REVENUE RECOGNITION

A GUIDE FOR MANUFACTURERS & DISTRIBUTORS

One of the most significant accounting developments currently facing manufacturing and distribution companies is the complete overhaul of revenue recognition guidance by the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB"). Because revenue is one of the most significant numbers within a set of financial statements, any change to the way it is accounted for is often met with many questions. As a result, Clark Schaefer Hackett has developed this publication to share some important highlights for manufacturing companies.

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OVERVIEW

Issued by FASB in May 2014, ASU 2014-09, Revenue from Contracts with Customers was created to replace virtually all industry-specific revenue recognition guidance within U.S. GAAP with one comprehensive industry-neutral model. This model was built upon the core principle that an entity should recognize revenue when control of goods or services transfers to customers for an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance of ASU 2014-09 is codified within the FASB Accounting Standards Codification as Topic 606.

To achieve the core principle, the FASB introduced the following five-step model.

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.**

Although this guidance represents a simplification of U.S. GAAP (something that is generally welcome), it also represents one of the most significant and fundamental changes within U.S. GAAP: a shift from explicit, rules-based accounting to more judgmental, principles-based accounting. Going forward, you will use the overarching, five-step framework above and your professional judgement when determining when and how revenue should be recognized.

Because of the significance of this change, most reporting entities will see some level of impact on their financial statements and/or operations. Many entities may see a change in the timing of their revenue recognition. Accordingly, we encourage businesses to analyze the standard before it becomes effective and implement the processes necessary to account for their transactions.

EFFECTIVE DATES

Public business entities, certain not-for-profit entities, and certain employee benefit plans will apply the guidance to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Early application is permitted.

All other entities will apply the guidance to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Early application is permitted.

TRANSITION METHODS

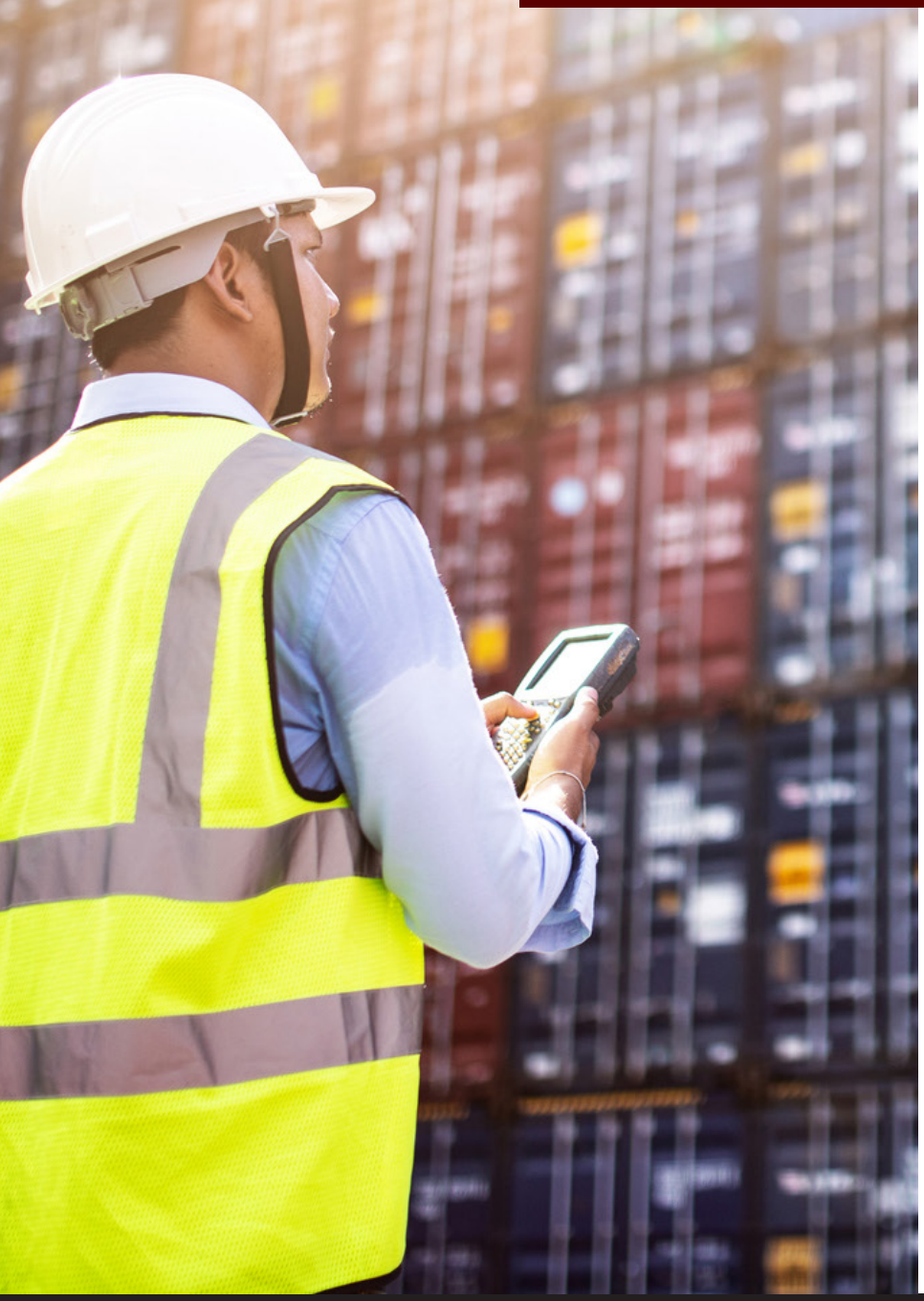
A reporting entity should apply the guidance of Topic 606 using one of the following two methods:

