CBIZ & MHM
Executive Education Series™

Revenue Recognition Check-In for the Professional Services Industry

Mark Winiarski & Pieter Combrink

November 30, 2018

About Us

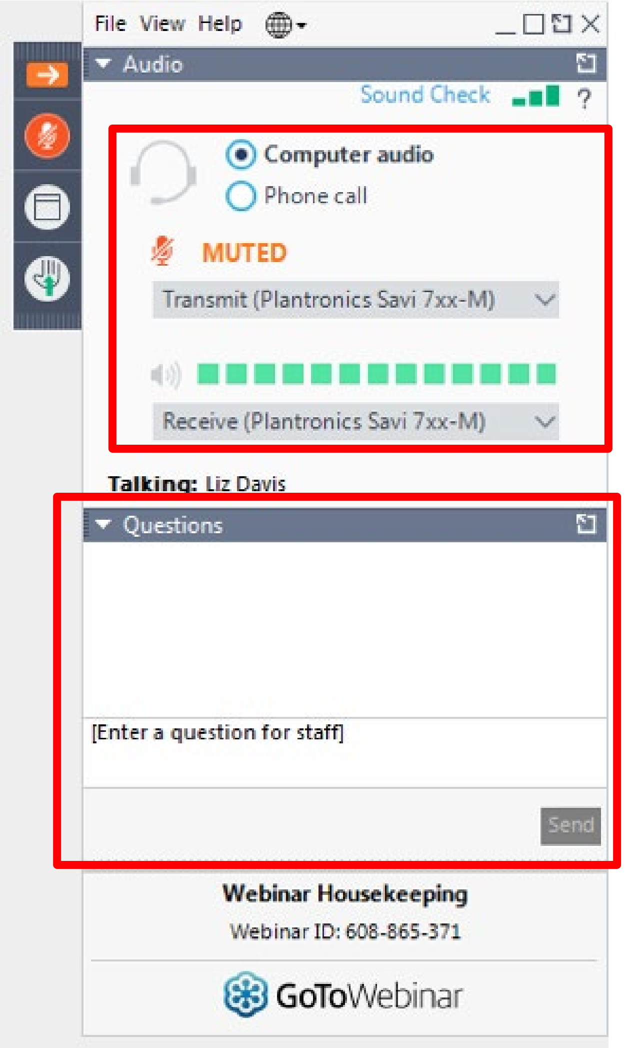
- Together, CBIZ & MHM are a Top Ten accounting provider
- Offices in most major markets
- Tax, audit and attest and advisory services
- Over 2,900 professionals nationwide

A member of Kreston International
A global network of independent accounting firms

MHM (Mayer Hoffman McCann P.C.) is an independent CPA firm that provides audit, review and attest services, and works closely with CBIZ, a business consulting, tax and financial services provider. CBIZ and MHM are members of Kreston International Limited, a global network of independent accounting firms.

Before We Get Started…

- Use the control panel on the right side of your screen to:
  - Change your audio mode
  - Submit questions
  - Download handouts
- If you need technical assistance:
  - Call support at 877-582-7011
  - Email us at cbizmhmwebinars@cbiz.com



CPE Credit

This webinar is eligible for CPE credit. To receive credit, you will need to answer polling questions throughout the webinar and be joined for the entire webinar time.

External participants will receive their CPE certificates via email within 15 business days of the webinar.

Disclaimer

The information in this Executive Education Series course is a brief summary and may not include all the details relevant to your situation.

Please contact your service provider to further discuss the impact on your business.

Presenter

MARK WINIARSKI, CPA
MHM Shareholder

Located in our Kansas City office, Mark is a member of our Professional Standards Group (PSG). Mark's role includes instructing in our national training program, presenting as a subject matter expert at webinars and conferences, and preparing MHM publications on accounting and auditing issues.

As a PSG member, Mark consults with clients and engagement teams across the country in many areas of accounting and auditing. Mark has served clients as an auditor, consultant and advisor in numerous industries including manufacturing, distribution, mining, retail sales, services and software.

