UHY LLP Certified Public Accountants

REVENUE FROM CONTRACTS WITH CUSTOMERS

ASC TOPIC 606 AND 340-40
PREPARED FOR: MANUFACTURING

The Next Level of Service

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INTRODUCTION

From May 2014 through February 2017, the Financial Accounting Standards Board (FASB) has continuously made changes to guidance for revenue accounting within ASC Topic 606. The new guidance clarifies the principles for recognizing revenue and develops a common standard for U.S. GAAP and IFRS. This guidance supersedes the current revenue recognition guidance, including industry specific guidance. The new standard aims to remove inconsistencies in revenue requirements, provide a more robust framework for revenue issues, improve comparability across industries and provide more useful information to users of financial statements with improved disclosure requirements.

EFFECTIVE DATES

- Public companies are required to adopt Topic 606 for fiscal periods beginning after December 15, 2017.
- All Other entities are required to transition for annual periods beginning after December 15, 2018, and interim periods beginning after December 15, 2019.
- Early adoption permitted for all entities.

Current GAAP	New Standard
Persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, price is fixed or determinable, collectability is reasonably assured.	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 using a five step process.
Limited disclosures on revenue and contracts.	Uniform disclosure requirements across all industries on revenue recognition policies.
Application of criteria is subject to industry specific guidance; including construction-and-production type contracts, software, real estate, etc.	Application of criteria is based on the terms of the contract with the customer.

FIVE STEP PROCESS

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

Step 1 Identify the contract with the customer

- For an arrangement to be a contract, it must include:
  - Approval and commitment of both parties (can be verbal)
  - Rights of both parties
  - Payment terms
  - Commercial substance
  - Probable the entity will collect consideration for good or service provided.
- If this standard is not met, there are special applications which can be applied.

Application to Manufacturer: Contracts

A purchase order received from a customer or an order taken by a sales agent over the phone likely is considered a contract under topic 606, as these items represent an agreement provided all criteria above are met and it is consistent with the entity's normal business practices.

Under the new revenue recognition standard, most manufacturers will meet the above attributes required to have a contract (approval, rights, payment terms, etc.).

For customers with poor credit, there must be a process to determine the likelihood of collection. The manufacturer must determine if it is probable it will collect the consideration it is entitled to, unless the customer has pre-paid. If the likelihood of collection is below 75-80% (based on historical trends or experience with this type of customer), revenue would not be recorded until funds are collected, even if the service has already been rendered.

Step 2 Identify the performance obligations

- A performance obligation is a commitment in a contract with a customer to transfer to the customer either:
  - A good or service that is distinct (or a bundle of goods or services)
  - A series of distinct goods or services that are essentially the same and have the same pattern of transfer to the customer.
- Distinct goods or services are accounted for as separate performance obligations.
  - A good or service is distinct if both customer can benefit from the good or service on its own or together with other readily available resources; and good or service is separately identifiable from other promises in the contract.

Application to Manufacturer: Revenue streams by performance obligation

We will discuss various performance obligations offered by a manufacturer to provide guidance. For steps two through five below, we will discuss one continuous case study. There is judgment involved in interpreting the new revenue recognition guidance. We will assume for this example, the performance obligations are:

- <u>Goods</u> – Unit has value on its own and is clearly stated in contract.
- <u>Design</u> – The manufacturer creates a design plan for the good, for which the manufacturer is not reimbursed. Once the design and prototype are approved, the customer then purchases individual units (performance obligation noted above). The design service does not represent a performance obligation because it is unlikely the design would have utility to the customer without the act of manufacturing the good. Since the manufacturer would generally account from manufacturing costs under ASC 340-10, it would not qualify as fulfillment cost. The design cost would be expensed as incurred. See fulfillment cost section below for more information.
- <u>Extended service warranty</u> – An extended warranty to stand ready to provide repairs. Warranty includes servicing the goods to make repairs as needed. Warranty is not required by law, and goes above and beyond standard warranties in the industry. The warranty is a performance obligation. Another indicator that a warranty could be a performance obligation is if it is separately purchasable.
- <u>Rebate / Customer give back</u> – To be a material right, a discount would need to be incrementally greater than other discounts (not a general discount given to everyone), the contract price of the good/service is below the stand alone selling price, and the discount is material to the contract. If all of these are true, a discount is capable of being a material right requiring a separate performance obligation. This a <u>not a material right</u> because the rebate is an offering of cash back, instead of product at a discount.

