# 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 – manufacture and sale of homogenous goods. Homogeneous goods are standardized products that have the same composition throughout any given sample (e.g., chemicals, food/beverage products, etc).

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.*

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# Project Overview and Summary of Conclusions

### 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:

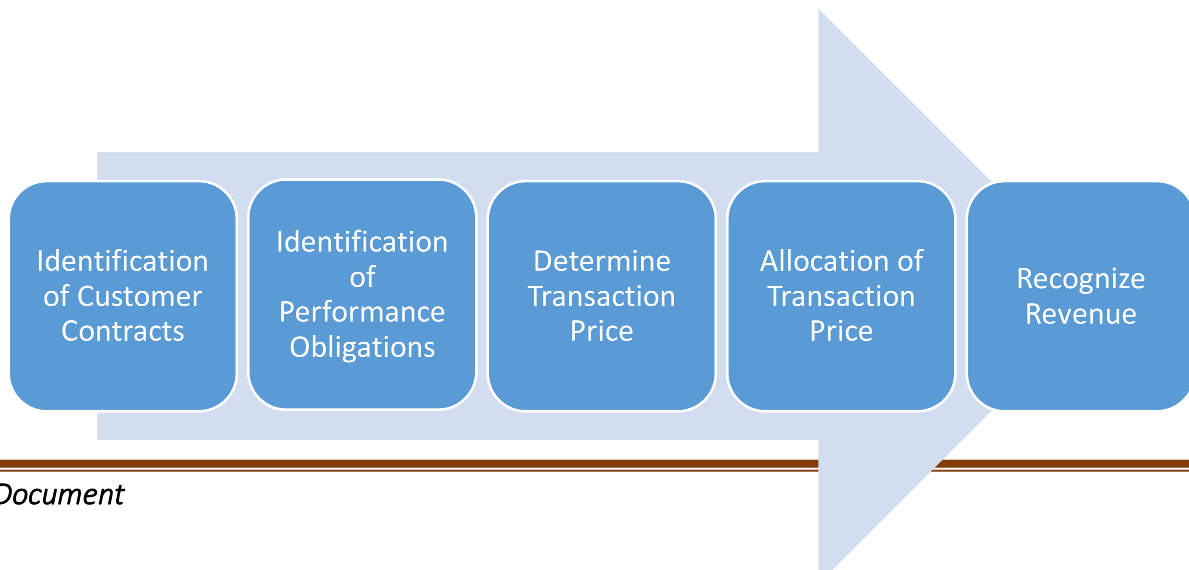
- Lease contracts within the scope of Topic 840, Leases.
- Insurance contracts within the scope of Topic 944, Financial Services-Insurance.
- Various other financial instruments that are included in the scope of topics: 310, 320, 323, 325, 405, 470, 815, 825, and 860.
- Guarantees (other than product 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.



### 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 manufacturer of homogeneous [food, beverage, goods, etc.] products. Customers include [retailers, distributors, brokers, direct to consumers via websites or retail stores, etc]. The majority of revenue is earned by supplying goods that have been [sold point of sale, shipped upon receipt of a purchase order (depending on the contract), etc]. The Company's contracts consist of [global terms and conditions supplied by the customer that outline the key provisions that will impact revenue, the Company's general terms and conditions, a point of sale receipt, the Uniform Commercial Code, etc.].*

*Breakdown of revenue:*

| **Revenue by Stream** | 2017 | | 2016 | |
|---|---|---|---|---|
| Stream 1 (Product Line A) | 60,000,000 | 92% | 55,000,000 | 84% |
| Stream 2 (Product Line B) | 5,000,000 | 8% | 10,000,000 | 15% |
| Stream 3 (Product Line C) | 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, the documents that comprise the terms, rights and obligations between the Company and the customer may vary, but typically consist of one or more of the following:

1. Customer Terms & Conditions – Standard terms and conditions that apply to all contracts executed by the customer, e.g., shipping and payment terms. Larger, more sophisticated customers are more likely to have their own terms and conditions.
2. Purchase Order – Either embodies an order of goods that the Company is committed to supply and the customer is committed to pay for or is used to establish pricing on subsequent goods.
3. Receipts – In cases where homogeneous goods are sold directly to the consumer (point of sale).

