Top 5 Impacts of ASC 606 on Manufacturing Companies

As private companies are gearing up for the implementation of Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, many are wondering how this guidance will impact the manufacturing industry. For privately-held entities, ASC 606 applies for annual periods beginning after December 15, 2018 (2019 will be the first year for December year-ends).

The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve the core principle, an entity should apply the following steps:

1) Identify the contract(s) with a customer;
2) Identify the performance obligations in the contract;
3) Determine the transaction price;
4) Allocate the transaction price to the performance obligations in the contract; and
5) Recognize revenue when (or as) the entity satisfies a performance obligation.

Below are the Top 5 Impacts on Manufacturers:

1) **Over Time or at Point in Time?** All manufacturers will need to evaluate whether performance obligations happen over time or at a point in time. This will primarily impact companies that are producing customized products built to the customer's specification and are recognizing revenue under the percentage-of-completion method. The primary considerations for whether revenue is to be recognized over time are threefold:
   a. if the customer simultaneously receives and consumes the benefits of the manufacturer's performance as it occurs;
   b. if the manufacturer's performance creates or enhances an asset that the customer controls, as the asset is created or enhanced; or
   c. if the manufacturer's performance does not create an asset with alternative use to the entity, **and** the manufacturer has an enforceable right to payment for performance completed to date.

   Though assessing if any of these three considerations apply can be cumbersome, ASC 606 requires that each entity perform this assessment. Furthermore, selecting the measure of progress is not free choice. ASC 606 requires that the measure of progress be based on the nature of the goods and services being transferred to the customer.

2) **Volume Discounts**. Manufacturing and supply contracts can include customer incentives to encourage future optional purchases. Under ASC 606, companies should assess whether any customer incentives provide a material right to the customer that it would have not received without entering into a contract. If the contract provides a material right to the customer, in effect, the customer pays in advance for future goods or services.

Under 606, a material right is a separate performance obligation at inception of the contract. As a result, a portion of the transaction price is to be allocated to the material right and revenue is recognized when those future goods or services are transferred or when the option expires.

3) **Warranties**. ASC 606 helps differentiate between assurance warranties and service warranties. Assurance warranties are those that provide a customer with the assurance that the product will function in accordance with agreed-upon specifications. On the contrary, service warranties provide the customer with a service, such as an extended warranty. Under ASC 606, an option to purchase a warranty separately represents a service warranty that should be accounted for as a separate performance obligation. Even if not sold separately, an entity should consider whether the warranty contains a service component in addition to an assurance component. Additionally, the amount of transaction price allocated to a separately priced extended warranty is determined using a standalone selling price methodology, rather than simply using the contractual price, as is the case under the current revenue guidance.

4) **Customer Acquisition Costs**. Issued concurrent with ASC 606, ASC 340-40, *Other Assets and Deferred Costs*, provides guidance on accounting for the incremental costs of obtaining a contract. These costs are defined as:
    a. Costs that relate directly to a performance obligation under a contract;
    b. Costs that generate or enhance resources of the vendor that will be used to satisfy performance obligations in the future; and
    c. Costs that are expected to be recovered through future sales.

    An example of a customer acquisition cost included in this guidance would be sales commissions. These costs would then be deferred and amortized proportionally in the same pattern that revenues from the contract will be recognized. Other costs not incremental in obtaining a contract are expensed as incurred.

5) **Tooling and Setup Costs.** Manufacturers often incur significant costs at the inception of a contract related to tooling, equipment and engineering start-up activities. Manufacturers will now need to consider whether these pre-production activities are a promised good or service **or** if they are fulfillment activities. The consideration should hinge on whether the customer will own the results of these activities. If so, this may indicate that the pre-production activity is a promised good or service. If this is the case, a portion of the transaction price in the contract would be allocated to that good or service, as either a single performance obligation or as part of a combined performance obligation.

When considering the transition method from current revenue guidance to ASC 606, entities have two options:

1) full retrospective or
2) modified retrospective.

Under the full retrospective method, all periods presented are restated. Conversely, under the modified retrospective method, an entity would apply ASC 606 to contracts that are incomplete at the initial application (beginning of 2019 for calendar year-end entities) and recognize the cumulative effect of the new standard as an adjustment to the opening balance of retained earnings. Essentially, prior year would not be restated under the modified retrospective approach. Under both methods, significant additional disclosures will be required to ensure that users of the financial statements understand the impact of adopting the new guidance.

If you need assistance or have any questions on how these changes could impact your business, please contact David Kloess or Rick Rosell by calling 770.396.2200.