

# *In depth*

A look at current financial reporting issues



## **Revenue from contracts with customers**

*The standard is final – A comprehensive look at the new revenue model*

### **Industrial products and manufacturing industry supplement**

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#### **At a glance**

On 28 May 2014, the IASB and FASB issued their long-awaited converged standard on revenue recognition. Almost all entities will be affected to some extent by the significant increase in required disclosures. But the changes extend beyond disclosures, and the effect on entities will vary depending on industry and current accounting practices.

This supplement highlights some of the areas that could create the most significant challenges for entities in the Industrial Products sector as they transition to the new standard. These areas include, but are not limited to, contract combinations and contract modifications, transfer of control, and contract costs. Other supplements present the impact of the new standard in other industrial sectors, including Aerospace and Defence, and Engineering and Construction.

#### **Overview**

The FASB and IASB developed a single, comprehensive revenue recognition model for all contracts with customers to achieve greater consistency in the recognition and presentation of revenue. The model in the new standard is based on changes in contract assets (rights to receive consideration) and liabilities (obligations to provide a good or perform a service). Revenue is recognised based on the satisfaction of performance obligations, which occurs when control of a good or service transfers to a customer.

The Industrial Products (IP) sector comprises a range of entities involved in the production of goods and delivery of services across a diverse industry base. This includes industrial manufacturing, metals, chemicals, and forest, paper and packaging entities. Although each industry in the IP sector has different product and service offerings, there are a number of common revenue recognition issues. Management of IP entities should carefully assess the new standard to determine the extent of its impact on their businesses.

## Identifying the contract with the customer

An IP entity may enter into multiple contracts with the same customer at the same time. These contracts may include products that will not be provided directly by the IP entity entering into the contract. The contracts could also be affected by subsequent modifications (such as change orders).

| New model   | Current US GAAP  | Current IFRS  |
|---|--|---|
| <p><b>Contract combinations</b></p> <p>Contracts entered into at or near the same time with the same customer need to be combined if one or more of the following criteria are met:</p> <ul style="list-style-type: none"> <li>• The contracts are negotiated as a package with a single commercial objective.</li> <li>• The amount of consideration to be paid in one contract depends on the price or performance of the other contract.</li> <li>• The goods or services promised in the separate contracts are a single performance obligation.</li> </ul> <p>Promises to provide goods or services to the customer's customer can be performance obligations if they are identified in the contract.</p> <p>Promises to pay cash to the customer, unless paid for a distinct good or service, are accounted for as reductions of the transaction price.</p> | <p>Combining contracts is permitted provided certain criteria are met. Combining is not required as long as the underlying economics of the transaction are fairly reflected.</p> <p>Cash paid to a customer is recorded as a reduction of revenue unless the cash is for the purchase of an identifiable good or service from the customer that is separate from the goods or services being provided by the entity.</p> <p><i>Impact – both IFRS and US GAAP:</i></p> <p>Current guidance under both IFRS and US GAAP requires that the contract be the unit of account, except when the criteria for combining contracts are met. The new standard provides criteria for combining contracts that are similar to existing guidance. Both frameworks also currently provide guidance on identifying and separately accounting for deliverables in an arrangement. The new guidance provides more detailed criteria that could result in the identification of more deliverables (performance obligations) than in the past.</p> <p>Entities that sell goods to a distributor, but promise additional goods or services directly to an end customer will need to allocate some of the transaction price in the contract to those goods and or services, even if they will be provided by a third party. Revenue is recognised when those goods or services are delivered.</p> <p>The accounting for cash paid to a customer is similar to today's requirements.</p> | <p>Combining contracts is required when certain criteria are met.</p> <p>Cash paid to a customer is recorded as a reduction of revenue unless the cash is for the purchase of an identifiable good or service from the customer that is separate from the goods or services being provided by the entity.</p> |

