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IFRS industry insights

IASB issues revised exposure draft on revenue recognition – insights for the manufacturing industry

The revised ED is the next step in developing an entirely new revenue recognition standard and follows extensive outreach and redeliberations on the proposals in the original ED issued in June 2010.

On 14 November 2011, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) jointly issued a re-exposure draft ED/2011/6 *Revenue from Contracts with Customers* ('the revised ED'). The revised ED is the next step in developing an entirely new revenue recognition standard and follows extensive outreach and redeliberations on the proposals in the original ED issued in June 2010. Although the underlying conceptual basis is unchanged, the IASB and the FASB (collectively 'the Boards') changed many detailed aspects of the original ED's proposals. As a result of these changes and the importance of the revenue line item to users of financial statements, the Boards decided to expose for public comment a revised ED. The comment period ends on 13 March 2012. The effective date of the proposed standard will not be earlier than for annual reporting periods beginning on or after 1 January 2015, with the IASB permitting early application.

This IFRS Industry Insight publication highlights aspects of the revised ED that may significantly affect manufacturing entities and provides insight to assist in the assessment of the potential impact of these revised proposals.

Identifying separate performance obligations

Both the original and revised EDs propose that a good or service would be accounted for as a separate performance obligation if it is deemed 'distinct'. The revised ED refines the definition of 'distinct' and, except as explained below, a good or service is distinct if either of the following criteria is met:

a) the entity regularly sells the good or service separately; or

b) the customer can benefit from the good or service either on its own or together with resources that are readily available to the customer.

Notwithstanding those criteria, a good or service in a bundle of promised goods or services is not distinct, and therefore the bundle of goods or services would be treated as a single performance obligation, if both of the following criteria are met:

a) the goods or services in the bundle are highly interrelated and transferring them to the customer requires the entity also to provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted; and

b) the bundle of goods or services is significantly modified or customised in order to fulfil the contract.

The revised proposals note that, as a practical expedient, an entity may account for two or more distinct goods or services as a single performance obligation if those goods or services have the same pattern of transfer to the customer.

The proposal to restrict the circumstances in which a bundle of goods or services can be treated as consisting of separate performance obligations may have an effect on some manufacturing entities. When a contract includes both the manufacturing of an asset and the provision of services such as designing and installing the asset for the customer, it will be necessary to consider whether the criteria above are met. Depending on the facts and circumstances, a manufacturer that currently accounts for design, manufacture and installation as separate contract elements may find that they have to be combined under the revised ED; conversely, in other circumstances, a manufacturer that currently accounts for them together may find that they have to be treated as separate performance obligations.

The original ED and the revised ED are consistent in requiring that the transaction price be adjusted to reflect the time value of money when there is a financing component that is significant to the contract.

Example

A manufacturer enters into a contract with a customer to design, build and install an asset. The asset is highly customised for the customer and the manufacturing process is highly interrelated with the professional services (design and installation). Because of the highly customised nature of the asset, the entity does not sell the asset without also selling the professional services. Rather, the entity's business model is to integrate the asset and professional services together to meet the individual needs of its customers. In this case, the asset and professional services may be considered a single performance obligation.

Determining the transaction price

The original ED proposed that if the transaction price is subject to variability, an entity would be required to use a probability weighted estimate of the transaction price if such an estimate can reasonably be made. The revised ED clarifies that "the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties." The transaction price would include discounts, rebates, refunds, credits, incentives, performance bonuses, penalties, concessions and other similar items. The estimation would reflect available historical, current and forecasted information and would be based on either the probability-weighted amount or the most likely amount (i.e., management's best estimate), "depending on which method the entity expects to better predict the amount of consideration to which it will be entitled." One method would need to be applied consistently throughout the contract.

Discounts are often receivable by a customer when specified cumulative levels of purchases are achieved. A manufacturing entity would estimate the transaction price using either a probability-weighted estimate or the most likely amount of cash flows expected from the transaction, depending on which is the most predictive of the amount to which the entity would be entitled. The estimate of cash flows would include the entity's expectation of future discounts. If an entity receives consideration from a customer and expects to refund some of that consideration because of discounts, a liability would be recognised for the amount that the entity expects to refund. Likewise, if a customer is required to pay additional consideration to an entity if specified performance metrics are met, the estimate of cash flows would include the entity's expectation of additional consideration. (As discussed later in this publication, the revised ED deals with uncertainty over variable consideration by imposing a cumulative cap on the amount of revenue recognised, rather than by restricting the estimate of the transaction price).