  The only effect of the rebate would be a reduction in transaction price since the manufacturer is expecting to pay cash back to the customer. There would be no performance obligation, revenue allocation, etc. Common items in manufacturing which may be a material right are a tiered discount or a one-time upfront cost with discounted renewals.

- Tooling – Tool will be used to make the individual units of goods. Assume the tool provides value to customer on its own as it has alternative uses and is distinct in the context of the contract. If the tooling does not have value on its own or was not separately identifiable from other promises in the contract, it would not be a separate performance obligation and further analysis would be required.
- Shipping and handling – Shipping and handling generally will not be considered a performance obligation. Any shipping and handling fee would likely be recognized as revenue upon transfer of ownership of goods to the customer. Shipping provided to the customer after the customer obtains control of the good would be a separate performance obligation.

Step 3 Determine the transaction price

- Transaction price is the amount of consideration the entity expects to be entitled.
- Transaction price can be adjusted for the following items, as well as others:
  - Variable consideration – reductions in price for discounts, performance bonus or penalty, rebates, and other similar arrangements which will change the overall price of an item.
  - Significant financing – adjust price for the present value of payments if customer is provided with a major financing benefit.
  - Non-cash consideration – customer pays with method other than cash measured at fair value.
  - Consideration payable to customer – credits and actual repayments.

Application to Manufacturer: The Facts

- Goods – Sale price is $4.95 per unit. To determine the transaction price of the good, the entity must use the expected value approach and net out the expected rebate. The amount which is expected to be paid back via the rebate will constrain the revenue per unit. The expected rebate per unit is the total price minus the expected value. See calculation below.
- Extended service warranty – 10-year warranty has a stand-alone selling price of $.25 per unit, which is provided to the customer free of charge.
- Rebate / Customer giveback – To determine the transaction price of the rebate, the entity must use the expected value approach (see page 7 and 8). The retroactive rebate is 10% per unit if more than 10,000 units are purchased and is 15% per unit if more than 15,000 units are purchased. Based on historical experience and customer purchasing forecast, the entity has determined that there is a 20% chance of selling under 10,000 units, a 75% chance of selling between 10,000-15,000 units, and a 5% chance of selling over 15,000 units. The expected amount of units sold must be reassessed through the period as facts change. The rebate offered by the manufacturer only applies to the unit price (not the warranty, tooling, etc.). Term of rebate is units purchased in one year.

- Tooling – Customer pays $5,500 for manufacturer to build tool. Customer makes progress payments to manufacturer based on cost incurred with a mark-up included by the manufacturer. Assume the tooling is owned by the customer and the manufacturer has historically recorded revenue on tooling projects on a net basis under ASC 605. If tooling was recorded on a net basis under ASC 605 in the past, it should be recorded on a net basis under ASC 606 going forward, unless there is evidence to the contrary.

  If the company is considered an agent for the tooling (see considerations below to decide), tooling revenue would be recorded on a net basis. In the context of the above example, if the cost of the tooling was $5,000, the manufacturer was considered an agent, and the sale price is $5,500, then $500 of revenue would be recorded and no cost of goods sold would be recorded (only a credit of $500 to revenue).

  Considerations to determine if a manufacturer is an agent or a principle are:

  1. The manufacturer is primarily responsible for fulfilling the promise to provide the tooling.
  2. The manufacturer has transaction risk before the tooling has been transferred to a customer, or after transfer of control to the customer (for example, if the customer has a right or return).
  3. The manufacturer has discretion in establishing the prices for the tool.

  If creation of tooling is not considered a part of ongoing major/central operations or tooling is considered a fulfillment/development activity, it would be accounted for under ASC 340-10 or ASC 340-40 (see fulfillment cost section below).

- Right of Return - The customer has a right of return for one year. At one year, the right of return expires. The expected returns should be recorded as a reduction of revenue when recognized. Based on historical experience, expected returns are 2% of revenue. The refund in this case applies only to the product sales (not the warranty, tooling, etc.). The goods can easily be resold. The cost per unit is $3.00. Note – if the goods could not be resold, they would not be recorded as a recoverable asset (page 9), but rather would be expensed.

Application to Manufacturer: Determine transaction price via the expected value approach (based on facts outlined above)

For performance obligations noted above, the price is known except the good and the rebate because of the variable consideration caused by the rebate. We must determine the transaction price for the individual units of goods since revenue per unit is recorded net of the expected rebate. To determine expected consideration per unit, the expected value method is generally the preferred method when there are more than two possible outcomes. See expected value method formula below:

$$\Big((Probability\ of\ Outcome\ \%\ \times Discount\ \%\ \times Unit\ Price) + (Probability\ of\ Outcome\ \%\ \times Discount\ \%\ \times Unit\ Price) \ldots \Big)$$

Continue the formula until all potential outcomes have been included and the sum of the probabilities of the possible outcomes equal 100%.

