Chapter Three

Revenue and Expense Recognition

PREVIEW OF CHAPTER 3

Revenue Recognition

Overview of Revenue Recognition	The Five-Step Process	Other Revenue Recognition Issues	Presentation and Disclosure
• Background • New revenue recognition standard	• Contract with customers • Separate performance obligations • Determining the transaction price • Allocating the transaction price • Satisfying performance obligations	• Right of return • Repurchase agreements • Bill-and-hold arrangements • Principal-agent relationships • Consignments • Warranties • Non-refundable upfront fees	• Presentation • Disclosure

CHAPTER Three

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.

LO 1

New Revenue Recognition Standard

ILLUSTRATION 3-1 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

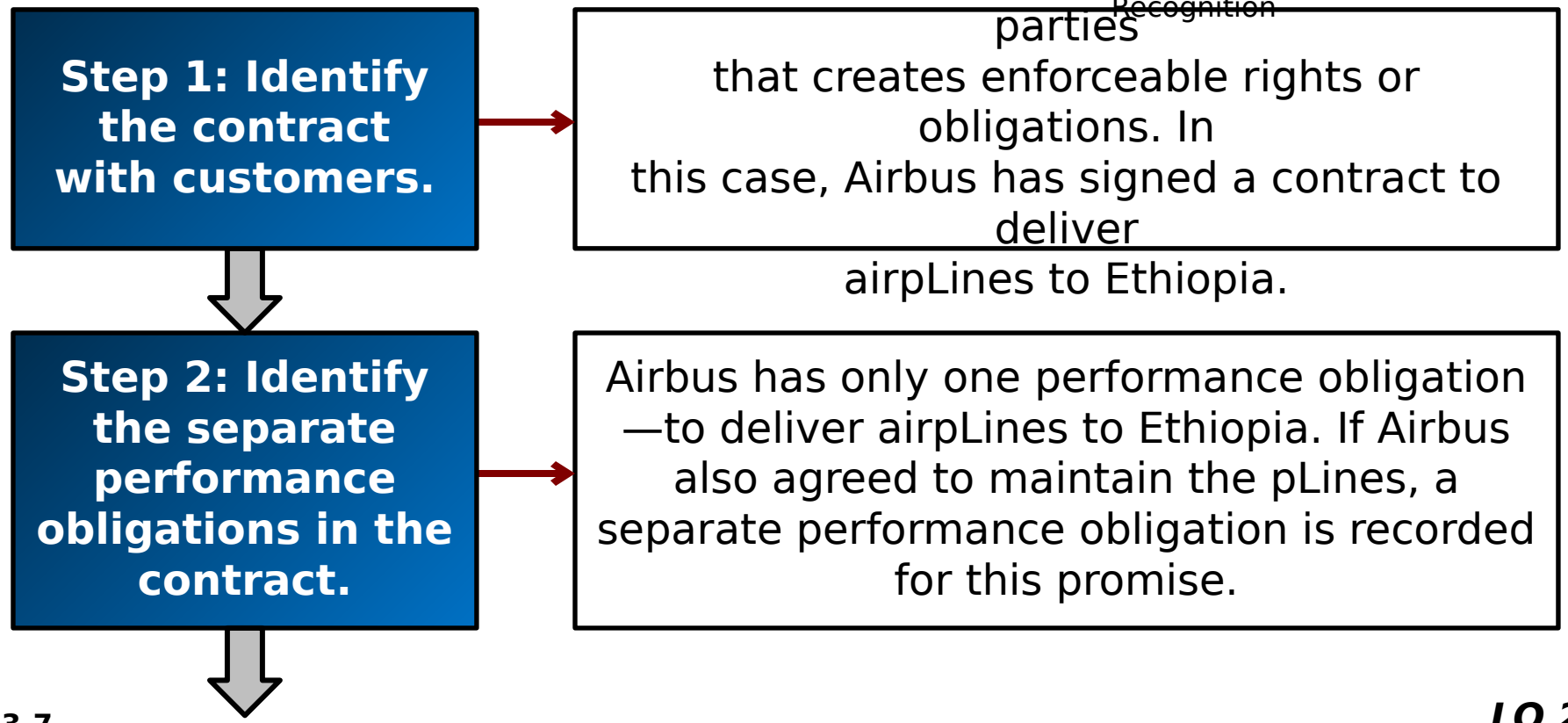
Recognize revenue in the accounting period when the performance obligation is satisfied.

Performance Obligation is Satisfied

THE FIVE-STEP PROCESS

Assume that **Airbus** (FRA) Corporation signs a contract to sell airpLines to **Ethiopian Airlines** (ETH) for Br.100 million.

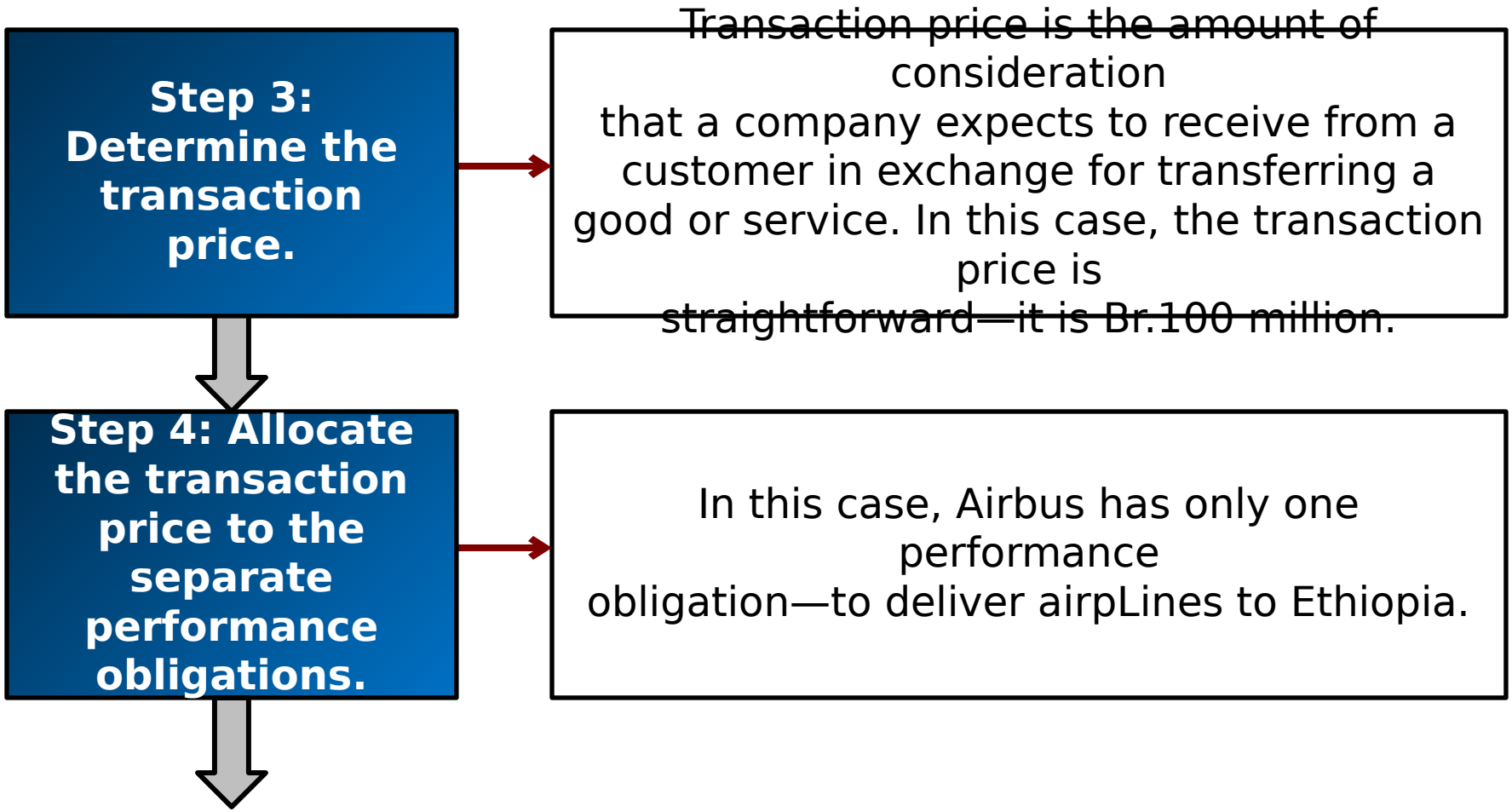
ILLUSTRATION 3-2
Five Steps of Revenue Recognition



