

Module 6: Revenue recognition

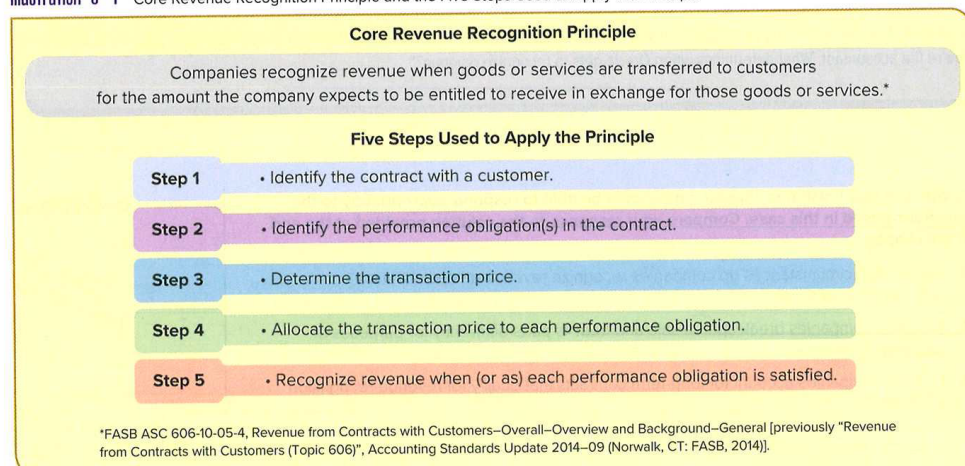


vs.



#	Question	Answer
(1)	When can <i>Pat's King of Steaks</i> record revenue related to the sale of a cheesesteak?	
(2)	When can <i>Sony</i> record the revenue related to the sale of the <i>Playstation 5</i> bundle?	

Illustration 6-1 Core Revenue Recognition Principle and the Five Steps Used to Apply the Principle





Learning Objective 6-01: State the core revenue recognition principle and the five key steps in applying it.

#	Question	Answer
(1)	What is a performance obligation ?	
(2)	When are performance obligations satisfied ?	
(3)	What is control in the context of revenue recognition?	



Learning Objective 6-02: Explain when it is appropriate to recognize revenue at a single point in time.

#	Question	Answer
(1)	What are <i>Indicators that Control Has Been Transferred from the Seller to the Customer?</i>	1. 2. 3. 4. 5.



Practice exercise: BE6-1

BE 6-1

Revenue
recognition at a
point in time

● LO6-2

On July 1, 2024, Apache Company, a real estate developer, sold a parcel of land to a construction company for \$3,000,000. The book value of the land on Apache's books was \$1,200,000. Terms of the sale required a down payment of \$150,000 and 19 annual payments of \$150,000 plus interest at an appropriate interest rate due on each July 1 beginning in 2025. How much revenue will Apache recognize for the sale (ignoring interest), assuming that it recognizes revenue at the point in time at which it transfers the land to the construction company?



Learning Objective 6-03: Explain when it is appropriate to recognize revenue over a period of time.

#	Question	Answer
(1)	What are the Criteria for Recognizing Revenue over Time ?	Revenue is recognized over time if either: 1. The customer consumes the benefit of the seller's work as it is performed, as when a company provides cleaning services to a customer for a period of time, or 2. The customer controls the asset as it is created, as when a contractor builds an extension onto a customer's existing building, or 3. The seller is creating an asset that has no alternative use to the seller, and the seller has the legal right to receive payment for progress to date, as when a company manufactures customized fighter jets for the U.S. Air Force.
(2)	How is revenue from Long-Term Construction Contracts recognized?	
(3)	What is Progress Toward Completion ?	



Practice exercise: BE6-3

BE 6-3

Timing of revenue recognition

● LO6-3

On May 1, 2024, Varga Tech Services signed a \$6,000 consulting contract with Shaffer Holdings. The contract requires Varga to provide computer technology support services whenever requested over the period from May 1, 2024, to April 30, 2025, with Shaffer paying the entire \$6,000 on May 1, 2024. How much revenue should Varga recognize in 2024?



Practice exercise: BE6-33

BE 6-33

Long-term contract; revenue recognition over time; profit recognition

● LO6-9

A construction company entered into a fixed-price contract to build an office building for \$20 million. Construction costs incurred during the first year were \$6 million, and estimated costs to complete at the end of the year were \$9 million. The company recognizes revenue over time according to percentage of completion. How much revenue and gross profit or loss will appear in the company's income statement in the first year of the contract?

$$\$20.0M * (\$6 / (\$6M + \$9M)) = \$20.0M * 40\% = \$8.0M$$

 Learning Objective 6-04: Allocate a contract's transaction price to multiple performance obligations.



vs.