1. Full Retrospective. The reporting entity will apply the guidance to each period presented within comparative financial statements as if it had been in effect since inception of all contracts presented within the financial statements.

2. Modified Retrospective. The reporting entity will apply the guidance to the current period (as of the application date) with no restatement of comparative periods; additional qualitative and quantitative disclosures will be required.

CONSIDERATIONS FOR MANUFACTURERS & DISTRIBUTORS

Beyond the basics of Topic 606, there are several issues that specifically impact companies within the manufacturing and distribution industry. This publication has been developed by Clark Schaefer Hackett to share our insights for manufacturing companies on these issues.



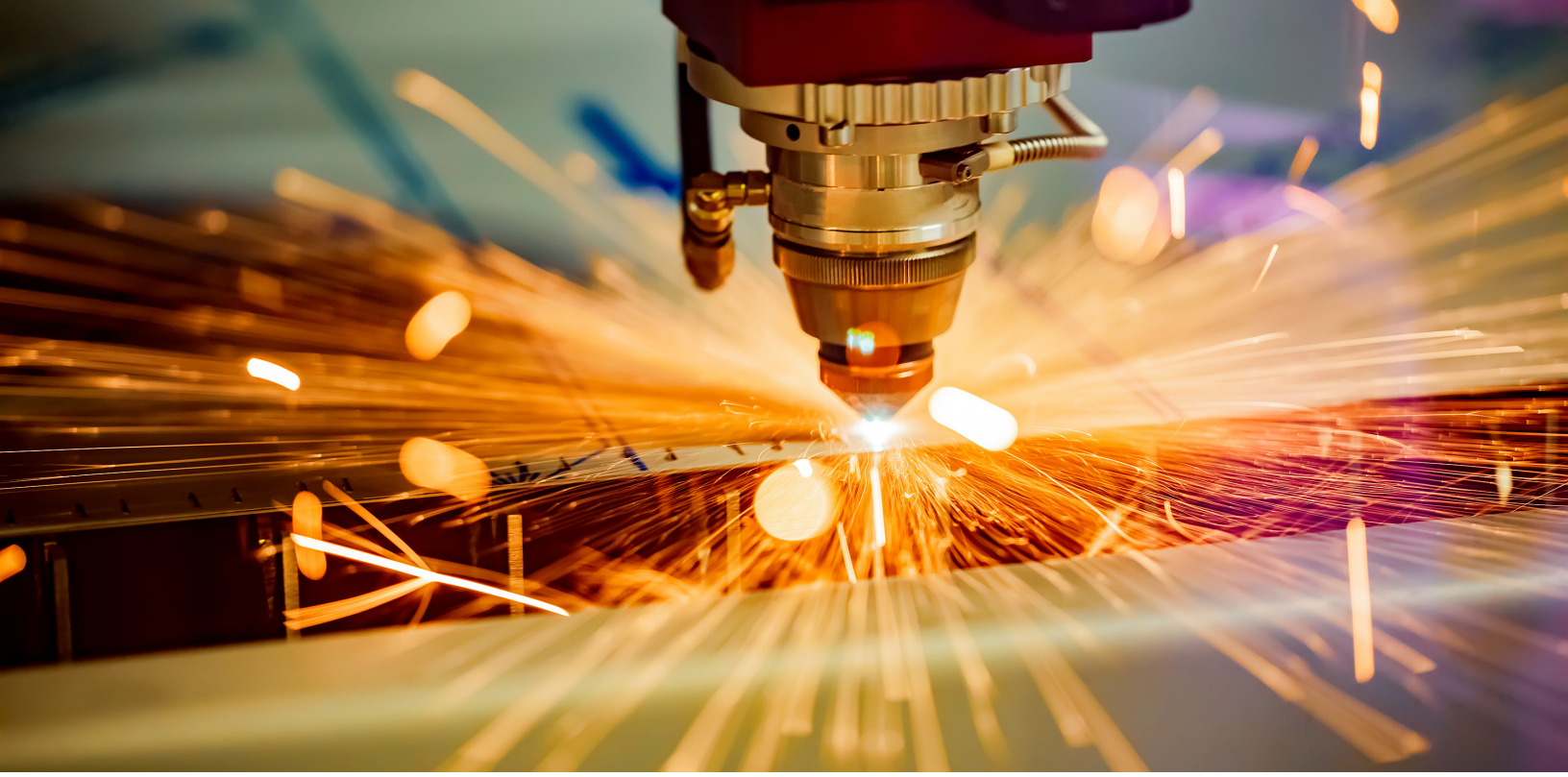
CONTROL

Prior revenue recognition guidance focused exclusively on the transfer of the risks and rewards of ownership to the customer in a sales transaction in order to recognize the related revenue. Topic 606 focuses on the broader concept of the transfer of control of a product or benefit of a service to the customer before revenue can be recognized. And control is determined from the perspective of the customer.

To determine when control of an asset is transferred, a manufacturer must consider factors such as when the following take place:

1. The manufacturer has a present right to payment.
2. The customer has legal title to the asset.
3. The manufacturer has transferred physical possession of the asset. This factor should be evaluated in connection with other contractual arrangements, for example, consignment inventory.
4. The customer has the significant risks and rewards of ownership of the asset.
5. The customer has accepted the asset.

Sometimes only one factor indicating the transfer of control may be present. However, the best evidence is a combination of multiple factors above.



Not to be forgotten in this discussion are the business practices of a manufacturer. Consider shipping terms, which specify the point in time in which title passes to a customer. Typically FOB shipping point would transfer control when goods are shipped. Conversely, FOB destination would transfer control at the time of delivery. Although these terms are standardized, Topic 606 requires an entity to consider its history to assess when the presumption created by shipping terms is correct.

For example, assume Manufacturer A enters into a contract to sell goods to Customer B using FOB shipping point terms. If Manufacturer A has historically accepted losses for goods damaged during shipment, however, their practice indicates Manufacturer A bears the risk of ownership while the goods are in transit. In other words, despite FOB shipping point terms, Manufacturer A's practice creates a synthetic FOB destination agreement. Practices like these require additional consideration by manufacturers. Most critically, are there two performance obligations within the contract?