LO 2

THE FIVE-STEP PROCESS

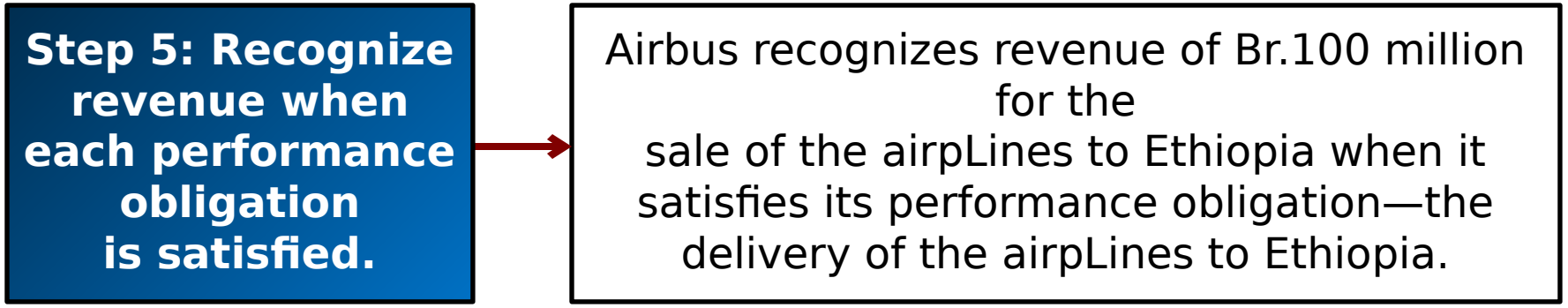
ILLUSTRATION 3-2 **Five Steps of Revenue Recognition**



LO 2

THE FIVE-STEP PROCESS

ILLUSTRATION 3-2 **Five Steps of Revenue Recognition**



LO 2

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 3-3.

Contract with Customers—Step 1

ILLUSTRATION 3-3 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 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.

LO 3

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

ILLUSTRATION 3-4
Basic Revenue Transaction

CONTRACTS AND RECOGNITION

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

Question: What journal entries should Abebe 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

ILLUSTRATION 3-4
Basic Revenue Transaction

CONTRACTS AND RECOGNITION

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

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

Abebe 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.

LO 3

Separate Performance Obligation

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

Given a new contract, Simon recognizes an additional:

Original contract [(100 units - 60 units) x Br.100] = Br.4,000

New product (20 units x Br.95) = 1,900

Total revenue **Br.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 Simon, the amount recognized as revenue for each of the remaining products would be a blended price of Br.98.33, computed as shown in ILLUSTRATION 3-5.

Products not delivered under original contract

(Br.100 x Br.40) = Br.4,000

Products to be delivered under contract

modification (Br.95 x 20) = 1,900

Total remaining revenue **Br.5,900**

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

Prospective Modification

Under the prospective approach, a blended price (Br.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

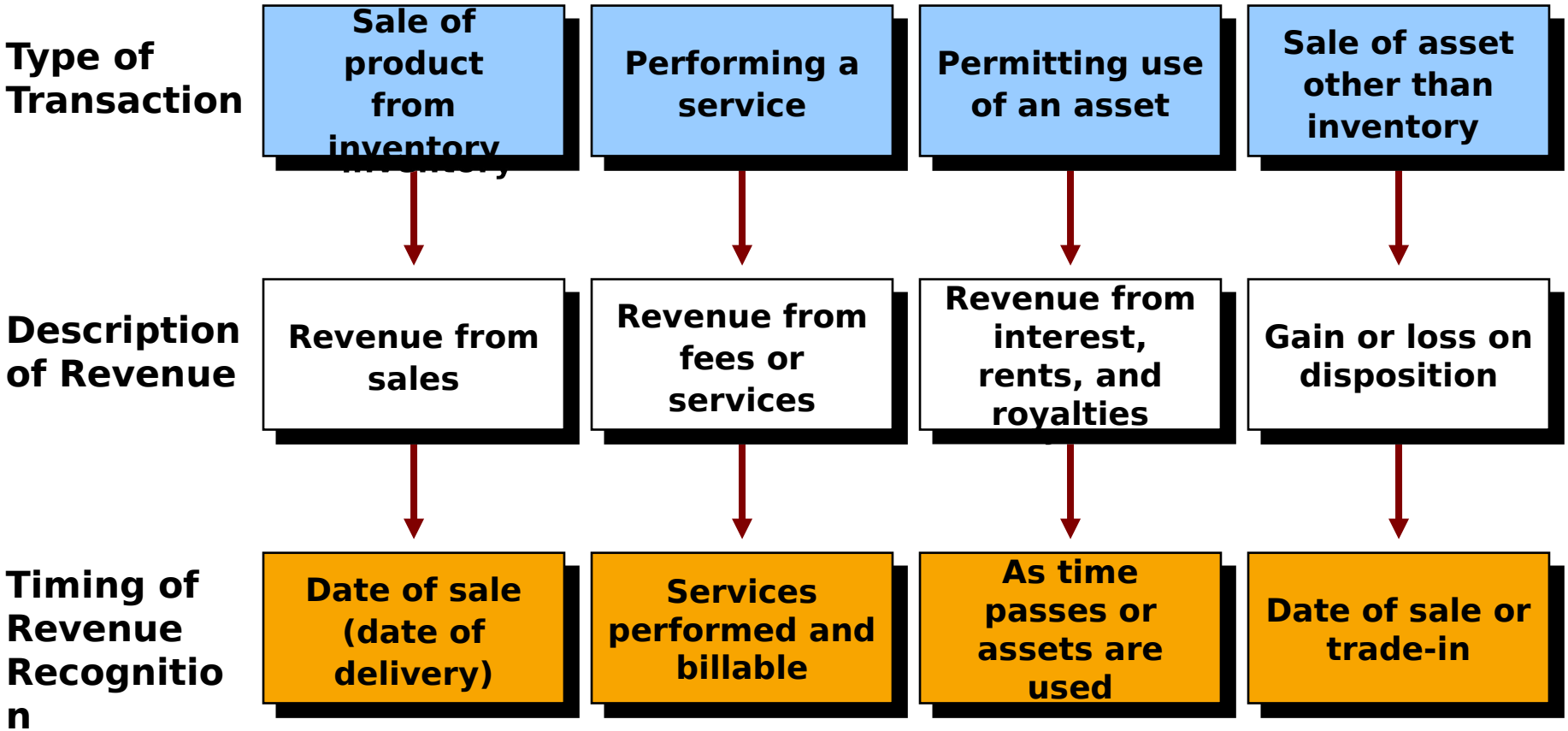
ILLUSTRATION 3 Comparison of Contract Modification Approaches

