
Making the Right Call in Revenue Recognition: Accounting Challenges and Judgments

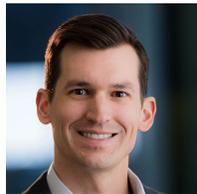
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Getting revenue recognition right is critically important for a business. As the Financial Accounting Standards Board (FASB) notes, “revenue is one of the most important measures used by investors in assessing a company’s performance and prospects.”¹ Revenue is a critical line item for investors and creditors because it depicts the value of goods and services transferred to customers in a given period.

Topic 606 of the FASB’s Accounting Standards Codification (ASC 606) dictates the timing and amount of revenue companies recognize for a given transaction. ASC 606 requires companies to identify performance obligations in contracts with customers and allocate the transaction price among those performance obligations.² Revenue is recognized when control of an asset is transferred to the customer.³ For many transactions, revenue recognition is a complex reporting exercise that requires careful

1 “Revenue Recognition,” Financial Accounting Standards Board, available at <https://www.fasb.org/jsp/FASB/Page/Section-Page&cid=1176163728398>.

2 ASC 606-10-25-14; ASC 606-10-32-1.

3 ASC 606-10-25-23 and 25. ASC 606-10-25-25 defines control as “the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset.”

application of judgment to contractual provisions and assumptions about market conditions.

To illustrate some of the complicated revenue recognition questions that can arise, we reviewed recent disclosures from vaccine manufacturers regarding contracts for the production and distribution of their COVID-19 vaccines. These contracts illustrate several aspects of revenue recognition facing vaccine manufacturers – milestone payments, purchase options, and bill-and-hold arrangements – that also apply to a wide range of other products and services.

Illustrative Revenue Recognition Issues

1. Milestone Payments

Some contracts include milestone payments, which are contractually agreed-upon payments that are required only if certain predetermined objectives are achieved. For example, Moderna's COVID-19 vaccine contract with the federal government included a \$300 million payment if regulatory approval was received before January 31, 2021.⁴ Similarly, BioNTech's agreement with Pfizer to jointly develop a COVID-19 vaccine included up to \$563 million in milestone payments.⁵

According to ASC 606, milestone payments should be treated as variable consideration.⁶ Companies must include in the transaction price an estimate of the variable consideration to which they expect to be entitled only to the extent it is *probable* that a significant reversal will not occur when the uncertainty is resolved.⁷

Before filing its third quarter financials, Moderna had not yet received approval for its COVID-19 vaccine. Given the uncertainty at the time, management had to assess the probability that Moderna would receive the milestone payment that was tied to approval. This required significant judgment about future events on the part of Moderna's management.

As of September 30, 2020, Moderna had not recognized any revenue associated with the \$300 million milestone payment, suggesting that significant uncertainty still existed about whether the milestone would be met.⁸ In such uncertain circumstances, different

4 Moderna, Inc., SEC Form 10-Q for the period ended September 30, 2020, p. 30.

5 "Pfizer and BioNtech Announce Further Details on Collaboration to Accelerate Global Covid-19 Vaccine Development," April 9, 2020, available at <https://www.pfizer.com/news/press-release/press-release-detail/pfizer-and-biontech-announce-further-details-collaboration>.

6 ASC 606-10-32-6.

7 ASC 606-10-32-5 and 11. Companies can use two methods to estimate the amount of variable consideration: 1) the expected value method which uses "the sum of the probability-weighted amounts in a range of possible consideration amounts," and 2) the most likely amount method which uses "the single most likely amount in a range of possible consideration amounts." The most likely amount method is more appropriate than the expected value method when there are only two possible outcomes for the milestone payment. See ASC 606-10-32-8.

8 Moderna, Inc., SEC Form 10-Q for the period ended September 30, 2020, p. 30.

accountants reasonably could come to different conclusions regarding a similar set of facts, leading to very different revenue recognition.

In December 2020, Moderna received emergency use regulatory approval, ostensibly meeting the contractual milestone requirements and permitting the inclusion of the milestone payment in the transaction price for revenue recognition purposes. Whether the entire milestone would be recognized during Q4 2020 would still depend on whether the milestone payment was allocated to previously satisfied performance obligations or to past and future performance obligations. Such a determination also requires significant judgment.

2. Purchase Options

Some contracts also include purchase options, which grant the customer the option to acquire additional goods (sometimes at a discount). For example, Moderna's COVID-19 vaccine contract with the US federal government includes "the option to purchase up to an additional 400 million doses at a fixed price of \$1.65 billion per 100 million doses."⁹ In December 2020, the government exercised its option to purchase an additional 100 million doses.¹⁰ Vaccine contracts with purchase options require additional analysis because the nature of a purchase option can affect the amount and timing of revenue recognized.