1. Sale of goods, and
2. Shipping and handling of goods.

If shipping and handling activities are performed after a customer obtains control of the goods, then a manufacturer may elect to account for the shipping and handling as activities to fulfill the promise to transfer the good (i.e. not a separate performance obligation). This election is required to be applied consistently to similar types of transactions. And if revenue is recognized for the related goods before the shipping and handling activities occur, the related costs of those shipping and handling activities shall be accrued.

CUSTOMIZED MANUFACTURED PRODUCTS

Prior revenue recognition guidance, generally, did not allow a manufacturer to recognize revenue on customized manufactured products until manufacturing of the product was complete and the risks and rewards of owning the product were transferred to the customer. Topic 606, however, requires revenue to be recognized over time for customized manufactured products that have no alternative use, cannot be sold to another customer, and for which an enforceable right to payment for performance exists. Accordingly, manufacturers of customized products should now recognize revenue (over time) during production if it can reasonably and reliably measure its progress toward complete satisfaction of the performance obligation.

For performance obligations satisfied over time, a manufacturer shall consistently apply a single method of measuring progress toward complete satisfaction of the performance obligation by considering the following:

1. Output methods – surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and/or units manufactured, or units delivered.

2. Input methods – resources consumed, labor hours expended, costs incurred, time elapsed, or machine hours used relative to the total expected inputs.

FINANCING COMPONENTS WITHIN A CONTRACT

Transactions may contain a significant financing component (either explicitly or implicitly) because a customer pays substantially before or after goods or services have been provided. In determining the transaction price of a contract, a manufacturer will need to adjust the promised amount of consideration for the effect of the time value of money if the timing of payments provides a customer with a significant benefit of financing the transfer of goods or services to the customer.

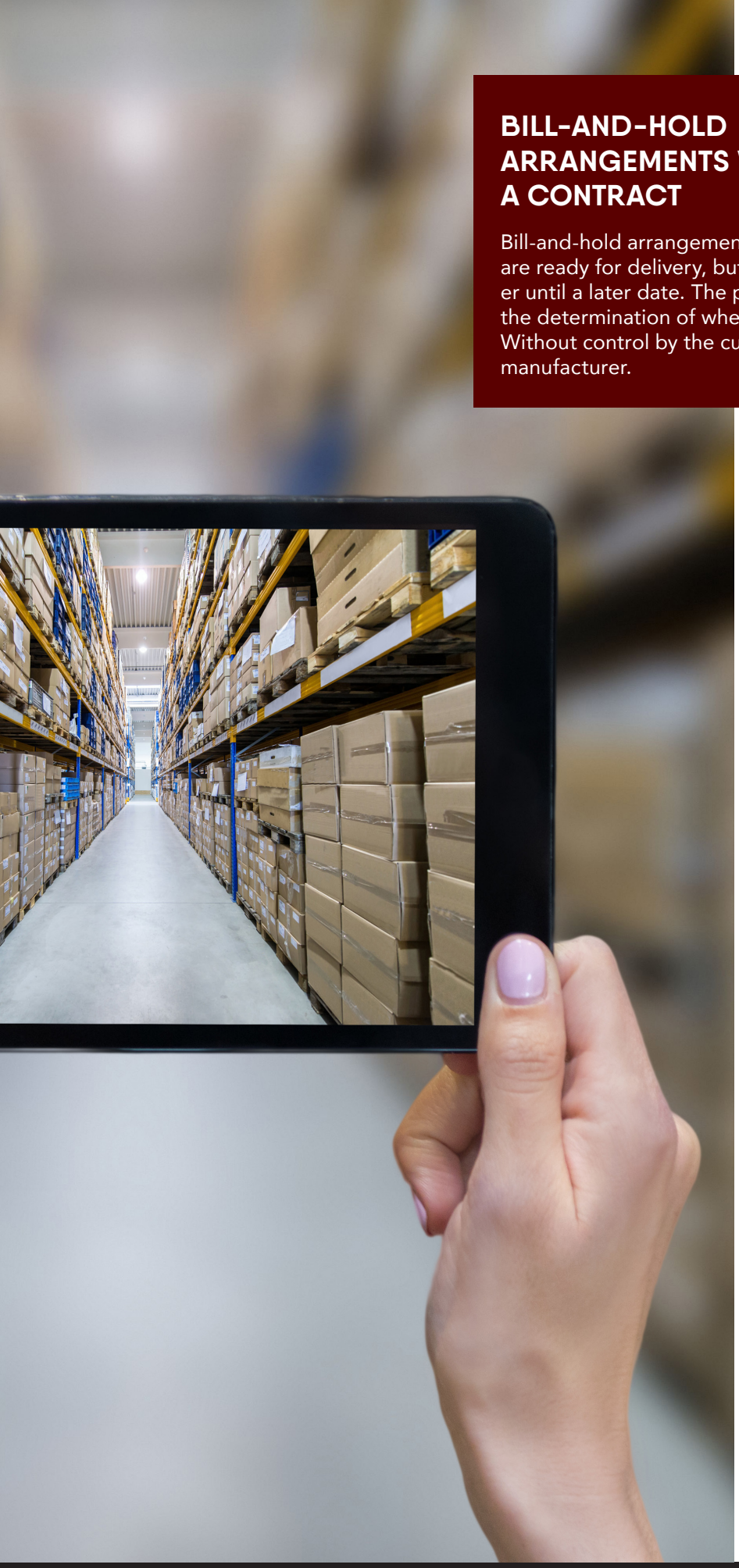
To determine if the financing is significant, a manufacturer should consider all relevant facts and circumstances, including the following:

1. **The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services. In other words, would the transaction price received be different if the financing component of the contract was not included?**
2. **The expected length of time between when a manufacturer transfers the promised goods or services to a customer and when the customer pays for those goods or services.**
3. **Whether the financing component within the contract would save the customer on financing charges using current interest rates.**

As a practical expedient, a manufacturer need not adjust the promised amount of consideration for the effects of a significant financing component if it expects, at contract inception, that the period between when the manufacturer transfers the promised good or service to a customer and when the customer pays for that good or service will be one year or less.

For comparison, Topic 606 indicates that a financing component is not significant if any of the following factors exist:

1. A customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.
2. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the manufacturer (e.g. a sales-based royalty).
3. The difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance to either the customer or the manufacturer, and the difference between those amounts is proportional to the reason for the difference (e.g. the payment terms might provide the manufacturer or the customer with protection from the other party failing to adequately complete some or all of its obligations in the contract).



BILL-AND-HOLD ARRANGEMENTS WITHIN A CONTRACT

Bill-and-hold arrangements arise when a customer is billed for goods that are ready for delivery, but those goods are not shipped to that customer until a later date. The primary issue in bill-and-hold arrangements is the determination of when the customer obtains control of the goods. Without control by the customer, revenue cannot be recognized by a manufacturer.

To determine if the customer has obtained control, a manufacturer should consider the following:

1. The manufacturer has a present right to payment, and
2. The customer has legal title to the asset.

Additionally, a manufacturer must also consider the following criteria when determining if the customer has obtained control:

1. The reason for the bill-and-hold arrangement must be substantive (e.g. the customer requests the bill-and-hold arrangement because it lacks the physical space to store the goods, or because the goods previously ordered are not currently needed due to the customer's production schedule).
2. The goods must be separately identified as belonging to the customer.
3. The goods must be ready for delivery upon the customer's request.
4. The goods cannot be used by the manufacturer to satisfy another order, nor may the manufacturer direct the goods to another customer.

When these criteria are met, then the manufacturing entity can recognize the portion of the transaction price that is being allocated to the manufactured good.

Keep in mind that the warehousing of the goods is a separate performance obligation, and revenue for this performance obligation would generally be recognized as revenue over a period of time.