Supply Agreements that provide the general terms related to the specific arrangement with the customer may also exist, however they are not prevalent in homogenous manufacturing arrangements.

# 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:
  - Minimum order quantity provisions
  - Documents needed to form a contract
- Step 2 – Identify performance obligations:
  - Warranty provisions
  - Shipping and handling
  - Services
  - Principal vs. Agent
- Step 3 – Determine the transaction price
  - Consideration paid to customers (slotting fees, marketing co-op agreements, etc.)
  - Discounts, rebates, and other customer incentives
  - Customary business practice considerations
- Step 5 – Recognize revenue as or when performance obligation is satisfied
  - Termination provisions and penalties
  - Consignment considerations
  - Bill and hold arrangements
  - When control transfers (if point in time – most common for homogeneous manufacturers)

Other terms may be present in some contracts 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 contracts, 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 sales when determining its approach to customer contracts that do not comprise the top XX% of sales. 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. Accordingly, the Company would expect that language in all customer contracts to be similar, regardless of the size of the customer.*

*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 sales. 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.

**Overview of Results**

The documents that form a contract in a homogeneous manufacturing arrangement can vary depending on the type of product and customer. In cases where homogeneous goods are sold directly to the consumer (point of sale – e.g., online commerce or retail stores), a receipt may comprise the terms, rights and obligations between the Company and the customer. In business to business arrangements, Terms and Conditions, Supply Agreement, and/or Purchase Order may comprise the contract. Unless there are minimum quantities specified in a supply agreement that contractually obligate the customer to purchase a certain quantity of goods, each purchase order (or other document obligates the customer to purchase the produced goods) is a separate contract for accounting purposes and the price in the agreement reflects the stand alone selling price (therefore no allocation is necessary).

*Edit as necessary: **Performance Obligations**: In most cases, the only performance obligations are to produce supply parts. 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: **Principal vs. Agent –** none of the arrangements included provisions that would indicate that the Company was not the principal in the transaction.*

*Edit as necessary:*

***Point in time vs. Overtime – product:** All product sales are for homogenous products that the Company has an alternative use for, specifically they could be diverted to another customer. Therefore, all product revenue is recognized at a point in time. The appropriate point in time is based on the shipping terms (FOB dock or destination).*

***Point in time vs. Overtime - services:** The services provided are such that the Customer receives the benefit as the service is provided. As such, it will be recognized ratably over the service period.*

**Transition & Disclosure**

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

# 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.

For each separate arrangement with the customer, there may be one to four documents that may individually or collectively 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.
2. Supply Agreement – Could be comprised of several different forms of documents. Provides the general terms related to the specific arrangement with the customer.
3. Purchase Order – Either embodies an order of goods that the Company is committed to supply and the customer is committed to pay for or is used to establish pricing on subsequent goods.
4. Receipt - In cases where homogeneous goods are sold directly to the consumer (point of sale – via website or retail).

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.

**Homogeneous Goods**

Although not prevalent in homogenous manufacturing arrangements, a Supply Agreement is occasionally executed by the parties and is governed by the Customer Terms & Conditions (T&C) unless explicitly excluded. The combination of these two documents produces an agreement that:

(a) identifies each party's rights,
(b) provides payment terms,
(c) has commercial substance, and
(d) is probable of collection.

