Revenue Recognition Ready?

Manufacturing

Agenda

- **General Information – Revenue Recognition**
- **Special Challenges for Manufacturers**
- **Transition and Disclosure**
- **Implementation in Your Organization**
- **Q&A**

History

- Multiple methods for timing, amount;
- Varying by industry

Revenue defined

*"income from **customers** arising from an entity's **central operations** in an **exchange transaction**"*

"Customer" may include an entity's customer's customer

(i.e., a manufacturer sells to a distributor/retailer

who sells to an end customer)

Rules-based to Principles-based

5 Basic Steps

Step 1: Identify the contract

Step 2: Identify the performance obligation

Step 3: Determine the transaction price

Step 4: Allocate the transaction price

Step 5: Recognize revenue

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5 Revenue Recognition Basic Steps

Step 1: Identify the contract

- Written
- Oral
- Implied by customary business practice

Step 1: Identify the contract

Side agreements considered with primary agreement

- Cancellation
- Termination
- Options
- Discounts

Step 2: Identify the performance obligation

- Performance obligation – "promise" that creates an expectation that an entity will provide a good or service
- Contracts are broken down or bundled to get to the level of "distinct" goods or services

“Distinct” goods or services

- Customer could benefit from the good or service on its own or in combination with other readily available resources
- Not distinct if one or more goods or services significantly modifies another, or the goods or services are highly interdependent

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5 Revenue Recognition Basic Steps

Step 3: Determine the transaction price

Variable consideration – estimate and record to the extent that it is unlikely to be reversed

Variable consideration

- Price concessions
- Coupons
- Volume discounts
- Incentives
- Rebates
- Refunds
- Credits
- Performance bonuses/penalties
- Royalties

5 Revenue Recognition Basic Steps

Step 4: Allocate the transaction price

- Allocated to performance obligations
- Based on standalone selling prices
  - Estimated using most directly observable information
- At contract inception
- Discounts generally allocated ratably
  - Unless specifically identified to one performance obligation

Step 5: Recognize Revenue

When the customer obtains control

Customer obtains control:

When it has the ability to use, consume, deploy, allow another to deploy, restrict another from deploying, pledge, or sell an asset

Step 5: Recognize revenue

Customer obtains control and revenue is recognized either

“over time” or

“at a point in time”

5 Revenue Recognition Basic Steps

Revenue recognized over time

If any one of the following criteria are met:

- Customer simultaneously receives and consumes the benefits as the entity performs (service)
- Entity's performance creates or enhances an asset that the customer controls
- Entity's performance does not create an asset with alternative uses to the entity and the entity has an enforceable right to payment for performance completed to date (including a profit component)

Otherwise recognized at a point in time when customer obtains control

Special Challenges for MANUFACTURERS

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Special Challenges for MANUFACTURERS

- Pre-production activities
- Transfer of control
- Shipping
- Volume discounts, incentive payments, etc.
- Right of return
- Milestone or progress payments
- Sales through a distributor
- Warranties
- Royalties
- Principal vs. agent determination
- Incremental costs of obtaining a contract

Pre-production Activities

- Not a separate performance obligation because no good or service transferred to the customer
- Example - design and development of tooling prior to production
  - If tooling is not transferred to the customer, no separate performance obligation
- Capitalized, amortized over the period of fulfillment of performance obligation

Transfer of Control

Revenue may be recognized over time for the manufacture of a customized asset

- Little or no alternative use to the entity
- Enforceable right to payment for performance completed to date, including profit

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Transfer of Control - Example

Facts: Contract to manufacture customized equipment

Customer may change specifications during the term

Non-refundable, interim progress payments required

Customer may cancel any time, but there are termination penalties that are designed to provide the entity with coverage of cost and some profit

Work-in-process has no alternative use to the entity

Physical possession and title pass at delivery of equipment

Transfer of Control - Example

Discussion: Customer specifications and ability to change specifications support no alternative use to the entity

Non-refundable progress payments and termination penalties suggest enforceable right to payment for work completed to date with some profit

Conclusion: Transfer of control and recognition of revenue is “over time”

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Transfer of Control – Measure of Progress Toward Performance Obligations

- Most appropriate measure
- Input – entity's efforts to satisfy performance obligation

  Examples: Cost; labor hours; machine hours; time lapsed; quantities of materials used

- Output – direct measure of value transferred to the customer

  Examples: Survey of work performed; units produced; units delivered; contract milestones

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Shipping

- Transfer of control to customer occurs at/after shipment
  - Fulfillment cost
  - Cost accrued, as under current guidance

- Transfer of control to customer occurs before shipment, with accompanying promise by entity to ship
  - Separate performance obligation
  - Allocation of transaction price
  - Consider principle vs. agent
  - May make a policy election to treat as fulfillment cost

Variable Consideration – Volume discounts, Incentive payments, etc.

