REVENUE RECOGNITION STANDARD

MANUFACTURERS

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09 – Revenue from Contracts with Customers (Topic 606) which attempts to clarify the principles for recognizing revenue. Although the ASU was issued in 2014, the FASB provided a long implementation period. For entities that are not considered public business entities (PBEs), the standard becomes effective for annual reporting periods beginning after December 15, 2018, which means January 1, 2019 for calendar year-ends.

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SO WHAT CHANGED?

The recognition of revenue under current accounting standards requires the consideration of two factors; being realized or realizable and being earned. FASB believes ASU 2014-09 will significantly enhance the comparability of revenue recognition practices while also providing a framework to ensure the guidance remains relevant. Specifically, the core principle of ASU 2014-09 is "that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." To achieve the core principle, ASU 2014-09 provides a list of steps to be taken.

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

Each entity will apply this five-step approach to determine when revenue and gains included within the scope of the standard should be recognized.

STEP ONE

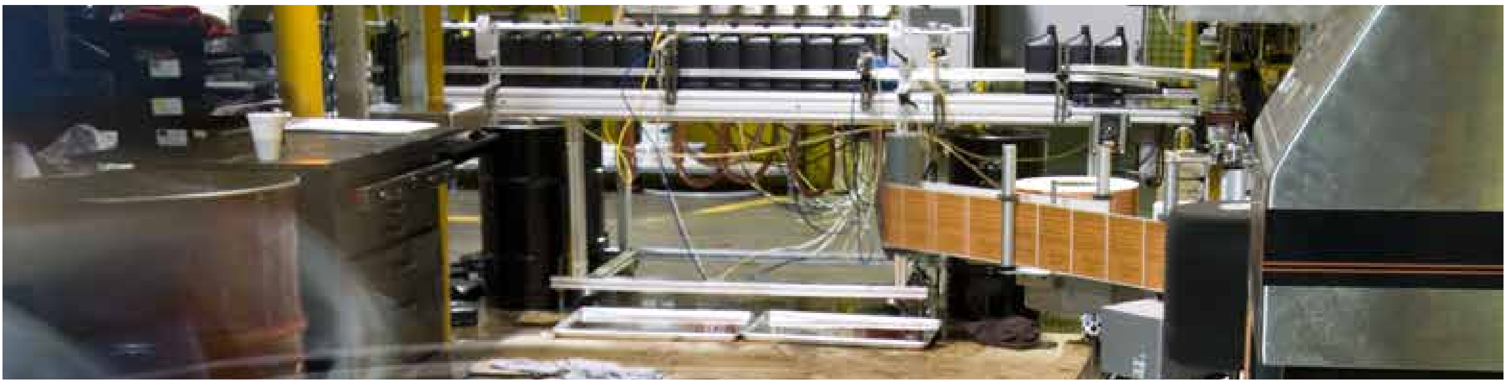
For step one, you have to identify if there is a contract in place which may be straightforward for goods manufactured to order. The contract has to have approval from all parties involved (which can be verbal) and creates enforceable rights and obligations. It needs to have commercial substance and be probable that the consideration will be collectible at the time of the contract inception. It will be important to watch for contracts that have termination clauses with no penalties because it could be considered that contract has no enforceable right to payment. For purposes of this accounting standard, enforcement is a matter of law. This step puts an emphasis on the substance of contracts. It will be important to have a good understanding of all the types of contracts you enter into with customers, their terms, and ultimately their enforceability.

STEP TWO

For step two, you have to identify the performance obligations in the contract. A contract may have distinct separate performance obligations (a good or service or a bundle of goods or services) or it may have multiple obligations that have a similar pattern of transfer to the customer and can be grouped together and treated as one performance obligation. To be considered distinct, the good or service has to provide the customer benefit on its own or with other resources that are readily available to the customer and the promise to transfer the good or service to the customer is identifiable separately from other promises in the contract. For a manufacturer that produces products on order, there is typically one performance obligation: to produce the final product. But be aware there are special circumstances that could create additional performance obligations for manufacturers. These include warranties beyond those that assure the good meets specifications and incentive programs that offer reduced prices for future purchase (e.g. a contract states that if a customer buys more than 500 products in a year, he/she receives a discount). Additionally, at contract inception, you will need to determine if the performance obligation is satisfied at a point in time or over time.

STEP THREE

For step three, you have to determine the transaction price. In many cases, this will be obvious because it will be stated on the contract, but variable consideration and non-cash consideration must be factored in which could make the transaction price different than the stated contract value. Examples of variable consideration for manufacturers are volume discounts, rebates, performance incentives, and the like. When determining the contract price, you will want to factor in the price (using an estimate) of the variable components if it is probable that it will occur and will not be reversed (if you were to record the revenue). For example, if you feel you will achieve a performance incentive, you would include that amount in your price to recognize. Any noncash consideration would be estimated at its fair value at the date of the contract inception. Another noteworthy item to consider in determining the price is how to treat tax related



items–an entity can make an accounting policy election to exclude taxes from the transaction price if they wish.

STEP FOUR

For step four, the total transaction price (from step 3) is allocated to each performance obligation (from step 2) on a standalone selling price basis (which is what you could sell that good or service for separately in similar circumstances to similar customers). If you don't know what the performance obligation would be on a stand-alone basis, you will need to estimate it. Besides doing an analysis of what it would sell for to other customers in a similar situation, you could take an expected cost plus a margin approach (costs of satisfying the performance obligation with an appropriate margin allocated to it). Another method to determine the price is using a residual approach (which is only used if you absolutely cannot determine a standalone price or if the price of that deliverable sells for a wide variety of amounts). The residual approach would be where the company takes the total contract price and backs off all of the other known costs. If you determined a contract only has one performance obligation, this step is straightforward; the entire price is allocated to the one obligation.

STEP FIVE

While steps 1-4 take place at the contract's inception, step five takes place when performance obligations are satisfied. For step five, you will actually recognize revenue for each performance obligation either over time or at a point in time. Currently, manufacturers typically recognize revenue upon shipment (at a point in time), but the new standard requires manufacturers to recognize revenue over time if they are not creating an asset with an alternative use and they have a right to payment (right to payment is enforceable right to cost and margin). This is required regardless of the length of the manufacturing cycle. Your contract terms will need to be evaluated to determine if it is appropriate to continue to recognize revenue upon shipment or if it needs to be recognized over time as manufacturing progresses.

At first glance, the new revenue recognition standard can appear complicated when applied to manufacturing entities. While it is true there are many new aspects to recognizing revenue, it is certainly possible that the final timing and amount of revenue recognition will not be materially different. An evaluation of all contracts will need to be completed to determine the effect on the entity.

If you have any questions regarding the revenue recognition standard (ASC 606) please contact us.

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