<u>Unit Price</u>

For the purposes of this example, assume manufacturer sold 10,000 units of inventory to the customer. Sale price per unit is recorded net of expected rebate of $4.54 per unit. See calculation below:

<u>Chance of selling >15k units</u>

Probability of Outcome		5%
Price Net of Discount	x	85%
Full Price	x	$ 4.95
		$ 0.21

<u>Chance of selling 10-15k units</u>

Probability of Outcome		75%
Price Net of Discount	x	90%
Full Price	x	$ 4.95
+		$ 3.34

<u>Chance of selling <10k units</u>

Probability of Outcome		20%
Price Net of Discount	x	100%
Full Price	x	$ 4.95
+		$ 0.99

Transaction Price per Unit ($0.21 + $3.34 + $0.99) = $4.54

Conclusion:

The estimated transaction price per unit using the expected value method is:

Transaction Price per Unit	Variable Constraint	Total
$4.54	$0.41	$4.95

Step 4 Allocate the transaction price to the performance obligations

- Allocate price to each performance obligation based on the stand-alone selling price of that good or service. Other approaches include:
  - Adjustment market assessment
  - Expected cost plus margin
  - Residual approach
- Discounts, variable consideration, and other items affecting final consideration must be allocated to the performance obligation transaction price.

Application to Manufacturer: Allocating the Good and Warranty to the transaction price via the adjusted market approach

The entity must determine the allocation of the transaction price between units and the warranty per unit. To determine revenue per unit vs. the warranty per unit, the adjusted market approach would likely be utilized.

<u>Equation for the adjusted market approach</u>

$$\frac{\textit{Stand- Alone Selling Price}}{\textit{Total of all Stand-Alone Selling Prices included within Consideration Paid)}}$$

* Expected Total Consideration = Allocation of Revenue per Unit

The price of the unit and warranty must be broken out from the expected consideration using the adjustment market assessment. The total stand-alone value of the offerings are:

Unit Value (Known Price)	Warranty Value (Known Price)
$4.95	$0.25

Total stand-alone selling price of offering is $5.20 ($4.95 + $0.25). Consideration expected at net is $4.54 (see step 3). Consideration expected will be allocated based on market assessment approach, see below:

Revenue per Unit				Warranty per Unit			
Unit Value		$	4.95	Warranty per Unit		$	0.25
Stand-alone Selling Price	÷	$	5.20	Stand-alone Selling Price	÷	$	5.20
			95%				5%
Transaction Price per Unit	x	$	4.54	Transaction Price per Unit	x	$	4.54
Per Unit Sold		$	4.32	Per Unit Sold		$	0.22

Journal entry to record sale of 10,000 units		
Dr. Accounts Receivable *(10,000 units x $4.95)*	$ 49,500	
Cr. Unit Revenue *(9,800 units x $4.32)*		$ 42,336
Cr. Deferred Revenue – Warranty *(10,000 units x $0.22)*		$ 2,200
Cr. Return Refund Liability *(200 units x $4.32)*		$ 864
Cr. Rebate Liability *(10,000 units x $4.95 x 8.282%*)*		$ 4,100

*Expected Rebate ($0.41) / Total Price ($4.95) = 8.282% Rebate Per Unit Expected

Journal entry to relieve inventory for sale of 10,000 units		
Dr. Cost of Sales *(9,800 units x $3.00)*	$ 29,400	
Dr. Right to Recover Assets *(200 units x $3.00)**	$ 600	
Cr. Inventory *(10,000 units x $3.00)*		$ 30,000

*Right to recover inventory is for the expected return of 2% of sales, noted in "The facts", step 3

If manufacturer were to obtain additional knowledge that sale projections would fall short of 10,000 units or exceed 15,000 units, the accounting should be adjusted based on the new consideration that is expected (new unit price).