#	Question	Answer
(1)	What is <i>Ryan Homes</i> selling to its customers?	

#	Question	Answer
(2)	What is <i>Home Depot</i> selling to its customers?	
(3)	How can we identify performance obligations ?	
(4)	What does the term distinct mean in relation to performance obligations ?	• Capable of being distinct: The customer could use the good or service on its own or in combination with other goods or services it could obtain elsewhere. • Separately identifiable from other goods or services in the contract: The promises to transfer goods and services are distinct in the context of the contract, because the seller is promising to provide goods and services individually as opposed to promising to provide a combined good or service for which the individual goods or services are inputs.
(5)	What is the definition of transaction price ?	
(6)	What is stand-alone selling price ?	The amount at which the good or service is sold separately under similar circumstances.



Practice exercise: BE6-4

BE 6-4

Allocating the
transaction price

LO6-4

Sarjit Systems sold software to a customer for \$80,000. As part of the contract, Sarjit promises to provide “free” technical support over the next six months. Sarjit sells the same software without technical support for \$70,000 and a stand-alone six-month technical support contract for \$30,000, so these products would sell for \$100,000 if sold separately. Prepare Sarjit’s journal entry to record the sale of the software.



Learning Objective 6-05: Determine when a contract exists, and whether some frequently encountered features of contracts qualify as performance obligations.

#	Question	Answer
(1)	When does a contract exist?	
(2)	Do prepayments represent performance obligations ?	Customer pays in advance for a product or service that will be delivered to them in the future. Verdict:
(3)	Do quality assurance warranties represent performance obligations ?	Obligation by the seller to make repairs or fix previously sold products; not sold separately. Verdict:
(4)	Do extended warranties represent performance obligations ?	An additional service that covers new problems arising after a customer takes control of a product; priced and sold separately. Verdict:
(5)	Do options represent performance obligations ?	Seller give the customer the right to receive additional goods and services at no cost or at a discount (e.g., software upgrade).



Practice exercise: BE6-5

BE 6-5

Existence of a contract

- LO6-5

Tulane Tires wrote a contract for a \$100,000 sale of tires to the new Garden District Tour Company. Tulane only anticipates a slightly greater than 50 percent chance that Garden will be able to pay the amounts that Tulane is entitled to receive under the contract. Upon delivery of the tires, assuming no payment has yet been made by Garden, how much revenue should Tulane recognize under U.S. GAAP?



Practice exercise: BE6-7

BE 6-7

Performance obligations; prepayments

- LO6-5

eLean is an online fitness community offering access to workout routines, nutrition advice, and eLean coaches. Customers pay a \$50 fee to become registered on the website, and then pay \$5 per month for access to all eLean services. How many performance obligations exist in the implied contract when a customer registers for the services?



Practice exercise: BE6-8

BE 6-8

Performance obligations; warranties

- LO6-5

Vroom Vacuums sells the Tornado vacuum cleaner. Each Tornado has a one-year warranty that covers any product defects. When customers purchase a Tornado, they also have the option to purchase an extended three-year warranty that covers any breakage or maintenance. The extended warranty sells for the same amount regardless of whether it is purchased at the same time as the Tornado or at some other time. How many performance obligations exist in the implied contract for the purchase of a vacuum cleaner?



Practice exercise: BE6-10

BE 6-10

Performance obligations; options

McAfee sells a subscription to its antivirus software along with a subscription renewal option that allows renewal at half the prevailing price for a new subscription. How many performance obligations exist in this contract?



Practice exercise: BE6-11

LO6-5

BE 6-11

Performance obligations; construction

LO6-5

Precision Equipment, Inc., specializes in designing and installing customized manufacturing equipment. On February 1, 2024, it signs a contract to design a fully automated wristwatch assembly line for \$2 million, which will be settled in cash upon completion of construction. Precision Equipment will install the equipment on the client's property, furnish it with a customized software package that is integral to operations, and provide consulting services that integrate the equipment with Precision's other assembly lines. How many performance obligations exist in this contract?



Practice exercise: BE6-13

BE 6-13

Performance obligations; right of return

- LO6-5, LO6-6

Aria Perfume, Inc., sold 3,210 boxes of white musk soap during January of 2024 at the price of \$90 per box. The company offers a full refund to unsatisfied customers for any product returned within 30 days from the date of purchase. Based on historical experience, Aria expects that 3% of sales will be returned. How many performance obligations are there in each sale of a box of soap? How much revenue, sales returns, and net revenue should Aria recognize in January?



Learning Objective 6-06: Understand how variable consideration and other aspects of contracts affect the calculation and allocation of transaction price.



Bryce Harper's Contract:

vs.

- 13 years / \$330,000,000
- \$20,000,000 Signing Bonus
- No Deferred Money
- Full No-Trade Clause
- \$500,000 for MVP
- \$100,000 for WS MVP
- \$50,000 for All-Star, Gold Glove, Silver Slugger, LCS MVP

#	Question	Answer
(1)	What is variable consideration ?	
(2)	How can we record revenue if there is variable consideration present?	

