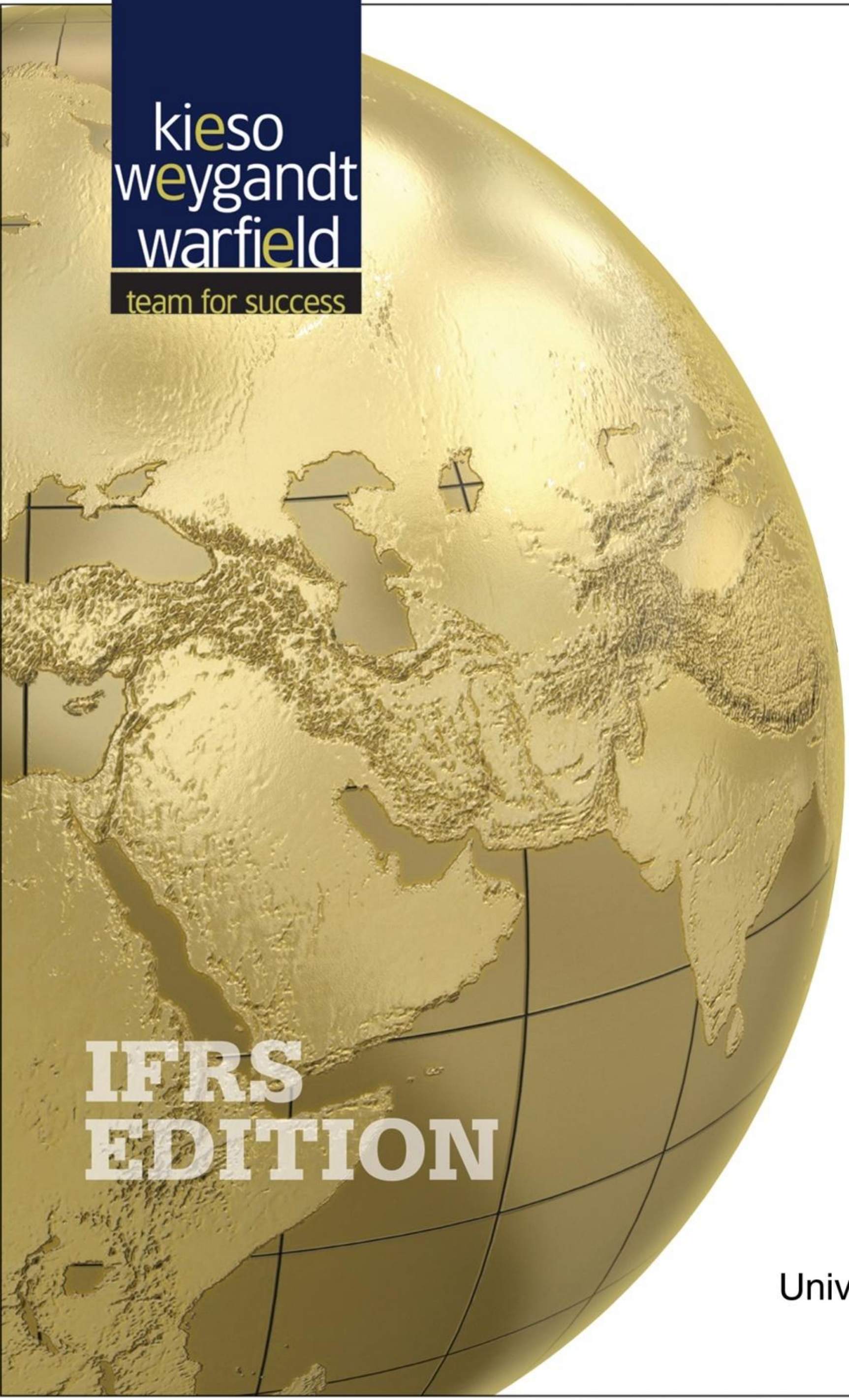
kieso
weygandt
warfield
team for success



INTERMEDIATE ACCOUNTING

SECOND EDITION

Prepared by
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WILEY

PREVIEW OF CHAPTER 18

Revenue Recognition

Overview of Revenue Recognition

- Background
- New revenue recognition standard

The Five-Step Process

- Contract with customers
- Separate performance obligations
- Determining the transaction price
- Allocating the transaction price
- Satisfying performance obligations

