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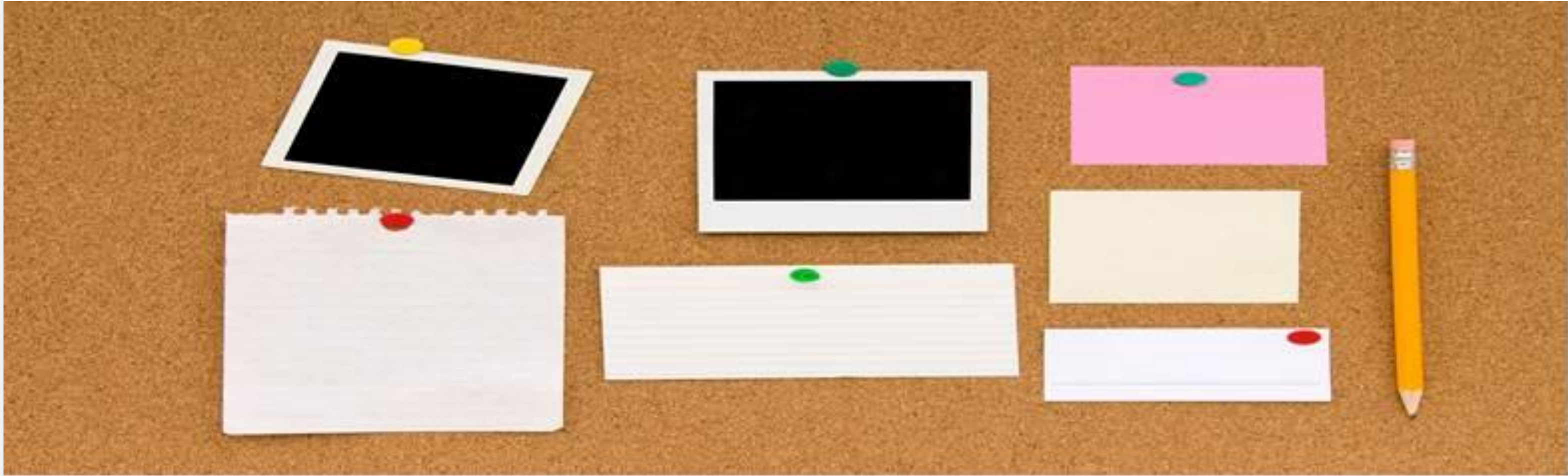

Accounting & Auditing News

IFRS 15 — *Revenue from Contracts with Customers*: Part 3N – Impact on Chemicals Sector

When should variable or uncertain revenues be recognized?

Background

Contracts in chemical sector will often include significant variable elements, such as performance bonuses or penalties and discounts. 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 when the uncertainty is resolved.

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.

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

Where chemical products are manufactured under contracts, the timing of revenue recognition may be significantly impacted by this new requirements if the products manufactured cannot be directed to another customer and if the manufacturer is entitled to payment for work to date. Recognizing revenue over time or at a point in time will often depend on careful analysis of specific contract terms. Quite small differences between otherwise similar contracts could have a fundamental impact on the timing of revenue recognition. 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.

Should contract costs be capitalized?

Background

The new standard introduces specific criteria for determining whether to capitalized certain costs, distinguishing between those costs associated with obtaining a contract (e.g. sales commissions) and those costs associated with fulfilling a contract.

Effect

In the chemicals sector, this becomes an issue where significant costs are incurred that are directly attributable to obtaining contracts with customers, for example sales commissions that are only

payable if a contract is obtained. bid costs incurred prior to a contract being awarded. At present, different entities might treat various types of cost differently so there may be an impact on operating profits.

The new standard requires capitalized contract costs to be amortized on a systematic basis that is consistent with the pattern of transfer of the goods or services. Entities will need to exercise judgment to determine the appropriate basis and time period for this amortization.

How will shipping terms impact revenue recognition?

Background

Under IAS 18, the timing of revenue recognition from the sale of goods is based primarily on the transfer of risk and rewards while IFRS 15 focuses on when control of those goods has transferred to the customer. Previously, revenue may have been recognized only at a point of delivery, on the basis that some exposure to risk and rewards is retained until then. Under IFRS 15, entities will need to assess whether control passes to the customer at the point of shipment or at a point of delivery

Effect

This may result in revenue being recognized at a different time.

How should breakage be recognized?

Background

In chemicals sector, it is common for customers to agree, under a ‘take or pay’ contract to purchase a specified minimum quantity of a particular good or service over a specified period of time. However, the customer has to pay the full amount stated in the contract, irrespective of whether the customer takes delivery of the minimum quantity. In a scenario in which customers do not always exercise all of their contractual rights, the unexercised rights are referred to as breakage. IFRS 15 include specific guidance on breakage. If an entity expect to benefit from breakage, it should recognized the estimated breakage amount as revenue in proportion to the pattern of rights exercised by the customer. Otherwise, the entity should recognized any breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote.

Effect

Entities will need to consider whether their current accounting needs to be amended in order to meet the requirements of IFRS 15.

Are collaborative arrangements in the scope of the new standard?

Background

It is common in chemicals sector for two separate entities to combine their resources and collaborate in their operations. Where this is the case, an entity will have to assess whether the other entity is its customer in order to establish whether transactions with the other entity are within the scope of the new standard.

Effect

The new standard introduces new specific guidance on this topic and this may result in some arrangements that have not been previously been regarded as revenue transactions nevertheless falling within the scope of the new standard. It may also result in some arrangements which have previously been treated as a revenue transactions being outside of the scope of the new standard and entities will need to consider in these cases whether it is still appropriate to apply the new standard by analogy.

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