A new Standard on Revenue Recognition – the FASB and IASB

Note that the content of this presentation is based on the 2014 FASB Update by Kieso, Weygandt, and Warfield (2014), PwC (2014) and Intermediate Accounting (9th Edition) by Spiceland, Sepe & Nelson.

Types of Accounting Fraud

Financial statement manipulation type : Fraud Cases Reported by the SEC 2000-2006

Manipulation type	Number of offences	Percentage
Improper revenue recognition	**381**	**35%**
Improper expense recognition	261	24%
Improper asset valuation	34	3%
Improper business combination	21	2%
Other - lying to the auditor	134	12%
Other - False press releases	96	9%
Other	170	15%
Total	**1097**	**100%**

(Linke end Emanuels, 2009)

Background

- Sarbanes-Oxley Act (SOX) of 2002 did not solve one of the accounting issues.
  - **How to properly account for revenue?**
- The SEC has increased its enforcement actions in this area.
  - Qwest Communications International Inc.
    - Non-recurring revenue reported as revenue.
  - iGo Corp.
    - Consignment sales and products reported as revenue.
  - Lantronix
    - Channel stuffing strategy.

Overview of Revenue Recognition

IFRS

- Lacked

  ___________________.

  - IAS 18 plus some limited guidance related to certain minor topics.

US GAAP

- Had _______________ standards related to revenue recognition (well over 100), but many of those standards were often _____________ with one another.

Revenue from Contracts with Customers

Before

- Revenues are recognized when
  - **It is __________________ or realizable**, AND
    - Goods or services are exchanged for cash or claims to cash (receivables)
    - Assets received in exchange of a sale can be readily convertible to cash or claims of cash.
  - **It is _______________________.**
    - Earnings process is completed!
- Reasonable certainty as to the ________________ of the assets to be received in exchange for goods and services.

After

- Revenues are recognized after the five steps.
  1. Identify **the contract** with customers.
  2. Identify the **separate performance obligations** in the contract.
  3. Determine **the transaction price.**
  4. Allocate the transaction price to the **separate performance obligations**.
  5. **Recognize revenue** when(or as) each performance obligation is satisfied.

The Five-Step Process

Assume that Boeing Corporation signs a contract to sell airplanes to Delta Air Lines for $100 million.

Step 1: Identify the contract with customers. → A contract is an agreement between two parties that creates enforceable rights or obligations. In this case, **Boeing has signed a contract to deliver airplanes to Delta**.

Step 2: Identify the separate performance obligations in the contract. → A Boeing has only **one performance obligation—to deliver airplanes to Delta**. If Boeing also agreed to **maintain the planes, a separate performance obligation** is recorded for this promise.

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The Five-Step Process

Step 3: Determine the transaction price. → Transaction price is the amount of consideration that a company expects to receive from a customer in exchange for transferring a good or service. In this case, **the transaction price is straightforward—it is $100 million.**

Step 4: Allocate the transaction price to the separate performance obligations. → In this case, **Boeing has only one performance obligation—to deliver airplanes to Delta.**

Step 5: Recognize revenue when each performance obligation is satisfied. → Boeing **recognizes revenue of $100 million for the sale of the airplanes to Delta when it satisfies its performance obligation**—the delivery of the airplanes to Delta.

Step 1: Identifying the contract with customers

- How to determine if a contract exists and whether that contract is with a customer?
  - Assessment made on ______________________________.
- Scope of ASC 606 or IFRS 15:
  - The revenue standard applies to all contracts with customers, except for contracts that are within the scope of other standards, such as **leases, insurance, financial instruments, non-monetary exchanges, and guarantees (other than product or service warranties**).

Step 1: Identifying the contract with customers

- Contract?
  - An agreement between two or more parties that creates enforceable ____________________.
  - Can be ________, oral, or implied from customary business practice.

