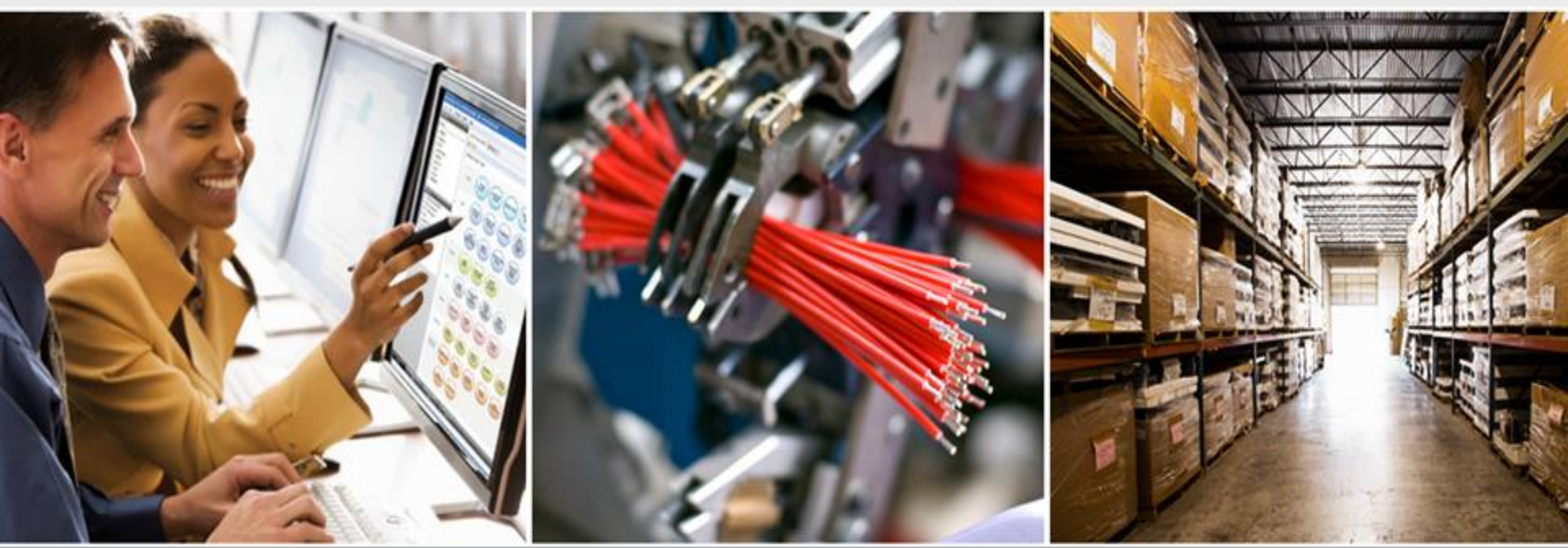
Revenue Recognition: ASC 606 & IFRS 15 From A Manufacturer's Perspective

August 29, 2016

V4.2



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Situation Overview

New Revenue recognition rules are coming into effect that will change the way some companies recognize revenue. Changes in these provisions may make revenue recognition more complicated for manufacturers.

The objective of the new rules is to establish the principles to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue from contracts with customers.

From a manufacturer's perspective the following are some examples of practices that may be impacted:

- Goods and services on same order or that are interrelated or cannot be used independently (for example required installation services for a piece of machinery).
- Selling goods with volume discounts, rebates, interest-free credit, financing arrangements, discounted settlement terms or entitlements to free goods
- Using Incoterms (International Commercial Terms) that transfer title to goods on receipt
- Selling goods on a sale or return basis
- Providing a warranty with your products
- Changing prices for products during life of an order

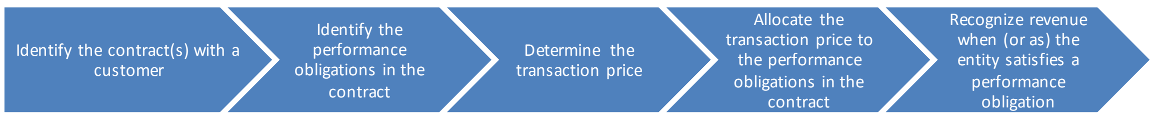
The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly drafted the standards embodied in FASB Accounting Standards Codification (ASC) 606 and International Financial Reporting Standards (IFRS) 15 respectively. These standards help to clarify the principles for recognizing revenue and can be applied consistently across various transactions, industries, and capital markets. Both are designed to improve financial reporting by creating common revenue recognition guidance for U.S. GAAP and IFRS.

Challenges

Main provisions

The core principle is that revenue should be recognized in an amount and time period that is aligned with the expectation of the actual amount to be earned and when it is earned (ie goods or services are delivered).

To achieve this core principle, an entity should apply the following steps:



The new standard requires more extensive disclosures in the financial statements, even if the new rules mean for some companies that there is no real change to the process of determining revenue recognition or the results themselves.

Identify the contract(s) with a customer

Identify contracts for revenue recognition purposes, which may not match with a single sales order in the system. There may be cases where what is delivered against two or more orders may be considered as part of a single contract for revenue recognition purposes. Under ASC 606, a contract is defined as an agreement between two or more parties that creates enforceable rights and obligations where enforceability is "a matter of law."

