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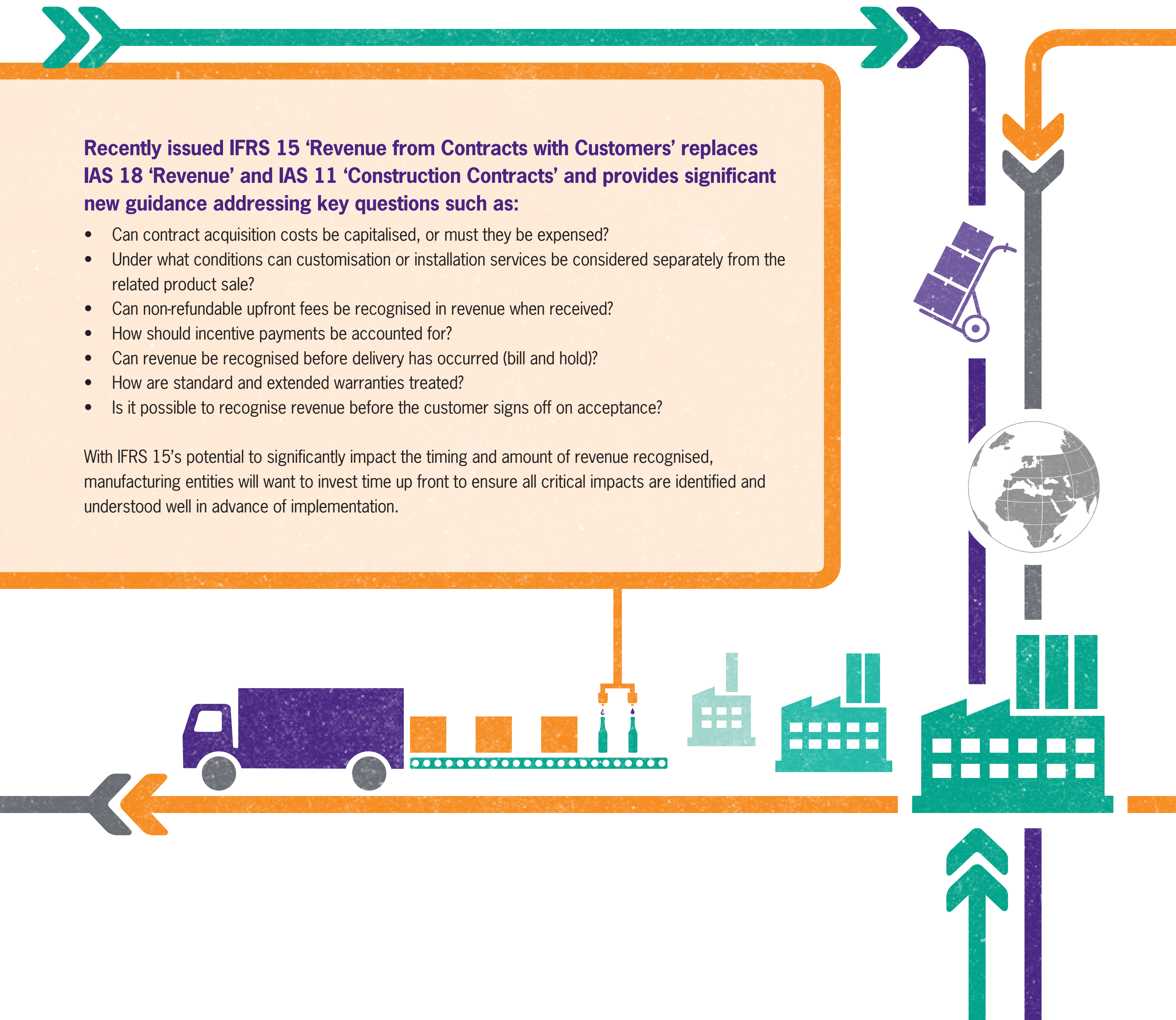
# A new global standard on revenue

