AASB 15 *Revenue from contracts with customers*

Consumer and industrial markets

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Your facilitators for today are…

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Agenda

- Introduction
- The 5 step model with practical examples
- Implementation considerations

Introduction

Where are we at?

Applicable years beginning on or after 1 Jan 2018

* If a retrospective transition method applied

Disclosures around standards issued but not yet effective

What does AASB 15 require?

Core principle

Recognise revenue to depict transfer of promised goods or services to customers in amount that reflects consideration to which entity expects to be entitled in exchange for those goods or service

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to performance obligations in the contract
5. Recognise revenue when (or as) the entity satisfies a performance obligation

The 5 step model

with practical examples

Step 1: Identifying the contracts with customers

1

A contract exists if...

... collection of consideration is considered probable.

... rights to products or services and payment terms can be identified.

... it has commercial substance.

... it is approved and the parties are committed to their obligations.

What is length of contracted term?

1

A contract only exists in the period it is enforceable

Can customer
leave at any time?

Are there significant
termination penalties?

Contract term can impact:

- Performance obligations identified
- Determination of transaction price
- Period over which upfront fees/revenue can be recognised
- Period over which fulfilment costs can be amortised

Example 1 - Contract term

1

Example:		Contract?
1.1	Manufacturer A enters into 3 year MSA with customer C for sale of bottles • C must purchase 1m bottles • No upfront consideration • Other than payment for 1m bottles, no further termination fees.	Contract exists for 1m bottles.
1.2	Manufacturer A enters into 3 year MSA with customer C for sale of bottles • No minimum quantity to be purchased by C • A pays C $200k on signing of MSA. $200k is not subject to clawback • No termination fees • C can only purchase these bottles from A and it is virtually certain that C will purchase at least 1m bottles from A.	Contract does not exist. Exclusivity or economic compulsion does not give rise to enforceable rights and obligations.

Q: What is the accounting for the $200k payment?

Watch this space!

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Step 2: Identify performance obligations

2

A promise to transfer to customer a **distinct** good or service

Capable of being distinct

Can customer benefit from promise on its own or together with other resources that are readily available?

+

Distinct within the context of the contract

Is it separately identifiable from other promises in the contract?

Distinct within the context of the contract

2

1 Are we providing a significant service of integration?

2 Are we customising or modifying the goods significantly?

3 Is the good or service highly dependent on or highly interrelated with other goods or services in the contract?

If the answer is yes to any of these questions, not separately identifiable

Example 2: Identifying performance obligations

2

Company A enters into a contract with Customer B to sell a piece of equipment. Promises in the contract include:

- Equipment
- Free installation/integration
- 1-year standard warranty
- 2-year extended warranty
- Discount of 20% on 10,000 units of consumables

Only A can perform installation. Installation does not significantly modify or customise equipment.

Example 2 solution: Identifying performance obligations

2

What has Company A promised in the contract?

Criteria	Equipment	Installing equipment	1 –year standard warranty	2-year extended warranty
Capable of being distinct	✓	✓	✗	✓
Separately identifiable	✓	✓	N/A	✓
Separate PO?	✓	✓	✗	✓

Q: What about the discount on consumables?

Example 2 solution: Identifying performance obligations

2

Entity grants customer option to acquire additional goods or services

Could customer obtain right to acquire additional goods or services without entering into sales agreement?

No

Yes

Option give customer right to acquire additional goods or services at price that reflects stand-alone selling price for goods or services?

No

Yes

Option is material right that gives rise to performance obligation

Option does not give rise to performance obligation

Allocated consideration will be recognised when goods or services are transferred or option expires

Example 2 solution: Identifying performance obligations

2

There are 4 performance obligations

Promises in the contract	Performance obligation?
Supply of equipment	✓
Free installation/integration	✓
1-year standard warranty	✗ (combined with equipment)
2-year extended warranty	✓
Customer option	✓

Example 3: Performance obligations and tooling

2

- Contract manufacturer T enters into a 6-year MSA with Customer C to manufacture bottle X.
- MSA does not include contractually committed volumes.
- Shape of bottle X is covered by customer specific intellectual property.
- On signing of the MSA, T arranges for and funds manufacture of customer specific tooling. MSA stipulates any customer specific tooling can only be used to manufacture C's product. At end of manufacturing arrangement, customer specific tooling will be provided to C.
- MSA includes clause that if MSA is terminated by C before specified target volumes are achieved, T will be entitled to a payment based on a fixed schedule with compensation reduced over-time as quantities are purchased.
- Tooling is operated and maintained by T.