Other Revenue Recognition Issues

- Right of return
- Repurchase agreements
- Bill-and-hold arrangements
- Principal-agent relationships
- Consignments
- Warranties
- Non-refundable upfront fees

Presentation and Disclosure

- Presentation
- Disclosure

Intermediate Accounting
IFRS 2nd Edition
Kieso, Weygandt, and Warfield

CHAPTER 18

Revenue Recognition

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. **Understand revenue recognition issues.**
2. Identify the five steps in the revenue recognition process.
3. Identify the contract with customers.
4. Identify the separate performance obligations in the contract.
5. Determine the transaction price.
6. Allocate the transaction price to the separate performance obligations.
7. Recognize revenue when the company satisfies its performance obligation.
8. Identify other revenue recognition issues.
9. Describe presentation and disclosure regarding revenue.

OVERVIEW OF REVENUE RECOGNITION

Background

Revenue recognition is a top fraud risk and regardless of the accounting rules followed (IFRS or U.S. GAAP), the risk or errors and inaccuracies in revenue reporting is significant.

Recently, the IASB and FASB issued a converged standard on revenue recognition entitled ***Revenue from Contracts with Customers***.

OVERVIEW OF REVENUE RECOGNITION

New Revenue Recognition Standard

Revenue from Contracts with Customers, adopts an **asset-liability approach**.

Companies:

- Account for revenue based on the asset or liability arising from contracts with customers.
- Are required to analyze contracts with customers
  - Contracts indicate terms and measurement of consideration.
  - Without contracts, companies cannot know whether promises will be met.

New Revenue Recognition Standard

ILLUSTRATION 18-1 Key Concepts of Revenue Recognition

KEY OBJECTIVE

Recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that the company receives, or expects to receive, in exchange for these goods or services.

FIVE-STEP PROCESS FOR REVENUE RECOGNITION

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 each performance obligation is satisfied.

REVENUE RECOGNITION PRINCIPLE

Recognize revenue in the accounting period when the performance obligation is satisfied.

Performance Obligation is Satisfied

CHAPTER 18

Revenue Recognition

LEARNING OBJECTIVES

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THE FIVE-STEP PROCESS

Assume that Airbus (FRA) Corporation signs a contract to sell airplanes to Cathay Pacific Airlines (HKG) for €100 million.

ILLUSTRATION 18-2
Five Steps of Revenue Recognition

Step 1: Identify the contract with customers.	A contract is an agreement between two parties that creates enforceable rights or obligations. In this case, Airbus has signed a contract to deliver airplanes to Cathay Pacific.
Step 2: Identify the separate performance obligations in the contract.	Airbus has only one performance obligation—to deliver airplanes to Cathay Pacific. If Airbus also agreed to maintain the planes, a separate performance obligation is recorded for this promise.

THE FIVE-STEP PROCESS

ILLUSTRATION 18-2 Five Steps of Revenue Recognition

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, Airbus has only one performance obligation–to deliver airplanes to Cathay Pacific.

THE FIVE-STEP PROCESS

ILLUSTRATION 18-2 Five Steps of Revenue Recognition

Step 5: Recognize revenue when each performance obligation is satisfied.	Airbus recognizes revenue of €100 million for the sale of the airplanes to Cathay Pacific when it satisfies its performance obligation–the delivery of the airplanes to Cathay Pacific.

CHAPTER 18

Revenue Recognition

LEARNING OBJECTIVES

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Identify Contract with Customers—Step 1

Contract:

- Agreement between two or more parties that creates enforceable rights or obligations.
- Can be
  - written,
  - oral, or
  - implied from customary business practice.

Company applies the revenue guidance to a contract according to the following criteria in Illustration 18-3.