| New model  | Current US GAAP  | Current IFRS  |
|--|--|---|
| <p><b>Contract modifications</b></p> <p>A contract modification, including a contract claim, exists when the parties to the contract approve a change that creates or changes the enforceable rights and obligations of the parties. A modification only affects a contract once it is approved, which can be in writing, oral, or based on customary business practices.</p> <p>A contract modification is treated as a separate contract only if it results in the addition of a distinct performance obligation and the price is reflective of the stand-alone selling price of that additional performance obligation.</p> <p>If the above criteria are not met, the contract modification is accounted for as an adjustment to the original contract, either through a cumulative catch-up adjustment to revenue or a prospective adjustment to revenue when future performance obligations are satisfied, depending on whether the remaining performance obligations are distinct from those in the original contract.</p> <p>Changes to only the transaction price will be treated like any other contract modification. As it will not result in a separate contract, the change in price will be either accounted for prospectively or on a cumulative catch-up basis, depending on whether the remaining performance obligations are distinct.</p> | <p>A change order is included in contract revenue when it is probable that the customer will approve the change order and the amount of revenue can be reliably measured.</p> <p>US GAAP includes detailed revenue and cost guidance on the accounting for unpriced change orders (or those in which the work to be performed is defined, but the price is not).</p> <p><i>Impact – both IFRS and US GAAP:</i></p> <p>Change orders are a common form of contract modification in the IP industry. Change orders will be treated as separate contracts under the new standard if they represent distinct performance obligations and the price reflects their stand-alone selling price. A good is distinct if the customer can benefit from it on its own (or with other readily available resources) and the entity’s promise to transfer the good is separable from the other promises in the contract.</p> <p>If the goods or services in the modification are distinct from those transferred before the modification, but the price of the additional goods or services does not represent the current selling price of those goods or services, the change is considered a modification of the initial contract and should be recorded prospectively. A change order that affects a partially completed performance obligation will be accounted for through a cumulative catch-up adjustment at the date of the contract modification.</p> | <p>A change order (known as a variation) is included in contract revenue when it is probable that the customer will approve the change order and the amount of revenue can be reliably measured.</p> <p>There is no detailed guidance on the accounting for unpriced change orders.</p> |

## Determining transfer of control and recognising revenue

Many IP entities have contracts that include long-term manufacturing and may include a service (installation or customisation) along with the sale of products. The products and services may be delivered over a period ranging from several months to several years.

| New model  | Current US GAAP   | Current IFRS   |
|--|---|--|
| <p><b>Transfer of control</b></p> <p>Revenue is recognised upon the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. Control can transfer at a point in time or over time.</p> <p>A performance obligation is satisfied over time if any of the following criteria is met:</p> <ul style="list-style-type: none"> <li>• The customer receives and consumes the benefits of the entity’s performance as the entity performs.</li> <li>• The entity’s performance creates or enhances an asset that the customer controls as the asset is created or enhanced.</li> <li>• The entity’s performance does not create an asset with alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.</li> </ul> <p>A performance obligation is satisfied at a point in time if it does not meet one of the criteria above.</p> <p>Determining the point in time when control transfers will require judgement. Indicators that should be considered in determining whether the customer has obtained control of a good include:</p> <ul style="list-style-type: none"> <li>• The entity has a right to payment.</li> <li>• The customer has legal title.</li> <li>• The customer has physical possession.</li> <li>• The customer has the significant risks and rewards of ownership.</li> <li>• The customer has accepted the asset.</li> </ul> | <p>Service revenue from transactions not specifically in the scope of contract accounting is recognised by applying either the proportional performance model or the completed contract model, depending on the specific facts.</p> <p>For transactions in the scope of construction-type and production-type contract guidance (ASC 605-35), revenue is recognised using the percentage-of-completion method when reliable estimates are available.</p> <p>When reliable estimates cannot be made, but there is assurance that no loss will be incurred on a contract (for example, when the scope of the contract is ill-defined, but the contractor is protected from an overall loss), the percentage-of-completion method based on a zero profit margin is used until more precise estimates can be made.</p> <p>The completed-contract method is required when reliable estimates cannot be made.</p> | <p>Revenue is recognised for transactions not in the scope of the contract accounting guidance once the following conditions are satisfied:</p> <ul style="list-style-type: none"> <li>• The risk and rewards of ownership have transferred.</li> <li>• The seller does not retain managerial involvement to the degree usually associated with ownership nor retain effective control.</li> <li>• The amount of revenue can be reliably measured.</li> <li>• It is probable that the economic benefit will flow to the entity.</li> <li>• The costs incurred can be measured reliably.</li> </ul> <p>Revenue is recognised for transactions in the scope of contract accounting, using the percentage-of-completion method when reliable estimates are available.</p> <p>When reliable estimates cannot be made but it is probable that no loss will be incurred on a contract (for example, when the scope of the contract is ill-defined, but the contractor is protected from an overall loss), the percentage-of-completion method based on a zero profit margin is used until more-precise estimates can be made.</p> <p>The completed contract method is not permitted.</p> |
| <p><b>Impact – both IFRS and US GAAP:</b></p> <p>Management will need to apply judgement to assess the criteria for whether performance obligations are satisfied over time, especially whether assets have an alternative use and whether the entity has a right to payment for performance completed to date. Depending on facts and circumstances, entities that are using construction-type accounting under IFRS may have to recognise revenue at a point in time. This is a change compared to current IFRS guidance which, unlike US GAAP, does not allow entities to use the completed contract method.</p>  |   |  |