Q1: Is MSA a contract for tooling?

Q2: Does control of the tooling transfer to the customer?

Q3: Is tooling a distinct performance obligation?

Example 3 solution: Performance obligations and tooling

2

Step 1: Identify the contract(s) with a customer

- MSA requires that if agreement is terminated by C, T will be entitled to payment for tooling sufficient to cover cost of manufacture plus a profit margin.
- MSA includes enforceable rights and obligations in respect of tool.

Step 2: Identify the performance obligations in the contract

- Q2: Does control of tooling transfer to customer?
- Q3: Is tooling a distinct performance obligation?

Example 3 solution: Performance obligations and tooling

2

Q2: Does control of the tooling transfer to the customer?

Factors to consider	Assessment
Customer can direct use and prevent others from using the tool	Tooling can only be used to manufacture bottle X for C
Economic benefits from tool depend entirely on orders from customer	MSA does not contain minimum purchase quantity, dependent on C issuing purchase orders
Substantive transfer of legal title if it is technically and economically feasible for another manufacturer to use tool	Practically tooling cannot be used by another manufacturer
Consideration for tooling exists	In event of termination or insufficient quantities are purchased
Tool is operated and maintained by manufacturer	Tooling is operated and maintained by T

Judgement required. A conclusion of no control transferring for tooling means no need to assess if tooling is a distinct performance obligation. Account for tooling as PP&E or intangible assets if criteria met. Otherwise, assess for capitalisation as fulfilment costs.

BUT if control does transfer….

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Example 3 solution: Performance obligations and tooling

2

Q3: Is the tooling a distinct performance obligation

Factors to consider	Assessment
Is development of tool interrelated or integrated with production of bottles?	No – development of tool is not interrelated/integrated with production of bottle. Tooling is specialised, but remainder of production process is same as for other customers. No transformative relationship between bottle and tool.
Must customer buy tooling together with the bottles?	No – No minimum purchase requirement. C can choose to buy or not buy bottles, this does not affect purchase of tool. C required to pay T for cost of tool if no bottles purchased.

Tooling likely to be a distinct performance obligation.

Example 4: Tolling arrangements

2

Company A sells and distributes mobile phones. Company B's principal activity is provision of assembling services.

A determines specification and design of phone and B is not responsible for any design flaws or defects in raw materials used in manufacture of phones. B sells finished phones at cost + margin to A. B negotiates its margin/pricing with A based on it's value added services arising from labour, overheads, depreciation of machineries, etc. B does not earn a margin on raw materials.

All raw materials must be purchased from A, B purchases raw materials based on forecast orders submitted by A. B is not exposed to any change in pricing of raw materials or any foreign exchange fluctuations.

There is no restriction on quantity of raw materials that B can purchase from A nor on their use for B's other customers.

Example 4 solution: Tolling arrangements

2

Considerations

What is the promise to A?
B solely provides assembly services based on instructions of A. B is not selling A finished phones.

B does not suffer from price fluctuation and only orders raw materials based on orders by A.

B has no involvement in mobile phone design specifications.

Revenue likely to be recognised net of the raw material costs.

Step 3: Determine the transaction price

3

Variable consideration

Non-cash consideration

Transaction price

Significant financing component

Consideration payable to customer

Variable consideration

3

Variable consideration can be:

Discounts | Credits | Incentives | Performance bonuses | Many more...

Variable consideration is estimated using most appropriate method of either:

Expected Value
(Sum of probability-weighted amounts in a range of possible outcomes)

Most Likely Amount
(Single most likely outcome, when the transaction amount has a limited number of possible outcomes)

Capped at an amount for which it is 'highly probable' that a significant reversal will not occur.

Example 5: Volume rebates - retrospective

3

Entity X has a two-year contract with Customer Y to supply beer. Contract price of beer is $1 per litre with a rebate allowance specified in contract dependent on total sales volume over two-year period.