Contract with Customers—Step 1

ILLUSTRATION 18-3 Contract Criteria for Revenue Guidance

Apply Revenue Guidance to Contracts If:	Disregard Revenue Guidance to Contracts If:
▪ The contract has commercial substance; ▪ The parties to the contract have approved the contract and are committed to perform their respective obligations; ▪ The company can identify each party's rights regarding the goods or services to be transferred; and ▪ The company can identify the payment terms for the goods and services to be transferred. ▪ It is probable that the company will collect the consideration to which it will be entitled.	▪ The contract is wholly unperformed, and ▪ Each party can unilaterally terminate the contract without compensation.

Contract with Customers—Step 1

Basic Accounting

- Revenue cannot be recognized until a contract exists.
- Company obtains rights to receive consideration and assumes obligations to transfer goods or services.
- Rights and performance obligations gives rise to an (net) asset or (net) liability.
- Company does not recognize contract assets or liabilities until one or both parties to the contract perform.

Contract asset = Rights received > Performance obligation

Contract liability = Rights received < Performance obligation

Basic Accounting

ILLUSTRATION 18-4
Basic Revenue Transaction

CONTRACTS AND RECOGNITION

Facts: On March 1, 2015, Margo Company enters into a contract to transfer a product to Soon Yoon on July 31, 2015. The contract is structured such that Soon Yoon is required to pay the full contract price of HK$5,000 on August 31, 2015.The cost of the goods transferred is HK$3,000. Margo delivers the product to Soon Yoon on July 31, 2015.

Question: What journal entries should Margo Company make in regards to this contract in 2015?

The journal entry to record the sale and related cost of goods sold is as follows.

July 31, 2015

Accounts Receivable	5,000	
Sales Revenue		5,000
Cost of Goods Sold	3,000	
Inventory		3,000

LO 3

Basic Accounting

ILLUSTRATION 18-4
Basic Revenue Transaction

CONTRACTS AND RECOGNITION

Facts: On March 1, 2015, Margo Company enters into a contract to transfer a product to Soon Yoon on July 31, 2015. The contract is structured such that Soon Yoon is required to pay the full contract price of HK$5,000 on August 31, 2015.The cost of the goods transferred is HK$3,000. Margo delivers the product to Soon Yoon on July 31, 2015.

Question: What journal entries should Margo Company make in regards to this contract in 2015?

Margo makes the following entry to record the receipt of cash on August 31, 2015.

August 31, 2015

Cash	5,000	
Accounts Receivable		5,000

Contract with Customers—Step 1

Contract Modifications

- Change in contract terms while it is ongoing.
- Companies determine
  - whether a new contract (and performance obligations) results or
  - whether it is a modification of the existing contract.

Contract Modifications

Separate Performance Obligation

- Account for as a new contract if **both** of the following conditions are satisfied:
  - Promised **goods or services are distinct** (i.e., company sells them separately and they are not interdependent with other goods and services), and
  - The company has the right to receive an amount of **consideration that reflects the standalone selling price** of the promised goods or services.

Separate Performance Obligation

For example, Crandall Co. has a contract to sell 100 products to a customer for $10,000 (€100 per product) at various points in time over a six-month period. After 60 products have been delivered, Crandall modifies the contract by promising to deliver 20 more products for an additional €1,900, or €95 per product (which is the standalone selling price of the products at the time of the contract modification). Crandall regularly sells the products separately.

Given a new contract, Crandall recognizes an additional:

Original contract [(100 units - 60 units) x €100] =	€4,000
New product (20 units x €95) =	1,900
Total revenue	**€5,900**

Contract Modifications

Prospective Modification

- Company should
  - account for effect of change in period of change as well as future periods if change affects both.
  - not change previously reported results.

Prospective Modification

For Crandall, the amount recognized as revenue for each of the remaining products would be a blended price of €98.33, computed as shown in Illustration 18-5.

Products not delivered under original contract	
($100 x 40) =	€4,000
Products to be delivered under contract	
modification (€95 x 20) =	1,900
Total remaining revenue	**€5,900**

Revenue per remaining unit (€5,900 ÷ 60) = **€98.33**

LO 3

Prospective Modification

Under the prospective approach, a blended price (€98.33) is used for sales in the periods after the modification.

