Revenue Recognition Case Study

MANUFACTURING INDUSTRY: POINT IN TIME

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. However, the contract is silent in regards to if 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 1,000 performance obligations.

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 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 although we determined each widget was it's own performance obligation. The allocation is equal across all widgets - or $15 per widget.

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 does not meet any of the above criteria and is required to recognize revenue at a point in time.

STEP FIVE - RECOGNIZE REVENUE (*CONTINUED*)

At the end of the reporting period Manufacturing Company A has completed, sent, and billed for 400 widgets.

Below are the related entries:

ENTRY MADE FOR BILLED 400 WIDGETS:			
Accounts Receivable		$6,000	
	Revenue		$6,000
Assume a sales rep will earn a $1,500 commission (10%) on this contract, the following entry would also be recorded:			
Commission Expense		$600	
	Commission Payable		$600
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.			

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

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