However, the combination of these documents does not include commitments by both parties related to any obligation in the Supply Agreement. Each party has the unilateral enforceable right to terminate the agreement with respect to wholly unperformed obligations without compensating the other parties (unless the documents specify a minimum quantity of parts to be supplied). When the Supply Agreement is executed, the Company has not yet transferred any promised goods or services to the customer nor has an explicit promise been made to transfer any goods or services to the customer, and the Company is not yet entitled to receive consideration in exchange for anything. If the supply agreement includes provisions that require the Customer to purchase a minimum number of goods or pay a substantive penalty then the combination of the Supply Agreement and the T&C creates a contract as enforceable rights and obligations have been established. In the event that the contract contains the legally enforceable minimum quantity provisions, a contract exists for all of the parts included in the minimum quantity. See step two for further discussion of minimum quantities.

Once the Purchase Order that specifies quantities (sometimes referred to as a production purchase order) 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 (where applicable) the Supply Agreement, 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, where applicable, the combination of the Supply Agreement, Customer Terms & Conditions, and Purchase Order produces a contract for all obligations in the Supply Agreement ("Supply Contract"). As such, the first Purchase Order completes the Supply Contract, and each additional Purchase Order creates a separate Supply Contract with the existing Supply Agreement and Customer Terms & Conditions. An exception to this rule exists when the Purchase Order states that specific or unspecific documents have no influence outside the Purchase Order. In that case, it may not be appropriate to consider either or both of the Supply Agreement and 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 either the Supply Agreement or Customer Terms & Conditions, comprise the Supply 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.*

# Detailed Analysis – Step 1

***Edit as appropriate:*** The Company sells equipment and consumable supplies for the equipment. In some instances, the equipment will be sold at a loss in order to secure future orders of the consumable supplies. If, at or near the time that the equipment is sold, the customer enters into an agreement with the Company to purchase a minimum number of the consumable supplies, the contract for the supplies and the equipment should be combined. This meets the criteria in 606-10-25-9 because the supply of the consumables was part of a package with a single commercial objective. However, if a substantive minimum quantity for the consumable supplies is not agreed to, no contract exists for the supplies until a purchase order is received. In those cases, because the purchase order for the supplies is not entered into at or near the same time as the contract for the equipment, combination is precluded.

Other than the above situation, 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.

***Edit as appropriate:*** *Conclusion: The Company considered whether the documents representing each arrangement with the same customer should be combined and analyzed as one contract. Each arrangement is not negotiated as a package with other arrangements. Due to differences in customer needs as previously described, they are negotiated separately.*

*-OR-*

*The Company enters into equipment and consumable supply contracts with substantive minimum quantities that should be combined into a single contract.*

## 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:*

*a. 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).*

*b. 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:*

*a. 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:*

   *1. 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*

   *2. The consideration promised as part of the contract modification.*

*b. 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).*

*c. 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:*

*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).*

As documented above, contracts in homogenous manufacturing arrangements are most commonly comprised of Purchase Orders or Receipts (in cases where sales are executed via website or retail). The customer can benefit from the goods in each Purchase Order or Receipt with other resources that are readily available (e.g., for a manufacturer of homogeneous food products, each food product can be used by the customer separately). Each Purchase Order or Receipt is a separate contract.

In cases where Supply Agreements exist, because each Purchase Order comprises a Supply Contract, and new Purchase Orders are issued sequentially, the Company should consider whether each subsequent Supply Contract should be accounted for as a separate contract or a modification of the existing one. As documented above, because each Purchase Order is a separate contract, the promise to transfer the goods in one Supply Contract is separately identifiable from the promise to transfer the goods in another Supply Contract. Therefore, each Supply Contract adds at least one distinct performance obligation. In addition, the price charged for goods in a Purchase Order is equal to the standalone selling price of those goods. As such, each new Supply Contract is priced to reflect the standalone selling price of the performance obligation(s) in that contract. Where applicable. each Supply Contract is therefore a modification that should be accounted for as a separate contract once it exists.

## 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.*

# Detailed Analysis – Step 2

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. Goods as ordered
2. Ship and handle ordered goods
3. Warranty
4. Other services
5. Intellectual property

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.

**<u>Goods as Ordered</u>**

Goods are a performance obligation, but what and when the obligation is created depends upon the provisions of the contract.