| New model   | Current US GAAP  | Current IFRS   |
|---|--|--|
|   | Manufacturers of large volumes of homogeneous goods produced to a customer's specification could meet the criteria for recognition over time when (1) such goods have no alternative use given they are highly customised or if they contractually cannot be redirected to another party, and (2) the payment terms provide that the customer will reimburse costs incurred plus a reasonable profit margin for both completed units and those in production at any point of time. This could result in revenue being recognised earlier than under current guidance.  |  |
| <p><b>Measuring progress for performance obligations satisfied over time</b></p> <p>Methods for recognising revenue when control transfers over time include:</p> <ul style="list-style-type: none"> <li>input methods that recognise revenue on cost incurred, labour hours expended, time lapsed, or machine hours used; and</li> <li>output methods that recognise revenue based on units produced or delivered, contract milestones, or surveys of work performed.</li> </ul> <p>Outputs used to measure progress may not be directly observable and the information to apply them may not be available without undue cost. In such cases an input method may be necessary.</p> <p>Output methods such as 'units produced' or 'units delivered' may not faithfully depict an entity's performance if at the end of the reporting period the value of work-in-progress or finished goods controlled by the customer is material or if the contract provides both design and production services. In such cases, each item produced or delivered may not transfer an equal amount of value to the customer.</p> | <p>The use of a proportional performance model based upon cost-to-cost measures is generally not appropriate for transactions outside the scope of contract accounting.</p> <p>Entities applying contract accounting use either an input method (for example, cost-to-cost, labour hours, labour cost, machine hours, material quantities), an output method (for example, physical progress, units produced, units delivered, contract milestones), or the passage of time to measure progress towards completion.</p> <p>Once a 'percentage complete' is determined (using the appropriate measure of progress), there are two different approaches for determining revenue, costs of revenue, and gross profit: the Revenue method or the Gross Profit method.</p> <p><i>Impact – both IFRS and US GAAP:</i></p> <p>The new standard allows both input and output methods for recognising revenue for performance obligations that are satisfied over time. Management should select the method that best depicts the transfer of control of goods and services to the customer. Input methods should represent the transfer of control of the asset or service to the customer and should therefore exclude the costs of any activities that do not depict the transfer of control (for example, abnormal amounts of wasted labour or materials).</p> <p>Entities manufacturing large volumes of homogeneous products that meet the criteria for performance obligations satisfied over time will be required to recognise revenue as goods are produced rather than when they are delivered to the customers. This could be the case for certain contract manufacturers depending on the terms of the arrangements.</p> | <p>Service revenue from transactions not in the scope of contract accounting is recognised based on the stage of completion if the transaction's outcome can be estimated reliably.</p> <p>Entities applying contract accounting can use either an input method (for example, cost-to-cost, labour hours, labour cost, machine hours, material quantities), an output method (for example, physical progress, units produced, units delivered, contract milestones), or the passage of time to measure progress towards completion.</p> <p>Once a 'percentage complete' is determined (using the appropriate measure of progress), IFRS requires the use of the Revenue method to determine revenue, costs of revenue, and gross profit. The Gross Profit method is not permitted.</p> |

| New model | Current US GAAP  | Current IFRS |
|-----------|--|--------------|
|           | The Gross Profit method of calculating revenue, costs of revenue, and gross profit based on the 'percentage complete' will no longer be acceptable under the new standard, which is a change from current US GAAP. Methods used under IFRS are likely to be acceptable under the new standard. |              |

### Example 1

**Facts:** A vendor enters into a contract to produce a significantly customised product for a customer. Management has determined that the contract is a single performance obligation. The contract has the following characteristics:

- The customisation is significant and customer's specifications may be changed at the customer's request during the contract term.
- Non-refundable, interim progress payments are required to finance the contract.
- The customer can cancel the contract at any time (with a termination penalty) and any work in process has no alternative use to the vendor.
- Physical possession and title do not pass until completion of the contract.