Time value of money

The original ED and the revised ED are consistent in requiring that the transaction price be adjusted to reflect the time value of money when there is a financing component that is significant to the contract. Given the subjectivity associated with determining whether a financing component is 'significant' to the contract, the revised ED provides factors an entity should consider in making this determination:

- the expected time period between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services;
- whether the amount of consideration would be substantially different if the customer paid in cash promptly in accordance with typical credit terms; and
- the interest rate in the contract and prevailing interest rates in the relevant market.

The revised ED notes that an entity should use "the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception." In addition, as a practical expedient, if at contract inception the period between the transfer of goods or services and ultimate payment is expected to be one year or less, an assessment of whether there is a significant financing component is not required.

Manufacturing entities that enter into long-term contracts may need to adjust the transaction price to reflect the time value of money. If a manufacturer expects to receive progress payments that are not commensurate with the progress towards completion, there may be a need to adjust the transaction price as a significant financing component might exist. This financing component may be either interest to or from the customer depending on the timing of the payments to the entity.

Collectibility

The revised ED requires estimates for expected credit losses (i.e., both initial estimates, where required, and subsequent adjustments to those estimates) to be recognised in a separate line item within the statement of comprehensive income adjacent to the gross revenue line item. The proposals do not include a revenue recognition criterion that requires an assessment of the customer's ability to pay the promised amount of consideration.

Manufacturing entities may need to assess the implications of any potential change to the presentation of financial results on key performance indicators such as gross margin ratios as the effects of credit risk would be presented within the gross margin.

The revised ED provides more flexibility in the estimation method used when the stand-alone selling price of a good or service is not directly observable.

Allocating the transaction price to separate performance obligations

The original ED proposed that an entity should "allocate the transaction price to all separate performance obligations in proportion to the stand-alone selling price of the good or service underlying each of those performance obligations at contract inception (i.e., on a relative stand-alone selling price basis)." The revised ED provides more flexibility in the estimation method used when the stand-alone selling price of a good or service is not directly observable. For example, a residual technique may be the most appropriate method for a performance obligation with a highly variable or uncertain stand-alone selling price. Discounts would generally be allocated to all separate performance obligations based on the relative stand-alone selling price unless each good or service is regularly sold separately and the observable selling price provides evidence of the performance obligation(s) to which the entire discount relates. All other subsequent changes in the transaction price would need to be allocated to the separate performance obligations on the same basis as at contract inception. Amounts allocated to a satisfied performance obligation would be recognised as revenue, or as reduction of revenue, in the period in which the transaction price changes.

Manufacturing entities that identify more than one performance obligation in a contract would need to account separately for these performance obligations and allocate the transaction price accordingly. The allocation may require significant judgment and modifications may be necessary to existing accounting policies and systems to capture appropriately the relevant data.

Recognising revenue as the performance obligations are satisfied

The original ED introduced the concept of "control" in the determination of when a good or service transfers to a customer and, thus, when revenue is recognised, which may be at a point in time (e.g., delivering a good) or continually over a period (e.g., rendering a service). The original ED provided specific indicators for analysing the transfer of control at a point in time and specified that control may be transferred continuously. The Boards tentatively decided to modify the proposed indicators of when a customer obtains control at a point in time and provide additional guidance that an entity must consider in determining whether control transfers continuously over time (including clarifying how an entity should measure its progress towards completion of a performance obligation that is continuously satisfied).

Transfers of control at a point in time – Consignment Arrangements

The revised ED carries forward most of the proposed guidance in the original ED but describes the concept of control instead of specifically defining it, removes the indicator of control that states that the design or function of the good or service is customer-specific and adds "risks and rewards of ownership" as an indicator of control. Indicators that the customer has obtained control of the good or service include:

- The entity has a present right to payment for the asset.
- The customer has been transferred legal title to the asset.
- The entity has transferred physical possession of the asset.
- The customer has significant risks and rewards of ownership of the asset.
- The customer has accepted the asset.

Some manufacturing entities may need to assess the terms of any consignment arrangements where products are delivered to another party for sale to an end customer to determine when control of the products has transferred. If the manufacturer is able to require the consignee to return the product, or the consignee does not have an unconditional obligation to pay for the products, then control has not transferred to the consignee. As such, revenue would only be recognised when the products are sold to a third party. Conversely, if the consignee has control of the products, including a right of return at their discretion, control of the products would transfer when the products are delivered to them. Manufacturing entities that currently base their revenue recognition policy solely on a transfer of risks and rewards criteria would need to consider the effect of the additional criteria in determining when control transfers to the consignee.