Step 5 Recognize revenue when (or as) the entity satisfies a performance obligation

- A transaction may be recognized over time if at least one of the following occur:
  - The customer concurrently receives and consumes the benefit provided by service received. – Will be rare in the manufacturing setting but is common with service offerings
  - The entity's performance creates or enhances an asset the customer controls as the asset is created or enhanced. – Example – A situation where the work in process is owned by the customer and the customer must pay for work in process goods.
  - The performance does not create an asset with an alternative use to the entity and the entity has a right to payment for the work performed. – Example – A situation where the asset cannot be used by another customer without significant rework costs. Manufacturer has a right to payment.
- If these standards are not met, recognition at a point in time would be applicable if the following are met:
  - The entity has a right to payment
  - The customer has legal title to the item
  - The seller has transferred physical possession of the item
  - The customer has the significant risk and rewards of ownership of the asset
  - The customer has accepted the asset

Application to Manufacturer: Transfer of ownership

- Goods – None of the indicators allowing recognition over time relate to individual units. Sale occurs at a point in time; when ownership of good transfers to the customer.

- Extended service warranty – This product is an offering to repair goods an unlimited number of times over the term of the warranty, which is 10 years. No matter how many repairs the customer obtains, the amount of remaining warranty is unaffected. The service is concurrently received and consumed as the service is provided because the service itself is standing ready to make repairs (not the act of making repairs themselves). This should be amortized to revenue over the course of the 10-year warranty policy based on passage of time (reversed out of deferred since the total is collected up front).

- Rebate / Customer giveback – Since the rebate is not a material right, there is no deferred revenue associated with this transaction.

  If there were a material right, revenue would be removed from deferred revenue and recognized upon expiration of the agreement due to failure to meet requirement within one year, or upon redemption of material right by customer.

- Tooling – Customer makes progress payments to manufacturer based on cost incurred with a mark-up included by manufacturer. Tooling could fall under a certain situations that require recognition over time:
  - One, if the tool is owned by the customer as it is being created and the manufacturer has a right to payment, this would require recognition of revenue over time.
  - Second, if tooling was highly specific to the customer and the manufacturer has a right to payment, this would also require recognition over time.

Completed contract method of accounting from Topic 605 is superseded, so if a tooling project meets the above specifications, it would be recorded to revenue over the course of the project. The method used to record revenue over time should be whatever method most faithfully depicts the transfer of the value to the customer, such as:

- The cost-to-complete approach, based on cost incurred on project (see example of this below in contract changes section).
- The project milestone method, based on output for achievements towards completing the tooling project.

If customer review and acceptance are included in the contract to deliver the tool, this could delay revenue recognition for the manufacturer until approval and will require judgement. If the manufacturer cannot objectively determine tooling is in line with the customer's required criteria for acceptance, or it is the customer's requirement to accept the tooling, revenue should be deferred until the customer approves the tool. If a manufacturer can objectively support specifications in the contract have been fulfilled, then control has essentially moved to the customer and revenue should be recorded.

If the manufacturer determines recognition over time is not required (based on above items), the recognition would occur at a point in time such as customer acceptance or upon completion of customer tooling requirements.

ADDITIONAL CONSIDERATIONS

SPECIAL ACCOUNTING TREATMENT ITEMS

Warranty Treatment

- If warranty only promises the good, or service complies with required specifications, account this for as standard warranty cost accrual.
- If warranty is not required by law, goes for a range of time, is optional, or provides future services beyond initial specification, this may be a separate performance obligation requiring a price allocation. See example above.

Portfolio Approach

- The new standard generally applied to an individual contract with a customer, however, an entity may apply the revenue model to a porfolio of contracts with similar characterisitcs if the entity expects that the financial statement effects of applying the new standard to individual contacts within the portfolio would not differ materially. This treatment is optional and has the ability to save time.

License of Intellectual Property

- When making the decision of the type of IP, must determine if the customer's rights obtain by the IP have significant standalone function.
  - Functional IP – Items such as software, movie rights, drug formula, etc. Performance obligation is satisfied at a point in time and recognized when the purchaser can benefit from the license.
  - Symbolic IP – Items such as brands, logos, franchise rights, etc. Performance obligations is satisfied over time.

Principal vs. Agent

- Must determine if the performance obligation is to provide good or service, or to arrange for another entity to provide a good or service.
  - Principal – If entity controls good or service in advance of transfer, the entity is the principal and recognizes revenue at gross.
  - Agent – If entity does not control good or service prior to transfer, the entity is an agent. Revenue for an agent would be recorded as the sale amount net of the cost of the goods.

Bill and Hold

- Recognize revenue when customer meets the criteria for obtaining control of the product and all criteria are met:
  - The reason for the bill and hold arrangement must be substantive (special customer request).
  - Product must be identified as belonging to customer.
  - Product is ready for shipment to customer.
  - Entity is unable to provide to another customer or use.