	Revenue Recognized Prior to Modification	Revenue Recognized After Modification	Total Revenue Recognized
Separate performance obligation	€6,000	€5,900	€11,900
No separate performance obligation—prospectively	€6,000	€5,900	€11,900

ILLUSTRATION 18-6
Comparison of Contract Modification Approaches

CHAPTER 18

Revenue Recognition

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

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Separate Performance Obligations—Step 2

Revenue Recognition Situations

ILLUSTRATION 18-7

Type of Transaction	Sale of product from inventory	Performing a service	Permitting use of an asset	Sale of asset other than inventory
Description of Revenue	Revenue from sales	Revenue from fees or services	Revenue from interest, rents, and royalties	Gain or loss on disposition
Timing of Revenue Recognition	Date of sale (date of delivery)	Services performed and billable	As time passes or assets are used	Date of sale or trade-in

Separate Performance Obligations—Step 2

- To determine whether a company has to account for multiple performance obligations, it evaluates a second condition.
- **Whether the product is distinct within the contract**.
  - If performance obligation is not highly dependent on, or interrelated with, other promises in the contract, then each performance obligation should be accounted for separately.
  - If each of these services is interdependent and interrelated, these services are combined and reported as one performance obligation.

Performance Obligations—Step 2

ILLUSTRATION 18-8 Identifying Performance Obligations

SoftTech Inc. licenses customer-relationship software to Lopez Company. In addition to providing the software itself, SoftTech promises to provide consulting services by extensively customizing the software to Lopez's information technology environment, for a total consideration of $600,000. In this case, SoftTech is providing a significant service by integrating the goods and services (the license and the consulting service) into one combined item for which Lopez has contracted. In addition, the software is significantly customized by SoftTech in accordance with specifications negotiated by Lopez. Do these facts describe a single or separate performance obligation?
The license and the consulting services are distinct but interdependent, and therefore should be accounted for as **one performance obligation**.

Performance Obligations—Step 2

ILLUSTRATION 18-8 **Identifying Performance Obligations**

Chen Computer Inc. manufactures and sells computers that include a warranty to make good on any defect in its computers for 120 days (often referred to as an assurance warranty). In addition, it sells separately an extended warranty, which provides protection from defects for three years beyond the 120 days (often referred to as a service warranty). In this case, two performance obligations exist, one related to the sale of the computer and the assurance warranty, and the other to the extended warranty (service warranty).
The sale of the computer and related assurance warranty are one performance obligation as they are interdependent and interrelated with each other. **However, the extended warranty is separately sold and is not interdependent.**

CHAPTER 18

Revenue Recognition

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Determining Transaction Price—Step 3

Transaction price

- Amount of consideration that company expects to receive from a customer.
- In a contract is often easily determined because customer agrees to pay a fixed amount.
- Other contracts, companies must consider:
  - Variable consideration
  - Time value of money
  - Non-cash consideration
  - Consideration paid or payable to customers

Determining Transaction Price—Step 3

Variable Consideration

- Price dependent on future events.
  - May include discounts, rebates, credits, performance bonuses, or royalties.
- Companies estimate amount of revenue to recognize.
  - Expected value
  - Most likely amount

Determining Transaction Price—Step 3

ILLUSTRATION 18-9 **Estimating Variable Consideration**

Expected Value: Probability-weighted amount in a range of possible consideration amounts.
▪ May be appropriate if a company has a large number of contracts with similar characteristics. ▪ Can be based on a limited number of discrete outcomes and probabilities.

Most Likely Amount: The single most likely amount in a range of possible consideration outcomes.
▪ May be appropriate if the contract has only two possible outcomes.

Variable Consideration

ILLUSTRATION 18-10
Transaction Price

ESTIMATING VARIABLE CONSIDERATION

Facts: Peabody Construction Company enters into a contract with a customer to build a warehouse for $100,000, with a performance bonus of $50,000 that will be paid based on the timing of completion. The amount of the performance bonus decreases by 10% per week for every week beyond the agreed-upon completion date. The contract requirements are similar to contracts that Peabody has performed previously, and management believes that such experience is predictive for this contract. Management estimates that there is a 60% probability that the contract will be completed by the agreed-upon completion date, a 30% probability that it will be completed 1 week late, and only a 10% probability that it will be completed 2 weeks late.