Rebate is paid at end of year 2 and applied retrospectively as follows:

- $0.01 per litre for up to 50,000 litres
- $0.03 per litre for > 50,000 litres
- $0.05 per litre for >100,000 litres

At contract inception, X expects Y will make the following purchases with following probabilities:

- 5% probability of 55,000 litres
- 35% probability of 75,000 litres
- 55% probability of 100,00 litres
- 5% probability of 120,000 litres

In year 1, Y buys 60,000 litres.

Q: How would X estimate transaction price at contract inception and at end of year 1?

Example 5 solution: Volume rebates - retrospective

3

X would use Expected Value method to estimate sales during two-year period.

Estimated litres	Probability	Weighting
55,000 litres	5%	2,750
75,000 litres	35%	26,250
100,000 litres	55%	55,000
120,000 litres	5%	6,000
Expected Value		**90,000**

X would use also consider constraint and not underestimate quantity that will be sold.

Based on 5% probability Y will purchase quantities in excess of 100,000 litres, entitling Y to a discount larger than $0.03, at contract inception 90,000 litres is used to estimate the variable consideration taking into account constraint.

Example 5 solution: Volume rebates - retrospective

3

At contract inception, X estimated 90,000 litres of sales to Y.

	Litres	Price per Litre	Total expected consideration
Litres 1 – 100,000	90,000	$0.97	$87,300

However, based on sales to end of year 1, X revises its expected value to 120,000 litres. How much revenue would X recognise at end of year 1 on 60,000 litres of sales?

	Litres	Price per Litre	Total revenue
Litres 1 – 100,000	60,000	$0.97	$58,200
True-up adjustment ($0.05-$0.03*60,000)			$(1,200)
Year 1 revenue			**$57,000**

Example 6: Volume rebates - prospective

3

Same fact pattern as per Example 5, however, rebate is applied prospectively as follows:

- Nil per litre for up to 50,000 litres
- $0.03 per litre for 50,001 – 100,000 litres
- $0.05 per litre for 100,000+ litres

Q: Would accounting change if rebate was applied prospectively? If yes, how?

Example 6 solution: Volume rebates - prospective

3

Prospective volume rebate is a material right representing a discount on future purchases.

- Estimate standalone selling price – consider level of discount and probability material right will be exercised (i.e. probability volume rebate will be achieved). Allocate transaction price between underlying good or service (e.g. beer) and material right.

- Recognise when underlying goods or services are purchased using option or when option expires. **I.e. only true-up for downward change in estimate of volume once discount period expires – end of two years.** Currently unclear on what to do with upward change in estimate of volume.

Watch this space!

Other typical types of rebates, discounts, etc.

3

Examples	Considerations
Change in price due to change in cost	Future change in price (e.g. price for next 3 months depends on raw material average cost for immediately preceding 3 months) is not variable consideration. Retrospective change in price would likely be considered variable consideration.
Time-based rebates E.g. 3-year supply contract where pricing is as follows: Yr 1 - $1 per unit Yr 2 - $0.95 per unit Yr 3 - $0.90 per unit	No minimum quantities, then this is not variable consideration. Minimum purchase quantities likely to be considered variable consideration.

Step 4: Allocating consideration to performance obligations

4

Allocate based on relative stand-alone selling prices

Performance obligation 1

Performance obligation 2

Performance obligation 3

Determine stand-alone selling prices

Observable price

Fair value measurement

Estimate price

Adjusted market assessment approach

Expected cost plus a margin approach

Residual approach only if selling price is highly variable or uncertain

Example 7: Allocating consideration

4

Same as example 2. Company A enters into a contract with Customer B to sell a piece of equipment for $500k. 4 performance obligations identified in contract include:

- Equipment
- Free installation/integration
- 2-year extended warranty
- Discount of 20% on 10,000 units of consumables. Each consumable has stand-alone selling price of $10 and A expects 9,000 units purchased.

A would sell equipment alone for $450k, installation alone for $90k and warranty at $30k a year.

Q: How is consideration allocated to each performance obligation?

Example 7 solution: Allocating consideration

4

Performance obligation	Stand-alone selling price	%	Transaction price allocation	Contractually stated amount
Equipment	$450k	73%	$365k	$500k
Installation/Integration	$90k	15%	$75k	
2-year extended warranty	$60k	10%	$50k	
Discount on consumables	$18k	2%	$10k	
Total	**$618k**	**100%**	**$500k**	**$500k**

Allocation could result in revenue amounts different to invoiced amounts!