How should the vendor recognise revenue?

**Discussion:** The terms of the contract, in particular the customer specifications (and ability to change the specifications) indicate that the work in process has no alternative use to the vendor, and the non-refundable progress payments suggest that control of the product is being transferred over the contract term. Revenue is therefore recognised over time as the products are produced. Management will need to select the most appropriate measurement model (either an input or output method) to measure the revenue arising from the transfer of control of the product over time.

### Example 2

**Facts:** A vendor enters into a contract to construct several products for a customer. Management has determined that the contract is a single performance obligation. The contract has the following characteristics:

- The majority of the payments are due after the products have been installed.
- The customer can cancel the contract at any time (with a termination penalty) and any work in process remains the property of the vendor.
- The work in process can be completed and sold to another customer.
- Physical possession and title do not pass until completion of the contract.

How should the vendor recognise revenue?

**Discussion:** The terms of the contract, in particular payment upon completion and the inability of the customer to retain work in process, suggest that control of the products is transferred at a point in time. The vendor will not recognise revenue until control of the products has transferred to the customer.

### Example 3

**Facts:** A vendor enters into a contract to manufacture ten products for a customer. Management has determined that the contract is a single performance obligation satisfied over time. Each product takes a few weeks to be manufactured and during production the entity has significant work in process.

How should the vendor recognise revenue?

**Discussion:** The entity should apply a method that depicts the entity’s performance to date, and that should not exclude a material amount of goods or services for which control has transferred to the customer. Given that the performance obligation is satisfied over time, control is transferred to the customer as the products are being manufactured. Since the work in process is always significant, using a units-of-delivery or a units-of-production method will ignore the work in process that belongs to the customer. Therefore these methods may not be appropriate. An input method such as cost-to-cost is likely to better depict the transfer of control.

### Variable consideration

The transaction price is the consideration the vendor expects to be entitled to in exchange for satisfying its performance obligations in an arrangement. Determining the transaction price may require judgement if the consideration contains an element of variable or contingent consideration. Common considerations in this area include the accounting for volume discounts, awards/incentive payments, claims, and significant financing components.

Variable consideration is included in the transaction price only to the extent that it is highly probable (IFRS) or probable (US GAAP) that a significant reversal in the cumulative amount of revenue recognised will not occur in future periods if the estimates of variable consideration change. However, entities need to consider whether there is some minimum amount that is not subject to reversal, even if the total amount of variable consideration is not included in the transaction price.

| New model   | Current US GAAP   | Current IFRS   |
|---|---|--|
| <p><b>Volume discounts</b></p> <p>Volume discounts represent variable consideration and are recognised as a reduction to revenue. Both a qualitative and a quantitative assessment need to be performed to determine if revenue is subject to a significant reversal. Factors that indicate that including an estimate of volume discounts in the transaction price could result in a significant revenue reversal include, but are not limited to the following:</p> <ul style="list-style-type: none"> <li>• The amount of consideration is highly susceptible to factors outside the entity’s influence.</li> <li>• The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.</li> </ul> | <p>Volume discounts are recognised as a reduction to revenue as the customer earns the rebate. The reduction is limited to the estimated amounts potentially due to the customer. If the discount cannot be reliably estimated, revenue is reduced by the maximum potential rebate.</p> <p><i>Impact – both IFRS and US GAAP:</i></p> <p>Entities will need to consider their experience with a client or with similar clients and other factors to determine what volume discounts are highly probable (IFRS) or probable (US GAAP) and what level of rebate should be deferred.</p> <p>The accounting for volume discounts may be different than under current US GAAP. Volume discounts are recognised as they are earned under current US GAAP. Under the new standard, these types of volume discounts represent an option that the customer receives, as it provides the customer with a right to a discounted product in the future. Revenue might have to be recognised later</p> | <p>Volume discounts are systematically accrued based on discounts expected to be taken. The discount is then recognised as a reduction of revenue based on the best estimate of the amounts potentially due to the customer. If the discount cannot be reliably estimated, revenue is reduced by the maximum potential rebate.</p> |

