

# REVENUE RECOGNITION: MANUFACTURING AND DISTRIBUTION

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## The following are the most significant impacts ASC 606 will have on manufacturers and distributors:

- OEMs will no longer be able to use the sell-through method (recognizing revenue when distributors resell to end users) to recognize revenue.
- When offering sales incentives to customers (i.e., volume discounts, prompt payment discounts, customer rebates, return rights, royalties), entities will need to estimate the variable consideration, and a portion may be constrained. Entities will be required to estimate the transaction price by using either (1) the most likely method, which considers the single most likely amount from a limited range of possible amounts or (2) the expected value method, which considers the probability-weighted amount of a range of possible amounts. Regardless of which method is used, entities will include in the transaction price some or all of the variable consideration only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved.
- Material rights allowing customers to purchase additional goods or services at a special price or discount will be accounted for as a separate performance obligation.
- Revenue from contracts for customized product (i.e., the product is specific to a customer) and for which the entity has an enforceable right to payment for performance completed to date will need to be recognized over time rather than upon shipment or delivery. Enforceable right to payment equals recovery of costs *plus* a reasonable margin at any point in the production process (not just for finished goods).
- Entities can continue to use a cost accrual method to account for assurance warranties, ensuring that the good or service complies with agreed-upon specifications. Service warranties—extended warranty going above and beyond industry norm—will be accounted for as a separate performance obligation. (Consideration will be allocated to this obligation and recognized as it is satisfied.) If the customer has the option to purchase the warranty separately, the warranty also will be accounted for as a separate performance obligation.
- There will be significantly more extensive qualitative and quantitative financial statement disclosures:
  - An entity's various contracts with its customers
  - Disaggregation of revenues
  - The performance obligations included within an entity's contracts with its customers
  - The significant judgments used to estimate the revenue recordedEntities may need to modify their systems and processes to gather information about contracts with their customers that is not otherwise readily available.
- As a result of ASC 606's disclosure requirements, it is expected entities will develop a comprehensive policy describing the methods, inputs, and assumptions used to record revenue.

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# REVENUE RECOGNITION

In May 2014, the Financial Accounting Standards Board (FASB) completed its revenue recognition project by issuing Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, which can be found in the new Accounting Standards Codification (ASC) Topic 606.

## Effective Dates

### PUBLIC ENTITIES

Reporting periods beginning after December 15, 2017

#### *Public entities include:*

- Public business entities
- Not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
- Employee benefit plans that file or furnish financial statements to the SEC

### OTHER ENTITIES

Reporting periods beginning after December 15, 2018

### Who will be impacted?

One common misconception is that the new standard will apply only to organizations in certain industries when, in fact, the standard will apply to all organizations that generate revenue from contracts with customers. While there is no doubt some industries will see a greater impact than others, all organizations will have to consider and respond to the new principles.

### When should planning start?

Another misconception is that there is plenty of time to address the new standard. However, delaying implementation could make it difficult to adopt the standard by the effective date, especially when long-term contracts are involved. Organizations that start planning now will also have more time to consider and prepare for practical changes to contracts and accounting systems.

# REVENUE RECOGNITION

## What is changing?

Under existing standards, revenue is generally recognized when it has been earned and/or is realized (or realizable) based on some commonly applied criteria, including:

- Evidence indicates an arrangement exists.
- Goods or services have been delivered.
- The price is fixed or determinable.
- Collectability is reasonably assured.

Organizations operating in certain industries must also apply industry-specific rules to determine when and how revenue for contracts should be recognized.

## The five-step principle

Revenue will be recognized under ASC 606 when a performance obligation is satisfied by **transferring control** of the product or service to the customer. The new standard replaces all of the existing revenue recognition guidance and industry-specific rules with a five-step, principle-based model that all organizations will use. To implement ASC 606, organizations will need to understand and develop a plan to incorporate these five steps into their accounting processes and practices.



1. Identify contracts with customers



2. Identify performance obligations (promises to deliver) in each contract



3. Determine the transaction price



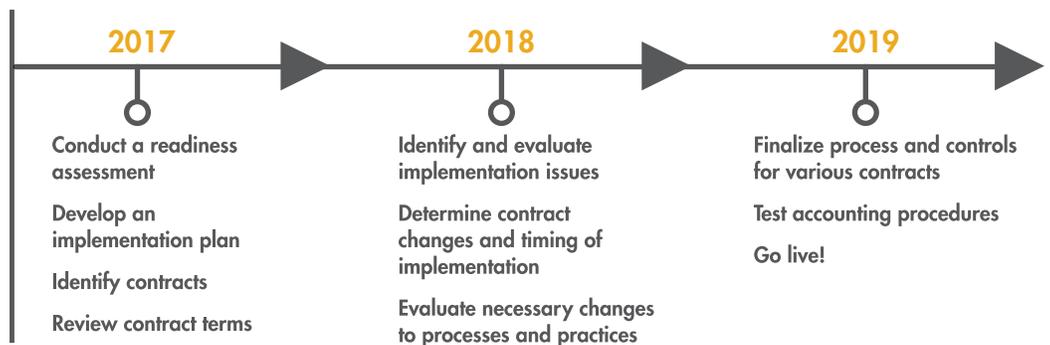
4. Allocate the transaction price to the performance obligations



5. Recognize revenue when or as performance obligations are satisfied

## What should I do now?

The first step is to develop an action plan to make the transition to the new standard as smooth as possible. Here are some broad goals a nonpublic entity might consider.



## Wipfli is here to help

Wipfli associates are monitoring the latest implementation guidance from the FASB and AICPA, and we are ready to help our clients as they implement ASC 606. Wipfli can help with:

- Readiness assessments
- Changes to accounting systems
- Implementation plans
- Evaluating impact on financial reporting (e.g., loan covenants)
- Reviewing contract terms
- Training and education (e.g., *Accounting Wire*, industry newsletters, webinars)
- Recommending contract changes

**Get started today!**

Contact your Wipfli relationship executive to learn more about revenue recognition for your organization.

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