Example 8: Loyalty programs

4

- Retailer C offers customer a loyalty program whereby for every $10 spent, 1 point is rewarded
- Each point is redeemable for a cash discount of $1 on future purchases
- C expects 97% of points to be redeemed (based on historical experience)
- During year 1, customers purchase $100,000 of product and earns 10,000 points

Q: How is price allocated between the performance obligations?

Example 8 solution: Loyalty programs

4

Performance obligation	Stand-alone selling price	%	Transaction price allocation
Products	$100,000	91%	$91,000
Points	$9,700	9%	$9,000
Total	**$109,700k**	**100%**	**$100,000**

Step 5: Recognising revenue over-time

5

A performance obligation is satisfied over-time if:

1. Customer simultaneously receives and consumes the benefits as the entity performs.
   - Routine or recurring services, e.g. maintenance services

OR

2. The customer controls the asset as the entity creates or enhances it.
   - Asset built on customer's site, e.g. power plant on customer's land

OR

3. The entity's performance does not create an asset for which the entity has an alternate use and there is a right to payment for performance to date.
   - Asset built to order

Recognising revenue at a point-in-time

5

Indicators that control has passed include a customer having…

- … a present obligation to pay
- … physical possession
- … legal title
- … risks and rewards of ownership
- …accepted the asset

Example 9: Over-time or point-in-time

5

Manufacturer T has a 5 year MSA with Customer X to manufacture a customer specific part for use in X's products. This part has no alternative use for T.

Under MSA, X is not required to purchase a minimum quantity of parts.

If X wishes to purchase parts, it must submit a purchase order. If X cancels purchase order for convenience, then it must pay T for any work in progress and any finished goods manufactured by T at the time of cancellation, at price current at time of cancellation.

Please complete polling question 5 that will appear on your screen shortly

Example 9 solution: Over-time or point-in-time

5

Criteria for recognising revenue over-time	Met?
Customer simultaneously receives and consumes benefit as entity performs; or	✘
Customer controls asset as entity creates or enhances it; or	✘
Entity's performance (a) does not create an asset with alternative use, and (b) right to payment for performance to date	 ✓ ✓

Revenue on parts recognised over-time as parts are manufactured.

Q: What about if MSA requires T to hold a certain quantity of safety stock, which X will pay for if contract is terminated for convenience?

Watch this space!

Other potential issues

Issue	Discussion
Combining contracts	Contracts are combined where: - Entered at or near same time with same customers or related parties of customer; and - Negotiated as a single commercial package, or - Consideration in contract is dependent on consideration in other contract, or - Goods or services (or some of goods or services) are a single performance obligation
Freight	Delivery terms could impact identification of performance obligations. FOB – freight is likely included with product as one performance obligations CIF – freight and product could be considered two separate performance obligations
Contract modifications	Change in scope or price of a contract, or both. 3 possible accounting outcomes: - Cumulative catch-up adjustment - Account for as separate contract (prospective) - Account for as termination of existing contract and creation of new contract (prospective)
Scrap sales	Consideration of whether proceeds from the sale of scrap and by-products are revenue from contracts with customers.

Implementation considerations

Broader impacts

Financial and operational system changes

- Existing systems may not capture required data
- Inventory of incremental information
- Processes re-designed
- Update systems vs new systems
- Dual systems for certain transition options
- Processing changes to contracts

Internal control assessment

- Effect on internal control environment
- New controls vs modify existing controls
- Identify new risk points
- Management review controls
- IT controls
- Process level controls

