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IFRS industry insights

The Revenue Recognition Project – An update for the manufacturing industry

Many respondents expressed concern that the criteria for determining when a good or service is distinct ignores the intent of the contracting parties and the underlying economics of transactions.

In June 2010, the IASB and FASB ('the Boards') took a major step towards developing an entirely new revenue recognition standard by issuing a set of proposals in the form of an exposure draft (ED). These proposals would significantly affect the recognition of revenue in the manufacturing industry. Since issuing the ED, the Boards have conducted extensive outreach. The comment period on the ED, which ended on 22 October 2010, garnered over 950 responses, and afterwards the Boards hosted roundtable sessions that included participants from all constituencies, including preparers, users and auditors, from a wide cross section of industries. Respondents from the manufacturing industry expressed concern over a number of proposals in the ED, including the identification of performance obligations, the satisfaction of performance obligations, the onerous contract test, contract costs, fulfilment costs and warranties. The Boards recently discussed these topics and made some tentative decisions which differ from the proposals in the ED and are following this up with further outreach activities.

Identification of separate performance obligations

The ED would require that an entity evaluates all goods and services promised in a contract to determine whether there are separate performance obligations. Goods and services that are 'distinct' would be accounted for separately, meaning that the good or service is either sold separately in the customer's market or could be sold separately because it would be useful in itself or in conjunction with another product that is available separately and has a distinct profit margin. The transaction price would be allocated to each separate performance obligation based on standalone selling prices.

Several manufacturing industry respondents indicated general agreement with the principle of using distinct goods or services to identify separate performance obligations in a contract. However, many respondents expressed concern that the criteria for determining when a good or service is distinct ignores the intent of the contracting parties and the underlying economics of transactions and may result in accounting for a single contract at an artificially disaggregated level. There was also concern that the inclusion of a distinct profit margin in the criteria would not be operational because it would be very difficult to determine the profit margin on goods and services that are not sold separately by the manufacturer.

In February 2011, the Boards tentatively decided to retain the 'distinct' concept with some revisions including the addition of an additional criterion for the identification of separate performance obligations. The additional criterion would require an entity to account for a bundle of promised goods or services as one performance obligation if the entity provides a service of integrating those goods or services into a single item that the entity provides the customer. The Boards indicated that this additional criterion should address concerns from the construction industry where a construction contractor is hired to construct an asset and provides both the materials and services. If that criterion is not met, a promised good or service, or a bundle of goods or services, would be treated as a separate performance obligation if the good or service has a 'distinct function' and the pattern of transfer of the good or service is different from the pattern of transfer of other promised goods or services in the contract. A good or service has a distinct function if the entity regularly sells the good or service separately, or the customer can use the good or service either on its own or together with resources that are readily available to the customer. The proposal that the good or service would need a distinct profit margin to be regarded as 'distinct' was tentatively eliminated.

Several manufacturing industry respondents commented that the Boards should improve the guidance for determining when control of goods or services is transferred to a customer.

The Boards' tentative decision to eliminate 'distinct profit margin' would help alleviate concerns about determining the profit margin for goods and services that are not sold separately. Additionally, the tentative decision that a bundle of promised goods or services would be treated as one performance obligation if the entity provides a service of integrating those goods or services into a single item that the entity provides the customer may address concerns about disaggregation being inconsistent with the underlying economics of many contracts.

Example

A manufacturer enters into a contract to design and manage the construction of an asset. The design and management services are highly interrelated with the manufacturing of the asset and the entity is required to integrate all of these items into a single item that the entity provides the customer. As the bundle of goods and services is integrated as a single item that the entity provides the customer, the manufacturer would be likely to consider the contract as a single performance obligation.

Satisfaction of performance obligations

The ED would require an entity to recognise revenue when it satisfies a performance obligation by transferring control of the promised good or service to the customer. Several manufacturing industry respondents commented that the Boards should improve the guidance for determining when control of goods or services is transferred to a customer. In particular, many respondents indicated that the proposed control guidance was insufficient for the provision of services because the indicators given were more applicable for determining the transfer of control of tangible products. Respondents requested that the Boards clarify how to evaluate the transfer of control for services.

In February 2011, the Boards tentatively decided that revenue recognition should be based on 'control' for both the sale of goods and the provision of services but that the final standard should include separate guidance for goods and services because the Boards believe that the transfer of control of goods is fundamentally different to the transfer of control of services. That is, the transfer of control for goods generally occurs at a point in time while provision of services generally occurs over time. The Boards tentatively decided to make revisions to the indicators for determining that a customer has obtained control of a good, including adding 'risks and rewards of ownership' to the list of indicators and removing 'the design or function of the good or service is customer specific' from the list of indicators. On the basis of these tentative decisions, the following indicators would be used to determine whether a customer has obtained control of a good:

a) the customer has an unconditional obligation to pay;

b) the customer has legal title;

c) the customer has physical possession; and

d) the customer has the risks and rewards of ownership of the good.