In many circumstances, a Supply Agreement that outlines the goods that are covered by the agreement and establishes pricing for the goods for the duration of the agreement (either a fixed price or how the price will be determined for each good) will not exist, especially in cases where orders are submitted via website or purchase order. However, when applicable, the Supply Agreement in many cases will indicate that a Purchase Order (or some other triggering document) will be issued by the customer before there is an obligation by the Company to provide goods AND the Company has a right to payment for those goods. In these cases, the Supply Agreement for the goods does not create a performance obligation because enforceable rights and obligations do not exist. This is seen as a customer option as discussed in ASC 606-10-55-42:

> ***606-10-55-42*** *If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.*
>
> ***606-10-55-43*** *If a customer has the option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract. In those cases, the entity has made a marketing offer that it should account for in accordance with the guidance in this Topic only when the customer exercises the option to purchase the additional goods or services.*

In situations where the Supply Agreement includes price downs in future years this is **typically** not considered a material right because the future price reductions are not dependent upon ordering goods today. Rather, it is only subject to the passage of time. Further, the purpose of the future price reductions is not intended to incentivize future sales but to reflect gained efficiencies. However, it should be noted that if future established price reductions exist that are above the range that is typically offered this would be a material right and a portion of the purchase price should be allocated to the obligation to stand ready to provide those future parts at the reduced rate.

However, in situations where the price declines after a certain volume is reached, this typically is a material right because the only way for the customer to obtain the lower price in the future is to purchase the higher priced goods today.

***Edit as appropriate:***

*Conclusion: It was noted that several of the agreements had provisions that result in a material right. A portion of the price of the product sold before the price is reduced should be deferred and recognized either upon the expiration of the option to acquire the lower cost goods (typically upon the new year) or when the option to purchase the lower priced goods is exercised. – OR – none of the contracts reviewed included material rights.*

***Minimum Purchase Agreements***

As discussed in Step 1, some Supply Agreements may have either explicit or implicit minimum quantity provisions. Explicit quantity provisions are straightforward and are rare. However, when these provisions are present there is a performance obligation for the number of units covered by the minimum quantity. Some contracts include implied minimum quantities. These implied minimums can take many forms, including capital recovery charges. For example:

> *"In the event that Buyer has not taken delivery of a sufficient quantity of goods to enable Seller to recover its upfront capital expenditures, Buyer shall also pay to Seller the amount of such unrecovered expenditures."*

When these provisions exist, it must be carefully evaluated to determine if this is a substantive cancellation penalty. If it is determined that the provision entitles the Company to compensation in the event that the customer cancels, the minimum order quantity evidences enforceable rights and obligations and a performance obligation exists when the Supply Agreement is signed before any Purchase Orders are received. When minimum quantity provisions exist, it will be necessary to estimate the quantity of goods necessary to fulfill the minimum if the number is not explicitly stated.

When it is determined that minimum quantities exist, the performance obligations are all of the goods needed to satisfy the minimum quantity. If no minimum quantity exists, the performance obligations are limited to the number of goods in each individual Purchase Order.

***Include if appropriate:***

*In the Supply Agreements reviewed, it was noted that minimum quantities were rare. The most common provision would indicate forecasted purchases for a given period (weekly, monthly, or annually) and a range for which pricing was fixed. If pricing exceeds the upper limit (Maximum Capacity Rate or "MCR"), then a surcharge was added to cover overtime and other premium costs incurred by the supplier. Most Supply Agreements are silent as to the impact of actual purchase volumes being less than the lower limit (Lean Capacity Rate or "LCR"). Historic practice and from a legal perspective would support that the effect of actual purchases being less than the LCR would only provide the Supplier the right to negotiate commercially with the buyer on the price. This is not an enforceable right to further consideration nor does it bind the customer to pay the Supplier a fee for not ordering a sufficient number of goods.*