Step 2: Identifying separate performance obligations

- How to account for multiple performance obligations?
  - If the product (good or service) is _________________ [**is <u>not highly dependent on, or interrelated with other promises</u>**] **within the contract**, account for the performance obligation separately.
- **Distinct? (p. 241)**
  - Capable of being ____________________________.
  - Separately ________________________________ from other goods or service in the contract.

Step 3: Determining the transaction Price

- Transaction price
  - The amount of ___________________________ that a company expects to receive from a customer in exchange for transferring ____________________________.
  - **Factors to consider:**
    - ______________ consideration
    - Time value of money
    - ______________ consideration
    - Consideration paid or payable to the customer

Time Value of Money

EXTENDED PAYMENT TERMS

Facts: On July 1, 2014, SEK Company sold goods to Grant Company for $900,000 in exchange for a 4-year, zero-interest-bearing note with a face amount of $1,416,163. The goods have an inventory cost on SEK's books of $590,000.

Questions: (a) How much revenue should SEK Company record on July 1, 2014? (b) How much revenue should it report related to this transaction on December 31, 2014?

Entry to record SEK's sale to Grant Company on July 1, 2014, is as follows.

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Time Value of Money

EXTENDED PAYMENT TERMS

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Questions: (a) How much revenue should SEK Company record on July 1, 2014? (b) How much revenue should it report related to this transaction on December 31, 2014?

Entry to record interest revenue at the end of the year, December 31, 2014.

Companies are not required to reflect the time value of money if the time period for payment is less than a year.

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Step 4: Allocating the transaction price to separate performance obligations

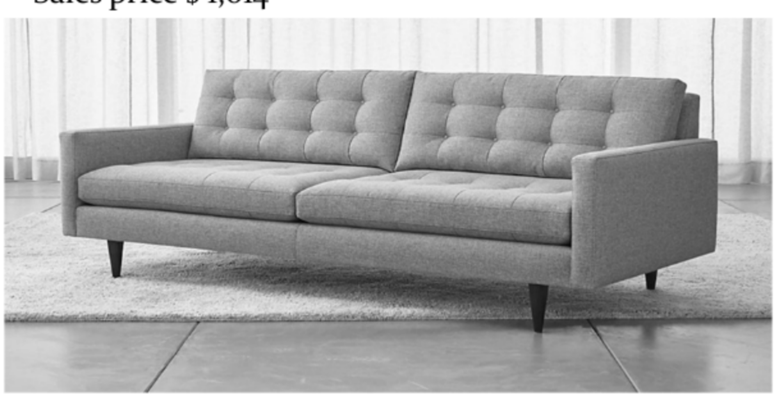
- If an allocation is needed, the transaction price allocated to the various performance obligation is based on the following options:
  1. ____ approach
  2. Expected ________________________ approach
     - If option 1 is not available, use expected cost of satisfying a performance obligation and then add an appropriate margin for the good or service.
  3. ____________________ **approach**
     - If options 1 and 2 are not available, residual approach = transaction price – sum of the observable standalone selling prices of other goods or services promised in the contract.

Step 5: Recognizing Revenue when each performance obligation is satisfied

- Company satisfies its performance obligation when the customer obtains control of the good or service.
- Change in Control Indicators
  1. **Customer** has an **obligation to** ______________ the seller.
  2. **Company** has **transferred** __________________ to asset.
  3. **Company** has _____________ **physical possession** of asset.
  4. **Customer** has significant ________________ **of ownership**.
  5. **Customer** has **accepted the asset**.

Recognizing Revenue at a Single Point in Time – one performance obligation

- Example: Crate and Barrel
  - Sales price $ 1,614



Recognize revenue for contracts that contain multiple performance obligations

- Allocation of transaction price to each performance obligation:
  - Use ___________________ (p. 242)

- Revenues are recognized after the five steps.
  1. Identify **the contract** with customers.
  2. Identify the **separate performance obligations** in the contract.
  3. Determine **the transaction price.**
  4. Allocate the transaction price to the **separate performance obligations**.
  5. **Recognize revenue** when(or as) each performance obligation is satisfied.