LO 3

Separate Performance Obligations—Step 2

Revenue Recognition Situations

ILLUSTRATION 3-7



LO 4

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

LO 4

Performance Obligations—Step 2

ILLUSTRATION 3-8 Identifying Performance Obligations

SoftTech Inc. licenses customer-relationship software to Abreham Company. In addition to providing the software itself, SoftTech promises to provide consulting services by extensively customizing the software to Abreham's information technology environment, for a total consideration of Br.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 Abreham has contracted. In addition, the software is significantly customized by SoftTech in accordance with

The license and the consulting services are distinct but interdependent, and therefore should be accounted for as **one performance obligation**.

performance obligation?

LO 4

Performance Obligations—Step 2

ILLUSTRATION 3-8 **Identifying Performance Obligations**

Ali 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

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.**

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 3-9 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 3-10
Transaction Price

ESTIMATING VARIABLE CONSIDERATION

Facts: Solomon Construction Company enters into a contract with a customer to build a warehouse for Br.100,000, with a performance bonus of Br.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 Solomon 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

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

Variable Consideration

ILLUSTRATION 3-10
Transaction Price

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

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

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

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

Br.150,000 (the outcome with 60% probability)

LO 5

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.

LO 5

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 3-12
Transaction Price - Extended Payment Terms

EXTENDED PAYMENT TERMS

Facts: On July 1, 2015, SEK Company sold goods to Silva Company for Br.900,000 in exchange for a 4-year, zero-interest-bearing note with a face amount of Br.1,416,163. The goods have a cost on SEK's books of Br.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 3-12
Transaction Price - Extended Payment Terms

EXTENDED PAYMENT TERMS

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

LO 5

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 3-13
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.

LO 5

Consideration Paid or Payable

ILLUSTRATION 3-13
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**

LO 5

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.

Allocating Transaction Price to Separate Performance Obligations—Step 4

ILLUSTRATION 3-14
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]

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

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 3-20
Summary of the Five-Step Revenue Recognition Process

Recognizing Revenue When (or as) Each Performance Obligation Is

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 3-20 Summary of the Five-Step Revenue Recognition Process

Recognizing Revenue When (or as) Each Performance Obligation Is

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 3-20
Summary of the Five-Step Revenue Recognition Process

Recognizing Revenue When (or as) Each Performance Obligation Is

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 3-20 Summary of the Five-Step Revenue Recognition Process

Recognizing Revenue When (or as) Each Performance Obligation Is

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 3-20
Summary of the Five-Step Revenue Recognition Process

OTHER REVENUE RECOGNITION ISSUES

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

Right of Return

- **Right of return** is granted for product for various reasons (e.g., dissatisfaction with product).
- Company returning the product receives any combination of the following.
  1. Full or partial refund of any consideration paid.
  2. Credit that can be applied against amounts owed, or that will be owed, to the seller.
  3. Another product in exchange.

Right of Return

ILLUSTRATION 3-21
Recognition—Right of Return

RIGHT OF RETURN

Facts: Aster Company sells 100 products for Br.100 each to Nejat Inc. for cash. Aster allows Nejat to return any unused product within 30 days and receive a full refund. The cost of each product is Br.60. To determine the transaction price, Aster 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, Aster estimates that:

1. Three 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 Aster record this sale?

LO 8

Right of Return

ILLUSTRATION 3-21
Recognition—Right of Return

Question: How should Aster record this sale?

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

Cash	**10,000**		
Sales Revenue	[Br.9,700 x (Br.100 x 97)]		**9,700**
Refund Liability	(Br.100 x 3)	**300**	

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

Cost of Goods Sold	**5,820**		
Estimated Inventory Returns	(Br.60 x 3)	**180**	
Inventory	**6,000**		

LO 8

Right of Return

ILLUSTRATION 3-21
Recognition—Right of Return

Question: How should Aster record this sale?

When a return occurs, Aster records the following entries.

Refund Liability (2 x Br.100)	**200**	
Accounts Payable		**200**
Returned Inventory (2 x Br.60)	**120**	
Estimated Inventory Returns		**120**

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

LO 8

Repurchase Agreements

- Transfer control of (sell) an asset to a customer but **have an obligation or right to repurchase**.
- If obligation or right to repurchase is for an amount **greater than or equal to** selling price, then transaction is a financing transaction.

Repurchase Agreements

ILLUSTRATION 3-22
Recognition—
Repurchase Agreement

REPURCHASE AGREEMENT

Facts: Urgecha Inc., an equipment dealer, sells equipment on January 1, 2015, to Line Company for Br.100,000. It agrees to repurchase this equipment on December 31, 2016, for a price of [illegible]

Question: How should Urgecha Inc. record this transaction?

Assuming an interest rate of 10 percent is imputed from the agreement, Urgecha makes the following entry to record the financing on January 1, 2015.

Cash	**100,000**	
Liability to Line Company		**100,000**

LO 8

Repurchase Agreements

ILLUSTRATION 3-22
Recognition—
Repurchase Agreement

Question: How should Urgecha Inc. record this transaction?

Urgecha Inc. records interest on **December 31, 2015**, as follows.

Interest Expense	**10,000**	
Liability to Line Company (Br.100,000 x 10%)		**10,000**

Urgecha Inc. records interest and retirement of its liability to Line Company on **December 31, 2016**, as follows.

Interest Expense	**11,000**	
Liability to Line Company (Br.110,000 x 10%)		**11,000**
Liability to Line Company	**121,000**	
Cash (Br.100,000 + Br.10,000 + Br.11,000)		**121,000**

LO 8

Bill-and-Hold Arrangements

- Contract under which an entity bills a customer for a product but the entity retains physical possession of the product until a point in time in the future.
- Result when buyer is not yet ready to take delivery but does take title and accepts billing.

Bill-and-Hold Arrangements

ILLUSTRATION 3-23
Recognition—Bill and Hold

BILL AND HOLD

Facts: Kiya Company sells Br.450,000 (cost Br.280,000) of fireplaces on March 1, 2015, to a local coffee shop, Fruit, which is planning to expand its locations around the city. Under the agreement, Fruit asks Kiya to retain these fireplaces in its warehouses until the new coffee shops that will house the fireplaces are ready. Title passes to Fruit at the time the agreement is signed.

