

IFRS industry insights

The Revenue Recognition Project – An update for the manufacturing industry

The Boards tentatively decided that the accounting for costs of products manufactured for delivery under long-term production programmes would not be in the scope of the revenue recognition project.

During April – June 2011, the IASB and FASB ('the Boards') continued their discussions on the revenue recognition project and made a number of tentative decisions, some of which differed from the proposals in the exposure draft (ED) that was issued last year. Specifically the Boards reached tentative decisions on production costs under long-term production programmes, financial statement disclosures and transition requirements. These are some of the topics that the manufacturing industry respondents expressed concern over in their comment letters on the ED. The Boards also decided to re-expose their tentative decisions for public comment. In this issue of our IFRS Industry Insights series for the manufacturing industry, we discuss these topics and effects the tentative decisions may have on the manufacturing industry.

Production costs under long-term production programmes

Many manufacturers have established programmes for the production of units to be delivered to customers under existing and anticipated contracts. In some production programmes, costs are accumulated and allocated to cost of sales by program. A programme consists of the estimated number of units of a product to be produced by an entity. The accounting for production costs at a programme level is often necessary because of the very long-term nature of some production efforts (e.g., aircraft manufacturers). The ED did not address production costs under long-term production programmes. Since the issuance of the ED, the Boards have reached tentative decisions on setup costs for service contracts, precontract costs and inventory of a services provider.



Several manufacturing industry respondents raised concerns about the affect of the revenue standard on an entity's ability to use long-term production programmes. These respondents noted that there is very limited cost guidance under IFRS and indicated that diversity in practice would continue to exist between IFRS and US GAAP preparers if the Boards do not address costs of products manufactured for delivery under long-term production programmes.

In May 2011, the Boards tentatively decided that the accounting for costs of products manufactured for delivery under long-term production programmes would not be in the scope of the revenue recognition project because these costs relate to accounting for inventory and intangible assets. The Boards indicated that this issue may be addressed as part of a separate project to converge IFRS and US GAAP. Until that time, practice would not change under IFRS and therefore a manufacturing entity would continue to apply other guidance such as existing standards on inventory, property, plant and equipment and intangible assets.

Disclosures

The ED would require entities to disclose extensive quantitative and qualitative information about contracts and the significant judgements made in applying the ED's proposals to those contracts. The ED would require that an entity provide, at a minimum, revenue disaggregated into categories, a reconciliation of contract balances and a description of the entity's performance obligation including a maturity analysis of outstanding performance obligations and liabilities recognised for onerous performance obligations.

Several respondents suggested that the disclosures should not be mandatory but should be presented as an indicative list of possible disclosures for management to consider.

While there was general support from the manufacturing industry respondents for the disclosure objective, most of the manufacturing industry respondents did not agree with the prescriptive level of detail and proposed package of disclosures. Additionally, some respondents felt that the lack of clarity around disclosures might lead to companies disclosing more information than necessary. Several respondents suggested that the disclosures should not be mandatory but should be presented as an indicative list of possible disclosures for management to consider. The respondents also noted that some of the disclosures proposed may provide useful information only to users of the financial statements of entities that operate in particular industries and questioned whether the benefits of the disclosures would justify the costs in terms of systems, preparation and validation of the data. Some respondents also noted that some of the disclosures proposed might duplicate other disclosure requirements such as the segment reporting disclosures required by IFRS 8 *Operating Segments*. Other respondents felt that the excessive additional disclosures might reveal too much information to their competitors.

The Boards tentatively decided to retain the disclosures proposed in paragraphs 69-83 of the ED, subject to the following clarifications and changes:

In the disaggregation of revenues:

- include additional examples of potential categories (e.g., contract duration, timing of transfer and sales channel) to disaggregate but not prescribe how an entity should disaggregate revenue;
- require an entity to use several categories to disaggregate revenue if necessary to meet the disaggregation objectives outlined in the ED;
- not require an entity to disaggregate any expected impairment loss; and
- permit an entity to disaggregate revenues either on the face of the statement of comprehensive income or in the notes to the financial statements.

In the presentation of contract assets and liabilities:

- require the presentation of net contract assets and net contract liabilities as separate line items in the statement of financial position;
- permit the provision of additional detail about contract assets and receivables either on the face of the financial statements or in the notes to the financial statements;

- permit the use of labels other than 'contract asset' or 'contract liability' on the statement of financial position in describing these balances, assuming sufficient information is available to users to distinguish between conditional and unconditional rights to consideration; and
- require a reconciliation of contract assets and contract liabilities during the period.

In relation to the remaining performance obligations as of period end:

- require a maturity analysis of remaining performance obligations from contracts with an original expected duration of more than one year on the basis of the transaction price determined under the proposed model.

In relation to assets derived from acquisition and fulfilment costs:

- require reconciliation of the carrying amount of an asset arising from the costs to acquire or fulfil a contract with a customer, by major classification, at the beginning and end of the period, in conjunction with separate disclosure of additions, amortisation, impairments and impairment losses reversed.

The Boards' tentative decision to clarify certain disclosure requirements will ease some of the concerns raised by the manufacturing industry respondents. However, many of the manufacturing industry's concerns that the disclosure package would be costly and difficult to implement would continue to exist. Entities may find it necessary to modify their internal systems and processes to gather the necessary information to comply with the proposed disclosure requirements.

Transition requirements

The ED would require entities to apply the new standard retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

The majority of manufacturing business industry respondents noted that while the retrospective application would provide users with comparable information, they felt that retrospective application was not feasible because it would require the assessment of a significant number of complex, multiple element and long term contracts. These respondents also noted that much of the data required to apply the proposed model is not currently available and therefore retrospective application would take significant time and be cost prohibitive.

The Boards have tentatively decided to re-expose their tentative decisions.

In June 2011, the Boards tentatively decided that an entity would adopt the revenue standard either by applying a full retrospective approach or adopting a retrospective approach subject to the following reliefs:

- not require restatement of contracts that begin and end within the same prior accounting period to be restated;
- allow the use of hindsight in estimating variable consideration;
- not require recognition as assets of fulfilment and acquisition costs recognised as an expense in prior periods;
- not require the onerous test to be performed in comparative periods but only at the effective date unless an onerous contract liability was recognised previously; and
- not require disclosure for prior periods of the maturity analyses of remaining performance obligations in the first year of application.

The Boards also tentatively decided that if an entity adopts the standard retrospectively subject to any of the above reliefs, it would be required to state which reliefs have been applied by the entity and provide a qualitative assessment of the likely effect of applying those reliefs.

The tentative decisions to include some relief from full retrospective application of the new standard will alleviate some concerns from the manufacturing industry. However, even with the availability of the reliefs, a significant amount of cost and effort would be required to adopt the revenue standard.

Re-exposure of tentative decisions

The Boards have tentatively decided to re-expose their tentative decisions in the third quarter of 2011 with a comment period of 120 days. The Boards will seek comments from constituents on the understandability, clarity, operability and wording of the overall re-exposure draft (including interaction of paragraphs).

The Boards also tentatively decided to invite comments on four specific areas where constituents generally have not had the opportunity to comment on the revised requirements:

- determining when a performance obligation is satisfied over time (i.e. the additional guidance in response to concerns about control and services);
- presenting the effects of credit risk adjacent to revenue;
- constraining the cumulative amount of revenue recognised to amounts that are reasonably assured (rather than constraining the transaction price to amounts that can be reasonably estimated); and
- applying the onerous test to a performance obligation satisfied over a long period of time.

We will provide you periodic updates as significant decisions are reached by the Boards.

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