

■ *Public Company Financial Executive Briefing*

# QUALITATIVE EVALUATION TO DETERMINE THE NECESSITY OF STEP 1 OF THE GOODWILL IMPAIRMENT TEST

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## **PROPOSED REVENUE RECOGNITION GUIDANCE**

The Financial Accounting Standards Board (FASB) has issued Proposed ASU No. 2011-230, *Revenue from Contracts with Customers*. The ASU would establish a comprehensive revenue recognition model applicable to most transactions and industries. It would supersede most of Topic 605, *Revenue Recognition*.

The guidance is designed to

- Remove inconsistencies and weaknesses in existing rules
- Provide a stronger framework for recognizing revenue
- Improve the comparability of revenue across entities
- Simplify financial statement preparation
- Convey information enabling financial statement users to understand revenue

## **ANALYSIS**

The following is a summary of the core principles of the guidance:

Recognized revenue should represent the transfer of goods and services to customers in an amount reflecting the consideration to which the entity expects to be entitled in exchange for goods and services. This would require the entity to:

- Identify the contract with a customer
- Identify the separate performance obligations within a contract
- Determine the transaction price
- Allocate the transaction price to separate performance obligations
- Recognize revenue when and as each performance obligation is satisfied

## **SCOPE**

The proposed guidance would apply to all contracts with a customer, except:

- Lease contracts
- Insurance contracts
- Contractual rights or obligations for receivables, debt and equity securities, liabilities and debt, derivatives and hedging, financial instruments, and transfers and servicing of financial assets
- Guarantees, other than product warranties
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers (i.e., other than the parties to the exchange)

## **IDENTIFYING THE CONTRACT**

A contract would be deemed to exist only if neither party could unilaterally terminate a wholly unperformed contract without penalty, and

- (1) The contract has commercial substance
  - Defined as “the risk, timing, or amount of future cash flows is expected to change as a result of the contract”,
- (2) The parties have approved the contract and are committed to satisfying their respective obligations
- (3) The reporting entity is able to identify each party’s enforceable rights in respect of the goods or services to be transferred
- (4) The reporting entity can identify the terms and manner of payment

### **Note 1 – Multiple Contracts**

Two or more contracts entered into at or near the same time with the same customer would have to be accounted for as a single contract if one of the following exists:

- The contracts are negotiated as a package with a single commercial objective
- The amount of consideration to be paid in one of the contracts is dependent on the price or performance of the other contract(s)

### **Note 2 – Contract Modifications**

A contract modification would have to be accounted for as a separate contract if it results in the addition to the contract of:

- (1) Distinct promised goods or services, and
- (2) The right to receive consideration in an amount that reflects the entity’s standalone selling price of the goods or services

A contract modification that does not constitute a separate contract would be accounted for as below:

- (1) If the remaining goods or services **are** distinct from those transferred before the date of the contract modification, the amount of consideration received but not yet recognized as revenue, plus the amount of any remaining consideration to be paid, would be allocated to the remaining separate performance obligations.
- (2) If the remaining goods or services **are not** distinct and are part of a single performance obligation that is partially satisfied, the transaction price and the measure of progress toward complete satisfaction of the performance obligation would be updated. The impact of the modification would be recognized as revenue or a reduction thereof at the date of modification on a cumulative catch-up basis.
- (3) If the remaining goods or services represent **a combination** of distinct and non-distinct goods and services, the amount of consideration received, plus the amount of any remaining consideration to be paid, would be allocated to the unsatisfied and partially unsatisfied performance obligations.
  - For a performance obligation to be satisfied over time, the transaction price and the measure of progress toward its completion would be updated. Adjustment of the amount of revenue recognized for performance obligations that were completely satisfied on or prior to the date of the modification would not be permitted.

Goods or services would be considered distinct if the entity regularly sells them separately, or the customer can benefit from the goods or services. Goods or services within a bundle would not be distinct if they are highly interrelated and transferring them to the customer requires the entity to provide a significant service to integrate the goods or services into the combined items, and the bundle is significantly modified for the purpose of fulfilling the contract.

## **IDENTIFYING SEPARATE PERFORMANCE OBLIGATIONS**

In addition to promises specified within a contract to transfer goods or services to a customer, performance obligations would include promises implied by an entity’s customary business practices, published policies, or statements if such promises create a valid expectation that the entity will transfer goods or services.

**Note 1 – Warranties**

If the customer has the option to purchase a warranty separately, such warranty would constitute a separate performance obligation. If, however, the customer does not have an option to purchase a separate warranty, no portion of the transaction price would be allocated.

If the reporting entity promises to transfer more than one good or service, each would have to be accounted for as a separate performance obligation if the good or service is distinct.

If not distinct, each would be combined with other goods or services until a distinct bundle of goods or services is identified.

**Note 2 – Pattern Of Transfer:** Two or more distinct goods or services could be accounted for as a single performance obligation if such goods or services have the same pattern of transfer to the customer.

