Smith • Schafer & Associates, Ltd.
Certified Public Accountants and Consultants

Revenue Recognition Case Study

MANUFACTURING INDUSTRY: OVERTIME

SCENARIO:

Manufacturing Company A enters into a contract to sell 1,000 widgets for a total of $15,000 or $15 per widget, to a customer. The contract contains a warranty to replace widgets that do not comply with the agreed-upon specifications.

Once produced, the widgets do not have an alternative use to Manufacturing Company A. If the contract is canceled by the customer Manufacturing Company A has the right to payment for performance completed to date.

STEP ONE - IDENTIFY THE CONTRACT WITH A CUSTOMER

Manufacturing Company A has a contract with a customer for 1,000 widgets.

STEP TWO - IDENTIFY PERFORMANCE OBLIGATIONS IN THE CONTRACT

Based on planned delivery the performance obligation could either be one, for the manufacturing of 1,000 widgets based on them being a bundle of goods. Or, since the customer can benefit from each widget independently and they will be shipped as they are produced, there can be 1,000 distinct performance obligations. We will assume one performance obligation.

The warranty does not provide an additional service to the customer if it's only related to replacing items that do not meet specifications. Under the current scenario, the warranty would be account for as a liability and an expense (no change from current accounting). If the customer had the opportunity to purchase an extended warranty that warranty would be a separate performance obligation and need to be accounted for based on its standalone selling price.

STEP THREE - DETERMINE THE TRANSACTION PRICE

$15,000

Variable pricing could make the transaction price more complicated. If the above contract included an option to purchase an additional 1,000 widgets for $14 per widget Manufacturing Company A would need to determine the likelihood of the customer opting to purchase the additional 1,000 widgets and based on that assessment possibly allocate the $1 discount received on the second 1,000 units across all 2,000 units.

STEP FOUR - ALLOCATION OF TRANSACTION PRICE

Based on the original scenario, no allocation is needed as only one performance obligation exists at a price of $15,000.

STEP FIVE - RECOGNIZE REVENUE

Revenue is general recognized upon the satisfaction of performance obligations, typically occurring when control of the good or service is transferred to the customer. Per the new standard control can be transferred at a point in time or overtime.

To be considered over time one of the following criteria needs to be met:

- The customer receives and consumes the benefits provided by the seller's performance as the seller performs (service)
- The seller's performance creates/enhances an asset that the customer controls as the asset is created/enhanced
- The seller's performance does not create an asset with an alternative use to the seller, and the entity has an enforceable right to payment for the performance completed to date

In this scenario Manufacturing Company A meets the third criteria and is required to recognize revenue over time. As a result Manufacturing Company A needs to determine the most appropriate method to measure the progress towards satisfying the performance obligation (output method or input method). Most companies will use an input method based on costs incurred.

Manufacturing Company A estimates the total cost to produce the 1,000 widgets is $12,000. At the end of the year they have costs related to the production of the widgets of $9,000. At the end of the reporting period Manufacturing Company A has completed, sent, and billed for 400 widgets.

Below are the related entries:

TO RECORD THE REVENUE RELATED TO THE CONTRACT (75% OF TOTAL CONTRACT BASED ON COSTS TO DATE):		
Revenue		$11,250
Accounts receivable	$6,000	
Unbilled accounts receivable	$5,250	

The entry includes $6,000 to accounts receivable related to the 400 widgets already billed and $5,250 to unbilled accounts receivable for the unconditional right for the remaining revenue, as the contract allows Manufacturing Company A to receive payment for performance completed to date even if the contract is cancelled.

Assume a sales rep will earn a $1,500 commission (10%) on this contract, the following entry would also be recorded:

Commission Expense	$1,125	
Commission Payable		$1,125

If we continued with the alternative in Step 3, and we assume the customer will purchase the additional 1,000 units and the commission on those units is 5%, the full commission is allocated across all 2,000 units.

CONTRACT MODIFICATION (CHANGE ORDERS)

A contract modification is treated as a separate contract if:

- it results in the addition of a distinct performance obligation.

  AND

- the price is reflective of the standalone selling price of that additional performance obligation.

Continuing with the above scenario, assume in the middle of production the customer requests and additional 500 widgets for $8,000 ($16 per widget) which represents the current selling price for the widget. Based on this the customer now has two contracts, one for 1,000 units and one for 500 units.

However, if the current selling price was $17 per widget (not the standalone selling price), Manufacturing Company A would combine the original and new contracts into one contract and would be required to determine the average selling price for all remaining widgets. Widgets that had already been completed, sent and billed would be excluded from this calculation.

DO YOU UNDERSTAND THE IMPACT OF THE NEW ACCOUNTING STANDARDS ON YOUR MANUFACTURING COMPANY?

Smith Schafer is a recognized leader in providing accounting, auditing and consulting services to the manufacturing industry since 1971. Our Manufacturing Group is committed to serving Minnesota manufacturing entities and stays on top of industry issues, trends, tools and technologies to ensure we give you the best possible advice.

For additional details on the new revenue recognition accounting rules or to learn more about how we can help, please contact a Smith Schafer professional at info@smithschafer.com.