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Revenue Recognition: Manufacturing and Distribution Industry

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Scott Ransberger

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Today’s Speaker

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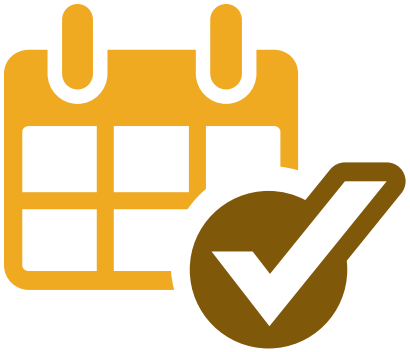
Agenda

Specific Considerations for M&D Entities Related To:



- Step 1 – Identify the Contract
- Step 2 – Identify the Performance Obligation
- Variable Consideration
- Disclosure Requirements
- IFRS 15 and ASC 606 Differences

Learning Objectives

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

- Recognize contract identification considerations for the M&D industry
- Describe performance obligations commonly identified in the M&D industry
- Discuss variable consideration impacts common in the M&D industry
- Repeat certain disclosure requirements in the new standard
- Identify M&D industry relevant differences in US GAAP and IFRS

Step 1 – Identify the Contract

Step 1 – Identify the Contract

Portfolio Approach

- An entity generally applies the Five-Step Model within ASC 606 to a single contract with a customer
- A practical expedient within ASC 606 is allowed for a portfolio of contracts (or performance obligations) with similar characteristics to be assessed as a single transaction if the following criteria have been achieved:

  1) The entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio.

  2) An entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

- The practical expedient may be available to many M&D entities and could impact the number of contracts to which Step 1 is applied

Step 1 – Identify the Contract

Purchase Order (PO) = Contract?

- A contract is defined as an agreement between two or more parties that creates enforceable rights and obligations. A contract can be written, oral or implied by an entity's customary business practices.

- A contract does not exist if each party can terminate the contract <u>prior to any performance occurring</u> without having to compensate the other party

- Is a PO that can be cancelled prior to any performance occurring without the need for compensation to the other party…would then a PO meet the definition of a contract?

  1) PO + Other agreements and/or terms and implied practices = Contract

  2) PO (by itself with no performance) = NO Contract

  3) PO + Performance = Contract

Polling Question #1

The portfolio approach to identifying contracts with customers can be used when:

A. The entity reasonably expects that using this approach will be less time consuming.

B. The entity reasonably expects that the affects on the financial statements of applying the standard to the portfolio would not differ materially from applying the standard to individual contracts.

C. The entity uses estimates and assumptions that reflect the size and composition of the portfolio.

D. Both B and C.

Step 2 – Identify the Performance Obligation

Step 2 – Identify the Performance Obligation

Overall Methodologies

- Immaterial promises - entities are not required to assess whether promised goods or services are performance obligations, if they are **immaterial in the context of the contract** with the customer

- Cost to fulfill a contract - performance obligations do not include activities that an entity must undertake to fulfill a contract unless the entity will transfer a good or service to the customer

- Cost to obtain a contract - these costs, for example **sales commissions**, are capitalized as a contract asset and amortized on a basis consistent with the transfer to the customer of the goods and services to which the asset relates…with available practical expedient
  - Legacy GAAP – Sales commissions are expensed as incurred.
  - ASC 606 –
    - Sales commissions are capitalized and expensed as or when revenue is recognized, OR
    - Elect the practical expedient to expense as incurred <u>if</u> the amortization period of the asset that would otherwise be recognized is one year or less

Step 2 – Identify the Performance Obligation

Sale of Goods Produced (Resale of Goods Purchased)

- Example of Criteria to Be Distinct - A manufacturer enters into a contract with a customer to construct a unique piece of equipment. The contract identifies various goods and services to be provided, including engineering, procurement, construction of the equipment, installation and set-up. How many performance obligations?
  - Under Step 2, a performance obligation must meet both of two criteria; (1) capable of being distinct and (2) distinct within the context of the contract
  - The promised goods and services in this example appear to be capable of being distinct, that is the customer can benefit from the goods and services either on their own or together with readily available resources
  - However, the goods and services are not distinct within the context of the contract, that is the entity's promise to transfer individual goods and services in the contract are not separately identifiable from other promises in the contract
- Because both criteria are not met in this example, all goods and services in the contract are treated as a single performance obligation

