AASB 15 – REVENUE RECOGNITION TO CHANGE FOR THE MANUFACTURING INDUSTRY

This month we take a closer look at the impacts of AASB 15 *Revenue from Contracts with Customers* on the manufacturing industry. For these entities, AASB 15 could significantly change the pattern of revenue and profit recognition, as well as affect bank covenants, performance-based compensation (including bonuses and share-based payments), internal budgeting processes, and market and investor communications.

AASB 15 contains more specific guidance on revenue recognition than the current AASB 118 *Revenue* standard.

The following areas are likely to have a significant impact on entities within the manufacturing industry under AASB 15:

- Volume discounts
- Volume rebates
- Set up fees
- Payments to customers
- Payments received in advance.

Effective date and transition

The effective date of AASB 15 is for annual reporting periods beginning on or after 1 January 2017. Entities can choose to apply a 'full' or 'partial' retrospective approach when first applying this Standard.

If an entity chooses to apply the 'full' approach, it will retrospectively restate its comparatives in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, subject to certain exceptions for completed contracts.

If applying the 'partial' approach', the entity will recognise the cumulative effect of the retrospective adjustments as an adjustment to opening retained earnings on 1 January 2017 (date of initial application). Contracts that are completed at the date of initial application are not retrospectively restated.

Volume discounts

AASB 15 includes more detailed guidance on 'variable consideration' and restricts the amount of variable consideration that can be recognised as revenue to the amount where it is **'highly probable that a significant reversal of revenue recognised will not occur'**.

Manufacturers often offer volume discounts as the production cost per unit typically decreases as more units are produced. Volume discounts are considered to be a form of 'variable consideration' under AASB 15 because the total amount to be paid by the customer for the contract is not known at the start, and is dependent on the total quantity of goods that is ultimately purchased by the customer.

Under AASB 15, manufacturing entities will need to estimate the amount of the volume discount and defer a portion of revenue until that discount is applied. This is likely to result in later recognition of revenue and profit in comparison with current accounting.

Example 1

On 1 July 2017, Widget Co signed a one year contract to supply widgets to Entity A for the following prices:

PRICE PER WIDGET	SALES VOLUME
$10	0-100,000 widgets
$9	100,001–200,000 widgets
$8	More than 200,000 widgets

Based on past experience, Widget Co estimates total sales volume of 150,000 widgets.

Question

At 31 December 2017 Widget Co has sold 30,000 widgets. How much revenue should Widget Co recognise under AASB 15?

Answer

The amount of revenue recognised per widget is $9.67. Therefore revenue recognised is $290,000 ($9.67 x 30,000). The amount is calculated as follows:

$10 per widget X 100,000 widgets	$1,000,000
$9 per widget X 50,000 widgets	$450,000
Total consideration	$1,450,000
Estimated total volume	150,000 widgets
Average price per widget	$9.67 ($1,450,000/150,000)

The average transaction price is $9.67 per widget.

	DR	CR
DR Cash ($10 per widget X 30,000 widgets)	$300,000	
CR Revenue ($9.67 per widget X 30,000 widgets)		$290,000
CR Contract liability		$10,000

The contract liability will reverse when sales >100,000 widgets and the amount billed is $9 per widget.

If 120,000 widgets are sold between 31 December 2017 and 30 June 2018, the journal entries are:

	DR	CR
DR Cash ($10 per widget X 70,000 widgets) + ($9 per widget X 50,000 widgets)	$1,150,000	
DR Contract liability	$10,000	
CR Revenue ($9.67 per widget X 120,000 widgets)		$1,160,000

The table below shows how revenue recognition for volume discounts is delayed under AASB 15.

	AASB 118	AASB 15
31 December 2017		
Revenue	$300,000	$290,000
Contact liability (B/S)		$10,000
30 June 2018		
Revenue	$1,150,000	$1,160,000
Total	**$1,450,000**	**$1,450,000**

(B/S) = balance sheet account

Volume rebates

Volume rebates are also considered to be a form of 'variable consideration' under AASB 15 because the total amount to be paid by the customer for the contract is not known at the start and is dependent on the eventual sales volume to customers.

Under AASB 15, manufacturing entities will need to estimate the amount of the expected volume rebate, and defer a portion of revenue as a liability until the rebate is claimed. This is likely to result in a reduction of revenue in earlier reporting periods.