Non-refundable Deposit

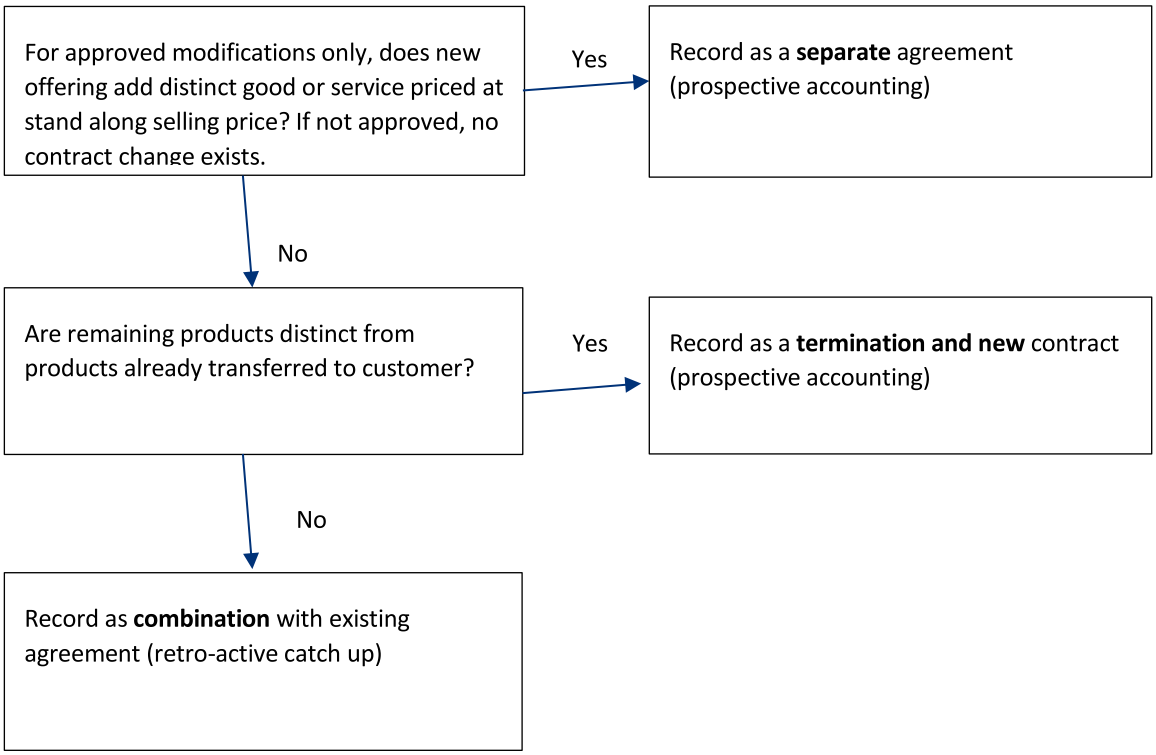
- If deposit relates to payment for completion or partial completion of a performance obligation, recognize revenue based on five step process.
- If deposit does not relate to a specific performance obligation (example, deposit for cost of setting up the customer in the system), recognize as the service or good is provided. If the service can be renewed on a periodic basis without additional deposit payments, a material right may exist. In this scenario, revenue should be recognized based on the term of the contract the company expects.

Sales Tax

- Taxes such as sales, use, value add, etc. affect the amount of consideration received. The transaction price per the new standard excludes amounts collected on behalf of third parties (such as taxing authorities). Manufacturer may chose an accounting policy election to exclude all taxes assessment by a government authority. If this election is made, it must be disclosed in the footnotes of the financials. If the manufacturer does not make this election, it must determine if it is a principal or an agent for all taxing jurisdictions. Taxes imposed on a manufacturer's gross receipts or inventory procurement process are excluded from the scope of this election.

CONTRACT CHANGES

Terminate and create new contract – Price is not standalone (for example – received at a discount or for fee because of existing agreement), but remaining good or service is distinct.
Combination – Remaining service is not distinct and form part of a single partially completed performance obligation.
Separate Contract – Stand-alone price on new offering and separate good or service is distinct from product already provided.



Application to Manufacturers: Contract changes –
See two examples of contract changes in the manufacturing industry below.