Transfers of control over a period and measurement toward completion

For an entity to recognise revenue over a period, it first must conclude that a performance obligation is continuously satisfied, and then it must select a method to measure progress toward completion. An entity satisfies a performance obligation continuously if at least one of the following criteria is met:

1. The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced (e.g., the customer controls the work-in-progress).

Manufacturing entities would need to carefully assess their contractual arrangements to determine whether control of an asset being created or enhanced transfers to a customer over time or at a point in time.

2. The entity's performance does not create an asset with 'alternative use' to the entity (e.g., the contract does not allow the entity to sell the work-in-progress to another customer or the work-in-progress is highly customer-specific and would not be suitable for another customer) and at least one of the following criteria is met:

   a. the customer simultaneously receives and consumes a benefit as the entity performs each task;

   b. another entity would not need to substantially re-perform the work completed to date if that other entity were to fulfill the remaining obligation to the customer (without having access to work-in-progress, or any other asset, controlled by the entity); or

   c. the entity has a right to payment (assuming that the seller complies fully with its contractual obligations) for performance completed to date and expects to fulfill the contract as promised. If the customer cannot cancel the contract, or the full contract price is payable on cancellation, this would appear to meet the criteria. If the contract can be cancelled by the customer and a fixed amount is payable on cancellation, which is lower than the total contract price, this may not be considered to be sufficient to compensate for performance to date and therefore may not satisfy this criterion.

For contracts where the customer controls the asset as it is created or enhanced, revenue would be recognised over time. A customer would control the asset if it has the ability to direct the use of and obtain benefits from the asset. Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from the asset. Often it will be obvious whether the customer has control but there may be situations where it is not as clear and factors will need to be considered, including, but not limited to, the entity's present right to payment for the work performed to date, whether the customer holds legal title to the work-in-progress and whether the customer has the significant risks and rewards of ownership of the work-in progress.

For contracts where the customer does not control the asset as it is created or enhanced, a manufacturer would need to first determine whether an asset is created with 'alternative use' to the entity. An asset with alternative use is an asset that the manufacturer 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 manufacturer (including legal ramifications) of directing the asset to another customer.

A manufacturer 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 criterion relating to the manufacturer's right to payment would be particularly relevant for the manufacturing industry. Contract terms would need to be evaluated to determine if a manufacturer has the right to payment if the contract is cancelled and, if so, whether the amount of payment will in all circumstances be such as to at least compensate for performance to date.

Manufacturing entities would need to carefully assess their contractual arrangements to determine whether control of an asset being created or enhanced transfers to a customer over time or at a point in time.

Example 1

A manufacturing entity enters into a contract with a customer to manufacture a piece of machinery that is customised to meet the specifications provided by that customer. The entity determined that the contract is a single performance obligation and the customer does not control the machinery as it is being built. The machinery is so customised that it could not be used by another customer unless the entity incurred significant costs to reconfigure it or the entity provides another customer with a significant discount. The terms of the contract provide the manufacturing entity the right to payment for performance to date even if the customer cancels the contract for convenience. In this example, control of the machinery would be transferred over time because the manufacturer cannot readily direct the asset to another customer and it has the right to payment for performance to date.

Example 2

A manufacturing entity enters into a contract with a customer to manufacture an automobile that is customised to meet the specifications provided by that customer. The entity determined that the contract is a single performance obligation and the customer does not control the automobile as it is being built. Although the entity manages its business by identifying particular automobiles on the production line with particular customer orders, there is nothing that prevents the entity from selling the automobile to a different customer and beginning production on another automobile with the same specifications for supply to the original customer. 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 (i.e., delivery of the automobile to the customer) rather than over time.

… the revised ED … imposes a constraint on the cumulative amount of revenue recognised, being that this should not exceed the amount to which the entity is reasonably assured to be entitled.

For each separate performance obligation that an entity satisfies over time, the entity would choose a method of measuring the progress towards complete satisfaction of that performance obligation (i.e., that best depicts the transfer of control) and recognise revenue by consistently applying that method to the contract and to similar contracts. The entity should update its measure of progress to depict the entity's performance to date when circumstances change. Appropriate methods of measuring progress include output methods and input methods.

Output methods recognise revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date (e.g., milestones, surveys, appraisals). Where an entity has the right to invoice a customer an amount that corresponds directly with the value of the performance completed to date, the entity would recognise revenue in the amount to which the entity has a right to invoice. In some instances, output methods are not directly observable and undue cost might be required to obtain such information. As such, input methods might be required.