Question: **When should Kiya recognize the revenue from this bill-and-hold arrangement?**

Kiya determines when it has satisfied its performance obligation to transfer a product by evaluating when Fruit obtains control of that product.

Bill-and-Hold Arrangements

ILLUSTRATION 3-23
Recognition—Bill and Hold

Question: **When should Kiya recognize the revenue from this bill-and-hold arrangement?**

For Fruit to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria should be met:

(a) The reason for the bill-and-hold arrangement must be substantive.

(b) The product must be identified separately as belonging to Fruit.

(c) The product currently must be ready for physical transfer to Fruit.

(d) Kiya cannot have the ability to use the product or to direct it to another customer.

In this case, it appears that the above **criteria were met**, and therefore **revenue recognition should be permitted** at the time the contract is signed.

LO 8

Bill-and-Hold Arrangements

ILLUSTRATION 3-23
Recognition—Bill and Hold

Question: **When should Kiya recognize the revenue from this bill-and-hold arrangement?**

Kiya makes the following entry to **record the sale**.

Accounts receivable	**450,000**	
Sales Revenue		**450,000**

Kiya makes an entry to record the related cost of goods sold as follows.

Cost of Goods Sold	**280,000**	
Inventory		**280,000**

Principal-Agent Relationships

- Agent's performance obligation is to arrange for principal to provide goods or services to a customer.
- Examples:
  - Preferred Travel Company (agent) facilitates the booking of cruise excursions by finding customers for Regency Cruise Company (principal).
  - **Priceline** (USA) (agent) facilitates the sale of various services such as car rentals at **Hertz** (USA) (principal).
- Amounts collected on behalf of the principal are not revenue of the agent.
  - Revenue for agent is amount of commission received.

Consignments

- Manufacturers (or wholesalers) deliver goods but **retain title to the goods** until they are sold.
- **Consignor** (manufacturer or wholesaler) ships merchandise to the **consignee** (dealer), who is to act as an agent for the consignor in selling the merchandise.
- **Consignor** makes a profit on the sale.
  - Carries merchandise as inventory.
- **Consignee** makes a commission on the sale.

Consignments

ILLUSTRATION 3-25
Recognition—Sales on Consignment

SALES ON CONSIGNMENT

Facts: Garcia Manufacturing Co. ships merchandise costing €36,000 on consignment to Best Value Stores. Garcia pays €3,750 of freight costs, and Best Value pays €2,250 for local advertising costs that are reimbursable from Garcia. By the end of the period, Best Value has sold two-thirds of the consigned merchandise for €40,000 cash. Best Value notifies Garcia of the sales, retains a 10% commission, and remits the cash due Garcia.

***Question:* What are the journal entries that the consignor (Garcia) and the consignee (Best Value) make to record this transaction?**

Solution:

GARCIA MFG. CO. (CONSIGNOR)			BEST VALUE STORES (CONSIGNEE)
Shipment of consigned merchandise			
Inventory (consignments)	36,000		No entry (record memo of merchandise
Finished Goods Inventory		36,000	received).
Payment of freight costs by consignor			
Inventory (consignments)	3,750		No entry.
Cash		3,750	

Consignments

ILLUSTRATION 3-25
Recognition—Sales on Consignment

SALES ON CONSIGNMENT

Payment of advertising by consignee					
No entry until notified.			Receivable from Consignor	2,250	
			Cash		2,250
Sales of consigned merchandise					
No entry until notified.			Cash	40,000	
			Payable to Consignor		40,000
Notification of sales and expenses and remittance of amount due					
Cash	33,750		Payable to Consignor	40,000	
Advertising Expense	2,250		Receivable from Consignor		2,250
Commission Expense	4,000		Commission Revenue (€40,000 × 10%)		4,000
Revenue from Consignment Sales		40,000	Cash		33,750
Adjustment of inventory on consignment for cost of sales					
Cost of Goods Sold	26,500		No entry.		
Inventory (consignments)		26,500			
[2/3 (€36,000 + €3,750) = €26,500]					

Warranties

Two types of warranties to customers:

1. Product meets agreed-upon specifications in contract at time product is sold.
    a. Warranty is included in sales price (**assurance-type warranty**).
2. Not included in sales price of product (**service-type warranty**).
    a. Recorded as a separate performance obligation.

Warranties

ILLUSTRATION 3-26
Performance Obligations and Warranties

WARRANTIES

Facts: Tesfaye Company sold 1,000 Rollomatics during 2015 at a total price of Br.6,000,000, with a warranty guarantee that the product was free of any defects. The cost of Rollomatics sold is Br.4,000,000. The term of the assurance warranty is two years, with an estimated cost of Br.30,000. In addition, Tesfaye sold extended warranties related to 400 Rollomatics for 3 years beyond the 2-year period for Br.12,000.

Question: **What are the journal entries that Tesfaye Company should make in 2015 related to the sale and the related warranties?**

LO 8

Warranties

ILLUSTRATION 3-26
Performance Obligations and Warranties

Question: **What are the journal entries that Tesfaye Company should make in 2015 related to the sale and the related warranties?**

To record the revenue and liabilities related to the warranties:

Cash (Br.6,000,000 + Br.12,000)	6,012,000	
Warranty Expense	30,000	
Warranty Liability		30,000
Unearned Warranty Revenue		12,000
Sales Revenue		6,000,000

To reduce inventory and recognize cost of goods sold:

Cost of Goods Sold	4,000,000	
Inventory		4,000,000

LO 8

Non-Refundable Upfront Fees

- Payments from customers before
  - Delivery of a product.
  - Performance of a service.
- Generally relate to initiation, activation, or setup of a good or service to be provided or performed in the future.
- Most cases, upfront payments are nonrefundable.
  - Examples include:
    - Membership fee in a health club.
    - Activation fees for phone, Internet, or cable.

PRESENTATION AND DISCLOSURE

Presentation

Contract Assets and Liabilities

- **Contract assets** are of **two types**:

  1. **Unconditional rights** to receive consideration because company has satisfied its performance obligation.
  2. **Conditional rights** to receive consideration because company has satisfied one performance obligation but must satisfy another performance obligation before it can bill the customer.

LO 9

Presentation

ILLUSTRATION 3-29
Contract Asset Recognition and Presentation

CONTRACT ASSET

Facts: On January 1, 2015, Hanan Company enters into a contract to transfer Product A and Product B to Samcate Co. for Br.100,000. The contract specifies that payment of Product A will not occur until Product B is also delivered. In other words, payment will not occur until both Product A and Product B are transferred to Samcate. Hanan determines that standalone prices are Br.30,000 for Product A and Br.70,000 for Product B. Hanan delivers Product A to Samcate on February 1, 2015. On March 1, 2015, Hanan delivers

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

Presentation

ILLUSTRATION 3-29
Contract Asset Recognition and Presentation

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

On **February 1, 2015**, Hanan records the following entry:

Contract Asset	30,000	
Sales Revenue		30,000

On February 1, Hanan does not record an accounts receivable because it does not have an unconditional right to receive the Br.100,000 unless it also transfers Product B to Samcate. When Hanan transfers Product B on **March 1, 2015**, it makes the following entry.