A termination causing new agreement (prospective treatment)
The Facts - Assume a customer ordered 100 units of part X for the year for $2 per unit. Part way through the agreement term, the customer increases their order by negotiating 50 units of part Z for $10 per unit. The stand-alone selling price of part Z is $15 per unit, but it is being offered at a discount because of the existing order on part X. At the time of this contract change, only 30 units of part X have been sold/delivered to the customer.

Selling price / Distinct Product determination – The price of part Z is not stand alone as it is directly influenced by the existing arrangement with part X and is not being sold at stand alone prices. Part Z is distinct from part X already transferred to the customer.

Accounting Treatment - This situation represents a termination of the original contract and creation of a new agreement (price is dependent, goods are distinct) and requires prospective accounting treatment. For the sales that have occurred to date ($2 * 30 = $60 in sales), there would be no change in revenue. For the sales going forward (the new agreement), the revenue per unit would be recorded based on the market assessment approach. Steps for determining selling price and recording the sale going forward:

1) Determine total remaining consideration for the new contract is $640:

Part X ($2.00 x 70 units)	$ 140.00
Part Z ($10.00 x 50 units)	$ 500.00

2) Determine total remaining stand-alone market value for the new contract is $890:

Part X ($2.00 x 70 units)	$ 140.00
Part Z ($15.00 x 50 units)	$ 750.00

3) Determination of individual stand-alone market value as a proportion of total stand-alone value:

Part X ($140.00 / $890.00)	15.73%
Part Z ($750.00 / $890.00)	84.27%

4) Determination of revenue per unit when sold:

	Part X	Part Z
Stand-alone Market Value	15.73%	84.27%
Total Remaining Consideration	x 640	x 640
	$ 100.67	$ 539.33
Units Remaining	÷ 70	÷ 50
Credit Entry to Revenue per Unit Sold	$ 1.44	$ 10.79

5) See accounting for a sale of 3 units of X and 5 units of part Z below:

Dr. Accounts Receivable *(($2.00 x 3) + ($10.00 x 5))*	$ 56.00	
Dr. Contract Asset *(plug)*	$ 2.27	
Cr. Sales *(($1.44 x 3) + ($10.79 x 5))*		$ 58.27

Contract Asset: When revenue has been earned, but a future performance is required prior to collection (besides the passage of time), a contract asset exists. In this case, the contract asset is based on the transfer of all units in the contract to the customer. If the right to payment is unconditional, present the contract asset as a receivable. Manufacturers must distinguish between contract asset, receivable, and contract cost in the financial statements. Based on the market value approach used above, sales per unit and accounts receivable per unit are not going to be equal until the contract is complete and all consideration is collected and units are transferred (see calculations in journal entry above). When contract finishes and all units are delivered, sales will equal accounts receivable.

For amortization of cost to obtain assets (e.g., commissions), those items should be amortized over the expected units transferred to the customer. Other methods or allocation are acceptable as well. If the known or expected term of the agreement changes, this should be accounted for prospectively. For example, if the customer increases its ordered units as noted above and the expected contract term now increases, the term of amortization would increase and be recorded to expense over the new remaining units of the agreement. If the costs to fulfil the agreement were recorded as an asset up front, this would be amortized over the estimated remaining units of the agreement, prospectively. The method of allocation for expensing contract assets whether over time, units, milestones, etc. should be based on whatever most faithfully follows the transfer of value to the customer.

If there was an additional commission for the sales representative who sold the extra units, this could cause additional cost to obtain and be amortizable, but the cost capitalized should be commensurate with the additional value provided to the customer.

A combination of 2 contracts (retroactive treatment)

The Facts - Manufacturer of large press machines enters into an agreement. The sale price of the press is contracted at $1.2 million. Expected term to complete press is 1 year. Part way through the job, the customer requests a change order, where the molding part of the press is heated, to allow for additional functionality to the press (melts materials to mold). This change will be an additional $350,000. This function when installed on existing machines is $390,000, but because of the existing order in place and negotiations, the add-on was provided at a discount.

Selling price / Distinct Product determination – Given the function of the machine, the heating function is not distinct from the original machine and the price also is not independent; therefore, this is a contract combination.

Accounting Treatment - The two contracts are accounted for as one agreement requiring retroactive treatment. The contract offering (press and heat element within press) remains a single performance obligation.