Question: **How should Peabody account for this revenue arrangement?**

Variable Consideration

ILLUSTRATION 18-10
Transaction Price

Question: How should Peabody account for this revenue arrangement?

Management has concluded that the **probability-weighted method** is the most predictive approach:

60% chance of $150,000 =	$ 90,000
30% chance of $145,000 =	43,500
10% chance of $140,000 =	14,000
	$147,500

Most likely outcome, if management believes they will meet the deadline and receive the $50,000 bonus, the total transaction price would be?

$150,000 (the outcome with 60% probability)

Variable Consideration

- Companies only **allocate variable consideration if it is reasonably assured that it will be entitled to the amount**.
- Companies only recognize variable consideration if
  1. they have experience with similar contracts and are able to estimate the cumulative amount of revenue, and
  2. based on experience, they do not expect a significant reversal of revenue previously recognized.

If these criteria are not met, revenue recognition is constrained.

Determining Transaction Price—Step 3

Time Value of Money

- When contract (sales transaction) involves a significant financing component.
  - Interest accrued on consideration to be paid over time.
  - Fair value determined either by measuring the consideration received or by discounting the payment using an imputed interest rate.
  - Company reports as interest expense or interest revenue.

Time Value of Money

ILLUSTRATION 18-12
Transaction Price - Extended Payment Terms

EXTENDED PAYMENT TERMS

Facts: On July 1, 2015, SEK Company sold goods to Silva Company for R$900,000 in exchange for a 4-year, zero-interest-bearing note with a face amount of R$1,416,163. The goods have a cost on SEK's books of R$590,000.

Questions: (a) How much revenue should SEK Company record on July 1, 2015? (b) How much revenue should it report related to this transaction on December 31, 2015?

Entry to record SEK's sale to Silva Company on July 1, 2015, is as follows.

Notes Receivable	1,416,163	
Sales Revenue		900,000
Discount on Notes Receivable		516,163
Cost of Goods Sold	590,000	
Inventory		590,000

LO 5

Time Value of Money

ILLUSTRATION 18-12
Transaction Price -
Extended Payment Terms

EXTENDED PAYMENT TERMS

Facts: On July 1, 2015, SEK Company sold goods to Silva Company for R$900,000 in exchange for a 4-year, zero-interest-bearing note with a face amount of R$1,416,163. The goods have a cost on SEK's books of R$590,000.

Questions: (a) How much revenue should SEK Company record on July 1, 2015? (b) How much revenue should it report related to this transaction on December 31, 2015?

Entry to record interest revenue at the end of the year, December 31, 2015.

Discount on Notes Receivable	**54,000**	
Interest Revenue (12% x ½ x $900,000)		**54,000**

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

LO 5

Determining Transaction Price—Step 3

Non-Cash Consideration

Goods, services, or other non-cash consideration.

- Companies sometimes receive contributions (e.g., donations and gifts).
- Customers sometimes contribute goods or services, such as equipment or labor, as consideration for goods provided or services performed.
- **Companies generally recognize revenue on the basis of the fair value of what is received**.

Determining Transaction Price—Step 3

Consideration Paid or Payable to Customers

- May include discounts, volume rebates, coupons, free products, or services.
- In general, these elements reduce the consideration received and the revenue to be recognized.

Consideration Paid or Payable

ILLUSTRATION 18-13
Transaction Price – Volume Discount

VOLUME DISCOUNT

Facts: Sansung Company offers its customers a 3% volume discount if they purchase at least ¥2 million of its product during the calendar year. On March 31, 2015, Sansung has made sales of ¥700,000 to Artic Co. In the previous 2 years, Sansung sold over ¥3,000,000 to Artic in the period April 1 to December 31.

Questions: How much revenue should Sansung recognize for the first 3 months of 2015?

Sansung makes the following entry on March 31, 2015.

Accounts Receivable	**679,000**	
Sales Revenue		**679,000**

Sansung should reduce its revenue by **¥21,000 (¥700,000 x 3%)** because it is probable that it will provide this rebate.

Consideration Paid or Payable

ILLUSTRATION 18-13
Transaction Price -
Volume Discount

Questions: How much revenue should Sansung recognize for the first 3 months of 2015?