| New model   | Current US GAAP  | Current IFRS   |
|---|--|--|
| <ul style="list-style-type: none"> <li>The entity's experience (or other evidence) with similar types of contracts is limited.</li> <li>The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.</li> <li>The contract has a large number and broad range of possible consideration amounts.</li> </ul> <p>Customer options to acquire additional goods or services for free or at a discount come in many forms, including sales incentives, customer award credits (or points), contract renewal options or other discounts on future goods or services.</p> | <p>than today given that entities will need to defer a portion of revenue from sales occurring earlier in the arrangement and recognise it in conjunction with discounted sales in the future. Entities will need to consider the variable consideration guidance to ensure that revenue recognised for sales occurring earlier in the arrangement will not be subject to significant reversal in the future. The accounting under the new standard is similar to existing IFRS guidance.</p>  |  |
| <p><b>Awards/Incentive payments/Claims</b></p> <p>Same as for volume rebates above.</p>   | <p>Awards/incentive payments are included in contract revenue (under the the scope of construction-type and production-type contract accounting) amount when the specified measured. standards are probable of reliably A claim is included in contract measured. only if negotiations have advanced stage such that it is probable A claim is recorded for contracts the under the scope of construction-type measured. and production-type contract accounting as contract revenue only if it is probable and can be reliably estimated, which is determined based on specific criteria. Claims meeting these criteria are only recorded to the extent of contract costs incurred. Profits on claims are not recorded until they are realised.</p> | <p>Awards/incentive payments are included in contract revenue when specified performance standards are probable of being met and the performance can be reliably being met and the amount can be revenue reached an</p> <p>customer will accept the claim and the amount can be reliably</p> |
| <p><b>Impact – both IFRS and US GAAP:</b><br/>Accounting for awards, incentive payments and claims is likely to be similar under the new standard compared to today's accounting (IFRS and US GAAP).</p>  |  |  |



| New model   | Current US GAAP  | Current IFRS   |
|---|--|--|
| <p><b>Significant financing component</b></p> <p>An entity will adjust the amount of promised consideration to reflect the time value of money if the contract includes a significant financing component.</p> <p>Interest income will need to be separately presented from the sale of goods or services.</p> <p>When discounting is required, the discount rate should reflect a separate financing transaction between the entity and its customer and also factor in credit risk.</p> <p>As a practical expedient, an entity is not required to reflect the effects of a significant financing component when the time period between payment and performance is less than one year.</p> <p>An entity paid in advance for goods or services need not reflect the effects of time value of money when:</p> <ul style="list-style-type: none"> <li>(a) the transfer of those goods or services to the customer is at the discretion of the customer;</li> <li>(b) if a substantial amount of the consideration promised by the customer is variable and the amount or timing of that consideration varies on the basis of the occurrence or non-occurrence of a future event not substantially in the control of the customer or the entity; or</li> <li>(c) the difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance to either the customer or the entity, and the difference between the two is proportional to the reason for the difference.</li> </ul> | <p>The discounting of revenues is required in only limited situations, including receivables with payment terms greater than one year.</p> <p>When discounting is required, the interest component is computed based on the stated rate of interest in the instrument or a market rate of interest if the stated rate is considered unreasonable.</p> <p><i>Impact – both IFRS and US GAAP:</i><br/>The new standard is not significantly different than today’s guidance. We do not expect a significant change to current practice for most IP and manufacturing entities in connection with the existence of a significant financing component, because payment terms often do not extend more than one year from the time of contract performance.</p> | <p>Discounting of revenues to present value is required in instances where the effect of discounting is material.</p> <p>An imputed interest rate is used in these instances for determining the amount of revenue to be recognised, as well as the separate interest income component to be recorded over time.</p> |

### Example #4

**Facts:** A chemical entity has a one-year contract with a car manufacturer to deliver high performance plastics. The contract stipulates that the chemical entity will give the car manufacturer a rebate when certain levels of future sales are reached, according to the following scheme:

| Rebate | Sales Volume                |
|--------|-----------------------------|
| 0%     | 0 - 10,000,000 lbs          |
| 5%     | 10,000,001 - 30,000,000 lbs |
| 10%    | 30,000,001 lbs and above    |

The rebates are calculated based on gross sales in a calendar year and paid at the end of the first quarter of the following year. Based on past experience and expected car sales for the year, management believes that the most likely rebate that it will have to pay is 5%. How does the chemical entity recognise revenue?

