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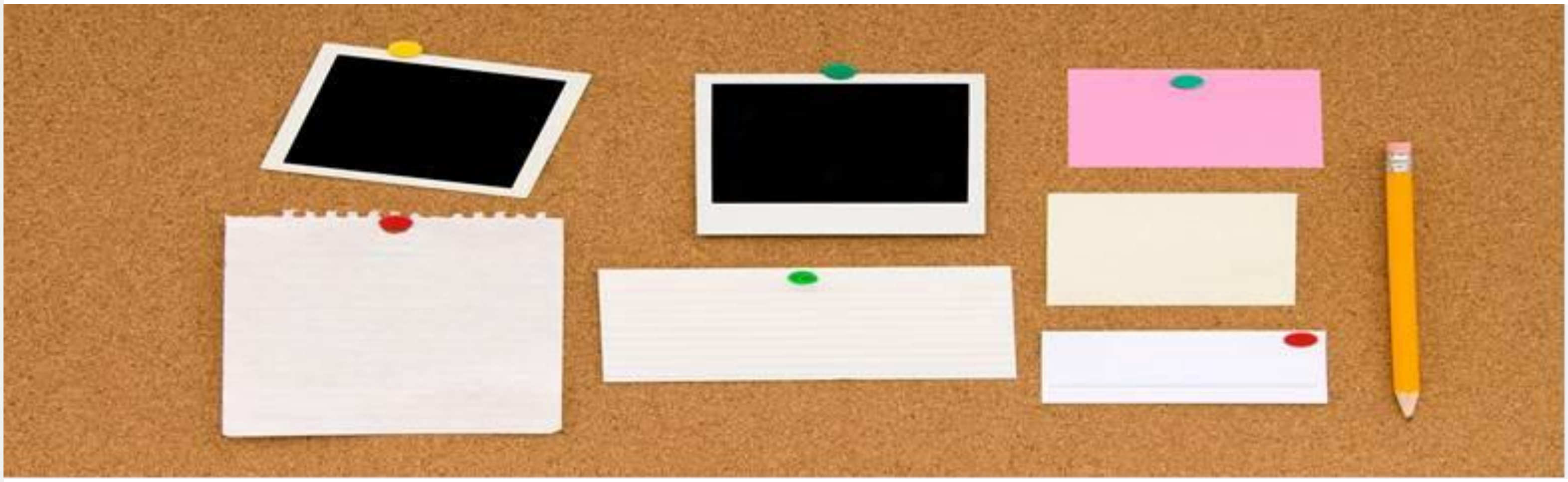

Accounting & Auditing News

IFRS 15 — *Revenue from Contracts with Customers*: Part 3I – Impact on Aerospace and Defense Sector

Can the cost of an item sold as a "loss leader" be deferred?

Background

Entities in the aerospace and defence sector sometimes sell a core product at a loss in order to generate a future stream of revenue in respect of the sale of further goods and services which relate to that specific product. At present, there may be diversity in practice over the appropriate accounting, with some entities capitalizing the initial loss as a cost of obtaining a customer.

Effect

The new standard include specific guidance addressing which costs associated with a customer contract must be capitalized and which must be expensed. Based on the guidance, it would appear that the loss generated on sale of the core product must be expensed rather than capitalized. This may significantly change the profile of profit recognition for some entities in the sector.

Should revenue be allocated to a customer options to acquire additional goods or services at a discount?

Background

Some aerospace contracts include a right for the customer to purchase additional goods or services at a discount.

Effect

Where this gives a “material right” for the customer (e.g. the option gives the customer the right to acquire additional goods at a substantial discount), an entity must allocate a portion of the transaction price to the option and recognize revenue when control of the goods and services underlying the option is transferred to the customer, or when the option expires.

Should Revenue be Recognized Over Time or at a Point in Time?

Background

IFRS 15 introduces a new approach to determine whether revenue should be recognized over time or at a point in time. Three scenarios are specified in IFRS 15 in which revenue will be recognized over time. If revenue is to be recognized over time, a method should be used which best reflects the pattern of transfer of goods or services to the customer. If a transaction does not fit into any of the three scenarios specified in IFRS 15, revenue will instead be recognized at a point in time, when control passes to the customer.

Effect

In the aerospace and defense sector, if an entity is manufacturing items for a specific customer, this may require a careful analysis in light of the new requirements. Quite small differences between otherwise similar contracts could have a fundamental impact on the timing of revenue recognition. When an entity in this sector enters into a defence contract with a government body, the government will have control over the goods being manufactured, which would result in revenue being recognized over time. It will often be particularly important to focus on contractual terms that allow the customer to cancel, curtail or significantly modify a contract and whether, in such cases, the seller is entitled to adequate compensation for work performed to date. Due to the long-term nature of contracts in this industry, particular consideration will need to be given as to the most appropriate basis for measuring revenue over time and the consequences of the basis adopted for the matching of revenues to the costs incurred.

Should revenue be adjusted for the effects of the time value of money?

Background

IFRS 15 introduces new and more extensive guidance on financing arrangements and the impact of the time value of money. Sales by aerospace and defence companies may include financing arrangements in that the timing of cash inflows from the customer may not correspond with the timing of recognition of revenue.

Effect

Under the new standard, the financing component, if it is significant, is accounted for separately from revenue. This applies to payments in advance as well as in arrears, but subject to an exemption where the period between payment and transfer of goods or services will be less than one year. This new guidance may change current accounting practices in some cases.

What is the impact if a contract is modified?

Background

In the past, IFRSs included only limited guidance on how to account for modifications to a contract. IFRS 15 includes detailed guidance on whether a contract modification should be accounted for prospectively or retrospectively.

Effect

It is not uncommon for the scope of price arrangements in the aerospace and defence sector to be modified and therefore this requirements may result in a change of practice for some entities.

When should variable or uncertain revenues be recognized?

Background

Contracts in the aerospace and defence sector can be of a long- term nature and will often include significant variable elements, such as performance bonuses, penalties, discounts, as well as the potential for subsequent downward price renegotiations. There are new specific requirements in respect of variable consideration such that it is only included in the transaction price if it is highly probable that the amount of revenue recognized would not be subject to significant future reversals as a result of subsequent re-estimation.

Effect

This approach to variable and contingent consideration is different from that previously reflected in IFRSs and, in certain scenarios, will require a significant degree of judgment to estimate the amount of consideration that should be taken into account. Accordingly, the profile of revenue recognition may change for some entities as a result.

Please contact the Technical Research Group at +63 2 581 9000 local 9088/9165/9078 or e-mail phtr@deloitte.com for questions regarding this publication.

Deloitte.

Member of Deloitte Touche Tohmatsu Limited

19th Floor Net Lima Plaza
5th Avenue corner 26th Street
Bonifacio Global City, Taguig
Philippines 1634

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