*The nature of the payment was also considered. In the event that the lower level of the range was not met and negotiation commenced, the outcome is generally one of two outcomes. (1) The customer would provide a capital recovery payment. This payment is to reimburse the customer for unrecovered capital expenditures. It is not a payment for goods, but rather a reimbursement of pre-production or other costs to fulfill. (2) The customer will award future work to the Company at prices that essentially makes the Company whole for the unrecovered capital. Because the contracts to supply the future goods will be separate contracts for distinct goods, and the contracts are not entered into at or near the same time as the existing contracts, it would not be appropriate to combine the contracts in order to allocate a portion of the future revenue to the current performance obligations.*

***Edit as appropriate:***

*Conclusion: Although no actual minimum quantities were identified in the contracts reviewed, the ongoing contract review and control process will look for provisions that create minimum quantities.*

**Ship and Handle Ordered Goods**

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.*

Note that the election in 606-10-25-18B to always treat shipping and handling as a cost of fulfillment is only available under US GAAP.

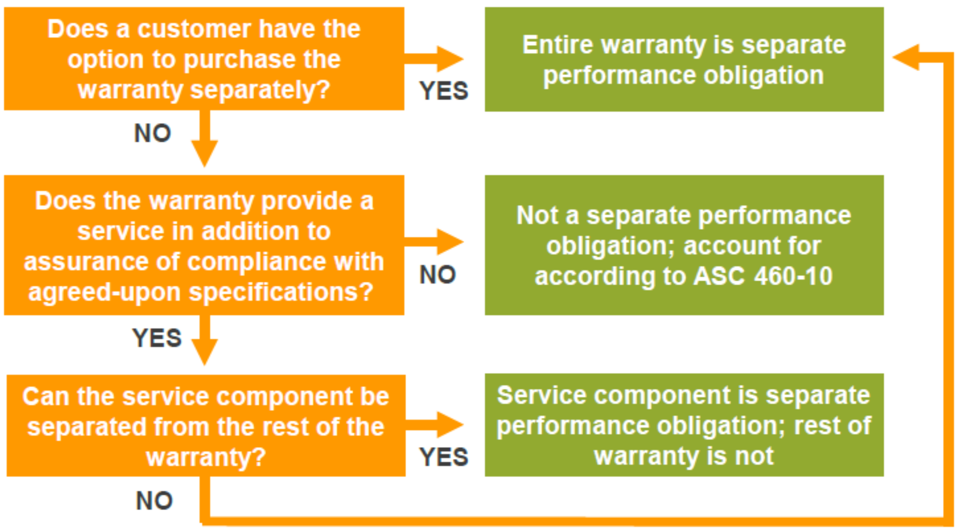
*Edit as appropriate: The Company has concluded to adopt the policy election and, consequently, all shipping and handling costs will be considered a cost to fulfill the contract.*

# Detailed Analysis – Step 2

**Warranty**

***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.

*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 product complies with agreed-upon specifications, the warranty provided by the Company should not be accounted for as a separate performance obligation.*

*Edit as appropriate – Because the Company separately sells extended product warranties that provide the customer with a service or extended coverage in addition to or beyond the assurance that the product complies with agreed-upon specifications, the extended warranty provided by the Company should be accounted for as a separate performance obligation.*

**Other Services**

Document consideration of other services and consider their significance relative to the other performance obligations identified to determine if they are material to the contract.

**Intellectual Property (IP)**

Some homogeneous 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 goods or (2) the agreement indicates that any IP owned, licensed and/or developed by the Company connected to the goods 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 goods. 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.

# Detailed Analysis – Step 2

Rather, in the event that IP is needed for the products to function as intended, the IP would be considered highly integrated and therefore not distinct from the promise to produce and supply parts. 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.

## 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*

***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 good 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.*

## 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 supply agreements. 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 good, subject to:
    a. Volume discounts
    b. Rebates
2. Consideration paid to the customer
3. Customary business practices
4. *Others as identified*

**Goods**
Because each Purchase Order creates a new Supply Contract that is a modification accounted for as a separate contract, the transaction price for that Supply Contract is determined by multiplying the price per unit stated in the Purchase Order by the quantity ordered unless there are minimum quantities or other variable pricing considerations.