816.945.5614 • mwiniarski@cbiz.com • @KCWini

Presenters

PIETER COMBRINK, CA(SA)

Senior Manager, CBIZ MHM, LLC

Pieter Combrink is a Senior Manager in the Attest Services Group of MHM. He was with the firm from 2005 through 2010, and again rejoined the firm in 2014, after gaining valuable experience as Senior Manager at a Fortune 500 company in the Computer Software industry in San Diego.

Pieter is a subject matter expert in Revenue Recognition, including revenue from software, software-as-a-service (SaaS), multiple element arrangements, gross vs. net arrangements, retail, et al. His technical expertise includes revenue recognition consulting, accounting for equity and liability financial instruments, and providing audit and review services of financial statements for multi-national publicly as well as non-publicly held companies.

Pieter's industry experience includes working with software and SaaS developers, technology and life science companies, telecommunication service providers, manufacturers and research and development companies.

858.232.8681 • pcombrink@cbiz.com

Agenda

01 Overview

02 Basic Contract Example

03 Confusing the Issue

04 Questions

OVERVIEW

General Application Criteria vs Steps

Topic 605

- Revenue is recognized when realized/realizable and earned - "four criteria" to recognize revenue
  - Persuasive evidence of an arrangement
  - Delivery and performance
  - Fixed or determinable sales price
  - Collectability is reasonably assured

VS

Topic 606

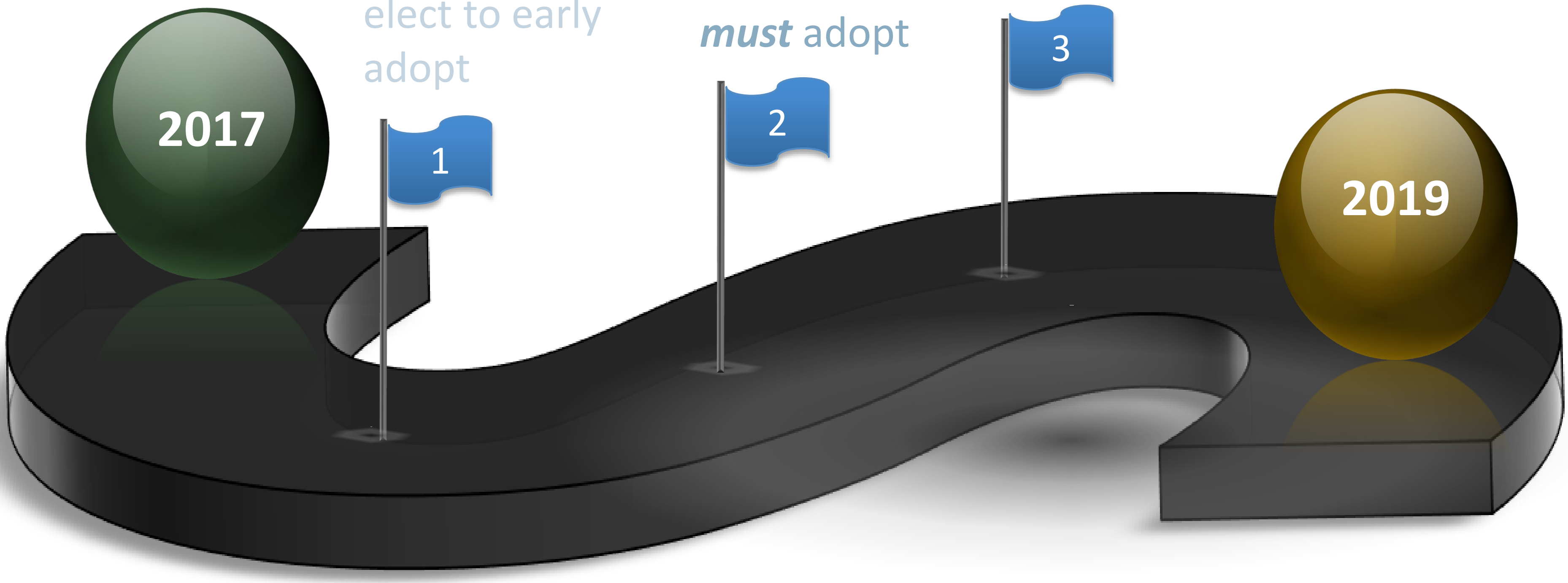
1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfied a performance obligation.

