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Revenue Recognition:
Considerations for the Food & Commodities Industry

January 24, 2018

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Today’s Speakers

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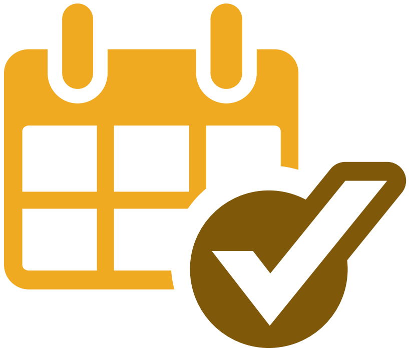
Agenda

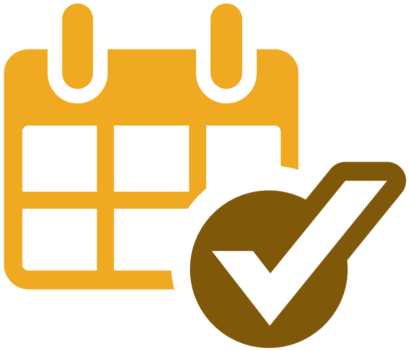
- Core principles of the new standard

- Specific considerations for Food and Commodities companies
  - Bill and hold / warehousing arrangements
  - Variable consideration
  - Customer acceptance provisions



Objectives

As a result of participating in this session, you should be able to:

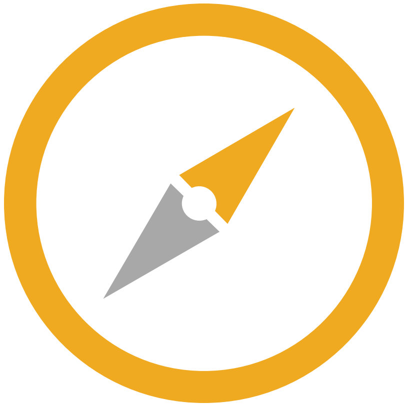


- Discuss the implications of the new standard on the Food and Commodities industry
- Identify the 5 steps in applying the new revenue recognition standard
- Evaluate performance obligations in contracts with customers
- Identify contracts with variable consideration

Core Principles of the New Standard

Core Principles of the New Standard

- The new standard outlines the principles an entity must apply to measure and recognize revenue.
  - The core principle is that an entity will recognize revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer.



- The principles in the new standards will be applied using the following five steps
  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 satisfies a performance obligation

Step 1: Identify the contract(s) with the customer

- To apply the model, an entity must first identify the contract, or contracts, to provide goods and services to customers.
- Any contracts that create enforceable rights and obligations fall within the scope of the new guidance.
- Such contracts may be written, oral or implied by the entity's customary business practice.
- Food and Commodities entities enter into a large number of contracts, many of which have similar terms and conditions. Use of a practical expedient is permitted.
  - The guidance allows for application to a portfolio of contracts or performance obligations with similar characteristics.

1

Step 2: Identify the performance obligations in the contract

- To apply the new guidance, an entity must identify the promised goods and services within the contract and determine which of those goods and services are separate, or distinct, performance obligations (i.e., the unit of account for purposes of applying the standard).
- Entities are not required to evaluate if goods and services are immaterial to the customer

2

Promised goods and services

- Promised goods or services in a contract may be identified explicitly in the contract
- Or, they may be implied by the entity's customary business practices

Step 3: Determine the transaction price

- The transaction price is based on the amount to which the entity expects to be "entitled."

- The concept of variable consideration has now been introduced

- This amount is meant to reflect the amount that the entity has rights to under the present contract.

- The "revenue constraint"

- The transaction price does not include the following:
  - Estimates of consideration from future change orders for additional goods
    and services.
  - Amounts collected on behalf of another party, such as sales taxes.

3

Step 4: Allocate the transaction price to the performance obligations in the contract

4

- Once the separate performance obligations are identified and the transaction price has been determined, the standard requires an entity to allocate the transaction price to the performance obligations.
- Generally, this is done in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis).
- As a result, any discount within the contract generally is allocated proportionally to all of the separate performance obligations in the contract.
- There are some exceptions:
  - An entity could allocate variable consideration to a single performance obligation in some situations.
  - Also, an entity could allocate any discount in a contract to only certain performance obligations, if specified criteria are met.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

- An entity recognizes revenue only when it satisfies an identified performance obligation by transferring a promised good or service to a customer.
- A good or service is considered to be transferred when the customer obtains control.
  - Recognizing revenue upon a transfer of control is a different approach from the "risks and rewards" model that currently exists in today's guidance.
- Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset.
- Control also means the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service.
- An entity must determine at contract inception whether it will transfer control of a promised good or service over time.
  - If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

5

Polling Question #1

What is not one of the five steps of the new revenue recognition model?

