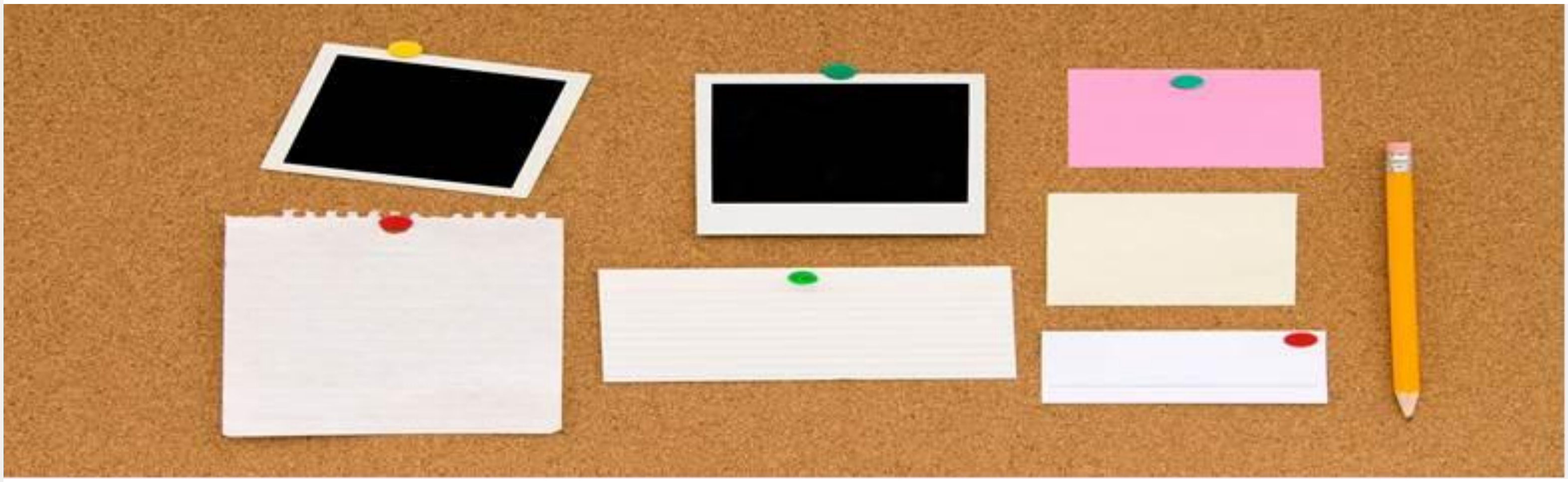
NavarroAmper&Co.

Philippines | Technical Research | 27 August 2014 (Issue 7)



Accounting & Auditing News

IFRS 15 — *Revenue from Contracts with Customers*: Part 3B – Impact on Retail, Wholesale and Distribution Sector

How should warranties be accounted for?

Background

IFRS 15 distinguishes between warranty providing assurance that a product meets agreed-upon specifications (accounted for as a cost provision) and a warranty providing an additional service (for which revenue will be deferred). Consideration of factors such as whether the warranty is required by law, the length of the warranty coverage period, and the nature of the tasks the entity promises to perform will be necessary to determine which type of warranty exists.

Effect

If a customer can choose whether or not to purchase a warranty as an ‘optional extra’, that warranty will always be treated as a separate service. Where a warranty is determined to include both elements (assurance and service), the transaction price is allocated to the product and the service in a reasonable manner (if this is not possible, the whole warranty is treated as a service).

In the retail, wholesale and distribution sector, it is common for warranties to include both elements. For example, a warranty may both assure the quality of the product and provide a free maintenance plan for two years. Where a warranty contains both elements, judgments will be needed in order to determine how to allocate the transaction price in a reasonable manner, and this may result in warranties being accounted for differently than at present.

How should breakage be recognized (e.g. customer loyalty schemes)?

Background

Many retailer offer customers future goods or services in exchange for a non-refundable upfront payment (gift cards, gift certificates, layaway sales deposits). The customers do not always exercise all their contractual rights in these scenarios. Such unexercised rights are often referred to as ‘breakage’.

Previously, IFRSs included only limited guidance on accounting for these unexercised rights, and only in the context of customer loyalty programmes. As such, a number of practices are currently used in accounting for breakage. IFRS 15 includes specific guidance on breakage, which is applicable to all revenue transactions with customers.

Effect

If an entity expects to benefits from breakage, it should recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer (i.e. by comparing the goods or services delivered to date with those expected to be delivered overall). Otherwise, the entity should recognize any breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote. Entities will need to consider whether their current accounting needs to be amended in order to meet the requirements of IFRS 15.

How will shipping terms impact the timing of revenue recognition?

Background

Under IAS 18, the timing of revenue recognition from the sale of goods is based primarily on the transfer of risks and rewards. IFRS 15 instead focusses to the customer.

Effect

The different approach between IAS 18 and IFRS 15 may result in a change of timing for revenue recognition for some entities. For example, some entities may supply goods on the basis that title passes to the customer at the point of shipment but, as matter of business practice, may compensate customers for loss or damage during shipping (either through credit or replacement). Previously, revenue may have been recognized only at the point of delivery. This may result in revenue being recognized at a different time. If revenue is recognized at the point of shipment, it may be necessary to allocate part of the transaction price to a distinct “shipping and risk coverage” service, with that element of revenue recognized when the service is provided.

When should variable or uncertain revenues be recognized?

Background

Contracts in this sector can include significant variable elements, such as volume rebates, credits and incentives. 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

The 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.

The standard also introduce a specific restriction for royalty payments relating to licenses of intellectual property, for example, some types of retail franchise licenses. If royalty payments are based on usage or onward sale, entities are restricted from recognizing the associated revenue until the usage or onward sale has occurred, even if it is possible to make a reliable estimate of this amount based on historical evidence.

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

Background

Some contracts in the retail, wholesale and distribution sector include a material right for the customer to purchase additional goods or services at a discount.

Effect

An entity must allocate a portion of the transaction price to the option and recognize revenue when control of the goods or services underlying the option is transferred to the customer or when the option expires.

How will the new standard impact the presentation of payments made to customers, e.g. slotting fees?

Background

Suppliers often make payments to retailers of their products in order to have their products prominently displayed, or for co-operative advertising (advertising by the retailer of the supplier's product).

Effect

Under the new standard, there is explicit guidance that addresses how to account for payments made to a customer. Suppliers will need to consider whether the payment is made for a separate good or service or should alternatively be treated as a deduction from revenue.

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. Financing arrangements such as buy now and pay later are commonplace in the retail, wholesale and distribution sector.

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.

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