Accounts Receivable	100,000	
Contract Asset		30,000
Sales Revenue		70,000

Presentation

ILLUSTRATION 3-30
Contract Liability Recognition and Presentation

CONTRACT LIABILITY

Facts: On March 1, 2015, Helen Company enters into a contract to transfer a product to Eden Inc. on July 31, 2015. It is agreed that Eden will pay the full price of Br.10,000 in advance on April 1, 2015. The contract is non-cancelable. Eden, however, does not pay until April 15, 2015, and Helen delivers the product on July 31, 2015. The cost of the product is

Question: **What journal entries are required in 2015?**

No entry is required on March 1, 2015:

- Neither party has performed on the contract.
- Neither party has an unconditional right as of March 1, 2015.

LO 9

Presentation

ILLUSTRATION 3-30
Contract Liability Recognition and Presentation

***Question:* What journal entries are required in 2015?**

On receiving the cash on April 15, 2015, Helen records the following entry.

Cash	10,000	
Unearned Sales Revenue		10,000

On satisfying the performance obligation on July 31, 2015, Helen records the following entry to record the sale.

Unearned Sales Revenue	10,000	
Sales Revenue		10,000

In addition, Helen records cost of goods sold as follows.

Cost of Good Sold	7,500	
Inventory		7,500

LO 9

Presentation

Costs to Fulfill a Contract

- Companies divide fulfillment costs (contract acquisition costs) into two categories:
  1. Those that give rise to an asset.
  2. Those that are expensed as incurred.

Presentation

Collectibility

- Credit risk that a customer will be unable to pay in accordance with the contract.
  - Whether a company will get paid is not a consideration in determining revenue recognition.
  - Amount recognized as revenue is not adjusted for customer credit risk.

Disclosure

Companies disclose qualitative and quantitative information about the following:

- Contracts with customers.
- Significant judgments.
- Assets recognized from costs incurred to fulfill a contract.

Disclosure

Companies provide a range of disclosures:

- Disaggregation of revenue.
- Reconciliation of contract balances.
- Remaining performance obligations.
- Cost to obtain or fulfill contracts.
- Other qualitative disclosures.
  - Significant judgments and changes in them.
  - Minimum revenue not subject to variable consideration constraint.

APPENDIX 3A LONG-TERM CONSTRUCTION CONTRACTS

REVENUE RECOGNITION OVER TIME

Under certain circumstances companies recognize revenue over time.

The most notable context in which revenue may be recognized over time is **long-term construction contract accounting**.

LO 10 Apply the percentage-of-completion method for long-term contracts.

APPENDIX 3A | **LONG-TERM CONSTRUCTION CONTRACTS**

REVENUE RECOGNITION OVER TIME

Long-term contracts frequently provide that seller (builder) may bill purchaser at intervals.

- Examples:
  - Development of military and commercial aircraft
  - Weapons-delivery systems
  - Space exploration hardware

LO 10

APPENDIX 3A | **LONG-TERM CONSTRUCTION CONTRACTS**

REVENUE RECOGNITION OVER TIME

A company recognizes revenue over time if **at least one** of the following two criteria is met:

1. Company's performance creates or enhances an asset (e.g., work in process) that the customer controls as the asset is created or enhanced; or
2. Company's performance does not create an asset with an alternative use. In addition…

LO 10

APPENDIX 3A | **LONG-TERM CONSTRUCTION CONTRACTS**

REVENUE RECOGNITION OVER TIME

In addition at least one of the following criteria must be met:

a. The customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs.

b. Another company would not need to substantially re-perform the work the company has completed to date if that other company were to fulfill the remaining obligation to the customer.

c. The company has a right to payment for its performance completed to date, and it expects to ful

LO 10

APPENDIX 3A | **LONG-TERM CONSTRUCTION CONTRACTS**

REVENUE RECOGNITION OVER TIME

If criterion 1 or 2 is met, then a company recognizes revenue over time if it can reasonably estimate its progress toward satisfaction of the performance obligations.

- Company recognizes revenues and gross profits each period based upon the progress of the construction—referred to as the **percentage-of-completion method**.
- If criteria are not met, the company recognizes revenues and gross profit when the contract is completed, referred to as the **cost-recovery**

LO 10

APPENDIX 3A **LONG-TERM CONSTRUCTION CONTRACTS**

Percentage-of-Completion Method

Measuring the Progress Toward Completion

Most popular input measure used to determine the progress toward completion is the **cost-to-cost basis**.

LO 10

APPENDIX 3A **LONG-TERM CONSTRUCTION CONTRACTS**

Percentage-of-Completion Method

Revenue to Recognized Cost-to-Cost Basis

ILLUSTRATION 3A-1

$$\frac{\text{Costs incurred to date}}{\text{Most recent estimate of total costs}} = \text{Percent complete}$$

ILLUSTRATION 3A-2

$$\text{Percent complete} \times \text{Estimated total revenue (or gross profit)} = \text{Revenue (or gross profit) to be recognized to date}$$

ILLUSTRATION 3A-3

$$\text{Revenue (or gross profit) to be recognized to date} - \text{Revenue (or gross profit) recognized in prior periods} = \text{Current-period revenue (or gross profit)}$$

LO 10

APPENDIX 3A PERCENTAGE-OF-COMPLETION METHOD

Illustration: Hardhat Construction Company has a contract to construct a Br.4,500,000 bridge at an estimated cost of Br.4,000,000. The contract is to start in July 2015, and the bridge is to be completed in October 2017. The following data pertain to the construction period.

	2015	2016	2017
Costs to date	£1,000,000	£2,916,000	£4,050,000
Estimated costs to complete	3,000,000	1,134,000	—
Progress billings during the year	900,000	2,400,000	1,200,000
Cash collected during the year	750,000	1,750,000	2,000,000

LO 10

APPENDIX 3A PERCENTAGE-OF-COMPLETION METHOD

	2015	2016	2017
Costs to date	£1,000,000	£2,916,000	£4,050,000
Estimated costs to complete	3,000,000	1,134,000	—
Progress billings during the year	900,000	2,400,000	1,200,000
Cash collected during the year	750,000	1,750,000	2,000,000

ILLUSTRATION 3A-4

	2015	2016	2017
Contract price	£4,500,000	£4,500,000	£4,500,000
Less estimated cost:			
Costs to date	1,000,000		
Estimated costs to complete	3,000,000		
Estimated total costs	4,000,000		
Estimated total gross profit	£ 500,000		
Percent complete	25% (£1,000,000 / £4,000,000)		

LO 10

APPENDIX 3A PERCENTAGE-OF-COMPLETION METHOD

	2015	2016	2017
Costs to date	£1,000,000	£2,916,000	£4,050,000
Estimated costs to complete	3,000,000	1,134,000	—
Progress billings during the year	900,000	2,400,000	1,200,000
Cash collected during the year	750,000	1,750,000	2,000,000