ASC 606 requires companies to determine whether a purchase option represents a material right or a marketing offer.¹¹ A material right offers a customer an option "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)."¹² Marketing offers, in contrast, provide customers with options to make future purchases – in our example, of additional vaccine doses – at an amount that essentially "reflect[s] the standalone selling price for that good or service."¹³

This determination affects revenue recognition because a material right is considered a performance obligation and a portion of the original contract's transaction price would be allocated to that performance obligation, causing some of the revenue in the contract to be deferred until the customer makes additional purchases (e.g., optional doses) or the option expires.¹⁴

In contrast, if a purchase option in the vaccine contract merely gives access to future vaccines at the expected price other customers would pay at the time (i.e., a marketing

9 Moderna, Inc., SEC Form 10-Q for the period ended September 30, 2020, p. 30.

10 "U.S. Government Exercises 1st Option for Additional 100 Million Doses of Moderna's COVID-19 Vaccine Candidate," Bloomberg, December 11, 2020, available at <https://www.bloomberg.com/press-releases/2020-12-11/u-s-government-exercises-1st-option-for-additional-100-million-doses-of-moderna-s-covid-19-vaccine-candidate>.

11 ASC 606-10-55-42 and 43.

12 ASC 606-10-55-42.

13 ASC 606-10-55-43.

14 ASC 606-10-55-42 and 44.

offer), the purchase option is not considered a performance obligation and none of the original transaction price is allocated to the purchase option.¹⁵

3. Bill-and-Hold Arrangements

Timing May Depend on the Customer

Bill-and-hold arrangements are contracts “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.”¹⁶ Bill-and-hold contracts for vaccines require additional consideration because the timing of revenue recognized can depend on whether the customer is the Strategic National Stockpile (SNS) – a cache of medical supplies maintained by the US federal government – or a non-SNS customer.¹⁷ Although the COVID-19 vaccine will not initially be sold into the SNS, vaccine manufacturers may have to address special consideration for these sales in the future.

Recall that ASC 606 requires companies to recognize revenue when control of an asset is transferred to the customer. ASC 606 requires that the following criteria be met for control to transfer under a bill-and-hold contract:

1. The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement).
2. The product must be identified separately as belonging to the customer.
3. The product currently must be ready for physical transfer to the customer.
4. The entity cannot have the ability to use the product or to direct it to another customer.¹⁸

Vaccine bill-and-hold contracts with the SNS are subject to supplemental SEC guidance, which states that “vaccine manufacturers should recognize revenue...when vaccines are placed into Federal Governmental stockpile programs because control of the enumerated vaccines will have been transferred to the customer and the criteria to recognize revenue in a bill-and-hold arrangement under ASC Topic 606 will have been met.”¹⁹ In short, the SEC guidance clarifies that vaccine manufacturers may recognize revenue for bill-and-hold vaccine sales to the SNS, removing any concern about whether the bill-and-hold criteria in ASC 606 have been met.

Importantly, the SEC guidance covering sales to the SNS applies only to vaccines. Sales to the SNS for other pandemic-related goods (e.g., personal protective equipment and ventilators) and sales to national stockpiles maintained by other countries are

15 ASC 606-10-55-43.

16 ASC 606-10-55-81.

17 “Strategic National Stockpile,” U.S. Department of Health & Human Services, available at <https://www.phe.gov/about/sns/Pages/default.aspx>; Brown, David, “Pediatric Vaccine Stockpile at Risk,” *The Washington Post*, April 17, 2005, available at <https://www.washingtonpost.com/wp-dyn/articles/A59516-2005Apr16.html>.

18 ASC 606-10-55-83.

19 “Updates to Commission Guidance Regarding Accounting for Sales of Vaccines and Bioterror Countermeasures to the Federal Government for Placement into the Pediatric Vaccine Stockpile or the Strategic National Stockpile,” Securities and Exchange Commission, August 18, 2017, available at <https://www.sec.gov/rules/interp/2017/33-10403.pdf>.

subject to normal bill-and-hold criteria. Thus, it is possible that revenue recognition would be different for nearly identical transactions with other countries, or for products other than vaccines.

Storage and Replacement Performance Obligation

Under SNS vaccine contracts, manufacturers must store the vaccines and replace expired doses.²⁰ Such contracts with the SNS require additional evaluation to consider whether storage and replacement services are considered additional ongoing performance obligations.

Recall that ASC 606 requires companies to identify performance obligations in a contract and allocate the transaction price among those performance obligations.²¹ However, promises immaterial to the contract are not considered performance obligations.²²

If a company determines that storage and replacement are separate performance obligations, the revenue attributable to storage and replacement would be deferred and recognized as the company fulfills those obligations. In contrast, if a company determines that storage and replacement are not separate performance obligations or do not meet the contract materiality threshold, the entire transaction price would be allocated to the sale of the vaccines and recognized when that obligation is satisfied.

In Summary

Revenue is a fundamental financial metric, but proper recognition and measurement of revenue is complicated, nuanced, and often subject to accountants' judgment concerning contractual provisions. Understanding the significant judgment required for revenue recognition is critical when evaluating a company's performance.

Using vaccine manufacturing contracts as examples, this article presents three scenarios that could complicate revenue recognition for a range of products and services. As with all accounting evaluations, the individual facts and circumstances should be considered when determining the appropriate revenue recognition.

20 Brown, David, "Pediatric Vaccine Stockpile at Risk," *The Washington Post*, April 17, 2005, available at <https://www.washingtonpost.com/wp-dyn/articles/A59516-2005Apr16.html>.

21 ASC 606-10-25-14; ASC 606-10-32-1. A performance obligation is defined as "a promise in a contract with a customer to transfer a distinct good or service." See ASC Master Glossary - Performance Obligation.

22 ASC 606-10-25-16A.