The Boards also tentatively decided that an entity would recognise revenue over time for the provision of a service if a performance obligation is satisfied continuously, which would occur if:

a) the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced (consistent with the guidance for the transfer of control of a good); or

b) the entity's performance does not create an asset with alternative use to the entity and at least one of the following criteria is met:

- the customer receives a benefit as the entity performs each task;
- another entity would not need to reperform the task performed to date if that other entity were to fulfil the remaining obligation to the customer without the benefit of any controlled inventory; or
- the entity has a right to payment for performance to date even if the customer could cancel the contract for convenience.

For a customised service contract where the customer owns the work-in-progress as the asset is being assembled, the revenue associated with that service would be recognised over the period of the contract. For service contracts where the customer does not control the work-in-progress, an entity will need to determine whether an asset is created with an alternative use to the entity. An asset with alternative use is an asset that the entity could readily direct to another customer. All facts and circumstances would need to be considered, including the contract terms, the significance of the costs involved to reconfigure the asset, discounts that would need to be provided to sell the asset to another customer and consequences to the entity (including legal ramifications) of directing the asset to another customer. An entity that determines that an asset does not have an alternative use must also meet one of the three criteria noted above to recognise revenue over time.

The staffs provided the following examples of services that may give rise to a continuous transfer of control on the basis of the first two of the new criteria (assuming that the customer does not control the work-in-progress and the entity's performance does not create an asset with alternative use to the entity):

- an entity that processes transactions on behalf of a customer because the customer receives a benefit as each transaction is processed; and

The Boards' tentative decision to conduct the onerous test at the contract level will alleviate many concerns …

- an entity that provides shipping services for a customer because the customer would not need to reperform the shipment of goods that are provided to date.

In evaluating whether an entity has a right to payment for performance to date, the entity must have a right to a fixed or variable amount that is intended to compensate the entity for its performance to date even if the customer can terminate for convenience (i.e. for reasons other than the entity's failure to perform as promised). Compensation for performance to date would include payment for recovery of the entity's costs plus a reasonable profit margin rather than compensation for the entity's potential loss of profit if the customer cancels the contract.

Manufacturers often enter into contracts with customers to sell bundles of goods and services. The tentative decisions provide some clarity as to whether manufacturers would satisfy their performance obligation associated with the manufacture of an asset continuously or at a point in time. Manufacturers will first need to determine whether the customer controls the work-in-progress. If not, manufacturers will then need to determine whether an asset has an alternative future use. An asset that is a standard inventory-type item will generally have an alternative future use because it can be easily sold to other customers. Conversely, a highly customised asset would be less likely to have to have an alternative future use because the manufacturer would typically incur significant costs to re-configure the asset for sale to another customer or would need to sell the asset to another customer at a significant discount. If the asset does not have an alternative future use, manufacturers will also need to determine whether one of the three additional criteria noted above are met. The criterion that would likely be particularly relevant for manufacturers is whether there is a right to payment for performance to date even if the customer could cancel the contract for convenience. In evaluating this criterion, the specific terms of the contract will be important in determining whether revenue associated with the manufacturing of an asset without an alternative future use should be recognised over time or at a point in time.

Example 1

An entity enters into a contract with a customer to manufacture machinery that is customised to meet the specifications provided by that customer. The customer does not control the work-in-progress. The machinery could not be used by other customers unless the entity incurred significant costs to reconfigure it and the machinery could not be sold to another customer unless the entity provided the other customer a significant discount. Additionally, the terms of the contract provide the entity the right to payment for performance to date even if the customer were to cancel the contract for convenience. In this case, the entity would satisfy its performance obligation to manufacture the machinery for the customer over time.

Example 2

An entity enters into a contract with a customer to manufacture an automobile that is customised to meet the specifications provided by that customer. The customer does not control the work-in-progress. The entity could easily sell the automobile to another customer and begin production on another automobile with the same specifications. Because the automobile has an alternative future use, the entity would satisfy its performance obligation to manufacture the automobile for the customer at a point in time rather than over time.

Onerous contract test

The ED would require an entity to evaluate an individual performance obligation to determine whether it is onerous. A performance obligation would be onerous if the direct costs that would be incurred to satisfy the obligation are greater than the allocated transaction price. If so, a separate liability would be recognised for that individual performance obligation.

Some respondents from the manufacturing industry expressed concern about applying the onerous test at the performance obligation level and suggested that the onerous test be conducted at the contract level. These respondents were concerned about performance obligations being identified as onerous at contract inception even if the contract as a whole was profitable leading to a loss at inception of the contract. These respondents believe that performing the onerous contract test at the performance obligation level would not reflect the economics of the transaction because items are often not priced at a performance obligation level but rather at a contract level.

In February and March 2011, the Boards changed their view and tentatively decided that an entity should conduct the onerous test at the contract level. The Boards also discussed whether an entity should recognise an onerous liability at the contract level or a higher unit of account upon entering into a contract that is priced at a loss in the expectation of obtaining future profitable contracts ('loss leader contracts'). The Boards tentatively decided that an exception should not be provided for loss leader contracts and therefore the onerous test would be applied at the contract level.