- Estimated for entire contract period and included in transaction price at contract inception
  - Probability
  - Most likely
- Subject to constraint
- Evaluated each accounting period

Right of Return

- Refund liability for estimated returns (reducing revenue)
  - Restocking charges are netted

- Corresponding asset for the right to recover product
  - Cost at the time of sale
  - Less expected reduction in value
  - Less expected costs to recover

Milestone or Progress Payments

- Could implicitly represent financing if payments occur significantly before or after performance
- Could benefit entity (advance payment) or customer (deferred payment)
- Record interest income/expense at market rate
- May be disregarded if period between fulfillment of performance obligation and payment is less than 1 year

Sales Through a Distributor

Selling through a distributor, with promises of goods or services directly to the end customer will require allocation of the transaction price to these goods or services.

Services to End Customer

Example:

Company X manufactures equipment that provides schools with new, cutting edge teaching and presentation hardware and technology. This equipment is sold through textbook and other education material providers and warehouses, who sell it to schools. However, because the technology is new and the manufacturer wants to ensure that users take full advantage of all of its features, it offers a free 3 hour training class for up to 3 users for each purchase. The training can be accessed with a code that is included with the product.

Services to End Customer

Example:

- What are the performance obligations for Company X?
- How is the transaction price allocated?
- How would the transaction change if the distributor provided the training on Company X's behalf?

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Warranties

- Assurance – product will function as expected – expense accrued – no change
- Service plus assurance – protection against wear and tear – separate performance obligation – allocate transaction price

Royalties

- Sales or usage-based other than for intellectual property – variable consideration
- Estimated, included in price, subject to constraint

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Principal vs. Agent Determination

- Gross vs. net revenue and cost recognition
- Substantive control of goods or services
  - Entity primarily responsible for fulfilling promise
  - Entity has risk
  - Entity performs integration service
  - Entity has pricing discretion

Principal vs. Agent Determination

Areas frequently requiring assessment

- Sub-contractors fulfill most/all obligations
- Goods or services are provided by a third party
- Shipping
- Expense reimbursement

Principal vs. Agent Determination

Clarifies - entity is an agent for amounts collected from customers on behalf of third parties (i.e., sales tax)

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Incremental Costs of Obtaining a Contract

- Would not have been incurred had the contract not been obtained
- Capitalized
- Amortized over the contract period, including expected renewals
- Policy election - expense if amortization period is one year or less

Implementation

Effective – Annual periods beginning after **December 15, 2018**

Implementation

Two methods of application:

1. Retrospective restatement
2. Modified retrospective restatement

Expanded disclosures

Retrospective restatement

- Restate any prior years presented
- Adjust beginning retained earnings for earliest year presented
- Disclose change in each prior year financial statement line

Modified Retrospective Restatement

- Don't adjust prior period
- Adjust beginning retained earnings for year of change
- Additional disclosure – amount by which each financial statement line item is affected by adoption

Presentation

- Contract assets – segregated by those that are unconditional other than for the passage of time and those that are conditional
- Contract liabilities
- Totaled at the contract level
- Revenue from contracts with customers must be segregated from all other types of revenue (i.e., lease, interest, gains, etc.)

Note Disclosures

Underlying objective – disclose qualitative and quantitative information about an entity's contracts with customers, significant judgments, changes in judgments, and assets recognized

Note disclosures – Non-public companies

- Disaggregated revenue
  - ✓Recognized over time vs. at a point in time
- Qualitative information about how economic factors affect the nature, amount, timing and uncertainty of revenue and cash flows

Note disclosures – Non-public companies

Performance obligations - descriptive information, including:

- ✓ When an entity typically satisfies its performance obligation
- ✓ Significant payment terms
- ✓ Nature of goods or services
- ✓ Obligations for returns, refunds, etc.
- ✓ Warranties, etc.

Note disclosures – Non-public companies

Significant judgments

- ✓ Method used to recognize revenue for performance obligations satisfied over time
- ✓ Methods, inputs, assumptions to assess variable consideration constraint

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Implementation

AT YOUR ORGANIZATION

Implementation at Your Organization

- Assess your revenue streams/cycles/contracts
- Determine accounting changes needed
- Educate management and staff
- Discuss with your Baden team
- Make necessary procedure and software changes
- Prepare disclosure information

Your Baden Team

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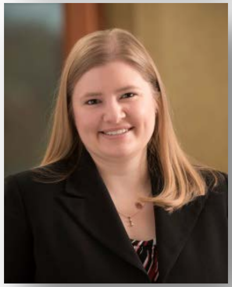

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