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PROFESSIONAL ACCOUNTING UPDATE

LESSONS LEARNED FROM SEC COMMENT LETTERS ON THE NEW REVENUE STANDARD

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The Financial Accounting Standard Board's (FASB) Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (ASC 606), provides a comprehensive revenue recognition model intended to reduce the complexity inherent in today's guidance by increasing financial statement comparability across companies and industries. The standard became effective January 1, 2018 for all calendar year-end public entities.

As part of this transition, the U.S. Securities and Exchange Commission (SEC) has carefully monitored the implementation of the new revenue standard. As it does with all newly adopted standards, the SEC's Division of Corporation Finance reviewed a selection of filings to monitor and enhance compliance with applicable disclosure and accounting requirements. In issuing comments to a registrant, the SEC may request supplemental information so the staff can better understand the company's disclosure. Depending on the particular facts and circumstances SEC staff may ask the registrant to revise (or provide additional) disclosure, in current or future filings.

In a November 2017 article, Financial Executives International's (FEI) Professional Accounting staff reviewed twenty-one SEC comment letters issued to companies addressing their application of ASC 606. This article analyzes eight SEC comment letters that have since been issued related to the new revenue standard[1].

TRENDS

The SEC comment letters analyzed by FEI encompassed the following areas of the new standard:

- Disaggregation of revenue
- Disclosure of performance obligations; consideration of significant payment terms
- Disclosure of performance obligations; determination of whether promised goods/ services are distinct
- Timing of satisfaction of performance obligations
- Principal versus agent considerations
- Transaction price determination and allocation to specific performance obligations
- Costs to obtain and fulfill a contract

These topics are discussed in more detail in the following pages. Comment letters that are hyperlinked within the text will redirect to the idaciti platform, where specific comment letters can be navigated using the panel on the left.

[1] Three of these companies received comment letters from the SEC regarding their disclosure of an incorrect effective date for the new revenue standard. For the purposes of this study, these comment letters will not be discussed in any detail.

DISAGGREGATION OF REVENUE

ASC 606 requires entities to disaggregate revenue into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. The guidance details considerations companies should make in determining appropriate categories for this disaggregation, but ultimately allows management to exercise significant judgment (ASC 606-10-50-5).

Two companies received comment letters[2] which addressed their disclosure of disaggregated revenue.

One company received two questions in this area: the first requesting an explanation of how the revenue guidance was considered in selecting the appropriate disaggregated revenue categories and how the current disclosures meet the objective of depicting how economic factors affect the nature, amount, timing and uncertainty of revenue and cash flows. The second question requested an explanation as to why two specific components were aggregated, noting some of their characteristics were different.

In its response, the company explained its rationale, and did not cite any plans to expand upon disclosures in future filings. However, in a follow up letter from the SEC, the SEC noted the registrant provided information outside of the financial statements in monthly sales reports, in a strategic update, and on an earnings call, and questioned if this information was used by the company to evaluate their financial performance or to make resource allocation decisions. The SEC requested the registrant elaborate on how the company considered the presentation and use of such information when determining the appropriate disaggregated revenue categories. In their response, the registrant used three specific examples to explain the manner in which they considered information disclosed in these other forums.

Similarly, the second company received a request to explain how the revenue guidance was considered in selecting appropriate categories to disaggregate revenue and how current disclosures meet the stated objectives of the standard. In their response, the company provided various considerations for their categories of disaggregation. However, in a follow up letter from the SEC, the SEC requested additional clarifications, which included:

- Specifically address how the company considered information that is regularly reviewed by the Chief Operating Decision Maker (CODM), and other information used to evaluate financial performance or make resource allocations, in selecting the type of categories to present.
- Explain if the information presents revenue in a manner that is further disaggregated than in the current disclosures.
- Provide a more specific and comprehensive discussion of what consideration the company gave to presenting certain revenues on a more disaggregated basis.
- Provide an analysis of how various device types and properties are impacted by economic factors.

[2] To view specific comment letters, click on the specific comment letter using the panel on the left to navigate.

In their follow-up response to these comments, the company further elaborated on the different factors considered for disaggregation, and ultimately concluded that further disaggregation of revenue would not be appropriate. However, the company affirmed their plans to evaluate the most appropriate manner to disaggregate revenues as their business evolves, and to revise the disaggregation in the future if necessary.

PERFORMANCE OBLIGATIONS: SIGNIFICANT PAYMENT TERMS

ASC 606 requires companies to disclose certain information about its performance obligations. This includes when the entity typically satisfies its performance obligations, significant payment terms, the nature of the goods or services being transferred, obligations for returns, and types of warranties and related obligations included in the contract (ASC 606-10-50-12).

Two registrants received comment letters focused on performance obligations, requesting greater clarification around the disclosure of significant payment terms, such as when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained. In both cases, the responding companies noted their plans to expand future disclosures to include additional information in accordance with the guidance.

PERFORMANCE OBLIGATIONS: DISTINCT GOODS OR SERVICES

ASC 606 requires companies to determine whether a good or service promised to a customer is distinct. A good or service is distinct if: (1) 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, and (2) if the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (ASC 606-10-25-19 through 25-21).

