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IFRS industry insights: Chemicals 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, companies in the chemicals sector will need to consider:
  - the impact of new guidance where pricing mechanisms include **variable amounts**;
  - whether revenue should be recognised **over time** or at **a point in time**;
  - whether particular **costs relating to obtaining a contract** must be capitalised;
  - how **shipping** terms will impact the timing of recognition of revenue;
  - the accounting for **breakage**; and
  - the existence of **collaborative arrangements** and whether they fall within the scope of the new Standard.
- 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.

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 chemicals sector

Below, we highlight certain key impacts resulting from the new Standard that will be of particular interest to those in the chemicals 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 chemicals 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 chemicals 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?

When should variable or uncertain revenues be recognised?
Contracts in the chemicals 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.

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.

Where chemical products are manufactured under contract, the timing of revenue recognition may be significantly impacted by these new requirements if the products manufactured cannot be directed to another customer and if the manufacturer is entitled to payment for work to date. The former may be the case, for example, where a product is manufactured to the specific requirements of the customer such that the product could not be readily redirected to a different customer. Careful analysis will be required as relatively small differences between otherwise similar contracts could have a fundamental impact on the timing of revenue recognition and could, for example, require entities to recognise revenue over time when previously they have been recognising it at a point in 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.

Should contract costs be capitalised?
In addition to more prescriptive guidance on revenue recognition, the new Standard introduces specific criteria for determining whether to capitalise certain costs, distinguishing between those costs associated with obtaining a contract (e.g. sales commissions) and those costs associated with fulfilling a contract. In the chemicals sector, this becomes an issue because significant costs may be incurred that are directly attributable to obtaining contracts with customers, for example sales commissions that are only payable if a contract is obtained. At present, different entities might treat these costs differently.
The new Standard will require entities to capitalise those costs associated with obtaining a contract, which will have an impact on operating profits. In addition, the new Standard requires capitalised contract costs to be amortised on a systematic basis that is consistent with the pattern of transfer of the goods or services. Entities will need to exercise judgement to determine the appropriate basis and time period for this amortisation.

How will shipping terms impact 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.

How should breakage be recognised?
In the chemicals sector, it is not uncommon for customers to agree, under a 'take or pay' contract, to purchase a set amount of units of a product at a specified price within a certain time frame, but then only to take delivery of a portion of those units. However, the customer has to pay the full amount stated in the contract, regardless of the number of units taken. In some cases, customers lose their right to purchase the remaining units when the time frame expires. In other cases, the contract allows customers to defer the purchase of the remaining units to a later date, although there is no compulsion to do so. In a scenario in which customers do not always exercise all of their contractual rights, the unexercised rights are often referred to as 'breakage'. Previously, IFRSs included only limited guidance on accounting for such unexercised rights, and only in the context of customer loyalty programmes. As such, a variety of practices may currently be used in accounting for breakage. IFRS 15 includes specific guidance on breakage, which is applicable to all revenue transactions with customers. If an entity expects to benefit from breakage, it should recognise the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer (i.e. by comparing the goods or services delivered to date with those expected to be delivered overall). Otherwise, the entity should recognise any breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote. Entities will need to consider whether their current accounting needs to be amended in order to meet the requirements of IFRS 15.

Are collaborative arrangements in the scope of the new Standard?
It is not uncommon in the chemicals sector for two separate entities to combine their resources and collaborate in their operations, for example joint development of a chemical product. Where this is the case, an entity will have to assess whether the other entity is its customer in order to establish whether the transactions with the other entity are within the scope of the new Standard. The new Standard introduces new specific guidance on this topic, and this may result in some arrangements that have not previously been regarded as revenue transactions nevertheless falling within the scope of the new Standard. It may also result in some arrangements which have previously been treated as revenue transactions being outside of the scope of the new Standard and entities will need to consider in these cases whether it is still appropriate to apply the new Standard by analogy.

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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