If the agreement includes minimum quantities that the customer must purchase (see step 2 for further discussion) (thereby creating a Supply Contract to produce all of the minimum quantities), the timing of the sale of the goods that will fulfill the Supply Contract needs to be estimated in order to determine the total transaction price.

*Edit as appropriate: **Conclusion**: None of the contracts reviewed included minimum quantity requirements, either explicit or implicit. Therefore, subject to any retrospective price adjustments, the price identified in the Purchase Order associated with each Release is the transaction price.*

**Volume Discounts**
Prospective: Any volume discounts that are applied to future orders will be reflected in the relevant Purchase Orders once the required volume is reached. Unless the future discount is determined to be a material right (see discussion in Step 2 in the section on “Supply Goods as Ordered”), the transaction price for each Supply Contract will include any applicable volume discounts. No estimation will be

necessary, as the criteria in Step 1 will be met at the same time as the transaction price for that Supply Contract becomes fixed, inclusive of volume discounts.

Retrospective: Contracts that allow for a retroactive price adjustment after volume thresholds are reached are considered variable pricing. The effect of the rebate will need to be estimated and the amount of revenue to be recognized adjusted to include the effect of the rebate. These can be stated in the supply agreement or expected based on past experience with a given customer.

*Edit as appropriate:* ***Conclusion:*** *Only retrospective adjustments are variable pricing. None of the contracts that were reviewed included any volume discounts. Certain customer relationships, either contractually or by practice, require an annual rebate based on volume purchased (for example, a rebate of 2% of total sales). This is variable consideration and will be accrued on a contract by contract basis based on the best estimate of the amount that will be rebated as the sales are made. The Company offers a general discount program covering all customers (either contractually or by practice) whereby a rebate of 1% of total purchases if offered for having reached a specified volume target. This is variable consideration and will be accrued on a contract by contract basis based on the best estimate of the amount that will be rebated as the sales are made.*

**<u>Consideration Paid to Customers</u>**

***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.*

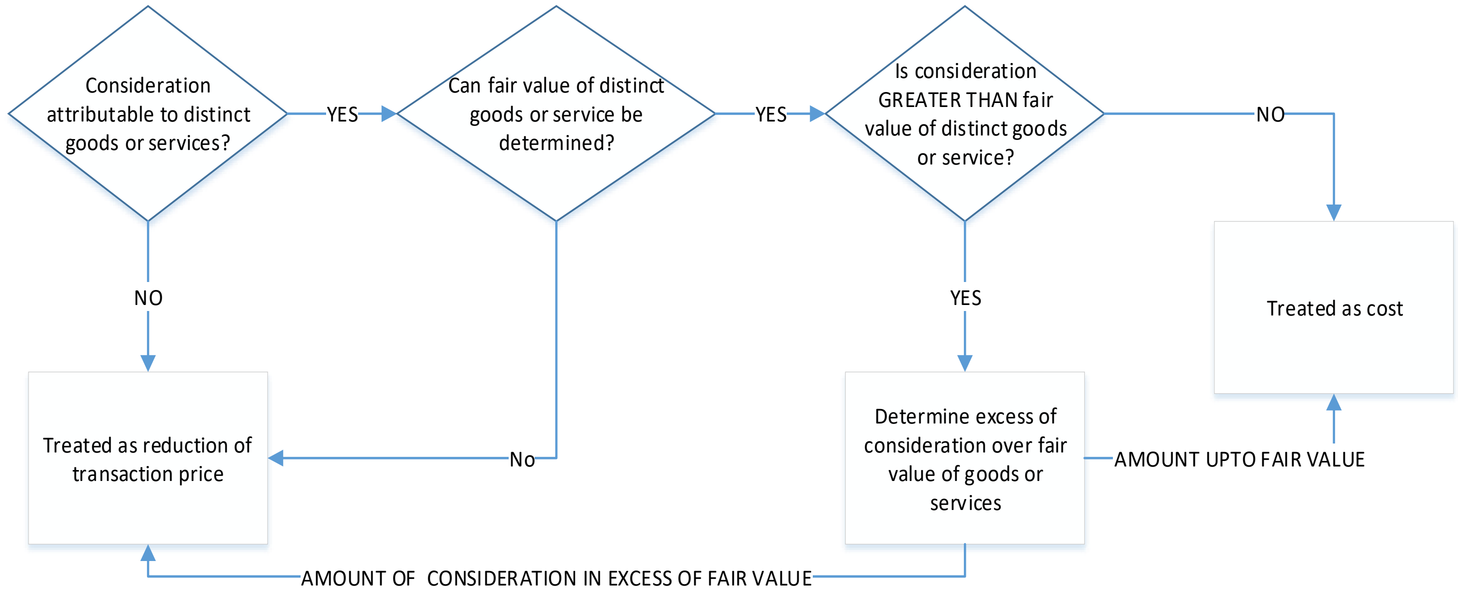
***606-10-32-26*** *If consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to 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:




Consideration paid to customers in homogenous manufacturing arrangements is most commonly in the form of:

1. Listing/slotting fees – For example, amounts paid to a customer for shelf space or for adding new items to their price lists.
2. Marketing co-op or promotional arrangements – For example, demonstrations or samplings performed by the customer for which consideration is paid by the Company.
3. Non-divergence payments – For example, amounts paid to a customer in exchange for their promise not to sell Company products to other non-eligible vendors.

Listing/slotting fees and non-divergence arrangements are not attributable to distinct goods and services received from the customer. The result of these arrangements is the ability to secure more favorable product placement or 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.

Marketing co-op or promotional arrangements such as demonstrations or promotions performed by the customer should be classified as selling, general and administrative expense if the customer can determine the fair value of the services provided and provide that the services promised were actually performed; otherwise, they should be classified as a reduction of revenue. Product costs taken from the customer's inventory should also be classified as a selling, general and administrative expense.

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 for listing/slotting fees, certain marketing co-op arrangements, or non-divergence payments will be capitalized as an asset and recognized as a reduction of revenue as the estimated goods are produced. 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 Supply 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 to each good based on estimated production over the term of the arrangement. –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. Because the annual volume over the term of the agreement is expected to be consistent and fairly steady, the asset will be amortized on a straight-line bases over the term of the agreement. Any difference between straight-line amortization and amortization based on estimated units would not be material.*

**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.*

## 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.*

**Goods**
If a supply agreement includes a minimum order quantity as discussed in Step 2 then the minimum order is the quantity of goods promised in the initial Supply Contract. The total transaction price for the goods is equal to the estimated amount that is expected to be invoiced and collected for the minimum quantity. The total estimated transaction price will then be allocated to each unit based on the relative stand- alone selling price. This will result in the revenue for each unit being the same, regardless of the stated price. The total transaction price will need to be re-evaluated periodically and the revenue per unit updated to reflect changes in estimates.

If the supply agreement does not include a minimum order quantity, either implicitly or explicitly, then each purchase order is a separate contract for accounting purposes. As such, the total transaction price is the sum of the extended amount for each separate good on the purchase order Goods sold by the Company are not unique to each customer. Specific to goods, generally the time to fulfill a contract is very short (less than a day) and any allocation between goods would not be meaningful. In the event that there are services, consideration must be given to if the services are being billed at their relative stand alone price.