In one comment letter, the SEC twice requested a specific and comprehensive analysis of why two promises were not distinct. In their response, the company referred to appropriate areas of the guidance, and the "Basis for Conclusions" to explain their decision-making process in determining the appropriate accounting treatment. The company also disclosed alternative views considered, but ultimately not used.

PERFORMANCE OBLIGATIONS: TIMING OF SATISFACTION

The new revenue guidance requires companies to determine whether performance obligations are satisfied over time or at a point in time. Entities with obligations which are satisfied over time must disclose the methods used to measure progress and an explanation as to why those methods are appropriate (ASC 606-10-50-18).

In one comment letter, the SEC noted that the company was recognizing revenue for a certain product over time. The SEC requested an explanation as to why over time revenue recognition is the appropriate method and why it provides a faithful depiction of the transfer of services. In their response, the company outlined the nature of their product and the considerations made to determine to recognize revenue over time. The company noted their plans to update their significant judgment disclosure to reflect the timing of revenue recognition consistent with guidance under 606.

In another comment letter, the SEC requested an explanation of how the company determined when to recognize revenue for the line item "Other Revenues." In their response, the company described their three offerings that accounted for other revenues, and outlined the considerations made in determining the timing of the performance obligations.

PRINCIPAL VERSUS AGENT

ASC 606 outlines how entities should determine whether they are a principal or an agent in transactions involving an additional party. If the nature of the entity's promise is a performance obligation to provide the specified goods or services itself, and controls the specified goods or services prior to transferring to the customer, the entity is a principal. If the entity is arranging for those goods or services to be provided by the other party, the entity is an agent. 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 (ASC 606-10-55-36).

In a comment letter from the SEC, the staff requested the registrant provide a specific and comprehensive discussion of how the company determined they are the principal in certain arrangements. In their response, the company cited their plans to revise future fillings to clarify their assessment of control before it is transferred.

In a follow up letter, the SEC requested further explanation of the company's principal versus agent analysis for advertising inventory sourced through third-party exchanges. Specifically the SEC requested the company to:

- More fully explain why the company has the sole ability to monetize certain inventory
- Disclose, if material, whether the revenue recognized from a specific product line is recognized on a gross or net basis.

In their response to the SEC, the company provided background information related to the business unit and the parties involved in the transaction. With diagrams that outlined the transaction flow, and a detailed analysis of considerations, the company was able to provide greater clarity on this matter.

DETERMINING THE TRANSACTION PRICE

When determining the transaction price and the amounts allocated to performance obligations, entities are required to disclose information about the methods, inputs and assumptions used in their determination (606-10-50-20).

In one comment letter, the SEC noted that certain customers may receive cash-based incentives or credits, which are accounted for as variable consideration and estimated based on the amount expected to be provided to customers. They also noted that that the company had certain obligations for refunds. The SEC requested the company to revise future filings to explain how the company determined the methods, assumptions and estimates for this variable consideration as it relates to these cash-based incentives, credits and refunds.

In their response, the company noted these amounts were not material and their plans to monitor the materiality of variable consideration in future periods.

CONTRACT COSTS

ASC 606 updated certain cost guidance in Subtopic 340-40. Under this guidance, entities are required to disclose, among other things, the judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer and the method it uses to determine the amortization for each reporting period (ASC 340-40-50-2).

In one comment letter, the SEC requested the company explain the nature of their prepaid revenue share amounts in the "Prepaid Revenue Share, Expenses and Other Assets" balance sheet line-item. The SEC noted it was unclear if the prepaid revenue share amounts or any other capitalized amounts related to fees paid to distribution partners, content providers, or to fees reflected within other costs of revenues. In their response, the company noted that the balance within the Prepaid Revenue Share, Expenses and Other Assets balance sheet line-item primarily consists of various prepaid expenses and other receivables, which are not material. The company noted that they will revise their balance sheet line-item in future filings as "Other Current Assets" and "Other Non-Current Assets." The company cited their plans to monitor the materiality of the amounts capitalized under ASC 340-40 in future periods and to revise if necessary.

BROAD IMPACTS OF 606

Two companies received letters which addressed broad effects of the new revenue standard.

In one letter the SEC asked the company to provide an analysis and the applicable ASC 606 references used to determine that some of its deferred gains could be de-recognized upon adoption of ASC 606. In their response, the company noted prior to the adoption of ASC 606, the sale of certain interests in an equity method investments were accounted for under ASC 360-20. Following the adoption of ASC 606, sales of equity method investments will be accounted for under ASC 860. While the company is still in the process of deliberating and reaching a conclusion on the treatment of this transaction with their auditors, upon adoption of ASC 606, the company expects deferred gains to be de-recognized through an opening adjustment to retained earnings. The company anticipated reaching a final conclusion prior to filing their Form 10-K for the year ended December 31, 2017, and will disclose as such in their related filing.

In another letter, the SEC asked the company to explain how the adoption of ASC 606 contributed to the increase in the amounts disclosed as local debt in international markets. In their response to the SEC, the company explained their specific fact pattern, noting how the company reported cash received in advance of certain international orders under ASC 605, and how the adoption of ASC 606 resulted in a reclassification to debt amounts that were previously reported as deferred revenue.

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FEI's Professional Accounting staff will continue to monitor additional SEC comment letters and address trends related to the adoption of ASC 606 in future editions of these series.

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