DISCOUNTS OFFERED WITHIN A CONTRACT

Topic 606 requires a manufacturer to consider discounts offered on purchases when determining the transaction price under a contract.

1. **Bundle Discounts:** Generally, discounts are allocated to all performance obligations in a contract unless the following criteria are met:

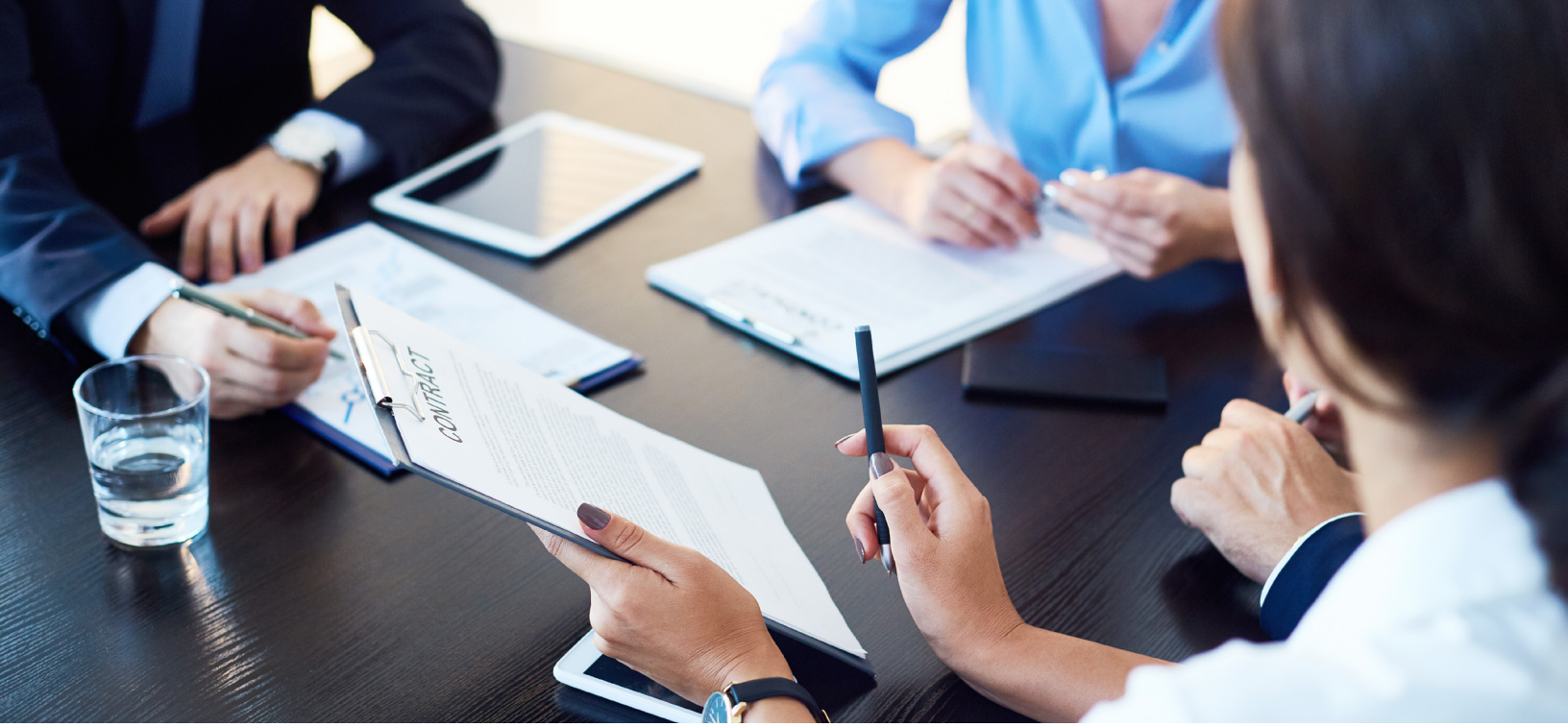
    a. A manufacturer regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis.

    b. A manufacturer also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle.

    c. The discount attributable to each bundle of goods or services (described in point b. above) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

Accordingly, if the criteria are met, a manufacturer would only allocate the discount over certain performance obligations identified in a contract rather than to all performance obligations.