The press is highly customized to the customer's business (cannot be resold to another customer without significant reworking costs) and based on contract terms / historical experience with this contract type, the manufacturer has rights to payment for work performed to date, with an agreed-upon margin included. The manufacturer elected to use the cost-to-complete method as the most accurate method to account for revenue allocation and the transfer of value to the customer. At the date of contract combination, the following facts and circumstances existed:

Original Total Cost on the Contract Projected	$ 1,000,000
New Total Cost with Heat Molding Elements Included	$ 1,150,000
Cost Incurred and Recorded to Date	$ 400,000

Cost Incurred and Recorded		$ 400,000
Original Total Cost	x	$ 1,000,000
Percentage of Total Cost		40%
Total Revenue	x	$ 1,200,000
Revenue Recorded to Date		$ 480,000

Cost Incurred and Recorded		$ 400,000
New Total Cost	x	$ 1,150,000
Percentage of New Total Cost		35%
New Total Revenue	x	$ 1,550,000
Combined Contract Revenue		$ 539,130
Revenue Recorded to Date		$ 480,000
Difference		$ 59,130

The difference would be recorded as a change to Revenue at the date of the contract combination.

Contract cancellations

In the case of a contract cancellation (customer ends the agreement – no further services or product), the upfront cost to fulfil or obtain the contract would be impaired as we assume the amounts are no longer recoverable.

If up-front costs were collected from the customer (deferred revenue), these would be recorded as revenue if the amounts are non-refundable or collectible regardless of cancellation and all performance obligations are satisfied. If an upfront payment amount is refundable to the customer, it would be retained in liability until paid.

BALANCE SHEET PRESENTATION – ASC 340-40

Manufacturer must distinguish between contract asset, receivable, and contract cost.

Net contract assets or liabilities

When revenue has been earned, but a future performance is required prior to collection (besides the passage of time), a contract asset exists. If the right to payment is unconditional, present as a receivable. A contract liability exists when more has been billed or collected than is recordable to sales, which can be caused by variable consideration/timing or other situations.

Contract costs

The cost to obtain or fulfill a contract is amortizable under ASC 340-40.

	Costs to Obtain	Costs to Fulfill
Examples	• Costs to solicit • Costs to negotiate • Commissions	• Direct labor and material • Costs chargeable to customer
When to Capitalize	• Incremental cost of obtaining contract • Recoverable	• Directly related • Generate resources to satisfy performance obligations • Recoverable
Capitalized Assets	• 1> year can expense • Amortize • Evaluate for impairment	• 1> year can not expense • Amortize • Evaluate for impairment

As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity would have recognized is one year or less.

Application to Manufacturer: Costs to obtain and fulfill a contract

These updated guidelines relate to up-front costs paid to obtain or fulfill and contract. To capitalize, costs must be recoverable. If the contract is cancelled or it is determined costs are not recoverable, costs would be impaired.

Costs to Obtain: We would expect the commissions on contract sales to be capitalized and amortized over the expected term of the contract. Standard salaries or administrative costs would not be capitalized; only incremental costs based on obtaining a contract should be capitalized.

Cost are amortized over expected term of contract based on historical experience (regardless of the stated term in the agreement). The rate of amortization is based on the transfer of value to the customer. For example, if 30% of value is transferred to the customer in the first month of a contract which is expected to continue for 15 months, 30% of the cost to obtain would be expensed in the first month. If expected term is under 1 year, the entire balance could be expensed under a one-year practical expedient. If the contract ended earlier than expected, this would represent an asset impairment, which would be expensed at that time. Assets must be reviewed for impairment periodically.

If a commissions is earned, but payable at a future date (next year, next quarter, etc.), the amount would still be capitalized as an amortizable asset.

If commission is earned as individual units are sold (not based on winning the contract, but rather on performance throughout the agreement selling individual units), the commission on the units sold would be expensed as they are sold. This is because the value of the product (such as 100 units) has been provided to the customer, so there is no term over which to expense the commission (any term under one year is expensed, see above).

Costs to Fulfill: If fulfillment does not qualify for to be capitalized as property, plant or equipment, ASC 340-10 (existing design and development guidance), or some other existing guidance, it could qualify for capitalization under topic 340-40 (new fulfillment cost treatment). Under topic 340-40, fulfillment cost is capitalized and amortized over the expected term of the agreement if the cost is:

- Recoverable
- The cost is directly traceable to the contract
- The cost enhances assets of the manufacturer

Tooling costs, launch costs, and design costs that are currently being accounted for under ASC 340-10 (the standard current guidance) should continue to follow existing cost capitalization, but there should be a review of guidance under ASC 340-40 to determine if costs are in the scope of the new guidance. If no other guidance applies to contract fulfillment costs, they should be accounted for under ASC-340-40.