A. Allocate the transaction price to performance obligations.

B. Identify contracts with a customer

C. Determine if collection is probable

D. Recognize revenue as performance obligations are satisfied

Specific Considerations for Food and Commodities

Bill-and-hold / warehousing arrangements

- A bill-and-hold/warehousing arrangement is a contract under which an entity bills a customer for a product but retains physical possession of the product until it is transferred to the customer in the future.
  - Current accounting allows for revenue recognition before delivery has occurred, if certain criteria are met
- Under the new standard, an entity will recognize revenue when it satisfies a performance obligation by transferring a product to the customer, with transfer considered to have occurred when the customer has control of the product.
  - The key consideration for revenue recognition under the new standard is determining when a customer has control of the product.
  - “Control of a product” refers to the ability to direct the use of, and obtain substantially all the remaining benefits from, the product (or the ability to prevent other entities from doing the same).

Bill-and-hold / warehousing arrangements (Continued)

- Transfer-of-control indicators (under the new standard)
  - Entity has the right to payment for the product
  - Customer has legal title to the product
    - If an entity retains legal title soley as a protection against the customer's failure to pay, the entity's rights would not preclude the customer from obtaining control of the product.
  - Customer has a the significant risks and rewards of ownership of the product
  - Customer has accepted the asset

- Additional criteria for bill-and-hold / warehousing transfer of control (under the new standard)
  - Reason for the arrangement must be substantive (for example, customer requested the arrangement)
  - Product must be identified separately as belonging to the customer
  - Product must be ready for physical transfer to the customer
  - Entity must not have the ability to use the product or to direct it to another customer

Bill-and-hold / warehousing arrangements (Continued)

- Current standards compared with new standard
  - Current standards include certain different or additional criteria for public and nonpublic entities. The new standard and all related criteria will be equally applicable to both public and nonpublic entities.

  - The previously discussed transfer-of-control indicators and additional criteria under the new standard are not substantially different from the guidance currently followed by entities in accounting for bill-and-hold / warehousing arrangements.
    - However, evaluation of previous conclusions (and policy documentation) and reconsideration of the terms of all bill-and-hold / warehousing contracts with customers in light of the new standard criteria are strongly recommended to ensure compliance and proper application of the new standard.

  - An area for possible change from current practices is the consideration of remaining performance obligations that is required under the new standard.
    - An agreement to store the customer's product on an entity's premises until a time specified in the contract is a common situation under bill-and-hold / warehousing arrangements and, under the new standard, will result in the need to evaluate whether a separate performance obligation exists.

Bill-and-hold / warehousing arrangements (continued)

- Performance obligations for custodial or warehousing services
  - Step two requirement for identifying a separate performance obligation that is distinct
  - Criteria for distinct performance obligations
    - Customer must be able to benefit from the good or service on its own
    - Good or service must be a separable
  - Likely to conclude that both criteria are met in a typical bill-and-hold/warehousing arrangement
    - Customer can benefit from warehousing service by not having to incur inventory holding or storage costs if the product were in its possession. Also, difficult to conclude that the customer does not benefit since the customer will likely have requested such arrangement.
    - Since control of the product would be with the customer, most bill-and-hold /warehousing contracts would include some reference to how and where the product will be stored until delivery is made. Further, step one clarifies that a contract with a customer does not have to be written but rather may be oral or implied by customary business practices.

Bill-and-hold / warehousing arrangements

- Example 1:

- Consider a corn processor that has enough on site storage capacity to stock 1 week's worth of corn for processing. The corn processor wants be able to control the flow of its raw ingredients for 3 months worth of processing. Therefore the corn processor purchases 3 months of corn in advance and stores the corn at the grain terminal's facility. The contract terms between the grain terminal and the corn processor provide for a fixed price on the purchase of the corn and a fixed storage rate per bushel per month.

- What performance obligations does the grain terminal have as a result of this transaction?
  1. Transfer control of a specified quantity of corn
  2. Store the corn at it's own facilities for a specified period of time

- Should the grain terminal recognize revenue at a point in time or over a period of time for each performance obligation?
  1. Revenue for the first obligation would be recognized when control is transferred (point in time)
  2. Revenue for the storage obligation would be recognized as the storage service is provided

- How is the transaction price for each performance obligation determined?
  - The contract specifies the price for each performance obligation in this example

Bill-and-hold / warehousing arrangements

- Example 2:

- Assume the same facts as previous example except that the contract terms between the grain terminal and the corn processor provide for a fixed price on the purchase of the corn; however, is silent as to a price for the warehousing obligation. The grain terminal states that in the past the two parties have verbally agreed that the corn processor will pay a fixed price above posted bid prices in order to compensate the grain terminal for the warehousing service it provides.