2. **Volume Discounts:** In estimating the transaction price for a volume discount, a manufacturer should first estimate the total units expected to be sold. After unit volume has been estimated, the manufacturer will then calculate the estimated average selling price per unit based on the schedule of discounts in the contract. Revenue is recognized at the average estimated selling price, and the remainder of any payment beyond this price is recorded as a contract liability. Subsequent sales below the estimated selling price reduce this liability. Similar to other transactions, revenue in a contract with volume discounts should only be recognized to the extent it is probable (a high likelihood, or ≈75-80%) that a significant reversal will not occur. At all times revenue should be recognized for at least the minimum price. If the estimated transaction price changes (due to changes in volume) during the contract period, this change should be allocated across all performance obligations (satisfied or otherwise) with a corresponding increase or decrease to revenue in the period of the change.



SERVICES WITHIN A CONTRACT

From time to time, a manufacturer may offer services within a contract. Topic 606 outlines two criteria, both of which must be met for the service to qualify as distinct, therefore requiring the manufacturer to account for the service as a separate performance obligation.

1. **Capable of Being Distinct:** A service is capable of being distinct if the installation could be used, consumed, or sold for an amount greater than scrap value, and a customer can benefit from the service either on its own or with other resources that the customer has readily available. A manufacturer might ask, "Does our company sell this service on a standalone basis?" or "Do any other companies sell this service on a standalone basis?" If the manufacturer can answer 'yes' to either of these questions, this is an indication that the customer can benefit from the installation on its own or with other readily available resources. Accordingly, the service is capable of being distinct.

2. **Distinct Within the Context of the Contract:** After determining that a service is capable of being distinct (i.e. criterion 1. above), the manufacturer must assess whether a service is distinct within the context of the contract. The objective is to determine whether the nature of the promise, within the contract, is to transfer each of the goods or services individually or, instead, to transfer a combined item or items to which those promised goods or services are inputs. The following factors indicate that a service within a contract is distinct within the context of the contract:

   a. The manufacturer does not provide a significant service with other goods or services in the contract.

   b. The service does not significantly modify or customize other goods or services in the contract.

   c. The service is not highly dependent on, or highly interrelated with, other goods or services in the contract.

Ultimately, if the service component within a contract is determined to be distinct, the revenue allocated to that service is typically recognized over time based on the output or input methods discussed above. Accordingly, manufacturers will need to assess contracts to determine if multiple performance obligations exist as revenue recognition may be impacted.

1. **Revenue from the sale of goods would most likely be recognized at a point in time, and**