ILLUSTRATION 3A-5

	2015		2016		2017	
To record costs of construction:						
Construction in Process	1,000,000					
Materials, Cash, Payables, etc.		1,000,000				
To record progress billings:						
Accounts Receivable	900,000					
Billings on Construction in Process		900,000				
To record collections:						
Cash	750,000					
Accounts Receivable		750,000				

LO 10

APPENDIX 3A PERCENTAGE-OF-COMPLETION METHOD

Illustration: Percentage-of-Completion Revenue, Costs, and Gross Profit by Year

ILLUSTRATION 3A-6

	To Date	Recognized in Prior Years	Recognized in Current Year
2015			
Revenues (£4,500,000 × 25%)	£1,125,000		£1,125,000
Costs	1,000,000		1,000,000
Gross profit	£ 125,000		£ 125,000
2016			
Revenues (£4,500,000 × 72%)	£3,240,000	£1,125,000	£2,115,000
Costs	2,916,000	1,000,000	1,916,000
Gross profit	£ 324,000	£ 125,000	£ 199,000
2017			
Revenues (£4,500,000 × 100%)	£4,500,000	£3,240,000	£1,260,000
Costs	4,050,000	2,916,000	1,134,000
Gross profit	£ 450,000	£ 324,000	£ 126,000

LO 10

APPENDIX 3A

PERCENTAGE-OF-COMPLETION METHOD

ILLUSTRATION 3A-6

	To Date	Recognized in Prior Years	Recognized in Current Year
2015			
Revenues (£4,500,000 × 25%)	£1,125,000		£1,125,000
Costs	1,000,000		1,000,000
Gross profit	£ 125,000		£ 125,000
2016			
Revenues (£4,500,000 × 72%)	£3,240,000	£1,125,000	£2,115,000
Costs	2,916,000	1,000,000	1,916,000
Gross profit	£ 324,000	£ 125,000	£ 199,000
2017			
Revenues (£4,500,000 × 100%)	£4,500,000	£3,240,000	£1,260,000
Costs	4,050,000	2,916,000	1,134,000
Gross profit	£ 450,000	£ 324,000	£ 126,000

ILLUSTRATION 3A-7

	2015		2016		2017	
To recognize revenue and gross profit:						
Construction in Process (gross profit)	125,000					
Construction Expenses	1,000,000					
Revenue from Long-Term Contracts		1,125,000				
To record completion of the contract:						
Billings on Construction in Process						
Construction in Process						

LO 10

APPENDIX 3A PERCENTAGE-OF-COMPLETION METHOD

Illustration: Content of Construction in Process Account—Percentage-of-Completion Method

ILLUSTRATION 3A-8

Construction in Process				
2015 Construction costs	£1,000,000	12/31/17	To close completed project	£4,500,000
2015 Recognized gross profit	125,000			
2016 Construction costs	1,916,000			
2016 Recognized gross profit	199,000			
2017 Construction costs	1,134,000			
2017 Recognized gross profit	126,000			
Total	£4,500,000	Total		£4,500,000

LO 10

APPENDIX 3A PERCENTAGE-OF-COMPLETION METHOD

Financial Statement Presentation—Percentage-of-Completion

Computation of Unbilled Contract Price at 12/31/15

ILLUSTRATION 3A-9

Contract revenue recognized to date: £4,500,000 ×	£1,000,000 / £4,000,000	£1,125,000
Billings to date		(900,000)
Unbilled revenue		£ 225,000

LO 10

APPENDIX 3A PERCENTAGE-OF-COMPLETION METHOD

Financial Statement Presentation—Percentage-of-Completion Method (2015)

ILLUSTRATION 3A-10

HARDHAT CONSTRUCTION COMPANY

Income Statement (from Illustration 18A-6)	2015
Revenue from long-term contracts	£1,125,000
Costs of construction	1,000,000
Gross profit	£ 125,000

Statement of Financial Position (12/31)		2015
Current assets		
Accounts receivable (£900,000 − £750,000)		£ 150,000
Inventory		
Construction in process	£1,125,000	
Less: Billings	900,000	
Costs and recognized profit in excess of billings		225,000

LO 10

APPENDIX 3A PERCENTAGE-OF-COMPLETION METHOD

Financial Statement Presentation—Percentage-of-Completion Method (2016)

ILLUSTRATION 3A-11

HARDHAT CONSTRUCTION COMPANY		
Income Statement (from Illustration 18A-6)		2016
Revenue from long-term contracts		£2,115,000
Costs of construction		1,916,000
Gross profit		£ 199,000
Statement of Financial Position (12/31)		
Current assets		
Accounts receivable (£150,000 + £2,400,000 − £1,750,000)		£ 800,000
Current liabilities		
Billings	£3,300,000	
Less: Construction in process	3,240,000	
Billings in excess of costs and recognized profits		60,000

LO 10

Cost-Recovery (Zero-Profit) Method

This method recognizes revenue only to the extent of costs incurred that are expected to be recoverable. Only after all costs are incurred is gross profit recognized.

LO 11 Apply the cost-recovery method for long-term contracts.

APPENDIX 3A COST-RECOVERY (ZERO-PROFIT) METHOD

Illustration: Hardhat Construction would report the following revenues and costs for 2015–2017.

ILLUSTRATION 3A-14

	To Date	Recognized in Prior Years	Recognized in Current Year
2015			
Revenues (costs incurred)	£1,000,000		£1,000,000
Costs	1,000,000		1,000,000
Gross profit	£ 0		£ 0
2016			
Revenues (costs incurred)	£2,916,000	£1,000,000	£1,916,000
Costs	2,916,000	1,000,000	1,916,000
Gross profit	£ 0	£ 0	£ 0
2017			
Revenues (£4,500,000 × 100%)	£4,500,000	£2,916,000	£1,584,000
Costs	4,050,000	2,916,000	1,134,000
Gross profit	£ 450,000	£ 0	£ 450,000

LO 11

APPENDIX 3A COST-RECOVERY (ZERO-PROFIT) METHOD

ILLUSTRATION 3A-14
Cost-Recovery Method Revenue, Costs, and Gross Profit by Year

	To Date	Recognized in Prior Years	Recognized in Current Year
2015			
Revenues (costs incurred)	£1,000,000		£1,000,000
Costs	1,000,000		1,000,000
Gross profit	£ 0		£ 0
2016			
Revenues (costs incurred)	£2,916,000	£1,000,000	£1,916,000
Costs	2,916,000	1,000,000	1,916,000
Gross profit	£ 0	£ 0	£ 0
2017			
Revenues (£4,500,000 × 100%)	£4,500,000	£2,916,000	£1,584,000
Costs	4,050,000	2,916,000	1,134,000
Gross profit	£ 450,000	£ 0	£ 450,000

ILLUSTRATION 3A-15
Journal Entries—Cost-Recovery Method

	2015		2016		2017	
Construction Expenses	1,000,000		1,916,000			
Revenue from Long-Term Contracts		1,000,000		1,916,000		
(To recognize costs and related expenses)						
Construction in Process (Gross Profit)					450,000	
Construction Expenses					1,134,000	
Revenue from Long-Term Contracts						1,584,000
(To recognize costs and related expenses)						
Billings on Construction in Process					4,500,000	
Construction in Process						4,500,000
(To record completion of the contract)						