*Edit as appropriate: **Conclusion**: In most cases, as there is typically not an enforceable minimum quantity of goods to be supplied, each purchase order embodies a stand alone contract and, as previously discussed, would not be combined with other contracts. Therefore, allocation of the transaction price is typically not significant.*

## Volume 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 volume discount. If the agreement does not have minimum purchase obligations then the contracts that the discount is related to are limited to the purchase orders for the goods. In this case, the discount would be applied only to the related purchase orders. If there are minimum quantities or other performance obligations that would be combined together, the discount would be allocated to each performance obligation. However, this situation is rare and the criteria in 606-10-32-37 would likely qualify and result in the discount being applied only to the goods.

*Edit as appropriate: **Conclusion:** While each Supply Contract (each purchase order) may have multiple performance obligations (more than one good), the timing of satisfaction of the performance obligation is very short and typically completed at the same time and on the same pattern of recognition for all goods on the purchase order. Therefore, allocation of the discount to individual performance obligations is not necessary or practical.*

**Material Rights**

> ***606-10-55-42*** *If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires*
>
> ***606-10-55-43*** *If a customer has the option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract. In those cases, the entity has made a marketing offer that it should account for in accordance with the guidance in this Topic only when the customer exercises the option to purchase the additional goods or services*

Customer options that provide a material right to the customer (such as a free or discounted good or service) give rise to a separate performance obligation. In this case, the performance obligation is the option itself, rather than the underlying goods or services. The Company will allocate a portion of the transaction price to such options, and recognize revenue allocated to the option when the additional goods or services are transferred to the customer, or when the option expires.

When material rights exist, the standalone selling price of the option must be determined in order to allocate a portion of the transaction price to it. The observable standalone selling price of the option should be used, if available. If it is not directly observable, it should be estimated using the guidance at ASC 606-10-55-44. The standalone selling price of the customer options should only reflect the options that are expected to be redeemed.

***Edit as appropriate:***

*Conclusion: It was noted that several of the agreements had provisions that result in a material right. A portion of the price of the product sold before the price is reduced should be deferred and recognized either upon the expiration of the option to acquire the lower cost goods or when the option to purchase the lower priced goods is exercised. The standalone selling price of the option [is directly observable] OR [is not directly observable, and was estimated as follows…] – OR – none of the contracts reviewed included material rights.*

## 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 goods as required
2. *Others if identified*

**<u>Consideration of Over Time Criteria:</u>** The goods supplied are homogenous and the Company would have an alternative use for them (specifically, supplying them to another customer). Therefore, the sale of goods do not meet the criteria to be recognized over time. For services, the customer receives and consumes the benefit as the Company supplies the service.

**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.*

***Goods:*** *Generally, for goods 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 goods or handles shipping through its own common carrier), title transfers once the goods are physically loaded to the carrier.*

**Consignment Considerations:**

***606-10-55-79*** *When an entity delivers a product to another party (such as a dealer or a distributor) for sale to end customers, the entity should evaluate whether that other party has obtained control of the product at that point in time. A product that has been delivered to another party may be held in a consignment arrangement if that other party has not obtained control of the product. Accordingly, an entity should not recognize revenue upon delivery of a product to another party if the delivered product is held on consignment.*

***606-10-55-80*** *Indicators that an arrangement is a consignment arrangement include, but are not limited to, the following:*

a. *The product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period expires.*
b. *The entity is able to require the return of the product or transfer the product to a third party (such as another dealer).*
c. *The dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).*

The ASC looks at consignment arrangements as arrangements where the customer has physical possession but control has not yet transferred to the customer. This may be different than how a customer agreement terms a consignment arrangement. Careful consideration needs to be given to the indicators in 606-10-55-80 to determine if the arrangement is a consignment arrangement and therefore would result in revenue not being recognized until the product is ultimately sold to the end customer.

*Edit as appropriate:* ***Conclusion****: The Company does not have any arrangements where physical possession transfers prior to title.*

*– OR –*

*– OR –*

***Conclusion****: The Company has some arrangements with customers where the Company maintains certain inventory levels at the client location. The customer is not obligated to purchase all inventory on hand and the Company can require return of the product. Considering these factors, control has not transferred to the customer and revenue should not be recognized until sale to the end customer.*

**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.*