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IFRS industry insights: Industrial products sector

New revenue Standard could impact profile of revenue and profit recognition

Headlines

- The **profile of revenue and profit recognition** will change for some entities as the new Standard is more detailed and more prescriptive than the existing guidance and introduces new complexities. In particular, industrial products companies will need to consider:
  - whether revenue should be recognised **over time** or at **a point in time**;
  - the impact of new guidance where pricing mechanisms include **variable amounts**;
  - the extent to which **distinct goods or services** are supplied, which should be accounted for separately;
  - the type of **warranty** coverage offered to customers;
  - how **shipping** terms will impact the timing of recognition of revenue;
  - how to account for **contract modifications**; and
  - whether revenue must be adjusted for the effects of the **time value of money**.
- The new Standard requires significantly more **disclosures** relating to revenue and entities will need to ensure that **appropriate processes** are in place to gather the information.

What's happened?

The International Accounting Standards Board (IASB) has published a new Standard, IFRS 15 *Revenue from Contracts with Customers* ('the new Standard'). The new Standard outlines a single comprehensive model of accounting for revenue arising from contracts with customers and supersedes current revenue recognition guidance, which is found currently across several Standards and Interpretations within IFRSs. The core principle is that an entity recognises revenue to reflect the transfer of goods or services, measured as the amount to which the entity expects to be entitled in exchange for those goods or services. However, the new Standard does not apply to transactions that are instead within the scope of the leasing standard.

The new Standard is effective for reporting periods beginning on or after 1 January 2017, with earlier application permitted. Entities can choose to apply the Standard retrospectively or use a modified approach in the year of application. It is the result of a convergence project with the US Financial Accounting Standards Board (FASB) that began in 2002. Almost fully converged, the most significant differences between IFRSs and US GAAP relate to interim disclosures and timing of adoption.

Implications for the industrial products sector

Below, we highlight certain key impacts resulting from the new Standard that will be of particular interest to those in the industrial products sector and then consider parts of the new Standard that may contribute to those impacts. Of course many more complexities exist and, as described below, Deloitte has produced further guidance which explores these in greater detail.

How might this affect you?

The timing of revenue and profit recognition may be significantly affected by the new Standard

Whereas previously IFRSs allowed significant room for judgement in devising and applying revenue recognition policies and practices, IFRS 15 is more prescriptive in many areas relevant to the industrial products sector. Applying these new rules may result in significant changes to the profile of revenue and, in some cases, cost recognition.

This is not merely a financial reporting issue. As well as **preparing the market and educating analysts** on the impact of the new Standard, entities will need to consider wider implications. Amongst others, these might include:

- changes to **key performance indicators** and other **key metrics**;
- changes to the **profile of tax cash payments**;
- availability of **profits for distribution**;
- for **compensation and bonus plans**, impact on the timing of targets being achieved and the likelihood of targets being met; and
- potential non-compliance with **loan covenants**.

Current accounting processes may require changes to cope with the new Standard

As explained below, IFRS 15 introduces new requirements to move to a more conceptual approach. The complexity of applying this approach and of producing the detailed disclosures required by the new Standard in the industrial products sector may require modifications to existing accounting processes. Entities should ensure they allow sufficient time to develop and implement any required modifications to processes.

What are the most significant changes?

Should revenue be recognised over time or at a point in time?

IFRS 15 introduces a new approach to determine whether revenue should be recognised over time or at a point in time. Three scenarios are specified in which revenue will be recognised over time – broadly, they are when (i) the customer receives and consumes the benefits of the seller's performance as the seller performs; (ii) the seller is creating a 'work in progress' asset which is controlled by the customer; and (iii) the seller is creating a 'work in progress' asset which could not be directed to a different customer and in respect of which the customer has an obligation to pay for the entity's work to date. If revenue is to be recognised over time, a method should be used which best reflects the pattern of transfer of goods or services to the customer. If a transaction does not fit into any of the three scenarios described above, revenue will instead be recognised at a point in time, when control passes to the customer.

In the industrial products sector, if an entity is manufacturing items for a specific customer, this may require a careful analysis in light of the new requirements. Quite small differences between otherwise similar contracts could have a fundamental impact on the timing of revenue recognition. For example, it is not uncommon for an entity in the sector to enter into a contract where the customer will have control over the goods being manufactured, which would result in revenue being recognised over time. It will often be particularly important to focus on contractual terms that allow the customer to cancel, curtail or significantly modify a contract and whether, in such cases, the seller is entitled to adequate compensation for work performed to date. In addition, due to the long-term nature of contracts in this industry, particular consideration will need to be given as to the most appropriate basis for measuring revenue over time and the consequences of the basis adopted for the matching of revenues to the costs incurred.

When should variable or uncertain revenues be recognised?