LO 11

APPENDIX 3A COST-RECOVERY (ZERO-PROFIT) METHOD

ILLUSTRATION 3A-14
Cost-Recovery Method Revenue, Costs, and Gross Profit by Year

	To Date	Recognized in Prior Years	Recognized in Current Year
2015			
Revenues (costs incurred)	£1,000,000		£1,000,000
Costs	1,000,000		1,000,000
Gross profit	£ 0		£ 0
2016			
Revenues (costs incurred)	£2,916,000	£1,000,000	£1,916,000
Costs	2,916,000	1,000,000	1,916,000
Gross profit	£ 0	£ 0	£ 0
2017			
Revenues (£4,500,000 × 100%)	£4,500,000	£2,916,000	£1,584,000
Costs	4,050,000	2,916,000	1,134,000
Gross profit	£ 450,000	£ 0	£ 450,000

ILLUSTRATION 3A-16
Comparison of Gross Profit Recognized

	Percentage-of-Completion	Cost-Recovery
2015	£125,000	£ 0
2016	199,000	0
2017	126,000	450,000

LO 11

APPENDIX 3A COST-RECOVERY (ZERO-PROFIT) METHOD

HARDHAT CONSTRUCTION COMPANY

Income Statement	2015	2016	2017
Revenue from long-term contracts	£1,000,000	£1,916,000	£1,584,000
Costs of construction	1,000,000	1,916,000	1,134,000
Gross profit	£ 0	£ 0	£ 450,000

Statement of Financial Position (12/31)		2015	2016	2017
Current assets				
Inventories				
Construction in process	£1,000,000			
Less: Billings	900,000			
Costs in excess of billings		£ 100,000		£ –0–
Accounts receivable		150,000	£ 800,000	–0–
Current liabilities				
Billings	£3,300,000			
Less: Construction in process	2,916,000			
Billings in excess of costs and recognized profits			£ 384,000	£ –0–

ILLUSTRATION 3A-17
Financial Statement Presentation—Cost- Recovery Method

LO 11

APPENDIX 3A | **LONG-TERM CONSTRUCTION CONTRACTS**

Long-Term Contract Losses

1. Loss in Current Period on a Profitable Contract

- Percentage-of-completion method only, the estimated cost increase requires a current-period adjustment of gross profit recognized in prior periods.

2. Loss on an Unprofitable Contract

- Under both percentage-of-completion and cost-recovery methods, the company must recognize in the current period the entire expected

LO 12 Identify the proper accounting for losses on long-term contracts.

APPENDIX 3A LONG-TERM CONTRACT LOSSES

Illustration: Loss in Current Period

	2014	2015	2016
Contract price	$675,000	$675,000	$675,000
Cost incurred current year	150,000	287,400	215,436
Estimated cost to complete in future years	450,000	215,436	0
Billings to customer current year	135,000	360,000	180,000
Cash receipts from customer Current year	112,500	262,500	300,000

Prepare the journal entries to record revenue and expense for 2014, 2015, and 2016 assuming the estimated cost to complete at the end of 2015 was Br.215,436.

Advance slide in presentation mode to reveal answers.

LO 12

APPENDIX 3A LONG-TERM CONTRACT LOSSES

Illustration: Loss in Current Period

	2014	2015	2016
Costs incurred to date	$ 150,000		
Estimated cost to complete	450,000		
Est. total contract costs	600,000		
Est. percentage complete	25.0%		
Contract price	675,000		
Revenue recognizable	168,750		
Rev. recognized prior year			
Rev. recognized currently	168,750		
Costs incurred currently	(150,000)		
Gross profit recognized	$ 18,750		

LO 12

APPENDIX 3A LONG-TERM CONTRACT LOSSES

Illustration: Loss in Current Period

	2014		2015		2016	
Construction in Process	18,750				7,314	
Construction Expenses	150,000				215,436	
Revenue from LT Contracts		168,750				222,750
Construction in Process				3,900		
Construction Expenses			287,400			
Revenue from LT Contracts				283,500		

LO 12

APPENDIX 3A LONG-TERM CONTRACT LOSSES

Illustration: Loss on Unprofitable Contract

	2014	2015	2016
Contract price	$675,000	$675,000	$675,000
Cost incurred current year	150,000	287,400	246,038
Estimated cost to complete in future years	450,000	246,038	0
Billings to customer current year	135,000	360,000	180,000
Cash receipts from customer Current year	112,500	262,500	300,000

Prepare the journal entries for 2014, 2015, and 2016 assuming the estimated cost to complete at the end of 2015 was **Br.246,038** instead of Br.170,100.

LO 12

APPENDIX 3A LONG-TERM CONTRACT LOSSES

Illustration: Loss on Unprofitable Contract

	2014	2015	2016
Costs incurred to date	$ 150,000		
Estimated cost to complete	450,000		
Est. total contract costs	600,000		
Est. percentage complete	25.0%		
Contract price	675,000		
Revenue recognizable	168,750		
Rev. recognized prior year			
Rev. recognized currently	168,750		
Costs incurred currently	(150,000)		
Gross profit recognized	$ 18,750		

Br.675,000 – 683,438 = (8,438)
cumulative loss

LO 12

APPENDIX 3A LONG-TERM CONTRACT LOSSES

Illustration: Loss on Unprofitable Contract

	2014		2015		2016	
Construction in Process	18,750				-	
Construction Expenses	150,000				243,000	
Revenue from LT Contracts		168,750				243,000
Construction Expenses			290,438			
Construction in Process				27,188		
Revenue from LT Contracts				263,250		

LO 12

APPENDIX 3A LONG-TERM CONTRACT LOSSES

Illustration: Loss on Unprofitable Contract

For the **Cost-Recovery** method, companies would recognize the following loss :

	2014	2015	2016
Loss on LT Contracts		8,438	
Construction in Process			8,438

LO 12

APPENDIX 3B REVENUE RECOGNITION FOR FRANCHISES

Franchises

Four types of franchising arrangements have evolved:

1. Manufacturer-retailer
2. Manufacturer-wholesaler
3. Service sponsor-retailer
4. Wholesaler-retailer

LO 13 Explain revenue recognition for franchises.

APPENDIX 3B REVENUE RECOGNITION FOR FRANCHISES

Franchises

Two sources of revenue:

1. Sale of initial franchises and related assets or services, and
2. Continuing fees based on the operations of franchises.

LO 13

APPENDIX 3B REVENUE RECOGNITION FOR FRANCHISES

Franchises

The **franchisor** normally provides the **franchisee** with:

1. Assistance in site selection
2. Evaluation of potential income
3. Supervision of construction activity
4. Assistance in the acquisition of signs, fixtures, and equipment
5. Bookkeeping and advisory services
6. Employee and management training
7. Quality control

LO 13

APPENDIX 3B REVENUE RECOGNITION FOR FRANCHISES

FRANCHISE ACCOUNTING

Performance obligations relate to:

- Right to open a business.
- Use of trade name or other intellectual property of the franchisor.
- Continuing services, such as marketing help, training, and in some cases supplying inventory and inventory management.