## What this means for the manufacturing industry

**The International Accounting Standards Board (IASB) and US FASB have finally issued their new Standard on revenue – IFRS 15 'Revenue from Contracts with Customers' (ASU 2014-09 or Topic 606 in the US). This bulletin summarises the new requirements and what they will mean for the manufacturing industry.**



**Recently issued IFRS 15 'Revenue from Contracts with Customers' replaces IAS 18 'Revenue' and IAS 11 'Construction Contracts' and provides significant new guidance addressing key questions such as:**

- Can contract acquisition costs be capitalised, or must they be expensed?
- Under what conditions can customisation or installation services be considered separately from the related product sale?
- Can non-refundable upfront fees be recognised in revenue when received?
- How should incentive payments be accounted for?
- Can revenue be recognised before delivery has occurred (bill and hold)?
- How are standard and extended warranties treated?
- Is it possible to recognise revenue before the customer signs off on acceptance?

With IFRS 15's potential to significantly impact the timing and amount of revenue recognised, manufacturing entities will want to invest time up front to ensure all critical impacts are identified and understood well in advance of implementation.

# The new Standard at a glance

**The new Standard replaces IAS 18, IAS 11, and some revenue-related Interpretations. All transactions within its scope will apply a single, control-based model centred around the following 5-steps:**

Step 1: Identify the contract with a customer

Step 2: Identify the performance obligations

Step 3: Determine the transaction price

Step 4: Allocate the transaction price to the performance obligations

Step 5: Recognise revenue when/as performance obligations are satisfied

IFRS 15 changes the criteria for determining whether revenue is recognised at a point in time or over time. IFRS 15 also has more guidance in many areas where current IFRSs are lacking such as:

- multiple-element arrangements
- non-cash and variable consideration
- rights of return and other customer options
- seller repurchase options and agreements
- warranties
- principal versus agent (gross versus net)
- licensing intellectual property
- breakage
- non-refundable upfront fees
- consignment and bill-and-hold arrangements.

IFRS 15 will require considerably more disclosure about revenue including information about contract balances, remaining performance obligations (backlog), and key judgements made.

## Transition and effective date

IFRS 15 is effective for annual periods beginning on or after 1 January 2017. Transition is retrospective, subject to some simplifications, including an option to not restate comparative periods. Early application is permitted.

**Manufacturers deal with a broad range of accounting issues, from accumulating contract costs, measuring progress towards completion, assessing whether revenue should be recognised over time or at a point in time, and determining whether or not promised goods or services represent separate performance obligations, to questions of customer acceptance, performance bonuses, and the impact established practices can have on contractual incoterms and the transfer of control. IFRS 15 provides additional guidance in many of these areas and as a result, entities will need to carefully assess their current practices for possible changes to the timing of revenue recognition.**

# What this means for the manufacturing industry

**IFRS 15 provides additional guidance in a number of areas not currently addressed by existing IFRS guidance. The extent of differences between the old and new guidance will depend (to some extent) on the accounting policies adopted by manufacturers under existing IFRS where gaps currently exist. Although in many cases entities will find the new guidance provides a similar result to the old, an evaluation of the new control-based model and new criteria is necessary as some manufacturers may find the timing of revenue recognition differs under IFRS 15.**

## Step 1: Identify the contract with a customer

Step 1 of the new model is to identify the contract. An entity is only able to proceed to the next steps in the model if:

- the contract has commercial substance
- the parties have approved the contract
- each party's rights and the payment terms can be clearly identified
- it is probable the entity will collect the consideration.

### Criteria not met

When the above criteria are not met, revenue cannot be recognised until they either are met, or one of the following occurs:

- performance is complete and all consideration received is non-refundable
- the arrangement has been cancelled and any consideration received is non-refundable.

