Grant Thornton
An instinct for growth™

A new standard on revenue

What this means for the manufacturing industry

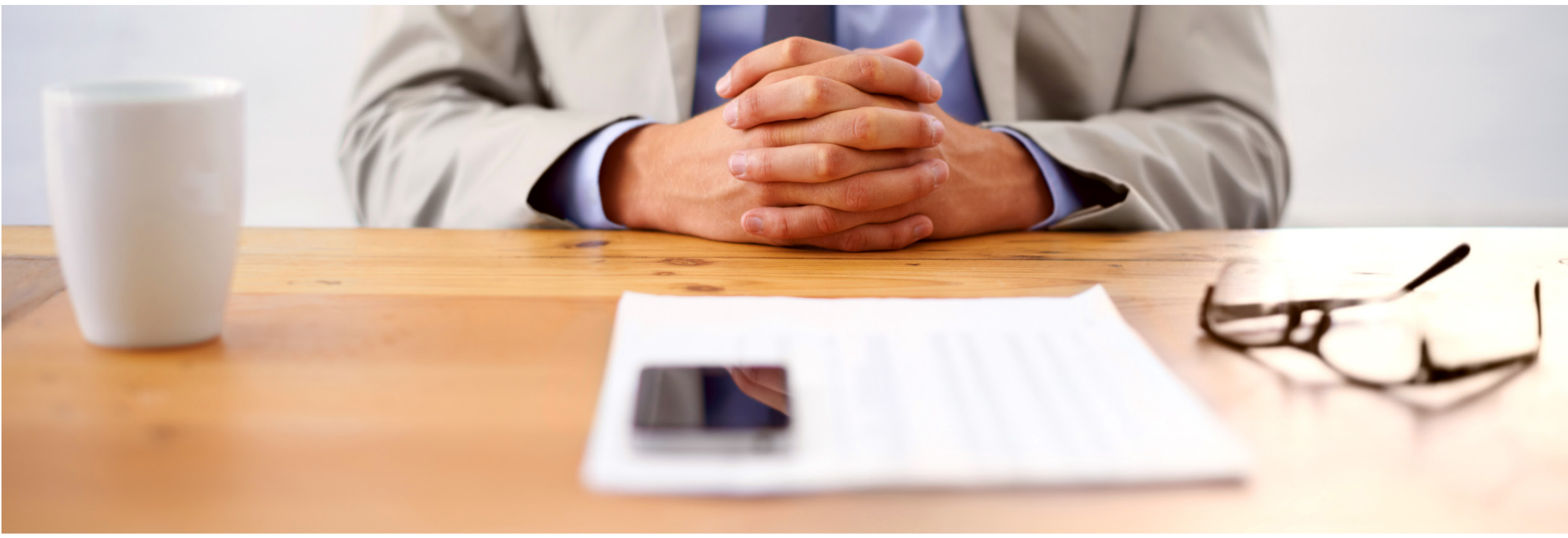
Contents

A new global standard on revenue

The new revenue recognition standard Financial Reporting Standard 115, Revenue from Contracts with Customers ('FRS 115') is effective from accounting period beginning on or after 1 January 2018. The standard is aligned with the new revenue recognition standard issued by the International Accounting Standards Board (IASB) - IFRS 15 'Revenue from Contracts with Customers' and ASU 2014-09 or Topic 606 issued by US FASB. This bulletin summarises the new requirements and what they will mean for the manufacturing industry.

Recently issued FRS 115 'Revenue from Contracts with Customers' replaces FRS 18 'Revenue' and FRS 11 'Construction Contracts' and provides significant new guidance addressing key questions such as:

- Can contract acquisition costs be capitalised, or must they be expensed?
- Under what conditions can customisation or installation services be considered separately from the related product sale?
- When should shipping be considered separately from the related product sale?
- Can non-refundable upfront fees be recognised in revenue when received?
- How should incentive payments be accounted for?
- Can revenue be recognised before delivery has occurred (bill and hold)?
- How are standard and extended warranties treated?
- Is it possible to recognise revenue before the customer signs off on acceptance?



The new Standard at a glance

Step 1

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Step 2

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Step 3

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The new Standard replaces FRS 18, FRS 11, and some revenue related interpretations. All transactions within its scope will apply a single, control-based 5-step model.

FRS 115 changes the criteria for determining whether revenue is recognised at a point in time or over time. FRS 115 also has more guidance in many areas where current FRSs are lacking such as:

- multiple-element arrangements
- non-cash and variable consideration
- rights of return and other customer options
- seller repurchase options and agreements
- warranties
- principal versus agent (gross versus net)
- licensing intellectual property
- breakage
- non-refundable upfront fees
- consignment and bill-and-hold arrangements.

FRS 115 will require considerably more disclosure about revenue including information about contract balances, remaining performance obligations (backlog), and key judgements made.