Input methods recognise revenue on the basis of the entity's efforts expended to date to satisfy a performance obligation (e.g., resources consumed, labour hours expended, costs incurred, machine hours, time lapsed) relative to the total expected inputs to the satisfaction of that performance obligation. Consequently, a revenue recognition method similar to the percentage of completion method might be appropriate provided that the entity meets the criteria for recognising revenue over time and appropriately depicts the transfer of control of goods and services to the customer. Where an entity's efforts are expended evenly, it might be appropriate to recognise revenue on a straight-line basis. In some instances, there might not be a direct correlation between the entity's efforts and the transfer of control of goods or services to the customer because of inefficiencies or other factors. As such, an entity should exclude the effects of any efforts that do not depict the transfer of control (e.g., costs of resources wasted due to inefficiency or error). If an entity uses an input method to measure progress towards completion, and goods are transferred to the customer significantly before the related services (e.g., materials that are controlled by the customer before the related service is provided by the entity), the revised ED indicates that the best depiction of performance may be for the entity to recognise revenue for the transfer of those goods equal to their costs (i.e., at nil margin) if:

- the cost of the transferred goods is significant relative to the total expected costs to completely satisfy the performance obligation; and

- the entity procures the goods from another entity and is not significantly involved in designing and manufacturing the goods (but the entity is acting as a principal).

If an entity is not able to measure reasonably the outcome of a performance obligation but expects to recover the costs (e.g., in the early stages of a contract), it should recognise revenue only to the extent of the costs incurred until the performance obligation becomes onerous or the entity is able to measure reasonably the outcome of the performance obligation.

Although the revised proposals allow entities to use either input or output methods, manufacturing entities will need to reassess carefully their contractual arrangements and ensure that they select the method that best demonstrates the transfer of control of goods and services. This may result in a change in the method of recognising revenue.

Constraining the cumulative amount of revenue recognised

For contracts with variable consideration, the revised ED takes a slightly different approach from that proposed in the original ED. Instead of restricting the total transaction price that is allocated between performance obligations, the revised ED ignores such restrictions when allocating the total transaction price but then imposes a constraint on the cumulative amount of revenue recognised, being that this should not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount of consideration allocated to satisfied performance obligations only if both of the following criteria are met:

- the entity has experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities); and

- the entity's experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations.

The change to a "reasonably assured" threshold may result in some manufacturing entities recognising revenue earlier and others deferring revenue depending on their circumstances as to whether they are reasonably assured of being entitled to revenue based on their history with similar contractual arrangements.

Example

A manufacturing entity enters into a three year contract to build an aircraft for CU200 million if the aircraft is delivered by a specified target date. If the aircraft is not completed by the specified date, the consideration is reduced to CU190 million. The manufacturer has significant experience with similar types of contracts and customers. Based on this experience, the manufacturer believes that it is 90 percent likely that the aircraft will be delivered by the specified target date. The manufacturer believes that its experience is predictive of the amount of consideration to which it will be entitled because it has reliable data from past contracts about the likely level of successful and timely completion and has no evidence to suggest that this will change.

The revised ED alleviates initial concerns by many manufacturers that costs to bid for and secure contracts which are significant might have had to be expensed.

The manufacturing entity determines that the transaction price is CU200 million (the fixed contract price of CU200 million assuming on-time delivery) which is the most likely amount. If circumstances change, the manufacturer would update its estimate of the transaction price and recognise less revenue using a cumulative catch up approach.

Onerous performance obligations

The revised ED retains the requirement of the original ED to assess for individual onerous performance obligations at inception of a contract, but limits that assessment to performance obligations that are satisfied over time and which are expected, at contract inception, to be satisfied over a period of greater than one year. The costs used in such a test and measurement of the onerous liability would be the lower of the direct costs to satisfy the performance obligation and the amount that the entity would have to pay to exit the performance obligation if the entity is permitted under the contract to do so other than by transferring the promised goods or services.

The revised ED may not alleviate concerns by some manufacturing entities that applying the onerous test at the performance obligation level rather than the contract level may result in performance obligations being identified as onerous at contract inception even if the contract is profitable – leading to a loss at inception of the contract. This issue is relevant for manufacturers that enter into contracts that include performance obligations that are satisfied continuously over a period of greater than one year if any of those performance obligations are individually onerous.