Assuming Sansung's customer meets the discount threshold, Sansung makes the following entry.

Cash	679,000	
Accounts Receivable		679,000

If Sansung's customer fails to meet the discount threshold, Sansung makes the following entry upon payment.

Cash	700,000	
Accounts Receivable		679,000
Sales Discounts Forfeited		21,000

CHAPTER 18

Revenue Recognition

LEARNING OBJECTIVES

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Allocating Transaction Price to Separate Performance Obligations—Step 4

- Based on their relative fair values.
- Best measure of fair value is what the company could sell the good or service for on a standalone basis.
- If not available, companies should use their best estimate of what the good or service might sell for as a standalone unit.

LO 6

Allocating Transaction Price to Separate Performance Obligations—Step 4

ILLUSTRATION 18-14
Transaction Price Allocation

Allocation Approach	Implementation
Adjusted market assessment approach	Evaluate the market in which it sells goods or services and estimate the price that customers in that market are willing to pay for those goods or services. That approach also might include referring to prices from the company's competitors for similar goods or services and adjusting those prices as necessary to reflect the company's costs and margins.
Expected cost plus a margin approach	Forecast expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
Residual approach	If the standalone selling price of a good or service is highly variable or uncertain, then a company may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract.[6]

LO 6

CHAPTER 18

Revenue Recognition

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Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied-Step 5

Company satisfies its performance obligation when the customer obtains control of the good or service.

Change in Control Indicators

1. Company has a right to payment for asset.
2. Company has transferred legal title to asset.
3. Company has transferred physical possession of asset.
4. Customer has significant risks and rewards of ownership.
5. Customer has accepted the asset.

Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied-Step 5

Recognizing revenue from a performance obligation over time

- Measure progress toward completion
  - Method for measuring progress should depict transfer of control from company to customer.
  - Most common are cost-to-cost and units-of-delivery methods.
  - Objective of methods is to measure extent of progress in terms of costs, units, or value added.

Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied-Step 5

Step in Process	Description	Implementation
1. Identify the contract with customers.	A contract is an agreement that creates enforceable rights or obligations.	A company applies the revenue guidance to contracts with customers and must determine if new performance obligations are created by a contract modification.

ILLUSTRATION 18-20
Summary of the Five-Step Revenue Recognition Process

Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied-Step 5

Step in Process	Description	Implementation
2. Identify the separate performance obligations in the contract	A performance obligation is a promise in a contract to provide a product or service to a customer. A performance obligation exists if the customer can benefit from the good or service on its own or together with other readily available resources.	A contract may be comprised of multiple performance obligations. Accounting is based on evaluation of whether the product or service is distinct within the contract. If each of the goods or services is distinct, but is interdependent and interrelated, these goods and services are combined and reported as one performance obligation.

ILLUSTRATION 18-20
Summary of the Five-Step Revenue Recognition Process

Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied-Step 5

Step in Process	Description	Implementation
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 goods and services.	In determining the transaction price, companies must consider the following factors: 1. variable consideration, 2. time value of money, 3. Non-cash consideration, and 4. consideration paid or payable to customer.

ILLUSTRATION 18-20
Summary of the Five-Step Revenue Recognition Process

Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied-Step 5

Step in Process	Description	Implementation
4. **Allocate the transaction price to the separate performance obligation.**	If more than one performance obligation exists, allocate the transaction price based on relative fair values.	The best measure of fair value is what the good service could be sold for on a standalone basis (standalone selling price). Estimates of standalone selling price can be based on 1. adjusted market assessment, 2. expected cost-plus a margin approach, or 3. a residual approach.

ILLUSTRATION 18-20
Summary of the Five-Step Revenue Recognition Process

LO 7

Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied-Step 5

Step in Process	Description	Implementation
5. Recognize revenue when each performance obligation is satisfied.	A company satisfies its performance obligation when the customer obtains control of the good or service.	Companies satisfy performance obligations either at a point in time or over a period of time. Companies recognize revenue over a period of time if 1. the customer controls the asset as it is created or 2. the company does not have an alternative use for the asset.

ILLUSTRATION 18-20
Summary of the Five-Step Revenue Recognition Process