Transition

Transition is retrospective, subject to some simplifications, including an option to not restate comparative periods.

Manufacturers deal with a broad range of accounting issues, from accumulating contract costs, measuring progress towards completion, assessing whether revenue should be recognised over time or at a point in time, and determining whether or not promised goods or services represent separate performance obligations, to questions of customer acceptance, performance bonuses, and the impact established practices can have on contractual incoterms and the transfer of control.

FRS 115 provides additional guidance in many of these areas and as a result, entities will need to carefully assess their current practices for possible changes to the timing of revenue recognition.

Step 1: Identify the contract with a customer

What this means for the manufacturing industry

FRS 115 provides additional guidance in a number of areas not currently addressed by existing FRS. The extent of differences between the old and new guidance will depend (to some extent) on the accounting policies adopted by manufacturers under existing FRS where gaps currently exist. Although in many cases entities will find the new guidance provides a similar result to the old, an evaluation of the new control-based model and new criteria is necessary as some manufacturers may find the timing of revenue recognition change under FRS 115.

Step 1 of the new model is to identify the contract. An entity is only able to proceed to the next steps in the model if:

- the contract has commercial substance
- the parties have approved the contract
- each party's rights and the payment terms can be clearly identified
- it is probable the entity will collect the consideration.

Criteria not met

When the above criteria are not met, revenue cannot be recognised until they either are met, or one of the following occurs:

- performance is complete and all consideration received is non-refundable
- the arrangement has been cancelled and any consideration received is non-refundable.

Collectability

FRS 115 establishes a collectability threshold under which an entity must determine whether "it is probable that the entity will collect the consideration to which it will be entitled."

If the threshold is not met, the entity is precluded from applying the remaining steps in the standard and recognizing revenue until it is probable that the consideration will be collected.

The collectability assessment is based on both the customer's ability and intent to pay as amounts become due based on assessment of facts and circumstances such as past experience with the customer or class of customer, expectations about the customer's financial stability, economic conditions as well as other factors

Contract modifications/change orders

Depending on the circumstances, a contract modification is accounted for either as a separate contract, as the termination of an existing contract and creation of a new contract, or as part of an existing contract. For example, where a fixed price manufacturing contract is impacted by a subsequent change order that is not considered to be 'distinct' from the original performance obligation, the seller adjusts both the transaction price and the measure of progress towards completion and adjusts revenue on a 'cumulative catch-up' basis.

Depending on the circumstances, a contract modification is accounted for either as a separate contract, as the termination of an existing contract and creation of a new contract, or as part of an existing contract.

Step 2: Identify the performance obligations

Existing IFRS lacks detailed guidance on whether warranty obligations are separate deliverables.

A cornerstone of the IFRS 15 model is the fact that revenue is recognised based on satisfaction of 'distinct' performance obligations rather than the contract as a whole. A promised good or service is 'distinct' if both:

- the customer benefits from the item on its own or along with other readily available resources
- it is 'separately identifiable' (eg the supplier does not provide a significant service integrating, modifying, or customising the various performance obligations).

Existing IFRS lacks detailed guidance on 'multiple element arrangements'.

Entities will be required to evaluate the separability of multiple elements based on the 'distinct' criteria outlined above which may result in more or different elements (referred to as 'performance obligations') being separated (such as services attached to standard warranties, material discounts on future purchases, and contract renewal options, among others). The subsequent allocation of arrangement consideration to the individual performance obligations identified is discussed in Step 4 below.

Shipping and handling

In some contracts, an entity may perform shipping and handling activities in connection with a contract for sale of its goods. If an entity performs shipping and handling activities after it transfers control of the goods to the customer, the entity has to consider shipping and handling as a promised service within the contract that must be evaluated to determine if it is a distinct performance obligation.

Shipping and handling activities that occur before the customer obtains control of the good are activities to fulfill the entity's promise to transfer the good and are not a promised service to the customer.

Warranties

Existing FRS lacks detailed guidance on whether warranty obligations are separate deliverables. We understand that many entities today account for extended-type warranties as separate deliverables, with allocated revenue recognised over the coverage period, while standard-type warranties are not typically regarded as separate deliverables and are instead accounted for by accruing estimated costs under FRS 37 'Provisions, Contingent Liabilities and Contingent Assets'.

We expect that the new guidance will not change current practice as under FRS 115, the entity will account for the warranty as a separate performance obligation (and therefore allocate a portion of the contract transaction price based on relative stand-alone selling price as discussed in Steps 3 and 4) if either:

- the customer has the option to separately purchase the warranty
- all or part of the warranty provides the customer with an additional service (beyond the assurance that the product will comply with agreed-upon specifications).

If the conditions above are not met, the entity accounts for the warranty using the cost accrual guidance in FRS 37.