Step 2 – Identify the Performance Obligation

Shipping and Handling Activities

- Shipping and handling activities that occur **before** the customer obtains control of the good (for example, a sale with FOB destination shipping terms) are fulfillment activities and thus not a separate performance obligation to be identified
- Shipping and handling activities that occur **after** the customer obtains control of the good may be either:
  - A separately identified performance obligation, OR;
  - Through an accounting policy election, be accounted for as fulfillment activities
    - If the accounting policy election is made, the entity should disclose the policy and apply it consistently to similar types of transactions. In situations where this election was made and where revenue is recognized for the related good before the shipping and handling activities occur, then the related costs of those shipping and handling activities should be accrued.

Step 2 – Identify the Performance Obligation

Shipping and Handling Activities

- Shipping Terms versus Transfer of Control
  - Shipping terms and when control of the goods transfer to the customer are NOT necessarily the same thing
  - Under the control model used in ASC 606, shipping terms are only indicators of transfer of control. These terms may factor into the conclusions on transferring control, but are not the only considerations.
- Gross versus Net Presentation (Principle versus Agent)
  - If the entity is responsible for and directs the terms of the shipping and handling activities, it would likely be the principle in the transaction and report the activities gross
  - If the entity is merely coordinating the shipping and handling activities and does not direct the terms and pricing of the activities, then the entity would likely be an agent in the transaction and report the activities net

Step 2 – Identify the Performance Obligation

Warranties

- Assurance-Type - provides a customer with assurance that the related product will function as the parties intended is referred to as an assurance-type warranty
  - Example: An industrial machine manufacturer's contract with a customer includes a warranty to provide for full repair of the machine if the machine fails to work properly within five years from the date of purchase
- Service-Type - provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications is referred to as a service-type warranty
  - Example: An industrial machine manufacturer's contract with a customer includes a warranty to provide for full repair of the machine if the machine fails to work properly within five years from the date of purchase <u>and</u> provides the first 3 scheduled maintenance services on the machine

Step 2 – Identify the Performance Obligation

Warranties

- Assurance-Type - generally will not represent a separate performance obligation.
  - Assurance-type warranties = NO CHANGES FROM LEGACY GAAP
- Service-Type - will represent a distinct service and will be considered a separate performance obligation
  - Service-type warranties = ACCOUNTING CHANGES UNDER NEW STANDARD
- If an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity should account for both of the warranties together as a single performance obligation (i.e., together as a service-type warranty)

Step 2 – Identify the Performance Obligation

Warranties – Assurance-Type Example

- MFG, Inc. sells an industrial machine to a customer for $10,000 and also provides the customer a warranty for full repair of the machine if the machine fails to work properly within five years from the date of purchase. The manufactured cost of the machine is $8,000 and MFG estimates warranty costs of product failures to be 2% of all production
  - MFG records the following journal entry to record the sale and warranty obligation:

DR.	Cash/AR	$10,000	
DR.	Warranty Expense	160	
CR.	Revenue		$10,000
CR.	Accrued Warranty		160

Step 2 – Identify the Performance Obligation

Warranties – Service-Type Example

- MFG, Inc. sells an industrial machine to a customer for $10,000 and also provides a warranty for full repair of the machine if the machine fails to work properly within five years from the date of purchase <u>and</u> provides the first 3 scheduled maintenance services on the machine. The manufactured cost of the machine is $8,000 and MFG estimates warranty costs of product failures to be 2% of all production. MFG separately sells the 3 scheduled maintenance services for $500.
  - MFG records the following journal entry to record the sale and warranty obligation:

DR.	Cash/AR	$10,000	
DR.	Warranty Expense	160	
CR.	Revenue		$9,524 *
CR.	Contract Liability		476 *
CR.	Accrued Warranty		160

* Relative selling price allocation – $500 / ($10,000 + $500) = 4.76% (percent of total transaction price to be allocated to the service-type warranty)

Step 2 – Identify the Performance Obligation

Warranties - Determining When Additional Service Is Provided

- Does customer have the option to purchase the warranty?
  - YES – Generally considered an additional service provided (Service-Type warranty)
  - NO – Depends (consider statutory requirements, tasks promised to be performed and warranty coverage period)