### Contract modifications/change orders

Depending on the circumstances, a contract modification is accounted for either as a separate contract, as the termination of an existing contract and creation of a new contract, or as part of an existing contract. For example, where a fixed price manufacturing contract is impacted by a subsequent change order that is not considered to be 'distinct' from the original performance obligation, the seller adjusts both the transaction price and the measure of progress towards completion and adjusts revenue on a 'cumulative catch-up' basis.

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# Step 2: Identify the performance obligations

Existing IFRS lacks detailed guidance on whether warranty obligations are separate deliverables.

A cornerstone of the IFRS 15 model is the fact that revenue is recognised based on satisfaction of 'distinct' performance obligations rather than the contract as a whole. A promised good or service is 'distinct' if both:

- the customer benefits from the item on its own or along with other readily available resources
- it is 'separately identifiable' (eg the supplier does not provide a significant service integrating, modifying, or customising the various performance obligations).

Existing IFRS lacks detailed guidance on 'multiple element arrangements'.

Entities will be required to evaluate the separability of multiple elements based on the 'distinct' criteria outlined above which may result in more or different elements (referred to as 'performance obligations') being separated (such as services attached to standard warranties, material discounts on future purchases, and contract renewal options, among others). The subsequent allocation of arrangement consideration to the individual performance obligations identified is discussed in Step 4 below.

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### Warranties

Existing IFRS lacks detailed guidance on whether warranty obligations are separate deliverables. We understand that many entities today account for extended-type warranties as separate deliverables, with allocated revenue recognised over the coverage period, while standard-type warranties are not typically regarded as separate deliverables and are instead accounted for by accruing estimated costs under IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'.

We expect that the new guidance will not change current practice as under IFRS 15, the entity will account for the warranty as a separate performance obligation (and therefore allocate a portion of the contract transaction price based on relative stand-alone selling price as discussed in Steps 3 and 4) if either:

- the customer has the option to separately purchase the warranty
- all or part of the warranty provides the customer with an additional service (beyond the assurance that the product will comply with agreed-upon specifications).

If the conditions above are not met, the entity accounts for the warranty using the cost accrual guidance in IAS 37.

# Step 3: Determine the transaction price

Under IFRS 15, an entity estimates and includes variable payment amounts in the contract price using either a probability-weighted or most likely amount approach, subject to a constraint.

### Variable consideration: performance incentives

Variable pricing arrangements (eg awards or incentive payments) of one type or another are common in the manufacturing industry. Under IFRS 15, an entity estimates and includes variable payment amounts in the contract price using either a probability-weighted or most likely amount approach. This amount is further subject to a revenue constraint such that estimated amounts are included in the contract price only to the extent that it is highly probable that a subsequent change in the estimate will not result in a significant reversal of cumulative contract revenue recognised.

We do not expect these requirements to have a significant impact on the timing of revenue recognition for incentive payments as existing guidance requires such payments to be included in contract revenue when both:

- it is probable that the specified performance standards will be met or exceeded
- the amount of the incentive payment can be measured reliably.

### Variable consideration: return and refund rights

Under the new guidance, variable consideration also includes a customer's right to return goods. A manufacturer should record a refund liability for the amount of revenue not expected to be recognised and a newly defined asset (a 'contract asset') for its right to the returned goods. The asset is measured by reference to the former inventory amount, adjusted through cost of sales for recovery costs and any expected decline in value.

This is similar to existing practice where a liability and related asset are also recognised although the asset is typically presented on the balance sheet under inventory, representing an entity's claim on the goods expected to be returned. Under IFRS 15, the contract asset must be presented separately from inventory and will need to be assessed for impairment under IFRS 9 'Financial Instruments' (or IAS 39 'Financial Instruments: Recognition and Measurement').

## Step 4: Allocate the transaction price to the performance obligations

Currently, there is no prescriptive guidance in IAS 18 on when or how to allocate revenue to multiple deliverables within a contract.