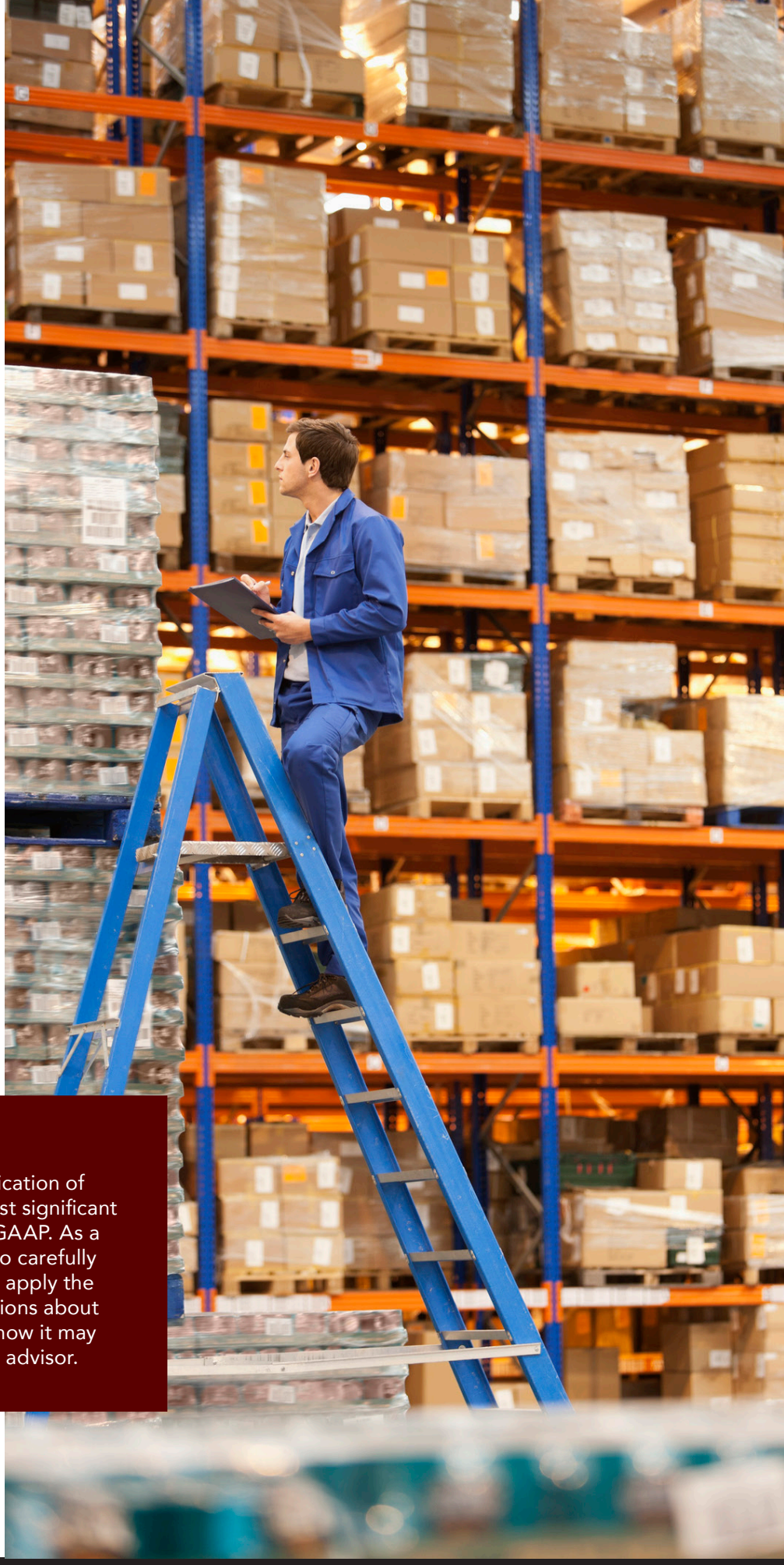
2. **Revenue from the service would most likely be recognized over time.**

WARRANTIES

Topic 606 classifies warranties into two categories, and because many manufacturers offer warranties, they can be impacted by the new revenue recognition standards.

1. **Assurance-Type Warranties:** An assurance-type warranty is a promise to repair or replace a delivered good or service if it does not perform as expected. This type of warranty is not a separate performance obligation. To account for an assurance-type warranty, a manufacturer estimates and accrues a warranty liability when the promised good or service is delivered to a customer.

2. **Service-Type Warranties:** A service-type warranty exists when (1) a customer has the option to purchase it, or (2) it provides service beyond an assurance-type warranty. This type of warranty represents a distinct performance obligation, and therefore, a portion of the transaction price is allocated to it. Generally, revenue from a service-type warranty is recognized as the warranty obligation is fulfilled, which is likely over the term of the warranty.



NEXT STEPS

Although this guidance represents a simplification of U.S. GAAP, it also represents one of the most significant and fundamental changes in the history of GAAP. As a result, manufacturing companies will need to carefully analyze their contracts to determine how to apply the principles in ASC 606. If you have any questions about the new revenue recognition standard and how it may impact your organization, contact your CSH advisor.