LO 13

APPENDIX 3B | **REVENUE RECOGNITION FOR FRANCHISES**

FRANCHISE ACCOUNTING

Franchisors commonly charge an initial franchise fee and continuing franchise fees:

- **Initial franchise fee** (payment for establishing the relationship and providing some initial services).
- **Continuing franchise fees** received
  - In return for continuing rights granted by the agreement.
  - For providing management training, advertising and promotion, legal assistance, and other support.

LO 13

APPENDIX 3B REVENUE RECOGNITION FOR FRANCHISES

Facts: Tum's Pizza Inc. enters into a franchise agreement on November 1, 2015, giving Food Fight Corp. the right to operate as a franchisee of Tum's Pizza for 5 years. Tum's charges Food Fight an initial franchise fee of Br.50,000 for the right to operate as a franchisee. Of this amount, Br.20,000 is payable when Food Fight signs the agreement, and the balance is payable in five annual payments of Br.6,000 each on December 31. Food Fight also promises to pay ongoing royalty payments of 1% of its annual sales (payable each January 31 of the following year) and is obliged to purchase products from Tum's at its current standalone selling prices at the time of purchase. The credit rating of Food Fight indicates that money can be borrowed at 8%. The present value of an ordinary annuity of five annual receipts of Br.6,000 each discounted at 8% is Br.23,957. The discount of Br.6,043 represents the interest revenue to be accrued by Tum's over t...

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APPENDIX 3B REVENUE RECOGNITION FOR FRANCHISES

Identify the performance obligations and the point in time when the performance obligations are satisfied and revenue is recognized.

Rights to the trade name, market area, and proprietary know-how for 5 years are not individually distinct.

- Each one is not sold separately and cannot be used with other goods or services that are readily available to the franchisee.
- Combined rights give rise to a single performance obligation.
- Tum's satisfies performance obligation at point in time when Food Fight obtains control of the rights.

LO 13

APPENDIX 3B REVENUE RECOGNITION FOR FRANCHISES

Identify the performance obligations and the point in time when the performance obligations are satisfied and revenue is recognized.

Training services and equipment are distinct because similar services and equipment are sold separately.

- Tum's satisfies those performance obligations when it transfers the services and equipment to Food Fight.

Tum's cannot recognize revenue for the royalty payments because it is not reasonably assured to be entitled to those royalty amounts.

- Tum's recognizes revenue for the royalties when (or as) the uncertainty is resolved.

LO 13

APPENDIX 3B REVENUE RECOGNITION FOR FRANCHISES

Consider the following for allocation of the transaction price at December 31, 2015.

Rights to the trade name, market area, and proprietary know-how	$20,000
Training services	9,957
Equipment (cost of $10,000)	14,000
Total transaction price	$ 43,957

Training is completed in January 2016, the equipment is installed in January 2016, and Food Fight holds a grand opening on February 2, 2016.

LO 13

APPENDIX 3B REVENUE RECOGNITION FOR FRANCHISES

On **December 31, 2015**, Tum's signs the agreement and receives upfront payment and note.

Cash	20,000		
Notes Receivable	30,000		
Discount on Notes Receivable			6,043
Unearned Franchise Revenue			20,000
Unearned Service Revenue (training)			9,957
Unearned Sales Revenue (equipment)			14,000

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APPENDIX 3B REVENUE RECOGNITION FOR FRANCHISES

On **February 2, 2016**, franchise opens. Tum's satisfies the performance obligations related to the franchise rights, training, and equipment.

Unearned Franchise Revenue	20,000	
Franchise Revenue		20,000
Unearned Service Revenue (training)	9,957	
Service Revenue (training)		9,957
Unearned Sales Revenue (equipment)	14,000	
Sales Revenue		14,000
Cost of Goods Sold	10,000	
Inventory		10,000

LO 13

APPENDIX 3B REVENUE RECOGNITION FOR FRANCHISES

RECOGNITION OF FRANCHISE RIGHTS REVENUE OVER TIME

Depending on the economic substance of the rights, the franchisor may be providing access to the right rather than transferring control of the franchise rights.

In this case, **the franchise revenue is recognized over time**, rather than at a point in time.

LO 13

APPENDIX 3B FRANCHISE REVENUE OVER TIME

Facts: Tech Solvers Corp. is a franchisor and provides a range of computing services (hardware/software installation, repairs, data backup, device syncing, and network solutions) on popular Apple and PC devices. Each franchise agreement gives a franchisee the right to open a Tech Solvers store and sell Tech Solvers' products and services in the area for 5 years. Under the contract, Tech Solvers also provides the franchisee with a number of services to support and enhance the franchise brand, including

(a) advising and consulting on the operations of the store;

(b) communicating new hardware and software developments, and service techniques;

(c) providing business and training manuals; and

(d) advertising programs and training.

LO 13

APPENDIX 3B FRANCHISE REVENUE OVER TIME

Facts: As an almost entirely service operation (all parts and other supplies are purchased as needed by customers), Tech Solvers provides few upfront services to franchisees. Instead, the franchisee recruits service technicians, who are given Tech Solvers' training materials (online manuals and tutorials), which are updated for technology changes, on a monthly basis at a minimum. Tech Solvers enters into a franchise agreement on December 15, 2015, giving a franchisee the rights to operate a Tech Solvers franchise in eastern Bavaria for 5 years. Tech Solvers charges an initial franchise fee of Br.5,000 for the right to operate as a franchisee, payable upon signing the contract. Tech Solvers also receives ongoing royalty payments of 7% of the franchisee's annual sales (payable each January 15 of the following year).

LO 13

APPENDIX 3B FRANCHISE REVENUE OVER TIME

Identify the performance obligations and the point in time when the performance obligations are satisfied and revenue is recognized.

Rights to the trade name, market area, and proprietary know-how for 5 years are not individually distinct.

- Each one is not sold separately and cannot be used with other goods or services that are readily available to the franchisee.
- Licensed rights and the ongoing training materials are a single performance obligation.
- Tech Solvers is providing access to the rights and must continue (over time) to perform updates and services.

LO 13

APPENDIX 3B FRANCHISE REVENUE OVER TIME

Identify the performance obligations and the point in time when the performance obligations are satisfied and revenue is recognized.

Tech Solvers cannot recognize revenue for the royalty payments

- Not reasonably assured to be entitled to those revenue-based royalty amounts.
- Payments represent variable consideration.
- Recognize revenue for royalties when (or as) uncertainty is resolved.

LO 13

APPENDIX 3B FRANCHISE REVENUE OVER TIME

Franchise agreement signed and receipt of upfront payment and note, December 15, 2015:

Cash	5,000		
Unearned Franchise Revenue			5,000

Franchise begins operations in January 2016 and records Br.85,000 of revenue for the year ended December 31, 2016.

Unearned Franchise Revenue	1,000		
Franchise Revenue (Br.5,000 ÷ 5)			1,000
Accounts Receivable	5,950		
Franchise Revenue (Br.85,000 x 7%)			5,950

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