**Discussion:** The entity has experience with similar types of contracts with this client. Considering that experience and its expectation of car sales for the year, management recognises revenue based on the amount not expected to be subject to significant reversal. So 95% of the transaction price is recognised as goods are provided to the car manufacturer. This estimate is monitored and adjusted, as necessary, using a cumulative catch-up approach.

### Contract costs

IP entities frequently incur costs prior to finalising a contract. Costs to obtain or fulfil a contract may include engineering set-up costs, pre-contract planning and design costs, and sales commissions.

| New model   | Current US GAAP  | Current IFRS  |
|---|--|---|
| <p>Incremental costs to obtain a contract should be recognised as an asset if they are expected to be recovered.</p> <p>Incremental costs of obtaining a contract are costs that the entity would not have incurred if the contract had not been obtained (for example, sales commissions). They can include costs incurred before the contract is obtained if those costs relate to an anticipated contract that the entity can specifically identify.</p> <p>An entity is permitted to expense contract acquisition costs as incurred as a practical expedient for contracts with a duration of one year or less.</p> <p>Direct costs incurred to fulfil a contract are first assessed to determine if they are within the scope of other standards (for example, inventory, intangibles, fixed assets), in which case the entity should account for such costs in accordance with those standards (either capitalise or expense). If they are not in the scope of other guidance, they should be</p> | <p>There is detailed guidance on the accounting for contract costs that are under the scope of construction-type and production-type contract guidance (ASC 605-35).</p> <p>Pre-contract costs that are incurred for a specific anticipated contract may be deferred only if the costs can be directly associated with a specific anticipated contract and if their recoverability from that contract is probable.</p> <p>Outside of contract accounting, there is limited guidance on the treatment of costs associated with revenue transactions. Certain types of costs incurred prior to revenue recognition may be capitalised if they meet the definition of an asset.</p> | <p>There is detailed guidance on the accounting for contract costs in construction contract accounting (IAS 11).</p> <p>Costs that relate directly to a contract and are incurred in securing that contract are included as part of contract costs that can be capitalised if they can be separately identified, measured reliably, and it is probable that the contract will be obtained.</p> <p>Costs associated with transactions that are not in the scope of contract accounting are capitalised if such costs are within the scope of other asset standards (for example, inventory, PP&amp;E or intangible assets) or meet the definition of an asset in the Conceptual Framework.</p> |
| <p><b>Impact – both IFRS and US GAAP:</b><br/>           Costs likely to be in the scope of this guidance include, among others, sales commissions, set-up costs for service providers, and costs incurred in the design phase of construction projects.</p>  |  |   |

| New model  | Current US GAAP | Current IFRS   |
|--|-----------------|--|
| <p>evaluated under the revenue standard. An entity recognises an asset only if the costs relate directly to a contract, generate or enhance resources that relate to future performance, and are expected to be recovered. Costs related to inefficiencies (for example, abnormal costs of materials, labour, or other costs to fulfil) should be expensed as incurred.</p> <p>Incremental costs to obtain a contract as well as fulfilment costs are amortised in a manner consistent with the pattern of transfer of the goods or services to which the asset relates.</p> |                 | <p>Cost to fulfil a contract can also include training costs. Under current IFRS, training costs typically cannot be capitalised as they do not meet the definition of an asset. As the trained employees can leave at any time, the manufacturer does not control the benefit associated with the training. Training costs are not covered specifically under current US GAAP guidance and there is therefore a policy choice on expensing versus capitalising.</p> <p>The impact on entities will vary depending on the guidance and policies followed currently. However, policy elections on whether to capitalise or expense costs will no longer be permitted, except as it relates to the practical expedient for costs to obtain a contract with a duration of one year or less.</p> |

### Example #5

**Facts:** A salesperson earns a 5% commission on a contract that was signed during January 20X1. The products purchased in the contract will be delivered throughout the next year. How should the entity account for the commission paid to its employee?

**Discussion:** The commission payment should be capitalised as it represents a cost of obtaining the contract. However, in this example, as a practical expedient, the commission can be expensed as incurred since the commission relates to a contract that extends one year or less.

### Example #6

**Facts:** A manufacturer incurs upfront contract costs at the beginning of a long-term production contract. These upfront costs include the training of employees, setting up the factory for production, and non-recurring engineering costs related to the production equipment. How should these costs be accounted for?