At Point of Sale (or Delivery)

- Multiple Performance Obligations
  - Example:
    - AT&T – **Internet, cable and mobile phone services sold for $150/month.** Separately, **internet service costs $ 80, cable service costs $70 and mobile phone service costs $100.**
    - **Customers have the right to return/cancel services and AT&T controls the delivery of these services.**

Internet	80 ÷ 250	32%	x 150	48
Cable	70 ÷ 250	28%	x 150	42
Mobile Phone	100 ÷ 250	40%	x 150	60
Total	250	100%		150

At Point of Sale (or Delivery)

- Multiple Performance Obligations
  - 12/31/2014: Grande Company sells **production equipment to Fargo Inc. for $50,000**.
  - Grande includes **a 1 year warranty service with the sale of all its equipment**.
  - FV equipment = $48,800 & FV warranty = $1,200.

Recognizing Revenue over a Period of Time – A single performance obligation.

- Recognize revenue over time if any one of the three criteria is met:
  1. The customer **receives** ________________ of the seller's work **as it is performed**, or
  2. **The customer controls** _____________ as it is created or enhanced, or
  3. **The seller is creating an asset that has no ____________ use** to the seller, and the seller has **the _______________ to receive the payment for progress to date**.

Recognizing Revenue over a Period of Time – A single performance obligation.

- **Output method**
  - Revenues are recognized based on ____________________ measurements of the value transferred to the customer.
  - For example,
    - surveys of work performed, units produced,
    - units delivered, and contract milestones.
- **Input method**
  - Revenues are recognized based on the ____________________ to satisfy the performance obligation.

Other Issues of Revenue Recognition

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Right of Return

- To account for the right of return, the seller should recognize all of the following:
  a) Revenue for the transferred products in the amount of consideration to which **the seller is reasonably assured to be entitled** (considering the products expected to be returned)
  b) A ________________________________
  c) **An asset for its right to recover the asset (inventory)** from the buyer on settling the refund liability.

Right of Return

RIGHT OF RETURN

Facts:

Venden Company sells 100 products for $100 each to Amaya Inc. for cash. Venden allows Amaya to return any unused product within 30 days and receive a full refund. The cost of each product is $60.

To determine the transaction price, Venden decides that the approach that is most predictive of the amount of consideration to which it will be entitled is the most likely amount. Using the most likely amount, Venden estimates that:

1. Three (3) products will be returned.
2. The costs of recovering the products will be immaterial.
3. The returned products are expected to be resold at a profit.

Question: How should Venden record this sale?

Right of Return

Question: How should Venden record this sale?

Venden records the sale as follows with the expectation that **three** products will be returned:

Venden records the cost of goods sold with the following entry.

Right of Return

Question: How should Venden record this sale?

When a return occurs, Venden records the following entries.

Companies record the returned asset in a separate account from inventory to provide transparency.

Repurchase Agreements

- Transfer an asset with an obligation or a right to repurchase the asset.
- Did the ___________________ or was the sale a disguised financing transaction?
  - If the company has an obligation or right to repurchase the asset for an amount greater than or equal to its selling price, then the transaction is **a ________________ transaction by the company.**

Repurchase Agreements

REPURCHASE AGREEMENT

Facts:

Morgan Inc., an equipment dealer, sells equipment on **January 1, 2014**, to Lane Company for $100,000. **It agrees to repurchase this equipment on December 31, 2015, for a price of $121,000.**

Question: How should Morgan Inc. record this transaction?

Assuming an interest rate of 10 percent is imputed from the agreement, Morgan makes the following entry to record the financing on January 1, 2014.

Repurchase Agreements

Question: How should Morgan Inc. record this transaction?

Morgan Inc. records interest on **December 31, 2014**, as follows.