Companies with a Calendar Yearend - Timeline

January 1, 2017 – Entities ***can*** elect to early adopt

January 1, 2018 – Public Business Entities* ***must*** adopt

December 31, 2019 – ***All*** other entities must adopt



* Includes NFP that has issued, or is conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or over the counter market, and EBPs that files/furnishes financial statements with the SEC

Topic 606 - Scoping

- The following are scoped out and retain there existing industry guidance:
  - **Leases**
  - Financial Instruments
    - Topic 310, Receivables
    - Topic 320, Investments- Debt and Equity Securities
    - Topic 323, Investments- Equity Method and Joint Ventures
    - Topic 325, Investments- Other
    - Topic 405, Liabilities
    - Topic 470, Debt
    - Topic 815, Derivatives and Hedging
    - Topic 825, Financial Instruments
    - Topic 860, Transfers and Servicing
  - **Guarantees**
  - **Insurance contracts**
  - Certain nonmonetary exchanges
  - Contracts not with customers

Basic Contract Example

Fixed Fee Arrangement

- A company enters into a contract to provide consulting services
- Project is expected to take 1,000 hours and 6 months
- Fee is $120,000

Key Questions

- When does a contract with a customer exist? (Step 1)
- When should revenue be recognized? (Step 5)
- If revenue is recognized over-time, how should it be measured? (Step 5)

When does a contract with a customer exist? (Step 1)

- Contracts with customers are/have:
  - Approved and the parties are committed
  - Identifiable rights
  - Identifiable payment terms
  - Commercial substance
  - Probable of collection
- Additionally a contract does not exist if it is wholly unperformed and without termination penalties

Additional Information

- No termination penalty
- Agreement was entered into June 1, 2018
- Deposit is due June 15, 2018
- Work begins July 15, 2018

Contract inception date

When should revenue be recognized? (Step 5)

- Revenue is recognized over time if:
  - The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs,
  - The entity's performance creates or enhances an asset (WIP) that the customer controls as the asset is created or enhanced, or
  - The entity's performance does not create an asset with an alternative use to the entity **and** the entity has a right to payment for performance completed to date.

Otherwise, recognize revenue at a point in time

When should revenue be recognized? (Step 5)

Additional Information

- At the end of the services a report of results and recommendations is issued
- The services are for an IT assessment of the control environment
- If the contract is terminated the customers pays a prorated amount based on efforts expended

Likely Conclusion: Revenue is recognized over time because 1) an asset is created with no alternative use and 2) right to payment

Revenue would likely be recognized at a point in time if:

- A right to payment for performance to date did not exist, and
- The customer receives no benefit until the report is issued

If revenue is recognized over-time, how should it be measured? (Step 5)

- Output method
  - Value transferred
    - Survey
    - Appraisal
    - Milestones
    - Number of items or acts
  - **Challenges:**
    - Not capturing value of work-in process
    - Cost of measurement

- Input method
  - Cost to cost
  - Hours of worked
  - Machine Hours
- **Challenges**
  - Do not capture efforts not related to transferring services
    - Inefficiencies
    - Administrative cost
    - Waste

The amount of time elapsed could be an output or input measurement.

If revenue is recognized over-time, how should it be measured? (Step 5)

- Do you choose:
  - Output measure based on passage of time?
  - Input measure based hours performed?
  - Input measure based on cost incurred?

- Likely choose an input measure based on hours work plus a factor representing the value of those hours (rate card)

$$\text{Revenue} = \frac{(\text{Hours Incurred x Rate})}{(\text{Expected Total Hours x Rate})} \text{ x Transaction Price}$$

Confusing the Issue

Issue #1: What if the contract is rate per hours?