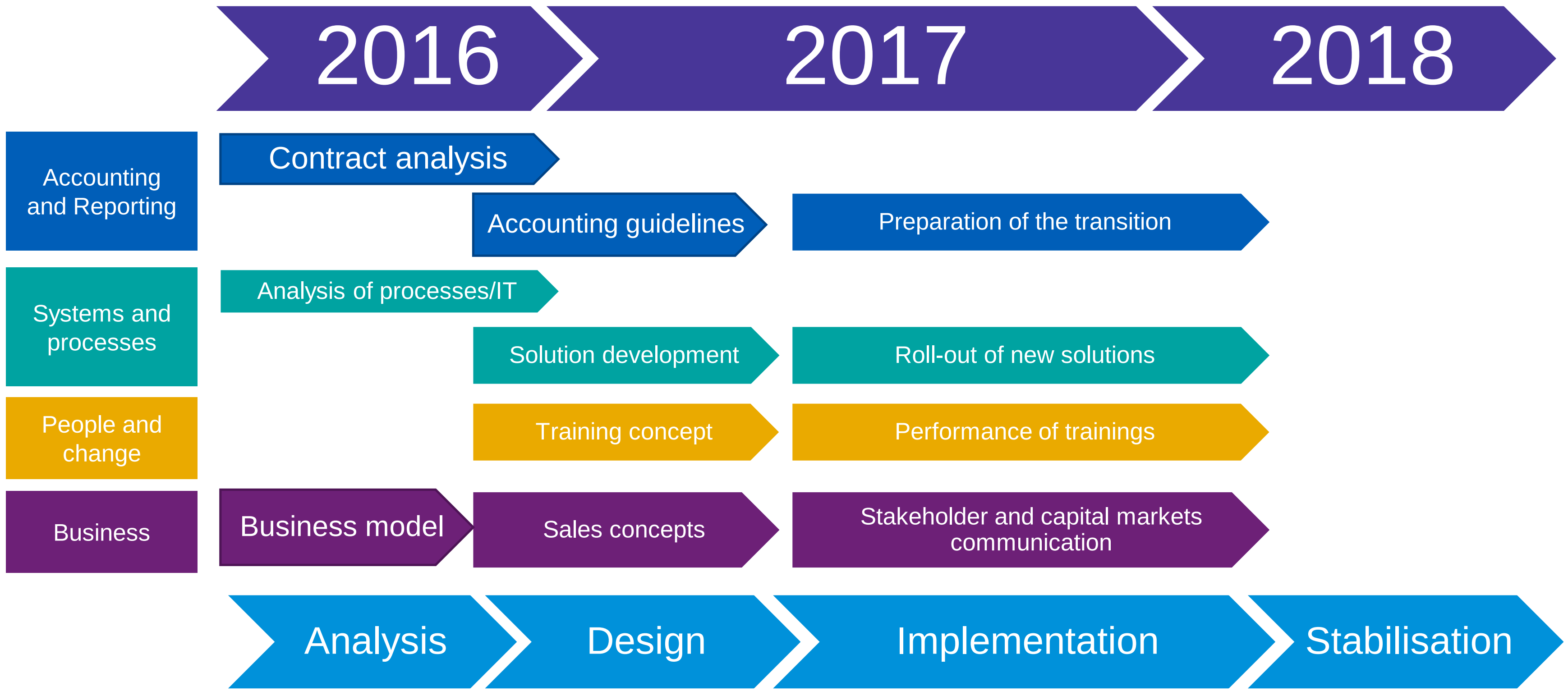
Governance and change

- Impact on internal resources
- Revenue change management team
- Change to contract practices
- Training (accounting, sales, etc)
- Multi-national locations
- Effect on management compensation metrics
- Impact on forecasting and budgeting processes

Communication with stakeholders

- Key to successful implementation
- Identify relevant stakeholders
- Messaging
- Timing of communication
- Comparability of data communicated
- Expected impact of change

Implementation requires time…



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Next steps

**Assessing the impact to your organisation is a critical first step.
The following activities may help position you to plan an effective implementation:**

1. **Establish project team and governance**
2. **Determine impacts to your accounting policies and disclosures**
3. **Identify new information requirements**
4. **Identify system and process gaps**
5. **Consider impact to internal controls**
6. **Involve tax resources**

Next steps

7 **Identify other parties that need to be involved**

8 **Develop initial thoughts regarding transition approach**

9 **Build a project plan**

10 **Determine the resource needs**

11 **Communicate with stakeholders and those charged with governance**

12 **Involve your external auditor throughout the process**

What questions do you have?

KPMG resources available

Implementation considerations for revenue standard – AASB 15

17 September 2015

Are you across the latest updates regarding the new revenue recognition standard AASB 15? We provide a refresher on the core concepts of the new revenue recognition model of AASB 15 Revenue from Contracts with Customers. We outline some of the key implementation challenges identified in the 18 months since the revenue standard was issued.

Highlights

- Webinar outline
- Revenue recognition standard AASB 15 – implementation considerations
- Revenue recognition standard AASB 15 webinar: September 2015

Thank you

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