The Boards' tentative decision to conduct the onerous test at the contract level will alleviate many concerns about recognising losses at the inception of a profitable contract but manufacturers may still recognise losses at inception for those entities that supply certain products or services as a loss leader on the basis of an expectation that a future profitable contract will be entered into with the same customer.

Several respondents indicated that contract acquisition costs should be recognised as an asset, citing various reasons …

Contract costs

The ED would require contract costs to be capitalised only if the costs give rise to an asset in accordance with other IFRSs, or relate directly to the contract, generate or enhance resources of the entity that will be used in satisfying future performance obligation and are expected to be recovered. Therefore, amounts paid to obtain a customer contract such as costs of selling, marketing, advertising and negotiations would be expensed when incurred.

Several respondents indicated that contract acquisition costs should be recognised as an asset, citing various reasons including: because the costs to bid for and secure contracts are significant; because the costs are incremental, necessary, recoverable and are directly related to a contract and because users of the financial statements could be confused by expensing bidding costs even though the entity has secured a profitable contract.

In February 2011, the Boards changed their view and tentatively decided that 'incremental costs' expected to be recovered would be capitalised. Incremental costs are those costs that are directly attributable to obtaining a contract that would not have been incurred if the contract had not been obtained. Therefore, sales commissions and other costs incurred that would not have been incurred if a customer contract had not been obtained would be capitalised. All other costs would be expensed when incurred.

In May 2011, the Boards tentatively decided to permit the recognition of contract acquisition costs as a period cost (as opposed to capitalising those costs) for contracts with an expected duration of one year or less. The Boards also tentatively decided that capitalised contract acquisition costs should be amortised on a systematic basis consistent with the pattern of transfer of goods or services to which the asset relates, which may include goods or services beyond those that are promised in the initial contract (e.g., renewal periods). The Boards supported only permitting an entity to look forward beyond the initial contract period if the entity has demonstrated that it has sufficient historical experience indicating that the contract will be renewed with the same customer.

Fulfilment costs

The ED proposed that if the costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other IFRSs, an entity should recognise an asset only if those costs relate directly to a contract (or a specific contract under negotiation), generate or enhance resources of the entity that will be used in satisfying performance obligations in the future and are expected to be recovered. Examples of costs that relate directly to a contract would include costs of direct labour and materials, depreciation of equipment used in fulfilling the contract and subcontractor costs.

While several manufacturing industry respondents supported the Boards' proposal to provide specific guidance on the treatment of fulfilment costs, they requested clarification as to whether contract fulfilment costs would include additional costs incurred at the start of a manufacturing process to determine the optimal production process and design as well as prototype costs that are incurred when bidding for the contract and that will be used by the entity to fulfil the contract.

In April 2011, the Boards tentatively decided to confirm the proposed requirements in the ED relating to fulfilment costs. Also, the Boards clarified that 'costs relating directly to a contract' include pre-contract fulfilment costs that relate directly to a specific anticipated contract and 'pre-contract fulfilment costs' are costs that an entity incurs prior to obtaining a contract, such as the costs of mobilisation, engineering and design, architectural or other fulfilment costs incurred on the basis of commitments or other indications of interest in negotiating a contract.

In May 2011, the Boards tentatively decided to permit the recognition of contract fulfilment costs as a period cost (as opposed to capitalised costs) for contracts with an expected duration of one year or less. The Boards also tentatively decided that capitalised fulfilment costs should be amortised on a systematic basis consistent with the pattern of transfer of goods or services to which the asset relates, which may include goods or services beyond those that are promised in the initial contract (e.g., renewal periods). The Boards supported only permitting an entity to look forward beyond the initial contract period if the entity has demonstrated that it has sufficient historical experience indicating that the contract will be renewed with the same customer.

The tentative decision clarifies the accounting for typical pre-contract fulfilment costs incurred by many manufacturing entities and therefore should alleviate many of the concerns expressed by manufacturing industry respondents.

Warranties

The ED distinguished between two types of product warranties – a quality assurance warranty that provides a customer with coverage for latent defects in the product and an insurance warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. A quality assurance warranty would not give rise to a separate performance obligation as it does not provide the customer with a service in addition to the promised product. An insurance warranty would give rise to a performance obligation for warranty services in addition to the performance obligation to transfer the promised good or service. Therefore, an entity would allocate the transaction price between the promised good or service and the promised warranty service.

It is common for manufacturers to provide warranties with their products. Many respondents expressed concern that the proposals on the accounting for warranties would inappropriately delay revenue recognition and would require complex accounting calculations. Several manufacturing industry respondents also commented that it may be very difficult to determine when a fault has arisen in a product.

In February 2011, the Boards tentatively decided that if the customer has the option to purchase the warranty separately, the warranty would be accounted for as a separate performance obligation. Otherwise, an entity would account for the warranty as a warranty obligation (cost accrual) unless the warranty provides a service in addition to assurance that the delivered item is as specified in the contract.

The Boards' tentative decision addresses the concerns of the manufacturing industry respondents and would generally result in the accounting for standard warranties that is consistent with existing practice.

Looking Ahead

The Boards still have a number of issues to discuss. The final standard is expected to be issued by the end of 2011. We will provide you periodic updates as significant decisions are reached by the Boards.

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