#	Question	Answer
(3)	How does the expected value method work?	Define all the possible outcomes. Assign a probability to each outcome happening. Multiply probabilities by value of each associated outcome. Sum the values.
(4)	How does the most likely amount method work?	Just what it sounds like. Choose the value of the outcome with the highest probability of happening.
(5)	What is a revenue reversal ?	Suppose estimates change and the company no longer anticipates receiving the variable consideration. In that case, previously recognized revenue on variable consideration must be reversed in the current period.
(6)	What are some indicators that a revenue reversal is needed ?	Sellers are limited to recognizing variable consideration to the extent that is probable that a significant revenue reversal will NOT occur in the future. The following are indicators that a significant revenue reversal could occur. 1. There's poor evidence on which to base an estimate. 2. The estimate depends on a lot of factors that are outside of the seller's control. 3. There's a history of the seller changing payment terms on similar contracts. 4. There's a broad range of outcomes that could occur. 5. There's a long delay between now and when the uncertainty will resolve itself.
(7)	Principal and agent transactions.	Would you say the travel website Expedia is a seller? Are they providing flights? Are they providing hotel rooms? Companies like Expedia are called agents. An agent does not control goods or services, but rather facilitates transfers between sellers and customers. A principal controls goods or services and is responsible

#	Question	Answer
		for providing them to the customer. In the Expedia example, when an airline ticket is sold the airline (e.g., US Airways) is the principal and Expedia is the agent. Agents only record revenue on commissions earned. Principals record revenue for the good or service provided to the customer.
(8)	What do we do when goods and services are not normally sold separately - there is no stand-alone selling price - and we need to recognize revenue separately for multiple performance obligations?	Sellers must ESTIMATE stand-alone selling prices.
(9)	What is the adjusted market assessment approach ?	Look at what similar products - perhaps competitor products - sell for in the market.
(10)	What is the expected cost plus margin approach ?	Estimate the cost to make the product on a stand alone basis and then add some profit margin.
(11)	What is the residual approach ?	Stand alone selling price = Total price of bundled product - total price of performance obligations with determinable stand alone prices



Practice exercise: BE6-14

BE 6-14

Variable
consideration

- LO6-6

Leo Consulting enters into a contract with Highgate University to restructure Highgate's processes for purchasing goods from suppliers. The contract states that Leo will earn a fixed fee of \$25,000 and earn an additional \$10,000 if Highgate achieves \$100,000 of cost savings. Leo estimates a 50% chance that Highgate will achieve \$100,000 of cost savings. Assuming that Leo determines the transaction price as the expected value of expected consideration, what transaction price will Leo estimate for this contract?



Practice exercise: BE6-21, BE6-22, BE6-23

LO6-6

BE 6-21

Estimating stand-alone selling prices: adjusted market assessment approach

LO6-6

O'Hara Associates sells golf clubs, and with each sale of a full set of clubs provides complimentary club-fitting services. A full set of clubs with the fitting services sells for \$1,500. Similar club-fitting services are offered by other vendors for \$110, and O'Hara generally charges approximately 10% more than do other vendors for similar services. Assuming that the golf clubs and the club-fitting services are separate performance obligations, estimate the stand-alone selling price of the club-fitting services using the adjusted market assessment approach.

BE 6-22

Estimating stand-alone selling prices: expected cost plus margin approach

LO6-6

O'Hara Associates sells golf clubs, and with each sale of a full set of clubs provides complimentary club-fitting services. A full set of clubs with the fitting services sells for \$1,500. O'Hara estimates that it incurs \$60 of staff compensation and other costs to provide the fitting services, and normally earns 30% over cost on similar services. Assuming that the golf clubs and the club-fitting services are separate performance obligations, estimate the stand-alone selling price of the club-fitting services using the expected cost plus margin approach.

BE 6-23

Estimating stand-alone selling prices: residual approach

LO6-6

O'Hara Associates sells golf clubs, and with each sale of a full set of clubs provides complimentary club-fitting services. A full set of clubs with the fitting services sells for \$1,500. O'Hara sells the same clubs without the fitting service for \$1,400. Assuming that the golf clubs and the club-fitting services are separate performance obligations, estimate the stand-alone selling price of the club fitting services using the residual approach.



Learning Objective 6-07: Determine the timing of revenue recognition with respect to licenses, franchises, and other common arrangements.

#	Question	Answer
(1)	When is revenue for licenses recognized?	
(2)	When is revenue for franchises recognized?	
(3)	When is revenue for bill-and-hold arrangements recognized?	
(4)	When is revenue for consignment arrangements recognized?	
(5)	When is revenue for gift cards recognized?	