Example 2

On 1 July 2018, Widget Co signed a one year contract to supply widgets to Entity B for $10 a widget. If Entity B orders more than $1,000,000 widgets within 12 months, Entity B will receive 10 per cent of the purchase price as cash back.

Based on past history, Widget Co is quite certain that Entity B will order more than $1,000,000 worth of widgets within the 12 months period.

Question

On 31 December 2018, Widget Co has sold 50,000 widgets. How much revenue should Widget Co recognise under AASB 15?

Answer

The amount of revenue recognised per widget is $9 ($1,000,000 - $100,000 cash back /100,000 widgets). The difference between the unit selling price ($10) and $9 is recognised as a liability for cash consideration to be paid at the end of the 12 months period.

Journal for 31 December 2018:

	DR	CR
DR Cash ($10 per widget X 50,000 widgets)	$500,000	
CR Revenue ($9 per widget X 50,000 widgets)		$450,000
CR Liability - consideration payable to customer		$50,000

If Widget Co sold 100,000 widgets to Entity B between 31 December 2018 and 30 June 2019, journal entries at 30 June 2019 are:

	DR	CR
DR Cash ($10 per widget X 100,00 widgets)	$1,000,000	
CR Revenue ($9 per widget X 100,000 widgets)		$900,000
CR Liability - consideration payable to customer		$100,000

	DR	CR
DR Liability - consideration payable to customer	$150,000	
CR Cash		$150,000

The table below shows how revenue recognition for volume rebates is impacted under AASB 15. While the overall net impact on profit or loss is the same under both AASB 118 and AASB 15 (albeit the selling cost and revenue could occur in different reporting periods under AASB 118), the total amount shown as revenue under AASB 15 will be less by the amount of the volume discount.

	AASB 118	AASB 15
31 December 2018		
Revenue	$500,000	$450,000
Selling cost	($50,000)	
Liability (B/S)	$50,000	$50,000
30 June 2019		
Revenue	$1,000,000	$900,000
Selling cost	($100,000)	-

(B/S) = balance sheet account

Set up fees

Fees for procurement of specialist machinery/equipment, recruiting specialist skilled employees, or building capacity to fulfil the contract are not recognised separately as revenue when incurred. As the customer does not directly receive a benefit from these activities, this does not represent revenue. Instead, any fees charged are recognised when the related goods are sold. Costs in relation to these activities may be capitalised and amortised as the goods are sold.

Example 3

On 30 June 2018, Widget Co signed a contract to supply Entity C with a special type of widget for $10 each. Entity C places an order for 100,000 widgets. To manufacture this type of widget, Widget Co needs to incur costs of $30,000 to reconfigure its machinery. Entity C has agreed to pay an upfront, non-refundable set up fee of $50,000 for the reconfiguration. Cost of production is $4 per widget.

Question

How should Widget Co recognise the setup fee and the associated costs under AASB 15?

Answer

The $50,000 received from the customer is not recognised separately as revenue on 30 June 2018, but is deferred and recognised as revenue as the widgets are sold. The reconfiguration costs are capitalised and amortised over the period of the contract. Under AASB 15, this results in revenue and profit being deferred in comparison to current accounting.

Journals for 30 June 2018 are:

	DR	CR
DR Cash	$50,000	
CR Deferred revenue		$50,000

	DR	CR
DR Contract asset	$30,000	
CR Cash		$30,000

Assume by 31 December 2018 that 50,000 widgets were sold. Revenue recognised per widget is $10.50 (($10 X 100,000) + $50,000)/100,000). Journals for 31 December 2018 are:

	DR	CR
DR Cash ($10 x 50,000)	$500,000	
DR Deferred revenue	$25,000	
CR Revenue ($10.50 x 50,000)		$525,000

	DR	CR
DR Cost of goods sold	$15,000	
CR Contract asset		$15,000

The table below shows how revenue recognition for setup fees is delayed under AASB 15.

	AASB 118	AASB 15
30 June 2018		
Revenue	$50,000	-
Expenses	($30,000)	
Profit	$20,000	-
Deferred revenue (B/S)	-	$50,000
Contract asset (B/S)	-	$30,000
31 December 2018		
Revenue	$500,000	$525,000
COGS	($200,000)	($215,000)
Gross profit	$300,000	$310,000
Deferred revenue (B/S)	-	$25,000
Contract asset (B/S)	-	$15,000

(B/S) = balance sheet account

Payments to customers

Manufacturers may make payments to their customers for promoting their products or other services. Under AASB 15, payments paid to a customer are treated as a reduction in revenue, rather than as a separate cost.