- How do you estimate the transaction price (Step 3)?

Likely choose not to

Invoicing practical expedient – Skip Steps 3-5

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, revenue may be recognized in the amount to which the entity has a right to invoice.

Issue #2: What if the contract is for unlimited IT support services?

The fee is $20,000 per month and the Customer can terminate at the end of each month without penalty

↓

The performance obligation is 1 month of support

↓

Account for each month as a separate contract (6 contracts)

↓

Recognize $20,000 per month

The customer pays a substantive penalty upon termination

↓

Each month of service is distinct, but one performance obligation (series)

↓

Obligation is to stand ready to perform

↓

Might recognize revenue ratably **or** based on expected performance

Issue #3: What if there is a right to renew?

Is the right to renew at a discount that is **incremental** and **not available to those who did not enter into the original contract**

Yes

A material right exists

Allocate revenue to the renewal option

No

A material right does not exist

No impact on the accounting for the revenue

Issue #5: What if the company pays a sales commission of 10%?

- Shall recognize an asset for the incremental cost of obtaining a contract with a customer if the cost is expected to be recovered
  - Only applies to costs that would not have been incurred if the contract had not been obtained

So, capitalize $12,000 and amortize it to expense as revenue is earned….

However, an entity can elect to expense directly costs that would have an amortization period of one year or less.

Issue #5: …but, the company doesn't pay sales commissions on renewals?

- Costs are amortized on a systematic basis that is consistent with the transfer to the customer of the goods and services the asset relates
  - Amortization period should consider if the costs relate to multiple contracts or anticipated contracts

Amortization period can exceed the initial contract term

Issue #5: …but, the company doesn't pay sales commissions on renewals?

- Additional information:
  - The customer can renew under the contract up to 5 times
  - Anticipate a customer to renew 3 times
    - Total of 2 years of services

- Required to capitalize the $12,000 commission
  - Amortization period would be 2 years

If the sales commission is for something other than obtaining a contract it is not capitalized (i.e. service component)

Issue #6: What if the company out sources the services to a third party?

Evaluate Principal vs Agent (Gross vs Net)

- An entity is a principal when it obtains control of a good or service prior to its transfer to the customer

- Evaluate each **performance obligation** based on indicators:
  - Responsibility for fulfillment
  - Inventory risk
  - Discretion to establish prices

Issue #6: What if the company out sources the services to a third party?

- Additional information:
  - The company gives the choice of three potential providers to the customer
  - The fees are quoted by the providers
  - The company collects the fee and remits 90% back to the provider
  - The provider is responsible for providing services acceptable to the customer

- The company is an agent matching the providers and the customer
  - Revenue would be recognized on a net basis ($12,000)
  - The performance obligation(s) may be:
    - Identifying and matching the providers and customer
    - Collection service for the provider

Issue #7: What if the company charges out-of-pocket costs?

Is the out-of-pocket cost a service provided to the customer or a cost to fulfill the contract?

Service

Assess whether the entity is a principal or an agent

Principal

Recognize revenue on a gross basis

Agent

Recognize revenue on a net basis

Cost

Charges for out-of-pocket costs are a form of variable consideration, the cost of the services is a cost of fulfilling the contract

Estimate the variable consideration in Step 3

Expense the cost as incurred, or capitalize as a cost to fulfill the contract if applicable.

Issue #8: What if the company collects sales taxes?

Generally, the company would elect to treat all sales and similar taxes as if the entity were an agent (i.e. net presentation).

Issue #9: What if the company performs work before winning the contract?

- Additional information:
  - In order to win this important new client the company sends a person on site prior to obtaining the contract in order to start the assessment to demonstrate their capabilities.
  - The costs are expected to be recovered.

- Cost to fulfill a contract guidance applies:
  - The company shall recognize an asset from the costs incurred if the following criteria are met:
    - The costs relate directly to a contract or to an **anticipated contract** that the entity can specifically identify
    - The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
    - The costs are expected to be recovered.