Under IFRS 15, when a manufacturer determines that a contract contains more than one performance obligation, it is required to allocate the transaction price to each performance obligation based on relative stand-alone selling prices.

### Stand-alone selling price

IFRS 15 defines stand-alone selling price as "the price at which an entity would sell a promised good or service separately to a customer". The observable selling price charged by the entity, if available, provides the best evidence of stand-alone selling price. If not available, the entity estimates the stand-alone selling price using all available information, maximising the use of observable inputs. IFRS 15 suggests (but does not require) three possible methods: adjusted market assessment, expected cost plus margin or the residual approach.

## Step 5: Recognise revenue when/as performance obligations are satisfied

### Recognising revenue over time or at a point in time

An entity determines at contract inception whether each performance obligation will be satisfied (that is, control will be transferred) over time or at a specific point in time.

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While many manufacturing-type contracts will transfer control at a point in time, an entity cannot presume that there is no change and must carefully assess when control transfers under the new model to determine when to recognise revenue.

Broadly, control is transferred over time if any one of the following conditions applies:

- the customer controls the asset as it is created or enhanced by the manufacturer's performance under the contract
- the customer receives and consumes the benefits of the manufacturer's performance as it occurs
- the manufacturer's performance creates or enhances an asset that has no alternative use to the entity, and the manufacturer has a right to receive payment for work performed to date.

If none of the above conditions are present, then control transfers at a point in time. In these situations a manufacturer recognises revenue by evaluating when the customer obtains control of the asset. IFRS 15 provides indicators of control including (but not limited to) the following:

- the entity has a present right to receive payment for the asset
- the customer has legal title to the asset
- the customer has physical possession of the asset

- the customer has assumed the significant risks and rewards of owning the asset
- the customer has accepted the asset.

### Bill-and-hold

IFRS 15 provides additional guidance to consider when assessing whether control over the finished product has been transferred to the customer and therefore revenue may be recognised in a 'bill-and-hold' scenario. Although these criteria differ in some respects from the guidance provided in IAS 18, we expect that in most cases, the accounting conclusion will be the same.

Manufacturers should also remember to consider whether their custodial duties from product completion to delivery represent a distinct performance obligation to which a portion of the arrangement consideration must be allocated (see Step 2).

### Customer acceptance

IFRS 15 includes application guidance related to customer acceptance; therefore, where contracts include clauses requiring customers to formally accept the delivered goods or services, an entity must carefully consider how the guidance in IFRS 15 will impact their assessment of whether control of the related asset has passed to the customer. If the manufacturer can objectively demonstrate that all agreed-upon specifications have been met, customer acceptance is a formality that does not affect when the customer obtains control of the good or service.

Additional considerations with respect to customer acceptance under IFRS 15 include:

- goods delivered for trial, demonstration, or evaluation purposes – no revenue is recognised until the trial period lapses or the customer formally accepts
- goods delivered subject to a general right of return – the manufacturer applies the requirements for variable consideration to determine the amount of consideration to which it expects to be entitled (see Step 3 above).

In practice, we expect that in most cases where customer acceptance is based on seller-specified or customer-specified requirements, the accounting conclusion will be the same as under IAS 18.

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## Other guidance

### Contract acquisition costs

IFRS 15 requires an entity to capitalise the incremental costs of obtaining a contract (eg sales commission) when certain criteria are met. However, as a practical expedient, a manufacturer is allowed to expense the costs as incurred if the amortisation period is one year or less.

Under IFRS 15, where a manufacturer expects to recover such costs through future revenue under a contract, the costs are amortised to profit or loss as revenue is earned and the related asset is assessed for impairment in accordance with IAS 36.

### Disclosures

IFRS 15 requires quantitative and qualitative disclosures that disaggregate revenue streams and identify contract assets/liabilities, among many other new disclosures that manufacturing entities may not have previously reported. As a result, systems and processes will need to capture and summarise the incremental information needed for manufacturers to comply with the new requirements.

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