Example 4

On 1 July 2017, Chairs Co enters into a contract to sell 1,000 chairs at $100 each to Entity C. Chairs Co also pays $10,000 to Entity C to ensure that its chairs are prominently placed in Entity C's stores for the next 12 months.

Question

On 31 December 2017, Chairs Co sells 500 chairs. How much revenue should Chairs Co recognise under AASB 15?

Answer

On 1 July 2017, Chairs Co recognises an asset of $10,000 being 'prepayment' for a right to occupy the prominent display area. The journals are:

	DR	CR
DR Asset – Right to prominent display	$10,000	
CR Cash		$10,000

On 31 December 2017, the amount of revenue to be recognised is reduced by the amount of payment to Entity C. Revenue to be recognised per chair is $90 {[($100x1,000)-$10,000]/1,000}

Journal entries for 31 December 2017 are:

	DR	CR
DR Cash ($100 per chair X 500 chairs)	$50,000	
CR Revenue ($90 per chair X 500 chairs)		$45,000
CR Asset – Right to prominent display ($10,000/1,000) X 500		$5,000

Contracts with payments received in advance

Customers may enter into a contract with a manufacturer where the customer pays upfront for the goods to be received in a future period (more than 12 months). Under AASB 15, the amount of revenue recognised on contracts with such arrangements is likely to be higher than the actual contract price. The advance payment from the customer represents a form of a financing to the manufacturer. Revenue recognised under AASB 15 would effectively be 'grossed up' by the amount of interest expense (being the amount 'borrowed' from the customer to fund the manufacturer).

Example 5

On 1 January 2017, Manufacturer Y is paid $3 million to supply ABC Ltd with 1 million badges at the end of each year for the next three years. Assume cost of goods sold is $500,000 per year. Manufacturer Y's three year borrowing rate is 10 per cent.

Question

How should Manufacturer Y account for the contract under AASB 15?

Answer

YEAR	OPENING CONTRACT LIABILITY (A)	AASB 15 INTEREST EXPENSE (B) = (A) X 10	AASB 15 REVENUE (C)	CLOSING CONTRACT LIABILITY (D) = (A) +(B) – (C)
2017	$3,000,000	$300,000	$1,100,000 [($3m+$300,000)/3m]X1m	$2,200,000
2018	$2,200,000	$220,000	$1,210,000 [($2.2m+$220,000)/2m] X1m	$1,210,000
2019	$1,210,000	$121,000	$1,331,000	

Total revenue of $3,641,000, and interest expense of $641,000 is recognised under AASB 15 for the three year contract as follows:

	2017	2018	2019	TOTAL
AASB 15				
Revenue	$1,100,000	$1,210,000	$1,331,000	$3,641,000
Cost of goods sold	$500,000	$500,000	$500,000	$1,500,000
Gross profit	**$600,000**	**$710,000**	**$831,000**	**$2,141,000**
Interest expense	$300,000	$220,000	$121,000	$641,000
Net profit	**$300,00**	**$490,000**	**$710,000**	**$1,500,000**

Revenue of $3 million is recognised under AASB 118 for the three year contract as follows:

	2017	2018	2019	TOTAL
AASB 118				
Revenue	$1,000,000	$1,000,000	$1,000,000	$3,000,000
Cost of goods sold	$500,000	$500,000	$500,000	$1,500,000
Gross profit	**$500,00**	**$500,00**	**$500,00**	**$1,500,000**
Interest expense	Nil	Nil	Nil	Nil
Net profit	**$500,00**	**$500,00**	**$500,00**	**$1,500,000**

Practical implications

The impacts of AASB 15 are not only the significant changes in the patterns of revenue and profit recognition as the above examples have shown. The impact and change of AASB 15 to systems and processes should not be underestimated. In the case of volume discounts, systems and processes would need to be in place to determine the amount of revenue to be deferred and to track the balance of the deferred revenue liability account. For some payments to customers and set up costs that qualify for recognition as an asset, systems and processes need to be in place to set up an additional asset account and to determine the amount of amortisation to be recognised as goods or services are provided. If there are any contracts with significant advanced payment terms, systems and processes will also need to be in place to account for the implicit borrowing cost and calculate the 'grossed up' revenue.