Step 3: Determine the transaction price

Under FRS 115, an entity estimates and includes variable payment amounts in the contract price using either a probability-weighted or most likely amount approach, subject to a constraint.

Variable consideration: performance incentives

Variable pricing arrangements (eg awards or incentive payments) of one type or another are common in the manufacturing industry. Under FRS 115, an entity estimates and includes variable payment amounts in the contract price using either a probability-weighted or most likely amount approach. This amount is further subject to a revenue constraint such that estimated amounts are included in the contract price only to the extent that it is highly probable that a subsequent change in the estimate will not result in a significant reversal of cumulative contract revenue recognised.

We do not expect these requirements to have a significant impact on the timing of revenue recognition for incentive payments as existing guidance requires such payments to be included in contract revenue when both:

- it is probable that the specified performance standards will be met or exceeded
- the amount of the incentive payment can be measured reliably.

Variable consideration: return and refund rights

Under the new guidance, variable consideration also includes a customer's right to return goods. A manufacturer should record a refund liability for the amount of revenue not expected to be recognised and a newly defined asset (a 'contract asset') for its right to the returned goods. The asset is measured by reference to the former inventory amount, adjusted through cost of sales for recovery costs and any expected decline in value.
This is similar to existing practice where a liability and related asset are also recognised although the asset is typically presented on the balance sheet under inventory, representing an entity's claim on the goods expected to be returned. Under FRS 115, the contract asset must be presented separately from inventory and will need to be assessed for impairment under FRS 109 'Financial Instruments'.

Step 4: Allocate the transaction price to the performance obligations

Currently, there is no prescriptive guidance in FRS 18 on when or how to allocate revenue to multiple deliverables within a contract.

Under FRS 15, when a manufacturer determines that a contract contains more than one performance obligation, it is required to allocate the transaction price to each performance obligation based on relative stand-alone selling prices.

Stand-alone selling price

FRS 15 defines stand-alone selling price as "the price at which an entity would sell a promised good or service separately to a customer". The observable selling price charged by the entity, if available, provides the best evidence of stand-alone selling price. If not available, the entity estimates the stand-alone selling price using all available information, maximising the use of observable inputs. FRS 115 suggests (but does not require) three possible methods: adjusted market assessment, expected cost plus margin or the residual approach.

Step 5: Recognise revenue when/as performance obligations are satisfied

An entity determines at contract inception whether each performance obligation will be satisfied (that is, control will be transferred) over time or at a specific point in time.

Recognising revenue over time or at a point in time

An entity determines at contract inception whether each performance obligation will be satisfied (that is, control will be transferred) over time or at a specific point in time.

While many manufacturing-type contracts will transfer control at a point in time, an entity cannot presume that there is no change and must carefully assess when control transfers under the new model to determine when to recognise revenue.

Broadly, control is transferred over time if any one of the following conditions applies:

- the customer controls the asset as it is created or enhanced by the manufacturer's performance under the contract
- the customer receives and consumes the benefits of the manufacturer's performance as it occurs
- the manufacturer's performance creates or enhances an asset that has no alternative use to the entity, and the manufacturer has a right to receive payment for work performed to date.

If none of the above conditions are present, then control transfers at a point in time. In these situations, a manufacturer recognises revenue by evaluating when the customer obtains control of the asset. FRS 15 provides indicators of control including (but not limited to) the following:

- the entity has a present right to receive payment for the asset
- the customer has legal title to the asset
- the customer has physical possession of the asset
- the customer has assumed the significant risks and rewards of owning the asset
- the customer has accepted the asset.

Bill-and-hold

FRS 115 provides additional guidance to consider when assessing whether control over the finished product has been transferred to the customer and therefore revenue may be recognised in a 'bill-and-hold' scenario. Although these criteria differ in some respects from the guidance provided in FRS 18, we expect that in most cases, the accounting conclusion will be similar.

Manufacturers should also consider whether their custodial duties from product completion to delivery represent a distinct performance obligation to which a portion of the arrangement consideration must be allocated (Step 2).

Customer acceptance

FRS 115 includes application guidance related to customer acceptance; therefore, where contracts include clauses requiring customers to formally accept the delivered goods or services, an entity must carefully consider how the guidance in FRS 115 will impact their assessment of whether control of the related asset has passed to the customer. If the manufacturer can objectively demonstrate that all agreed-upon specifications have been met, customer acceptance is a formality that does not affect when the customer obtains control of the good or service.

Additional considerations with respect to customer acceptance under FRS 115 include:

- goods delivered for trial, demonstration, or evaluation purposes – no revenue is recognised until the trial period lapses or the customer formally accepts
- goods delivered subject to a general right of return – the manufacturer applies the requirements for variable consideration to determine the amount of consideration to which it expects to be entitled (see Step 3 above).

