Case A: Revenue Recognition for Products

Smooth Blend, Inc., a calendar year company, produces several blends of whiskey. Maturing whiskey is stored for 3 years in a large, dark aromatic warehouse owned by Smooth Blend. Smooth Blend sells the whiskey to Distributor Company at the beginning of the aging process (January 1, 2011). Distributor Company will pick up the whiskey at the end of the aging process (December 31, 2013) and take it to its facilities for bottling. Distributor Company pays the full purchase price to Smooth Blend on January 1, 2011 to protect itself against price increases.

1. When should Smooth Blend recognize revenue? Why?
2. Would your answer change
   a) If the quality control manager of Distributor Company had the right to taste the whiskey on December 31, 2013 and receive a full refund if not satisfied with the quality of the liquor?
   b) If there was no right of return but Smooth Blend promised to help Distributor Company attract customers?
   c) If Smooth Blend acquired a fixed price option from Distributor Company to repurchase the whiskey in 6 months?
3. How would your answer change if Smooth Blend sold the whiskey to Friendly Bank, agrees to oversee the aging process on the bank’s behalf, and acquires a fixed price forward from Friendly Bank to repurchase the whiskey in 6 months?

Case B: Revenue Recognition: Timing

Accountants from Construction Company, Boat Builder Company and BMW are discussing revenue recognition. All are calendar year companies. A description of the production process of each company follows.

Construction Company builds homes on lots it owns. It currently is building a home for Billy Bob (BB). The terms of the contract required BB to pay the entire $200,000 price of the home on the date the construction contract was signed (October 1, 2012). The advance payment protects BB from a forecasted increase in home prices. The contract promises BB that he can move into the house no later than 9 months from when he signs the contract (June 30, 2013). The total expected cost of completing the house is $150,000. If the house is not completed by June 30, 2013 Construction Company must pay BB a $1,500 penalty each week until he can move into the house. Construction Company spends $20,000 to lay the foundation for the house in 2012. It completes the house for $2,000 under budget on July 1.
Boat Builder Company currently is completing work on a boat that a customer contracted for on September 30, 2012 and expects to take delivery of on August 1, 2013. The $200,000 fixed price contract does not obligate the customer to pay Boat Builder until the boat is delivered and the title transfers to the customer. The boat is a basic design offered by Boat Builder. Customers individualize the basic boat by selecting custom trim, accessories and other finish details. Boat Builder typically fulfills specific customer orders rather than holding boats in inventory. If the customer cancels the contract prior to delivery, Boat Builder must be paid for any work completed up to that date. Boat Builder incurs initial design and selling costs of $10,000. Boat Builder’s actual and expected building costs are $150,000, which consists of raw materials of $50,000 and labor costs of $100,000. The raw materials are purchased on October 1, 2012. Raw materials are consumed and direct labor costs are incurred evenly over the construction period.

BMW agrees to sell Joe Customer a new BMW 650i for $85,000 on December 4, 2012 through one of its company-owned dealerships. The cost to BMW to produce the car is $60,000. Because of the highly specified nature of the options requested by this customer, BMW must build the car from scratch, a process that will take 8 weeks. BMW anticipates delivering the vehicle on February 1, 2013.

1. Under current GAAP, how much revenue should Construction Company, Boat Builder and BMW recognize in 2012 and 2013?

Case C: Cellular Telephone Contract

XTel runs a promotion in which new customers who sign a two-year contract receive a free phone. There is a one-time activation fee of $50 and a monthly fee of $40 for the ongoing service. The same monthly fee is charged by XTel regardless of whether the free phone is provided. Each phone costs XTel $100. XTel frequently sells the phone separately for $120. XTel is not required to refund any portion of the fee paid for any reason. XTel is a sufficiently capitalized, experienced and profitable business. There is no reason to believe the two years of service will not be provided.

1. How should XTel account for this transaction?