

## IFRS industry insights: Aerospace and defence sector

### New revenue Standard could have a major impact on the 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, aerospace and defence 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 impact of new guidance for capitalising certain costs on sales of **'loss leaders'**;
  - the appropriate accounting for **customer options to acquire additional goods or services at a discount**;
  - 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.

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 aerospace and defence sector

Below, we highlight certain key impacts resulting from the new Standard that will be of particular interest to those in the aerospace and defence 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 aerospace and defence 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 aerospace and defence 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 aerospace and defence 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 may often be the case that where an entity in the sector enters into a defence contract with a government body, the government 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 aerospace and defence 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 as a result of subsequent re-estimation. 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.

##### ***Can the cost of an item sold as a 'loss leader' be deferred?***

Within the aerospace and defence sector, entities sometimes sell a core product at a loss in order to generate a future stream of revenue in respect of the sale of further goods and services which relate to that specific product (which typically cannot be supplied by a different entity). At present, there may be diversity in practice over the appropriate accounting, with some entities capitalising the initial loss as a cost of obtaining a customer. The new Standard includes specific guidance addressing which costs associated with a customer contract must be capitalised and which must be expensed. It appears unlikely that the loss generated on the sale of the core product will meet the criteria to be capitalised. This may significantly change the profile of profit recognition for some entities in the sector.

***Should revenue be allocated to customer options to acquire additional goods or services at a discount?***

Some aerospace contracts include a right for the customer to purchase additional goods or services at a discount. Where this gives a 'material right' for the customer (e.g. the option gives the customer the right to acquire additional goods at a substantial discount), an entity must allocate a portion of the transaction price to the option and recognise revenue when control of the goods or services underlying the option is transferred to the customer, or when the option expires.

***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 of accumulated revenue when the modification occurs). It is not uncommon for the scope or price of arrangements in the aerospace and defence 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 aerospace and defence companies 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](http://www.iasplus.com). Further industry publications are also available here.

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