- Is the warranty required by law?
  - YES – Generally not considered an additional service provided (Assurance-Type warranty)
  - NO – Depends (consider tasks promised to be performed and warranty coverage period)

- Nature of the tasks promised to be performed
  - A promise to perform specified tasks in addition to assuring that a product complies with agreed-upon specifications likely indicates an additional service provided
  - Recall the previous example of providing the first 3 scheduled maintenance services as an illustration of a specified task that likely would be indicative of an additional service and thus a service-type warranty

Step 2 – Identify the Performance Obligation

Warranties - Determining When Additional Service Is Provided

- Length of warranty coverage period
  - The longer the coverage period, the more likely a conclusion of an additional service provided
  - Example: An industrial machine manufacturer's contract with a customer includes a lifetime warranty to provide for full repair of the machine if the machine fails to work properly (the industry standard expected life of the machine is five years)
  - The warranty coverage beyond the five year expected life may be considered by the entity as an additional service and thus a service-type warranty

- Will require judgment of facts and circumstances
  - The examples provided are relatively straight-forward facts and circumstances. Other entity-specific instances may require more judgment when determining whether additional services are provided
  - Entities should consider (and document) all relevant facts and circumstances

Step 2 – Identify the Performance Obligation

Bill and Hold Arrangements

- A bill and hold arrangement is a contract under which the seller bills a customer for a product but retains physical possession of the product until it is transferred to the customer at a point in time in the future
- The timing for revenue recognition depends on when the customer obtain control of the product. For a customer to have obtained control of a product in a bill and hold arrangement, all of the following criteria must be met;

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

- Generally, when these criteria are met, the customer has control of the product even though it has decided not to exercise its right to take physical possession. Consequently, the seller does not have control the product, but rather provides custodial services to the customer over the customer's asset…But are the custodial services a separate performance obligation?

Polling Question #2

A warranty with terms such that it contains both an assurance-type warranty and a service-type warranty, the two of which cannot be reasonably be accounted for separately, should be accounted for as:

A. Separately as assurance-type and service-type because the underlying classification of the warranty will always determine the accounting treatment.

B. Together as an assurance-type warranty.

C. Together as an service-type warranty.

D. Neither warranty needs to be accounted for in this situation.

Variable Consideration

Variable Consideration

Overall Methodologies

- If the consideration promised in a contract includes a variable amount, an entity should **estimate** the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer
- Consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, or other similar items. Consideration also can vary if an entity's entitlement to the consideration is contingent on the occurrence or nonoccurrence of a future event. For example, consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

Variable Consideration

Overall Methodologies

- The amount of variable consideration must be estimated by using either of the following methods:
  - Expected Value Method - the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
  - Most Likely Amount – the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus for delivering a constructed machine to a customer within a specified time period or does not).
- Revenue Constraint
  - The transaction price should only include variable consideration not subject to significant revenue reversal

Variable Consideration

Volume Incentive Discounts or Rebates

- MFG, Inc. contracts with its customer to sell modular homes for a base price of $50,000 per unit. If the customer purchases more than 100 units in a calendar year, the contract specifies that a rebate of 2% of all purchases will be payable to the customer. For the first quarter, MFG sells 20 units to the customer.
  - Assuming MFG has determined, through consideration of all information that is reasonably available, that it will not sell more than 100 units to the customer during the year. How much revenue should MFG recognize in the first quarter for this contract with its customer?

Variable Consideration

Volume Incentive Discounts or Rebates

- MFG would recognize revenue of $1,000,000 for the first quarter because its estimate of variable consideration is zero, and it concludes that it is probable that a significant reversal in the cumulative amount of revenue will not occur. The transaction would then be recorded as (ignoring cost and inventory aspects of the entry):

DR.	A/R	$1,000,000	
CR.	Revenue		$1,000,000

o 20 units sold x (Price per unit of $50,000 – variable consideration estimate of $0) = $1,000,000

Variable Consideration

Volume Incentive Discounts or Rebates

- During the second quarter, MFG, Inc. sell 40 units to the customer
  - Assuming MFG has determined it will sell more than 100 units to the customer during the year. How much revenue should MFG recognize in the second quarter for this contract with its customer?