Issue #9: What if the company performs work before winning the contract?

- Costs that Qualify:
  - Direct labor
  - Direct materials
  - Allocations of costs that relate directly to the contract or to contract activities
  - Costs that are explicitly chargeable to the customer under the contract
  - Other costs that are incurred only because an entity entered into the contract
- Costs that Do Not Qualify:
  - General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract)
  - Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract
  - Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (past performance)
  - Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

Issue #9: What if the company performs work before winning the contract?

Did the incurred costs transfer control of services to the customer (i.e. does the customer benefit)?

Yes

Capitalize as an asset

- Upon inception of the contract (Step 1) derecognize the costs and recognize the proportionate amout of revenue, **or**
- Expense when the costs are not expected to be recovered or the contract is no longer anticipated

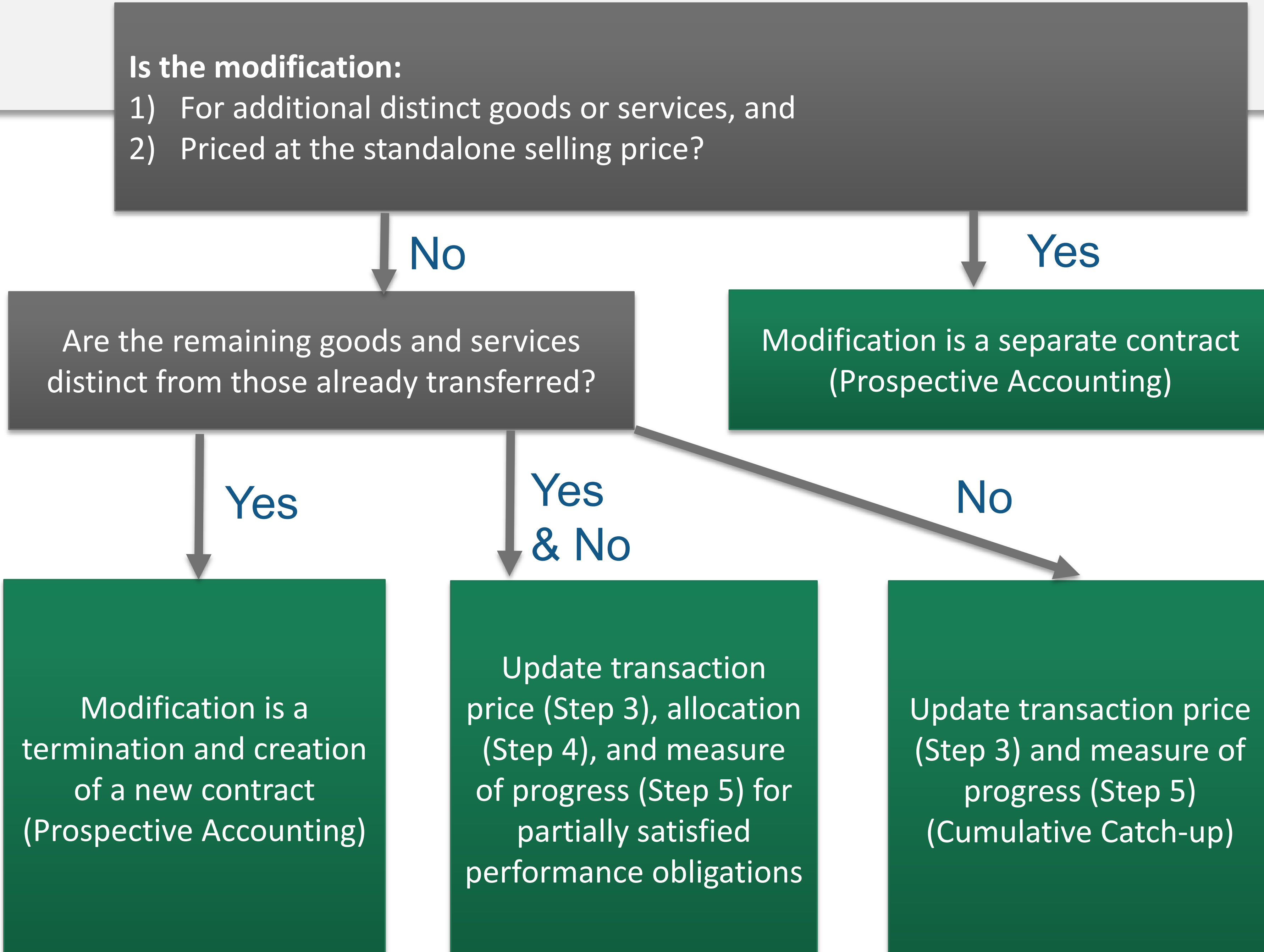
No

Capitalize as an asset

- Amortize the asset in proportion to the revenue recognized for the related performance obligation(s)
- Expense when the costs are not expected to be recovered or the contract is no longer anticipated

Issue #10: What if the company adds new services?

- Additional information:
  - After two months, the customer negotiates an additional IT service to be added to the existing contract.
    - The new service is priced at its stand-alone selling price.
  - In month four, the customer expands the scope of the IT assessment to include a separate computer system that is its subsidiary 80% of the typical rate.


Is the modification:
1) For additional distinct goods or services, and
2) Priced at the standalone selling price?
No
Yes
Are the remaining goods and services distinct from those already transferred?
Modification is a separate contract (Prospective Accounting)
Yes
Yes & No
No
Modification is a termination and creation of a new contract (Prospective Accounting)
Update transaction price (Step 3), allocation (Step 4), and measure of progress (Step 5) for partially satisfied performance obligations