Contracts in the industrial products sector can be of a long-term nature and will often include significant variable elements, such as performance bonuses or penalties, discounts, as well as the potential for subsequent downwards price renegotiations. There are new specific requirements in respect of variable consideration such that it is only included in the transaction price if it is highly probable that the amount of revenue recognised would not be subject to significant future reversals when the uncertainty is resolved. This approach to variable and contingent consideration is different from that previously reflected in IFRSs and, in certain scenarios, will require a significant degree of judgement to estimate the amount of consideration that should be taken into account. Accordingly, the profile of revenue recognition may change for some entities as a result.

How to identify and allocate revenue to different goods and services?

Previously, given the lack of specific guidance in IFRSs, there was greater room for judgement when identifying the goods and services within a contract and then allocating the revenue to those goods and services identified. Entities may have to amend their current accounting policies as a result of the more detailed guidance in IFRS 15. The new Standard requires the revenue from a contract to be allocated to each distinct good or service provided on a relative standalone selling price basis, though a 'residual' approach is permitted in limited circumstances.

This may significantly change the profile of revenue recognition for some entities where, for example, they offer a 'free' servicing period to customers as part of a transaction. Where entities have a large number of customers with different options, there may be some practical challenges to overcome in order to ensure processes are in place to deal with the new requirements.

It is not uncommon in this sector for entities to sell two or more component parts of a finished product to a third party entity that may be responsible for transforming or assembling those parts into the finished product that is eventually put back to the original entity. In this scenario, entities will have to consider whether they sell those separate parts and repurchase the product, or whether in substance they have paid the third party entity for the service of transforming the parts to produce the final product.

How should warranties be accounted for?
The new Standard distinguishes between a warranty providing assurance that a product meets agreed-upon specifications (accounted for as a cost provision) and a warranty providing an additional service (for which revenue will be deferred). Consideration of factors such as whether the warranty is required by law, the length of the warranty coverage period, and the nature of the tasks the entity promises to perform will be necessary to determine which type of warranty exists. If a customer can choose whether or not to purchase a warranty as an 'optional extra', that warranty will always be treated as a separate service. Where a warranty is determined to include both elements (assurance and service), the transaction price is allocated to the product and the service in a reasonable manner (if this is not possible, the whole warranty is treated as a service).

In the industrial products sector, it is common for warranties to include both elements. For example, a warranty may both assure the quality of the product and provide a free maintenance plan for two years. Where a warranty contains both elements, judgement will be needed in order to determine how to allocate the transaction price in a reasonable manner, and this may result in warranties being accounted for differently than at present.

How will shipping terms impact the timing of revenue recognition?
Under IAS 18, the timing of revenue recognition from the sale of goods is based primarily on the transfer of risks and rewards. IFRS 15 instead focuses on when control of those goods has transferred to the customer. This different approach may result in a change of timing for revenue recognition for some entities. For example, some entities may supply goods on the basis that title passes to the customer at the point of shipment but, as a matter of business practice, may compensate customers for loss or damage during shipping (either through credit or replacement). Previously, revenue may have been recognised only at the point of delivery, on the basis that some exposure to risks and rewards is retained until then. Under IFRS 15, entities will need to assess whether control passes to the customer at the point of shipment or at the point of delivery. This may result in revenue being recognised at a different time. If revenue is recognised at the point of shipment, it may be necessary to allocate part of the transaction price to a distinct "shipping and risk coverage" service, with that element of revenue recognised when the service is provided.

What is the impact if a contract is modified?
In the past, IFRSs included only limited guidance on how to account for modifications to a contract. IFRS 15 includes detailed guidance on whether a contract modification should be accounted for prospectively (as an adjustment to future revenues) or retrospectively (via an adjustment when the modification occurs). It is not uncommon for the scope or price of arrangements in the industrial products sector to be modified and therefore these requirements may result in a change of practice for some entities.

Should revenue be adjusted for the effects of the time value of money?
IFRS 15 introduces new and more extensive guidance on financing arrangements and the impact of the time value of money. Sales by industrial products entities may include financing arrangements in that the timing of cash inflows from the customer may not correspond with the timing of recognition of revenue. Under the new Standard, the financing component, if it is significant, is accounted for separately from revenue. This applies to payments in advance as well as in arrears, but subject to an exemption where the period between payment and transfer of goods or services will be less than one year. This new guidance may change current accounting practices in some cases.

What else might change?

In addition to the key changes discussed above, the new Standard introduces detailed guidance in many areas regarding the reporting of revenue and entities will need to ensure that they have considered all of these when assessing the extent to which their accounting policy for revenue may need to be amended.

More detailed information on the impact of IFRS 15 can be found in Deloitte's IFRS in Focus publication available from www.iasplus.com. Further industry publications are also available here.

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