**Note 3 – Satisfying Performance Obligations:** Revenue would be recognized when or as an identified performance obligation is satisfied and when the customer obtains control of such goods or services.

- Control would be obtained when the customer has the ability to direct use of and receive benefit from the goods or services.

**Note 4 – Transferred Over Time:** Goods or services would be transferred over time if:

- (1) The reporting entity's performance creates or enhances an asset (such as a construction type asset) controlled by the customer as such asset is created or enhanced.
- (2) The asset created or enhanced does not have an alternative use to the reporting entity, and at least one of the following is met:
  - The customer simultaneously receives and consumes the benefits of the entity's performance as they are performed.
  - Another entity would not need to re-perform the work the reporting entity has completed for the other entity to fulfill the remaining obligation to the customer.
  - The reporting entity has a right to payment for performance completed to date and expects to fulfill the contract.

If the goods or services are transferred to a customer over a period of time, one of the following methods would be applied to recognize revenue:

- An output method that recognizes revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date (for instance: units produced, contract milestones).
- An input method that recognizes revenue on the basis of efforts expended relative to total efforts intended to be expended.
- A method based on the passage of time (the straight-line basis over the expected duration of the contract).

When the outcome of a performance obligation is not subject to reasonable measurement but all costs incurred in satisfying the performance obligation are expected to be recovered, revenue would be recognized only to the extent of costs.

**Note 3 – Indicators Of Control:** indicators that the customer has obtained control, would include the following:

- The customer's unconditional obligation to pay.
- The customer has legal title to the asset (i.e., the goods or services).
- The customer holds physical possession of the goods.
- The customer holds the significant risks and rewards of ownership.
- The customer has accepted the asset.

## **DETERMINING THE TRANSACTION PRICE**

When a performance obligation is satisfied, revenue would be recognized in the amount of the transaction price allocated to that performance, subject to certain limitations.

The effects of all of the following factors would have to be evaluated in determining Transaction Price:

**Variable consideration** – Adjustments to the amount of consideration resulting from discounts, rebates, refunds, incentives, performance bonuses, penalties, contingencies, price concessions, and the like. Depending on circumstances, either of the following estimation methods could be applied:

- Expected value, which is the sum of the probability-weighted amounts in a range of possible outcomes.
- The most likely amount, which is the single most likely amount in a range of possible outcomes.

If some or all of the consideration received is expected to be refunded to the customer, a refund liability would be established.

**Time value of money** – TVM would be reflected by discounting the amount of promised consideration at a rate that would be used in a separate financing transaction with the same customer.

**Non-cash consideration** – Non cash consideration would be measured at its fair value, unless fair value could not be reasonably estimated, in which case the non-cash consideration would be measured indirectly by reference to the standalone selling price of the goods or services transferred.

**Consideration payable to the customer** – The amount of consideration paid or expected to be paid to the customer in the form of cash or credit that can be applied against amounts owed by the customer. The consideration would be recognized as a reduction of revenue upon the later of:

- (1) the entity transfers the promised goods or services to the customer, or
- (2) the entity pays or promises to pay the consideration, even if such payment is conditional on a future event.

**Collectibility** – Collectibility refers to the customer's credit risk (defined as: the risk that the full amount of consideration to which the reporting entity is entitled will not be collected from the customer). Collectibility would not impact the transaction price or revenue. Any difference between the measurement of the receivable and the amount of revenue recognized would be presented as a separate line item adjacent to revenue in the income.

## **ALLOCATING THE TRANSACTION PRICE**

The transaction price would have to be allocated to all separate performance obligations on a relative basis in proportion to the standalone selling price of the goods or services underlying each of those performance obligations at the contract's inception.

- The best evidence of a standalone selling price would be the observable price of goods or services sold separately by the entity in similar circumstances and to similar customers.
- If a standalone selling price is not directly observable, it would have to be estimated.

If the sum of standalone selling prices of promised goods or services exceeds the transaction price, the discount would have to be allocated to all separate performance obligations on the basis of relative standalone selling prices.

If the transaction price includes consideration contingent on a future event or circumstance (e.g., a specific outcome of the entity's performance), the contingent amount would be entirely allocated to a single distinct good or service if the contingent payment terms for the good or service relate to the entity's efforts to transfer that good or service, and after considering all performance obligations, entirely allocating the contingent amount would best depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying each separate performance obligation.

Subsequent changes in the transaction price would be allocated to all performance obligations on the same basis on which the allocation was made at contract inception.

## OTHER PROPOSED ITEMS

Although not discussed in this whitepaper, other important matters were discussed in the proposed guidance, including the following:

- **Constraints on the Cumulative Amount of Revenue**
- **Onerous Performance Obligations**
- **Contract Costs**
- **Amortization and Impairment**
- **Presentation and Disclosure**

## EFFECTIVE DATE AND COMMENT DEADLINE

The proposed ASU states that final guidance would be effective *no earlier* than for years beginning on or after January 1, 2015. The effective date for nonpublic companies at least one year later.

The comment deadline is March 13, 2012. Comments should be sent to:

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