Contract costs

Costs of fulfilling a contract that are not addressed by another standard would be capitalised if "the costs relate directly to a contract (or a specific anticipated contract), the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future and the costs are expected to be recovered." Examples of such costs might include direct labour and direct materials. However, general and administrative costs and costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract would typically be expensed when incurred. The revised ED also clarifies that the costs that relate directly to a contract include costs that are incurred before the contract is obtained if those costs relate specifically to an anticipated contract (i.e., pre-contract costs).

The revised ED proposes that the incremental costs of obtaining a contract with a customer should be recognised as an asset if the entity expects to recover those costs. Incremental costs are the costs that an entity incurs in its efforts to obtain a contract with a customer and that it would not have incurred if the contract had not been obtained (e.g., a sales commission that becomes payable only if a contract is successfully obtained). Costs that would have been incurred regardless of whether the contract was obtained should be recognised as an expense when incurred, unless they are explicitly chargeable to the customer regardless of whether the contract is obtained. As a practical expedient, acquisition costs incurred may be expensed instead of capitalised for those contracts with an expected duration of one year or less.

Capitalised costs should be amortised "on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates." The period may extend beyond the initial contract term with the customer (e.g., considering contract renewals and related subsequent sales).

The revised ED alleviates initial concerns by many manufacturers that costs to bid for and secure contracts which are significant might have had to be expensed. Manufacturing entities may need to assess whether capitalised costs need to be allocated among multiple performance obligations within a contract (where the related amortisation periods may vary significantly). For example, costs associated with a product may be recognised early in the life of an arrangement while capitalisable costs associated with maintenance services may be amortised over a longer period of time that could extend beyond the initial contract period. Manufacturing entities may need to modify their current accounting policies and make the appropriate system modifications to track contract costs, potentially allocate the costs to the individual performance obligations and determine the appropriate amortisation periods.

Bill-and-hold arrangements

Manufacturing entities that have contractual bill-and-hold arrangements will need to carefully assess when control of the goods has transferred to their customers. The revised ED proposes that all the following criteria must be met to conclude that a customer has obtained control in such an arrangement:

- the reason for the bill-and-hold arrangement must be substantive;
- the product must be identified separately as belonging to the customer;
- the product currently must be ready for physical transfer to the customer; and
- the entity cannot have the ability to use the product or to direct it to another entity.

… manufacturing entities would need to consider carefully whether other services are provided in addition to a warranty.

The revised proposals also require the entity to assess whether there are other separate performance obligations within the contractual arrangements to which the entity needs to allocate a portion of the transaction price (e.g., custodial services).

Warranties

The revised ED proposes the following:

- If a customer has the option to purchase a warranty separately from the entity, the entity should account for the warranty as a separate performance obligation. Hence, the entity would allocate revenue to the warranty service.

- If a customer does not have the option to purchase a warranty separately from the entity, the entity would account for the warranty as a cost accrual unless the warranty provides a service to the customer in addition to assurance that the product complies with agreed-upon specifications (in which case the entity would account for the warranty service as a separate performance obligation).

The revised proposals indicate that when determining whether the exception in the second criterion (other services) applies, the entity would consider whether the entity is required by law to provide a warranty, the length of the warranty coverage period and the nature of the tasks that the entity promises to perform. The proposed accounting for warranties is similar to current practice but manufacturing entities would need to consider carefully whether other services are provided in addition to a warranty.

Example 1

A manufacturer sells its product, which includes a two year standard warranty that is not sold separately. The warranty provides only assurance that the product complies with agreed-upon specifications for two years from the date of purchase. As the warranty is not sold separately and does not provide an additional service, the manufacturer should account for expected outflows relating to the warranty as a cost accrual.

Example 2

A manufacturer sells its product, which includes a warranty covering a two year standard warranty as well as a one year extended warranty (which could be purchased separately) and rights to free maintenance services. The manufacturer would need to assess whether the elements within the warranty should be accounted for as separate performance obligations. As the standard two year warranty does not provide an additional service and is not sold separately, the manufacturer should account for this element as a cost accrual. As the extended warranty (which could be purchased separately) and the maintenance services are both individual services to the customer in addition to assurance that the manufacturer will replace defective components of the product under the standard warranty, the manufacturer would likely account for these elements as separate performance obligations. As such, the manufacturer would need to allocate the transaction price between the product, the extended warranty, and the maintenance services. Revenue allocated to the maintenance services would be recognised over the service period on an appropriate basis while the revenue allocated to the extended warranty would be recognised over the extended warranty period (i.e., from day 1 of year 3 following the first two years) on an appropriate basis.

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