**Discussion:**

Training costs will likely be expensed as incurred under the new standard. Only those costs that generate or enhance resources used to satisfy performance obligations in the future can be capitalised. Training of employees is unlikely to generate or enhance resources of the entity, and therefore do not meet the criteria for capitalisation. Demonstrating that training costs relate to future performance obligations might be difficult and may result in some of those costs being expensed as incurred.

The costs of setting up the factory and engineering should first be assessed to determine if they should be capitalised under fixed asset guidance. Those costs and any other upfront contract costs incurred which are not covered by existing fixed asset standards should be assessed to determine if they (a) relate directly and exclusively to this specific contract; (b) generate or enhance resources of the entity that will be used for the production, and (c) are probable of recovery. Costs that meet all three criteria are capitalised and then amortised over the contract period as control of the goods produced is transferred to the customer.

## Collectability

Collectability refers to the risk that the customer will not pay the promised consideration. The new model includes a collectability threshold for determining whether a transaction is in the scope of the revenue guidance.

| New model  | Current US GAAP   | Current IFRS   |
|--|---|--|
| <p>To be in the scope of the new standard, an entity needs to conclude at the inception of the contract that collectability is probable. The term 'probable' has different meanings under IFRS and US GAAP.</p> <p>The collectability assessment is based on both the customer's ability and intent to pay as amounts become due. The assessment of collectability should be made after considering any price concessions that the entity might provide to the customer.</p>   | <p>Revenue from an arrangement is deferred in its entirety if an entity cannot conclude that collection from the customer is reasonably assured.</p> <p>Credit risk is reflected as a reduction of accounts receivable by recording an increase in the allowance for doubtful accounts and bad debt expense.</p>  | <p>An entity must establish that it is probable that the economic benefits of the transaction will flow to the entity before revenue can be recognised.</p> <p>A provision for bad debts (incurred losses on financial assets including accounts receivable) is recognised in a two-step process: (1) objective evidence of impairment must be present; then (2) the amount of the impairment is measured based on the present value of expected cash flows.</p> |
| <p>When a contract with a customer does not meet the collectability threshold and the entity receives consideration from the customer, the entity shall recognise the consideration received as revenue only when either:</p> <ul style="list-style-type: none"> <li>(a) the entity has no remaining obligations to transfer goods or services to the customer and all, or substantially all, of the consideration promised by the customer has been received by the entity and is non-refundable; or</li> <li>(b) the contract has been terminated and the consideration received from the customer is nonrefundable.</li> </ul> <p>An entity shall reassess throughout the contract period whether (a) an arrangement that did not meet the collectability threshold subsequently meets that threshold and therefore should be accounted for under the revenue standard, or (b) there is an indication of a significant change in facts and circumstances relating to a contract that initially met the collectability threshold.</p> <p>Initial and subsequent impairment should be presented prominently as an expense below gross margin.</p> | <p><i>Impact – both IFRS and US GAAP:</i></p> <p>The inclusion of a collectability threshold is not a significant change to current guidance. An arrangement that does not meet the collectability threshold does not meet the criteria to be a contract in the scope of the new revenue standard. An entity that receives consideration from a customer in an arrangement that does not meet the collectability threshold will likely not recognise revenue for that consideration as it is received from the customer, even if it is nonrefundable. In other words, an arrangement that does not meet the collectability threshold does not default to cash basis accounting. Any consideration received is recorded as a liability until there are no remaining performance obligations and all or most of the consideration has been received or the contract is terminated and any consideration that has been received is non-refundable. This could result in revenue being recorded later than under current guidance in some situations.</p> |  |

## Principal versus agent

IP entities may involve third parties when providing goods and services to their customers. Management needs to assess whether the entity is acting as the principal or an agent in such arrangements.

