
A Research on the Sale of the Volcano System

Executive Summary

Our corporation, Coconut Telegraph Corporation, has recently entered into a contract with Buffet Worldwide Inc. On February 1, 2018, the terms of the contract were set. We would deliver our flagship product, the Volcano System, and one year of post contract customer support (PCS) beginning March 1, 2018. This memo will provide the research necessary to decide whether the Volcano System and PCS should be stated separately or as one single performance obligation. Also, the research will determine how much revenue will be recognized and how much revenue will be deferred. On May 1, 2018, the contract with Buffet Inc. was modified to include an additional year of PCS and training services on the system. The research enclosed in this memo will help determine whether this modification should be treated as a separate contract or not as a separate contract. It will also help determine the amount allocated to unearned training service revenue and unearned PCS revenue as a result of the modification.

Sale of Volcano System on February 1, 2018

· The accounting literature necessary to decide whether or not the sale of the Volcano System and post contract customer support on February 1, 2018 should be reported separately includes the FASB codifications of 606-10-25-19, 606-10-25-20, and 606-10-25-21. Paragraph 19 explains that goods and services can be considered distinct and treated separately if the good or service meets a certain criteria consisting of two parts. First, the customer must be able to benefit from the good or service on its own or together with readily available resources. In this arrangement, the volcano system is beneficial to the customer on its own and the PCS is beneficial with readily available resources[1]. Paragraph 20 states a readily available resource can be considered a good or service obtained from the entity including goods that will have already transferred to the customer under the contract[2]. Specifically, the PCS is beneficial to Buffett with the readily available resource of the Volcano System because it provides services to ensure the system runs smoothly and efficiently. Second, the transfer of the good or service is separately identifiable from other promises in the contract. The Volcano System and PCS can be considered separately identifiable because the customer could decide not to purchase the PCS, and the Volcano System would not be significantly affected[3].

· By treating the items as separate, the revenue will be allocated to each performance obligation on a relative standalone selling basis[4]. The allocation can be calculated by dividing each standalone price by the total standalone prices of both the PCS and Volcano System. This

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proportion is then multiplied by the selling price⁴. For example, the total revenue from the Volcano System can be calculated by dividing the standalone price of \$12,000 by the total standalone price of \$14,000 to get a proportion of .857143. This proportion is then multiplied by the selling price of \$12,000 to get total revenue from the Volcano System as \$10,285.72. The same process calculates the total revenue for PCS as \$1,714.28.

· The revenue recognized on April 30, 2018 will be \$10,285.72 for the Volcano System and \$285.71 for the PCS. This is because revenue will be recognized when the entity has no remaining obligations to transfer goods and services or the contract has been terminated^[5]. This applies directly for the Volcano System because there are not any remaining obligations. The PCS is \$285.71 because revenue can only be recognized for the services provided up until April 30⁵. This number was determined by dividing \$1714.28 by twelve to determine the monthly revenue, and then multiplying by 2 to account for March and April. The remaining \$1428.57 will be the deferred revenue balance because Coconut has an obligation to perform services in the future^[6].

Contract Modification as a Separate Contract and Not as a Separate Contract

· According to FASB codification 606-10-25-12, a contract modification will be recorded as a separate contract if two conditions are met. First, the scope of the contract must increase because of the addition of distinct goods or services is promised^[7]. Also, the price of the contract must increase by an amount equal to the standalone selling price of the goods and services⁷.

· If the contract is not a separate contract, the entity must account for the promised goods or services not yet transferred at the date of the contract modification. This is possible in one of the three following ways^[8]. First, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the modification⁸. This will be treated as if it were a termination of an existing contract and formation of a new contract. The new performance obligation will be the sum of the new consideration from the modified contract and the remaining obligation from the original contract. Second, if the goods or services from the modification are not distinct from the goods and services on the remaining contract, then the entity should account for the modification as if it were a part of the original contract⁸. The modification will form a single performance obligation with the remaining goods or services. Adjustments to revenue will have to be made at the date of the modification. Finally, there are situations in which some of the remaining goods and services are distinct with the modified goods and services, and some are not distinct. In this situation, the entity must account for the modification to satisfy the needs of both of the two previous situations⁸.

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Modification of Buffet Contract on May 1, 2018

- If Coconut decides to record the contract modification not as a separate contract, the balance for unearned PCS service would be \$3228.57. Of this amount, \$1428.57 is from the original contract and \$1800 is from the modification. The amount from the modification is calculated by dividing the standalone price of PCS services from the modification by the total standalone price of the PCS services and training services from the modification and then multiplying this proportion by the selling price⁴. In this case, the calculation was made by dividing the \$2,000 standalone price by the \$5,000 sum of the standalone prices to get a proportion of .40. This proportion was multiplied by the \$4,500 to get an allocated revenue of \$1,800. Since none of the services have been completed as of May 1, 2018, then the entire amount of the contract will be considered unearned PCS revenue⁶.

- Similar steps can be taken to determine the amount allocated to unearned training service revenue. The same calculations will be used as when the unearned PCS revenue from the modification was calculated⁴. The only difference will be that the standalone price for the training services is \$3,000 making the proportion .60. The total revenue allocated to training services comes out to \$2,700. Since the services do not begin until June 1, all of this revenue will be considered unearned training service revenue⁶.

Conclusion

After research and some calculations, we believe we have figured out how to approach this situation with respect to FASB accounting standards. In the original contract on February 1, 2018, we decided to treat the Volcano System sale and PCS as separate obligations. We also calculated the revenue recognized on April 30, 2018, to be \$10,285.72 for the sale of the Volcano System and \$285.71 for PCS. As a result, the deferred revenue balance for PCS will be \$1428.57. The contract modification on May 1, 2018 will not be treated as a separate contract. The amount allocated to unearned training service revenue will be \$2,700 and the amount allocated to unearned PCS will be \$1,800.

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