Update transaction price (Step 3) and measure of progress (Step 5) (Cumulative Catch-up)

GETTING STARTED

Revenue Streams

- Identify ALL revenue streams
- Determine if the portfolio approach can be used for each revenue stream or if there are some unique contracts within a stream or streams.
- Apply the five step model to EACH portfolio/contract to assess and document recognition under Topic 606
- Review and modify internal controls surrounding revenue recognition
- Discuss with your auditors EARLY and OFTEN throughout your assessment process

Choosing a Transition Approach

Retrospective:

Financial Statements
Year ended December 31, 2019 and 2018

	2019	2018
Reported based on:	Topic 606	Topic 606*[1]

*Disclosure of changes under Topic 606 is required
[1] Adjust opening retained earnings

Modified Retrospective:

Financial Statements
Year ended December 31, 2019 and 2018

	2019	2018
Reported based on:	Topic 606*[1]	Topic 605

*Disclosure of difference from Topic 605 is required
[1] Adjust opening retained earnings

Start Yesterday…

- Benefits to getting started NOW:
  - You can become aware of potential changes and their financial impacts.
  - Potential significant impacts should be discussed early with lenders and other financial partners.

QUESTIONS

Connect with Us

MHM	CBIZ
linkedin.com/company/mayer-hoffman-mccann-p.c.	linkedin.com/company/cbiz-mhm-llc
@mhm_pc	@cbizmhm
youtube.com/mayerhoffmanmccann	youtube.com/BizTipsVideos
slideshare.net/mhmpc	slideshare.net/CBIZInc

If You Enjoyed This Webinar…

Upcoming Courses:

- 12/4: Preparing for a Successful Implementation of the New Not-for-Profit Reporting Standards – Now is the Time!
- 12/5: How Will New Revenue Recognition and Leasing Standards Affect the Real Estate Sector?
- 12/11: How Private Companies can be Prepared for Tax Reform Accounting
- 12/14: Revenue Recognition Check-In for the Construction Industry

Recent Publications:

- Six Questions Tech Companies Should be Asking About Revenue Recognition
- FASB Releases Consolidation Relief
- Four Things Private Companies can do in 2018 to Make Adopting the Leasing Standard Easier
- How to Make Sure You're in Compliance with the GDPR

THANK YOU

CBIZ & Mayer Hoffman McCann P.C.
cbizmhmwebinars@cbiz.com