| New model  | Current US GAAP   | Current IFRS   |
|--|---|--|
| <p>An entity recognises revenue on a gross basis if it is the principal in the arrangement, and on a net basis (that is, equal to the commission received) if it is acting as an agent.</p> <p>An entity is the principal in an arrangement if it obtains control of the goods or services of another party in advance of transferring control of those goods or services to a customer. The entity is an agent if its performance obligation is to arrange for another party to provide the goods or services.</p> <p>Indicators that the entity is an agent include:</p> <ul style="list-style-type: none"> <li>• The other party has primary responsibility for fulfilment of the contract (that is, the other party is the primary obligor).</li> <li>• The entity does not have inventory risk.</li> <li>• The entity does not have discretion in establishing prices.</li> <li>• The entity does not have customer credit risk.</li> <li>• The entity's consideration is in the form of a commission.</li> </ul> | <p>Specific indicators are provided for entities to consider when assessing whether the entity is the principal or the agent in an arrangement.</p> <p>Revenue is recognised net (for example, based on the amount of the commission) in an agency relationship.</p> <p><i>Impact – both IFRS and US GAAP:</i><br/>The indicators of a principal or agent relationship are similar to the current guidance in IFRS and US GAAP. The guidance does not weigh any of the indicators more heavily than others, similar to IFRS. Under existing US GAAP, some indicators carry more weight (for example, the entity is the primary obligor, has general inventory risk, and latitude in establishing price). Regardless, we do not expect a significant change in practice for many industrial products and manufacturing entities. However, the criteria should be carefully considered to determine if control of a good or service passes to an entity before it is transferred to a customer.</p> | <p>Specific indicators are provided for entities to consider when assessing whether the entity is the principal or the agent in an arrangement.</p> <p>Revenue is recognised net (for example, based on the amount of the commission) in an agency relationship.</p> |

## Warranties

Many IP entities provide standard warranties with their products that can be effective for a number of years. A standard warranty is given to all customers and protects against defects for a specific time period. Many entities also offer extended warranties or sell warranties separately that provide for coverage beyond the standard warranty period.

| New model   | Current US GAAP   | Current IFRS   |
|---|---|--|
| <p>An entity will account for a warranty as a separate performance obligation if the customer has the option to purchase the warranty separately.</p> <p>An entity will account for a warranty as a cost accrual if it is not sold separately unless the warranty is to provide the customer with a distinct service.</p> <p>If a part of a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the entity should account for that part of the warranty as a performance obligation. A warranty that provides both assurance and services should be accounted for as a service if the entity is unable to distinguish the assurance portion from the service portion.</p> | <p>Entities typically account for standard warranties protecting against latent defects in accordance with existing loss contingency guidance. An entity recognises revenue and concurrently accrues any expected costs for these warranty repairs.</p> <p>Separately priced extended warranties result in the deferral of revenue based on the contractual price of the extended warranty. The value deferred is amortised to revenue over the extended warranty period.</p> <p><i>Impact – both IFRS and US GAAP:</i><br/>Warranties that are sold separately are separate performance obligations for which revenue is recognised over the warranty period, similar to the accounting treatment under existing guidance.</p> <p>Under US GAAP, the value ascribed to warranties that are separately priced may be affected as the arrangement consideration will be allocated on a relative stand-alone selling price basis rather than at the contractual price under current guidance. As a result, the amount of revenue deferred for extended warranties might differ under the new standard compared to current guidance. The new standard should not change current practice under IFRS.</p> | <p>Entities typically account for standard warranties protecting against latent defects in accordance with existing provisions guidance. An entity recognises revenue and concurrently accrues any expected cost for these warranty repairs.</p> <p>Revenue from the sale of extended warranties is deferred and recognised over the period covered by the warranty.</p> |

### Example #7

**Facts:** An entity sells a product which includes a 90-day standard warranty. The entity will replace defective components of the product under the standard warranty. The warranty does not provide an additional service to the customer. How does the entity account for such a warranty?

**Discussion:** The entity should account for the warranty as a cost accrual, similar to today's guidance.

### Example #8

**Facts:** An entity sells a product which includes a 90-day standard warranty. Customers can also purchase a separate warranty that provides for an additional 18 months of coverage. How does the entity account for such a warranty?

**Discussion:** The standard warranty is accounted for in the same manner as the standard warranty offered in Example 7 above because it is not sold separately and does not provide an additional service. Similar to current guidance under both IFRS and US GAAP, the warranty sold separately is accounted for as a separate performance obligation. Management will allocate the transaction price (that is, contract revenue) to the product and the extended warranty based on their relative stand-alone selling prices. Revenue allocated to the extended warranty would be recognised over the warranty coverage period (starting on day 91 through the following 18 months).

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## Contact us

### *Questions?*

To have a deeper discussion, please contact:

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