contract. If revenue is recognized before customer acceptance, the entity still must consider whether there are any remaining performance obligations (for example, installation of equipment) and evaluate whether to account for them separately.

**606-10-55-87** However, if an entity cannot objectively determine that the good or service provided to the customer is in accordance with the agreed-upon specifications in the contract, then the entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance. That is because, in that circumstance the entity cannot determine that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service.

**606-10-55-88** If an entity delivers products to a customer for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses, control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses.

*Edit as appropriate: **Equipment:** Once the equipment is produced, the Company has a present right to payment, and the customer has legal title to it along with the significant risks and rewards of ownership. The contract specifies that control transfers when the customer accepts the equipment, which may or may not be when the customer receives the equipment (see discussion below on Bill and Hold). Customer acceptance is performed by an inspector designated by the customer and documented by a signature from the inspector (tailor as necessary – other examples: customer acceptance is not received until the customer has run parts on the machine at their location and submitted an approval form to the Company to document acceptance, etc.). Based on the weight of the indicators, for revenue on equipment performance obligations recognized at a point in time, the revenue should be recognized when the equipment is produced and acceptance is received from the customer.*

*-OR-*

*Once the equipment is produced, the Company has a present right to payment, and the customer has legal title to it along with the significant risks and rewards of ownership because the contract terms state that the customer is responsible for picking up the equipment at the Company site. Although the contract states that the customer must accept the completed equipment, customer acceptance is based on the equipment meeting the Company's standard specifications only. Because there is relatively little modification to the equipment design on a customer by customer basis, the standards are objective and customer acceptance is a formality only. The Company does not have a history of customers rejecting the equipment after the Company has determined it to be*

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*complete due to the standard nature of the design. Based on the weight of the indicators, for revenue on equipment performance obligations recognized at a point in time, the revenue should be recognized when the equipment production is complete. See bill and hold discussion below for additional considerations.*

*-OR-*

*Generally, for equipment shipped and recognized at a point in time, the point in time that control transfers will coincide with the shipping terms. For shipping terms that are FOB destination, the right to payment, title, and risk of loss transfers upon receipt by the customer, which is the point in time that the customer obtains control and revenue is recognized. For FOB shipping point, the right to payment, title, and risk of loss transfers upon shipment and revenue will be recognized. In instances where shipping is not provided by the Company (the customer picks up the equipment or handles shipping through its own common carrier), title transfers once the equipment is physically loaded to the carrier.*

*-OR-*

***Equipment and installation as single performance obligation:*** *Due to installation being required in order for the Company to fulfill its promise to the customer, control is not transferred to the customer until installation is complete. Once the equipment is installed and the customer has accepted the installed equipment, the Company has a present right to payment for the installation, and the customer has legal title to it along with the significant risks and rewards of ownership. Customer acceptance is documented by a signature from the inspector (tailor as necessary). Based on the weight of the indicators, for revenue on equipment with installation as a single performance obligation recognized at a point in time, the revenue should be recognized when the installation is complete and the customer has accepted the installed equipment.*

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### Bill and Hold:

**606-10-55-81** A bill-and-hold arrangement is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future. For example, a customer may request an entity to enter into such a contract because of the customer's lack of available space for the product or because of delays in the customer's production schedules.

**606-10-55-82** An entity should determine when it has satisfied its performance obligation to transfer a product by evaluating when a customer obtains control of that product (see paragraph 606-10-25-30). For some contracts, control is transferred either when the product is delivered to the customer's site or when the product is shipped, depending on the terms of the contract (including delivery and shipping terms). However, for some contracts, a customer may obtain control of a product even though that product remains in an entity's physical possession. In that case, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product. Consequently, the entity does not control the product. Instead, the entity provides custodial services to the customer over the customer's asset.

**606-10-55-83** In addition to applying the guidance in paragraph 606-10-25-30, for a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:

- a. The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement).
- b. The product must be identified separately as belonging to the customer.
- c. The product currently must be ready for physical transfer to the customer.
- d. The entity cannot have the ability to use the product or to direct it to another customer

**606-10-55-84** If an entity recognizes revenue for the sale of a product on a bill-and-hold basis, the entity should consider whether it has remaining performance obligations (for example, for custodial services) in accordance with paragraphs 606-10-25-14 through 25-22 to which the entity should allocate a portion of the transaction price in accordance with paragraphs 606-10-32-28 through 32-41.

Bill and hold arrangements primarily come into play when it is concluded that control transfers at a point in time. In these arrangements, the customer has requested the Company to bill them for a good but not take delivery until a later date. In order to conclude that control of the good has transferred, the criteria in 606-10-55-83 must all be met.

*Edit as appropriate: **Conclusion:** None of the contracts that were reviewed contained bill and hold provisions. Further, the Company does not have any arrangements outside of the documents reviewed that would result in a bill and hold transaction.*

– OR –

***Conclusion:** The Company has bill and hold arrangements. Each will be analyzed individually to determine if the criteria is met.*