In practice, we expect that in most cases where customer acceptance is based on seller-specified or customer-specified requirements, the accounting conclusion will be the same as under FRS 18.

Other Guidance

Contract acquisition costs

FRS 115 requires an entity to capitalise the incremental costs of obtaining a contract (eg sales commission) when certain criteria are met. However, as a practical expedient, a manufacturer is allowed to expense the costs as incurred if the amortisation period is one year or less.

Under FRS 115, where a manufacturer expects to recover such costs through future revenue under a contract, the costs are amortised to profit or loss as revenue is earned and the related asset is assessed for impairment in accordance with FRS 36.

Disclosure

FRS 115 requires quantitative and qualitative disclosures that disaggregate revenue streams and identify contract assets/liabilities, among many other new disclosures that manufacturing entities may not have previously reported. As a result, systems and processes will need to capture and summarise the incremental information needed for manufacturers to comply with the requirements.

Way forward

The implementation of FRS 115 is likely to impact business in varying degrees and the impact for affected companies is expected to pervasive (with changes to systems and processes) and not limited to accounting function alone!

It is important to consider that preparing for FRS 115 is more than an accounting change. It is a wider change management exercise which requires consideration of not just financial reporting function but other aspects of the organisation such as sales and operations, IT, investor relations, MD&A, employee performance measurement, tax to name a few.

Given that the entities in Singapore will be required to implement and present the financial statements for year ended 31 December 2018 under the new standard, this is the right time for those responsible for financial reporting to understand how this new guidance will impact their company's results and start taking steps towards transition.

How we can help

Grant Thornton's Financial Reporting Advisory Services team comprises financial reporting, and industry experts, each having several years of hands-on practical experience across GAAPs and sectors. Our professionals uniquely combine their technical expertise with the intuition, insight and confidence gained from their extensive practical experience to develop a systematic, reliable, efficient and scalable reporting framework for converging to the new revenue standard.

This will entail a careful and well-documented evaluation (and suitable modifications) of the financial reporting process, in order to achieve an optimal balance between transparency, consistency, accuracy, reliability and speed, while also controlling costs.

Diagnostic review

- Analyse contracts with customer under FRS 115.
- Identify areas of impact under FRS 115 and documentation of such impact assessment.
- Analyse and report on expected impact on processes, systems, controls, taxes, and KPIs.

Implementation

- Draft accounting position papers for accounting positions for all GAAP differences
- Design templates and working notes for mathematical computations of GAAP adjustments
- Update business process and policy manuals

Reporting

- Prepare computation of adjustments as of transition date to FRS 115 based on transition option selected by the Company
- Conduct a series of workshops and trainings for supporting the implementation
- Draft the additional disclosures required under FRS 115.
- Provide input on changes to systems and processes to generate information for sustainable financial reporting.

Support Services

- Provide regular updates on evolving changes in the accounting literature that are likely to have an effect on an ongoing basis

About Financial Reporting Advisory Services

In today's competitive business environment and fast changing regulatory & reporting landscape, dynamic organisations face several challenges with respect to financial reporting which could potentially impact the value of the businesses.

There is a greater need for accurate and timely financial information now. As a part of our Audit and Assurance practice, Financial Reporting Advisory Services (FRAS) has developed innovative solutions to make financial reporting process smooth, time-bound and auditable.

The FRAS team at Grant Thornton is a multi-disciplinary team that designs and implements creative solutions to address these complexities. Most of our team members are former auditors and assist Companies design 'auditor ready' solutions such as whitepaper, reporting packages, reconciliations supporting financial report disclosures.

What differentiates us

- We pre-empt problems and draft solutions to them
- Most of our professionals have auditing experience, which helps them appreciate practical complexities in financial reporting
- Our team combines accounting knowledge with technological skills to deliver efficient and sustainable financial reporting solutions
- Our senior professionals are chosen experts with deep technical accounting knowledge and vast experience of advising clients on accounting matters
- Our size and structure create advantages for you. We adapt a flatter structure, with shorter decision making chains, empowered teams and no complex chains of command. Our teams are more responsive
- Access to wide pool of IFRS experts from our offices in the region as well as our office in US, UK. India and Ireland.

About Grant Thornton Singapore

Grant Thornton Singapore is a member of Grant Thornton International Ltd. We aim to unlock the potential for growth in dynamic organisations and this aim underpins everything we do. We apply strong technical guidance and breadth of experience to ensure that clients receive a truly unique experience. Our proactive teams, led by accessible and approachable partners, use insights, experience and instinct to understand complex issues for privately owned, publicly listed and public sector clients, and help them find growth solutions.

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"Our competitive advantage includes our use of software technology, experience in working with international clientsm and commitment to value and excellence."

Rodger Flynn,
CEO, Grant Thornton Singapore Pte Ltd

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