If an agreement's contract term is expected to continue for multiple years based on experience (even if the stated contract term is 1 year, month to month, etc.), cost would be amortized over the expected term only. Fulfilment costs must be reviewed periodically for impairment. If term is expected to be under 1 year, the fulfillment cost would still be capitalized and amortized over expected term (which is different from costs to obtain noted above).

DISCLOSURES

Disclosure requirements under the new standard are significantly more comprehensive than the current GAAP requirements. The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of the financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Disclosure requirements include qualitative and quantitative information and include the following:
Its contract with customers.
Significant judgements made in applying the guidance to the contracts.
Disaggregation of revenue to depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.
Opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers.
Information about performance obligations including types of goods or service, significant payment terms, typical timing of satisfying obligation and other provisions.
Information about the remaining performance obligations that are unsatisfied. Including a quantitative disclosure about the aggregate amount of the transaction price that are unsatisfied and the timing of when the entity expects to recognize that amount of revenue.
Information about the entity's costs to obtain or fulfill a contract.

For these rules, there are exceptions for scenarios where an entity may opt-out of disclosing above line items.

Application to manufacturing industry: Required disclosures for non-public manufacturers, net of opt-out options

At a minimum, non-public manufacturers should disclose:

- Revenue and any impairment losses by revenue source.
- Disaggregate revenue based on revenue recognized over time vs. a point in time.
- Opening and closing balances of receivables, contract assets, and contract liabilities.
- Information about performance obligations such as types of goods / services, significant payment terms, typical timing of satisfying obligations, etc.
- A description of significant judgements that affect the amount and timing of revenue recognition and changes in those judgements.

TRANSITION APPROACHES

The standard requires retrospective application. It allows for "full retrospective" adoption or "modified retrospective" adoption.

Full Retrospective Adoption

Entities that elect full retrospective adoption will apply the standard to each period presented in the financial statements. This means entities will apply the standard as if it had been in effect since the beginning of all its contracts with customers presented in the financial statements and will recast revenue and expenses for all prior periods presented in the year of adoption. An entity may use one or more of the following practical expedients with full retrospective adoption.

Practical Expedients Available

- For completed contracts, an entity need not restate contracts that begin and end within the same annual reporting period.
- For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
- For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.
- For contracts that were modified prior to the beginning of the earliest reporting period presented, an entity need not retrospectively restate the contract for those contract modifications that occur before the beginning of the earliest period presented under the new standard. Instead an entity should reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented when identifying the satisfied and unsatisfied performance obligations, determining the transaction price, and allocating the transaction price to the satisfied and unsatisfied performance obligations for the modified contract at transition.

Modified Expedients Available

Entities that elect the modified retrospective method will apply the new standard only the most current period presented in the financial statements. In addition, the entity will have to recognize the cumulative effect of applying the standard as an opening balance at the date of initial application.

Practical Expedients Available

- For contracts that were modified prior to the beginning of the earliest reporting period presented, an entity need not retrospectively restate the contract for those contract modifications that occur before the beginning of the earliest period presented under the new standard. Instead an entity should reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented when identifying the satisfied and unsatisfied performance obligations, determining the transaction price, and allocating the transaction price to the satisfied and unsatisfied performance obligations for the modified contract at transition.

PREPARING TO TRANSITION

In order to transition to the new revenue standards suggestions are recommended to be implemented before the new guidance takes effect:

- Consider creating a transition timeline and plan of action.
- Determine transition approach, full or modified.
- Educate all accounting and finance staff to provide an understanding of new revenue accounting guidance.
- Review contracts to compute the effects of implementing the new standard.
- Examine the potential impact the transition will have on income taxes at the local and state level.

OTHER AREAS TO CONSIDER

The following list contains other implications the new guidance may have on an entity:

- **IT systems**: Entities may need to modify their existing systems to capture additional data necessary to support the new accounting and disclosure requirements.
- **Sales process**
- **Accounting processes, procedures, and internal controls**
- **Financial Statements**: Significant implications for the preparation of financial statements and related internal control.

Reconsidering various metrics: KPI's and other performance evaluation metrics, compensation plans, loan covenants, etc.

NEED ASSISTANCE? **CONTACT UHY**

Contact your UHY LLP advisor to discuss any questions or if you need assistance creating a transition plan structured specifically to your Company's individual needs. UHY is equipped with audit & assurance, tax, and consulting specialists ready to assist your Company with the transition to the upcoming revenue recognition standards. We look forward to serving you.

For additional information, please contact:

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