- What performance obligations does the grain terminal have as a result of this transaction?
  - Performance obligations are the same as example 1

- Should the grain terminal recognize revenue at a point in time or over a period of time for each performance obligation?
  - Timing of revenue recognition will be the same as example 1

- How is the transaction price for each performance obligation determined?

Polling Question #2

Which of the following statements is true related to bill-and-hold arrangements under the new standard?

A. Revenue recognition on bill-and-hold arrangements is prohibited under the new standard.

B. The criteria to be met to allow for revenue recognition are completely different under the new standard compared with current standards.

C. The criteria to be met to allow for revenue recognition are exactly the same under the new standard compared with current standards, and no evaluation is needed to ensure compliance with the new standard.

D. Consideration of remaining performance obligations in a bill-and-hold arrangement is a new requirement under the new standard.

Variable consideration

- Variable consideration relates to contracts where a portion of the transaction price could vary because of the contract terms. Variable consideration normally arises from factors such as:
  - Unpriced sale pricing structure
  - Final settlement based on destination weights and grades
  - Rebates
  - Coupons
  - Discounts
  - Other incentives

- Variable consideration is only recognized as revenue when the related performance obligation is satisfied and the company has determined that it is probable that there will not be a significant reversal of revenue in future periods.

Variable consideration (continued)

- The amount of variable consideration included in a contract must be estimated at the contract inception, and the estimate should be updated at each reporting date. Estimated variable consideration shall be either of the following:
  - The expected value – the sum of the probability-weighted amounts in a range of possible amounts
  - The most likely amount – the single most likely amount in a range of possible consideration amounts
- The method considered the better predictor of the amount of consideration to which the entity will be entitled should be used consistently throughout the contract.

Variable consideration (continued)

Variable consideration constraint

- Consideration included in the transaction price should be constrained to the extent that it is probable that a significant reversal in the amount of cumulative recognized revenue will occur when uncertainties associated with the variable consideration are eventually resolved.

- Consider both the likelihood and the magnitude of a revenue reversal.

Variable consideration (continued)

Example 1:

- Coupon programs are common in the Food industry.

- A ketchup manufacturer sells 100 cases (10 bottles per case) of ketchup to a grocery store for $3,000, and simultaneously issues coupons for $1 discount per bottle. Control of the product transfers to the grocery store when it is received at the grocery store. The ketchup manufacturer will need to estimate the amount of variable consideration associated with the coupons.
- How should the company account for this coupon program –
  - Scenario 1: Assume ketchup manufacturer has past experience running coupon programs at this same grocery store and therefore has historical data for similar coupons at this grocery store, which indicates that 75 percent of the coupons will be redeemed.

  - Scenario 2: Assume the ketchup manufacturer is offering the coupon program at a new grocery store in a new geography.

Variable consideration

Example 2:

- Unpriced sales are common in the Commodity industry.

- A commodity dealer has a contract to sell product to a customer for delivery in December 2018. The contract terms specify that the price for the product will be set at 20 cents under the December 2018 Futures price for this commodity. The contract further states that the customer has 30 days after the date of delivery to fix the price.

- Assuming all performance obligations have been met and control of the product has transferred to the customer, how should the company determine transaction price at December 31, 2018 if the customer has not fixed the product price?

Variable consideration

Example 3:

- Sales settled based on destination weights and grades are common in the industry.

- A commodity dealer has a contract to sell product to a customer for delivery in December 2018. The contract terms specify the quantity, grade, and provide a fixed price. The contract also specifies that the final settlement will be based on weights and grades determined upon customer's unloading and testing of the product. The Company can estimate weight and grade based on upon internal data.

- Assuming all performance obligations have been met and control of the product has transferred to the customer, how should the company determine transaction price at December 31, 2018 if the customer has not unloaded the product?

Polling Question #3

Which of the following statements is true related to variable consideration under the new standard?

A. The amount of variable consideration included in a contract must be estimated at the contract inception, and the estimate should be updated at each reporting date.

B. There is no constraint to recognizing variable consideration.

C. Variable consideration should not be updated at each reporting date.

D. Variable consideration should not be recognized until uncertainty is resolved.

Customer acceptance provisions

- Product specifications are common in the food and commodity industry. Therefore customer acceptance provisions must be considered when determining the satisfaction of a performance obligation.

- If a company can <u>objectively determine</u> that agreed-upon specifications have been met, control has transferred (assuming all other criteria met).

- For example, objective evidence would consist of the following:
  - Independent testing to meet customer specifications
  - Quality control and history of lot failures

Polling Question #4

Are you currently in the process of adoption of the new revenue recognition standard within your organization?

a. Yes, and please have a Crowe professional contact me for assistance.

b. No, but please have a Crowe professional contact me for future assistance.

c. Yes, but please do not contact me for assistance.

d. Not at this time.

Thank you

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