Variable Consideration

Volume Incentive Discounts or Rebates

- MFG would recognize revenue of $1,940,000 for the second quarter because its estimate of variable consideration is now 2% of all customer purchases. The transaction would then be recorded as (ignoring cost and inventory aspects of the entry):

DR.	A/R	$2,000,000	
CR.	Revenue		$1,940,000
CR.	Contract liability		60,000

- 60 aggregate units sold x (estimated transaction price of $50,000 x 98%) = $2,940,000
- Aggregate transaction price of $2,940,000 - $1,000,000 recognized in first quarter = $1,940,000

Variable Consideration

Volume Incentive Discounts or Rebates

- During the second half of the year, MFG, Inc. sells only 20 more units to the customer. How much revenue should MFG recognize in the second half of the year for this contract with it customer?

- MFG would recognize revenue of $1,060,000, which would reflect the revised estimate of variable consideration to zero and effective settlement of the contract liability and the transaction would be recorded as (ignoring cost and inventory aspects of the entry):

DR.	A/R	$1,000,000	
DR.	Contract liability	60,000	
CR.	Revenue		$1,060,000

- 80 units sold x (Price per unit of $50,000 – variable consideration estimate of $0) = $4,000,000
- Aggregate transaction price of $4,000,000 - $2,940,000 recognized in first half = $1,060,000
- Contract liability effectively settled and entry recorded to reverse

Variable Consideration

Volume Incentive Discounts or Rebates

- Accounting impacts largely similar to legacy GAAP
- New considerations under ASC 606
  - Portfolio approach as a practical expedient, if criteria is achieved
  - Variable consideration estimated at inception of the contract with the customer
  - Disclosure requirements
    - Policy disclosures related to practical expedient, if applied
    - Contract liability disclosures

Variable Consideration

Right of Return

- A right of return is considered variable consideration and may be contractual, implicit, or a combination of both
- Considerations related to rights of return apply to contracts when a customer has a right to receive any combination of the following:
  - A full or partial refund of any consideration paid
  - A credit that can be applied against amounts owed
  - A credit that can be applied to future purchases
- It does not apply to:
  - Exchanges of product with the same type, quality, condition and price
  - Returns for faulty or damaged products

Variable Consideration

Right of Return

- To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity should recognize all of the following:
  - Revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (i.e., no revenue recognized for the products expected to be returned);
  - A refund liability, and;
  - An asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.
- The right of return guidance under ASC 606 is generally similar to legacy GAAP; <u>however, net balance sheet presentation is no longer permitted!</u>

Variable Consideration

Right of Return - Example

- MFG, Inc. sells 50,000 products at $100 each, with a cost of $50 each. MFG has a 30-day return policy that allows the customer to return the product in “like new” condition for a full refund. MFG estimates, based on its experience from a portfolio of similar contracts, that 1.5% of products will be returned by the customer and there will be no cost to recover the asset nor any decrease in value of returned products.

- The entry to be recorded based on the facts and circumstances presented within this scenario is as follows (with changes from legacy GAAP noted in red):

DR.	A/R	$5,000,000	
CR.	Revenue		$4,925,000
CR.	Refund liability		75,000
DR.	COGS	2,500,000	
CR.	Inventory		2,500,000
DR.	Recovery Asset	37,500	
CR.	COGS		37,500

Variable Consideration

Significant Financing Component

- In determining the transaction price, an entity should adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer, i.e., a **significant financing component.**

- A practical expedient within ASC 606 states that the promised amount of consideration does not need to be adjusted for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

Polling Question #3

To account for the transfer of products with the right of return, an entity should recognize:

A. Revenue for the transferred products in the amount of consideration to which the entity expects to be entitled.

B. A refund liability.

C. An asset for its right to recover products from customers on settling the refund liability.

D. All of the above.

Disclosure Requirements

Disclosure Requirements

Disclose both quantitative and qualitative information that enables users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers

- Much more extensive than those of legacy GAAP and include:
  - Disaggregation of revenue
  - Significant changes in contract assets, liabilities and costs
  - Information about performance obligations (e.g., type, payments terms, timing)
  - Transaction price allocated to remaining performance obligations (and when expected to recognize)
  - Significant judgments and changes in judgments
  - Information about policy decisions

Disclosure Requirements

Disaggregation of Revenue

- Disclosure of **disaggregation of revenue** that depicts how the nature, amount, timing and uncertainty of revenue and cash flows are effected by economic factors

- The extent to which an entity's revenue is disaggregated depends on the facts and circumstances that pertain to the entity's contracts with customers and should consider:

  - How information is presented for other purposes (information reviewed by the chief operating decision maker), and;

  - How information is presented for other purposes (earnings releases, annual reports, investor presentations).

