

IFRS industry insights: Retail, wholesale and distribution sector

New revenue Standard could impact profile of revenue and profit recognition

Headlines

- The **profile of revenue and profit recognition** will change for some entities as the new Standard is more detailed and more prescriptive than the existing guidance and introduces new complexities. In particular, retail, wholesale and distribution companies will need to consider:
 - the type of **warranty** coverage offered to customers;
 - the accounting for **customer loyalty schemes** and similar arrangements;
 - how **shipping** terms will impact the timing of recognition of revenue;
 - the impact of new guidance where pricing mechanisms include **variable amounts**;
 - the appropriate accounting for **customer options to acquire additional goods and services at a discount**;
 - how the new Standard will impact presentation of **payments made to customers**, e.g. slotting fees; and
 - whether revenue must be adjusted for the effects of the **time value of money**.
- The new Standard requires significantly more **disclosures** relating to revenue and entities will need to ensure that **appropriate processes** are in place to gather the information.

What's happened?

The International Accounting Standards Board (IASB) has published a new Standard, IFRS 15 *Revenue from Contracts with Customers* ('the new Standard'). The new Standard outlines a single comprehensive model of accounting for revenue arising from contracts with customers and supersedes current revenue recognition guidance, which is found currently across several Standards and Interpretations within IFRSs. The core principle is that an entity recognises revenue to reflect the transfer of goods or services, measured as the amount to which the entity expects to be entitled in exchange for those goods or services.

The new Standard is effective for reporting periods beginning on or after 1 January 2017, with earlier application permitted. Entities can choose to apply the Standard retrospectively or use a modified approach in the year of application. It is the result of a convergence project with the US Financial Accounting Standards Board (FASB) that began in 2002. Almost fully converged, the most significant differences between IFRSs and US GAAP relate to interim disclosures and timing of adoption.

Implications for the retail, wholesale and distribution sector

Below, we highlight certain key impacts resulting from the new Standard that will be of particular interest to those in the retail, wholesale and distribution sector and then consider parts of the new Standard that may contribute to those impacts. Of course many more complexities exist and, as described below, Deloitte has produced further guidance which explores these in greater detail.

How might this affect you?

The timing of revenue and profit recognition may be significantly affected by the new Standard

Whereas previously IFRSs allowed significant room for judgement in devising and applying revenue recognition policies and practices, IFRS 15 is more prescriptive in many areas relevant to the retail, wholesale and distribution sector.

Applying these new rules may result in significant changes to the profile of revenue and, in some cases, cost recognition. This is not merely a financial reporting issue. As well as **preparing the market and educating analysts** on the impact of the new Standard, entities will need to consider wider implications. Amongst others, these might include:

- changes to **key performance indicators** and other **key metrics**;
- changes to the **profile of tax cash payments**;
- availability of **profits for distribution**;
- for **compensation and bonus plans**, impact on the timing of targets being achieved and the likelihood of targets being met; and
- potential non-compliance with **loan covenants**.

Current accounting processes may require changes to cope with the new Standard

As explained below, IFRS 15 introduces new requirements to move to a more conceptual approach. The complexity of applying this approach and of producing the detailed disclosures required by the new Standard in the retail, wholesale and distribution sector may require modifications to existing accounting systems and, in some cases, entities may conclude that they should develop new systems processes. Entities should ensure they allow sufficient time to develop and implement any required modifications to processes.

What are the most significant changes?

How should warranties be accounted for?

The new Standard distinguishes between a 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. 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, judgment 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 recognised (e.g. customer loyalty schemes)?

Many retailers 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. If an entity expects to benefit from breakage, it should recognise 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 recognise 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?

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 focuses on when control of those goods has transferred to the customer. This different approach 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 a matter of business practice, may compensate customers for loss or damage during shipping (either through credit or replacement). Previously, revenue may have been recognised only at the point of delivery, on the basis that some exposure to risks 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 the point of delivery. This may result in revenue being recognised at a different time. If revenue is recognised 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 recognised when the service is provided.

When should variable or uncertain revenues be recognised?

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 recognised would not be subject to significant future reversals as a result of subsequent re-estimation. 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 judgement 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 introduces a specific restriction for royalty payments relating to licences of intellectual property, for example, some types of retail franchise licences. If royalty payments are based on usage or onward sale, entities are restricted from recognising 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?

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. In this type of scenario, an entity must allocate a portion of the transaction price to the option and recognise 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?

In this sector, 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). 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?

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. 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 else might change?

In addition to the key changes discussed above, the new Standard introduces detailed guidance in many areas regarding the reporting of revenue and entities will need to ensure that they have considered all of these when assessing the extent to which their accounting policy for revenue may need to be amended.

More detailed information on the impact of IFRS 15 can be found in Deloitte's IFRS in Focus publication available from www.iasplus.com. Further industry publications are also available here.

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