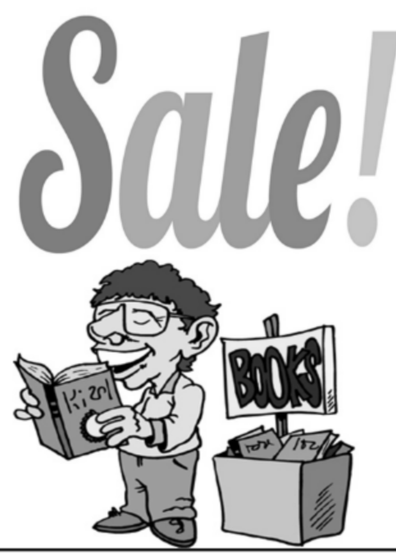
Morgan Inc. records interest and retirement of its liability to Lane Company on **December 31, 2014**, as follows.

Repurchase Agreements

- What if the repurchase price is not greater or equal to the selling price?

Facts:

Morgan Inc., an equipment dealer, sells equipment on **January 1, 2014**, to Lane Company **for $100,000. It agrees to repurchase this equipment on December 31, 2015, for a price of $90,000.**



Accounting for Long-Term Contracts

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Revenue Recognition Before Delivery

	Percentage Completion Method	Completed Contract Method
How does this work?	• Recognize **x% revenues and gross profit** based on **<u>%-of-completion</u>**, **prior to the completion of the project**.	• Recognize **100% revenues and gross profit** until **<u>the completion of the project</u>**.
Circumstances to use each method? **<u>Certainty on cash collection, reasonable estimate of cost and WIP.</u>**	• Terms of contract is enforceable for both the **buyer (payment**) and the **contractor (complete the project).** • Satisfy or execute ALL obligations?	• **SHORT term** contract! • Terms of contract may not be enforced. • **Inherent risk in the contract** beyond the normal business risk.

Revenue Recognition Before Delivery

	Percentage Completion Method	Completed Contract Method
How to recognize **revenues?** [illegible] **Use cost-to-cost basis!**	• In each period prior to the completion of the project: %[illegible] = [illegible] • Current **REVENUE** to be recognized = (%[illegible] Contract Price) - [Total **REVENUES** Previously Recognized].	• At date of **<u>completion of the project</u>**: • 100% of revenue.
How to recognize **gross profit?** [illegible] **Use cost-to-cost basis!**	• In each period prior to the completion of the project: %[illegible] = [illegible] • Current **GROSS PROFIT** to be recognized = (%[illegible] Contract Price) - [Total **GROSS PROFIT** Previously Recognized].	• At date of **<u>completion of the project</u>**: • 100% of gross profit.

Revenue Recognition Before Delivery

	Percentage Completion Method	Completed Contract Method
Journal entry to record **<u>cost of construction in process</u>**?	Contruction in process (CIP) Cash, Accounts Payables, etc.	
Journal entry to record **<u>billings in process and collection of AR</u>**?	Accounts Receivable Billings on Construction in Process Cash Accounts Receivable	

Revenue Recognition Before Delivery

	Percentage Completion Method	Completed Contract Method
Journal entry to recognize **revenue and gross profit**?	Contruction in process (CIP) Gross Profit Construction Expense Revenue from LT contracts	
Journal entry to record **completion of the contract**?	Billings on CIP Contruction in process (CIP)	Billings on CIP Revenue from LT contracts Construction Expense or Costs Contruction in process (CIP)

Revenue Recognition Before Delivery

	Percentage Completion Method	Completed Contract Method
Financial Statement Presentation **prior to the completion of the project?**	**If CIP > Billing in progress,** treat the difference as a current asset within the inventory. • **CIP in excess of billings.** **If CIP < Billing in progress,** treat the difference as a current liability: • **Billings in excess of CIP.**	
What to do with a LOSS situation?	Construction Expense Contruction in process (CIP) - Loss	Loss from LT contracts Contruction in process (CIP) - Loss

Loss should be recognized immediately prior to the date of completion of the project.