Disclosure Requirements

Disaggregation of Revenue

- Some entities may need to use more than one type of category for meeting the objective of disaggregating revenue, while other might meets this objective with only one category. Examples of categories that might be appropriate include:
  - Type of good or service
  - Geographical region
  - Market or type of customer
  - Type of contract
  - Contract duration
  - Timing of transfer of goods and services
  - Sales channels
- Non-public business entities may elect to not provide the quantitative disaggregation disclosures. If election is made, must still provide disclosures of revenue disaggregated according to the timing of transfer of goods and services and qualitative information about how economic factors (e.g., type of customer, geographic location of customers, and type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows.

Disclosure Requirements

Information About Policy Decisions

- Disclosure of **information about policy decisions** that enables users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers

- The disclosure about policy decisions would include:

  - Practical expedients (for example, the portfolio approach or significant financing components)

  - Accounting policy elections (for example, shipping and handling activities as fulfillment activities)

IFRS 15 and ASC 606 Differences

IFRS 15 and ASC 606 Differences

While IFRS 15 and ASC 606 are substantially converged and largely contain the same provisions, separate amendments by the Boards created some differences between the standards, and include the following:

- **Effective Date** - The effective date of IFRS 15 for nonpublic entities is annual periods beginning after January 1, 2018. This means that nonpublic business entities may need to adopt the revenue standard one year earlier compared to what would be required for US stand-alone financial statements.

- **Collectability Threshold** – In step 1 of the new standard, one of the criteria in determining if a contract with a customer exists is that collectability is probable. The collectability threshold is “probable” under both US GAAP and IFRS 15; however, under GAAP, probable is defined as “likely to occur” and under IFRS it is defined as “more likely than not”. Probable, as defined under GAAP, is a slightly higher threshold as compared to IFRS; this may mean there will be differences between what is considered a contract with a customer under the two revenue recognition standards.

IFRS 15 and ASC 606 Differences

- **Shipping and Handling Policy Election** – Under IFRS 15, there is no policy election to treat shipping and handling activities undertaken by the entity after the customer has obtained control of the related goods as a fulfillment activity (i.e. not a performance obligation). Under IRFS 15, an entity determines if shipping and handling activities are distinct from the shipped goods (i.e. a performance obligation). If so, some revenue is allocated to the shipping activity and deferred until shipping and handling occurs.

- **Step 3 – Sales Taxes Policy Election** – Under IFRS 15, there is no policy election to present all sales and similar taxes on a net basis. The company evaluates whether sales and similar taxes are collected on behalf of a third party (e.g. government) on a jurisdiction-by-jurisdiction basis (i.e. a principal vs. agent evaluation).

- **Disclosure Requirements** – Under IFRS 15, the entity needs to estimate certain variable consideration for disclosure purposes only, even when those estimates are not needed for the recognition of revenue; however, IFRS 15 has fewer disclosure requirements for interim financial reporting than ASC 606.

Polling Question #4

The disclosure requirements of ASC 606 include disclosure of which of the following:

A. The aggregate cost of implementing ASC 606.

B. Disaggregation of performance obligations.

C. Disaggregation of revenue.

D. Significant changes in profitability from top customers.

Summary

All M&D entities will be impacted with the implementation of ASC 606. Keep these topics in mind as you go through your implementation to ensure that your entity has considered the concepts of the new standard that are commonly applicable to the M&D industry:

- Portfolio approach (practical expedient for identifying contracts with customers)
- Sales commissions (as costs to obtain a contract)
- Shipping and handling activities (policy election to treat as fulfillment activities)
- Warranties (assurance-type v. service-type)
- Bill and hold arrangements (custodial services as possible performance obligation)
- Volume incentive discounts and rebates (portfolio approach and disclosure requirements)
- Right of return (net presentation no longer permitted)
- Significant financing component (practical expedient for time period of one year or less)

Thank you

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