Identify the performance obligations in the contract

Define individual performance obligations within the contract against which revenue may be allocated. It could be that case that several order lines are considered to be part of the same performance obligation, where they are not considered to be distinct promises to transfer goods or services.

Determine the transaction price

Determine the impact of pricing, discounts, rebates and free goods on the amount of revenue that can be recognized at each stage of the contract. Revenue must be allocated to performance obligations on the basis of standalone selling prices, and revenue must be determined net of variable consideration. Variable consideration takes into account the expected outcome of future event, such as volume discounts, cash settlement discount, etc.

Allocate the transaction price to the performance obligations in the contract

There is a need for qualified accounting staff to be involved in applying judgment from the inception of contracts and through all stages of delivery against such contracts to define, estimate and record the elements required to properly determine the revenue recognition for that contract.

Recognize revenue when (or as) the entity satisfies a performance obligation

Management needs to determine when control has passed to the customer, and whether such control passes over time. The new standard could mean that, in some cases, revenue has to be recognized earlier than under previous standards which would have required that revenue was only recognized at the end of the process when all of the economic risk had transferred to the customer. In other cases, revenue recognition could be later than under previous standards, if all the criteria in the new standards are not met.

Why is the change being made?

Revenue is a key measure used by stakeholders to evaluate a company's financial performance and position. Previous revenue recognition requirements varied around the world and were in need of improvement.

U.S. GAAP guidelines contained both broad concepts and specific requirements by industry or transaction type which sometimes resulted in different accounting for economically similar transactions. In contrast, IFRS provided limited guidance making application difficult in complex transactions and for multiple element arrangements.

To address these issues, the FASB and the IASB initiated a joint project to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and IFRS that would:

1. Remove inconsistencies and weaknesses in revenue requirements
2. Provide a more robust framework for addressing revenue issues
3. Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets
4. Provide more useful information to users of financial statements through improved disclosure requirements
5. Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer

The result of these efforts is ASC 606 (Revenue from Contracts with Customers) and IFRS 15 (Revenue from Contracts with Customers).

Who is impacted?

The new guidance on revenue recognition affects any reporting organization (public and nonpublic) that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts; a comprehensive list is provided in ASC 606-10).

From a manufacturing perspective, QAD customers with the following characteristics are more likely to be impacted:

- Food & Beverage / Consumer Packaged Goods: Sales promotions/variable pricing

- Automotive: Retroactive price changes, long term contracts
- Life Sciences: High value equipment with required after sales service
- Project related businesses

Companies that are Make to Stock (MTS) or Assemble to Order (ATO) are less likely to be significantly impacted.

When will this become a requirement?

Under ASC 606, public organizations should apply the new revenue standard to interim reporting periods within annual reporting periods beginning after December 15, 2017. Nonpublic organizations should apply the new revenue standard to interim reporting periods within annual reporting periods beginning after December 15, 2018. IFRS 15 is effective for the first interim period within annual reporting periods beginning on or after January 1, 2018, with early adoption permitted.

Two methods exist for moving to the new standard: full retrospective and simplified transition (also known as modified retrospective application). Both methods seek to establish dual reporting for a period of time to allow for comparisons and baselines. Under full retrospective adoption, companies would track revenue using the existing and new standard at least 1 year prior to when the requirements take effect. Under the Simplified Transition method, companies would start tracking according to the new rules when the requirements come into effect and correct the first period for contracts not yet completed while applying both the new revenue standard and previous standard for the first year of initial application.

Solution Description

What should you do?

With an effective date rapidly approaching preparations should be made now. The impact of the new standard is likely to be different for each company, and will depend on the industry in which they operate.

Rules are open to interpretation and Industry specific interpretation of rules are still under discussion. Talk with your auditors for guidance on how these rules apply to your company and work to develop a plan to address the new rules.

Companies need to consider how the new revenue recognition will affect other departments than the Finance department, including possible changes to the way that goods and services are sold, and the way in which sales staff and other employees are remunerated.

Enhancements or customizations to your various software applications may be required in order to support any process changes that you need to make in light of the new regulations.

If you are impacted by these new regulations QAD can help.

How QAD Can Help

QAD Services can conduct a Revenue Recognition Q-Scan assessment to help determine what process and software options makes the most sense given the level of impact the new regulations have on your business and the version of the software you are currently running.

For customer currently running Enterprise Financials, the QAD Revenue Recognition Module is the suggested approach to evaluate. More information on the QAD Revenue Recognition module is available in the next section.

Customers not running Enterprise Financials should consider an upgrade to Enterprise Financials to access the native functionality that can help address the new regulations.

QAD is developing a Revenue Recognition Hub that will allow SE and Pre SE customers to remain on their current release and leverage the functionality delivered in the Revenue Recognition Module outlined above. With additional services, the hub can be extended to cover 3rd party ERP systems.

Other options exist including implementing manual process (spreadsheets, manual journal entries, use of extra entities for dual reporting period), Customizations to reduce amount of manual work and potential for errors to meet compliance requirements and 3rd party solutions with associated integration.

The Revenue Recognition Q-Scan assessment is designed to assist you in the evaluation of these options.

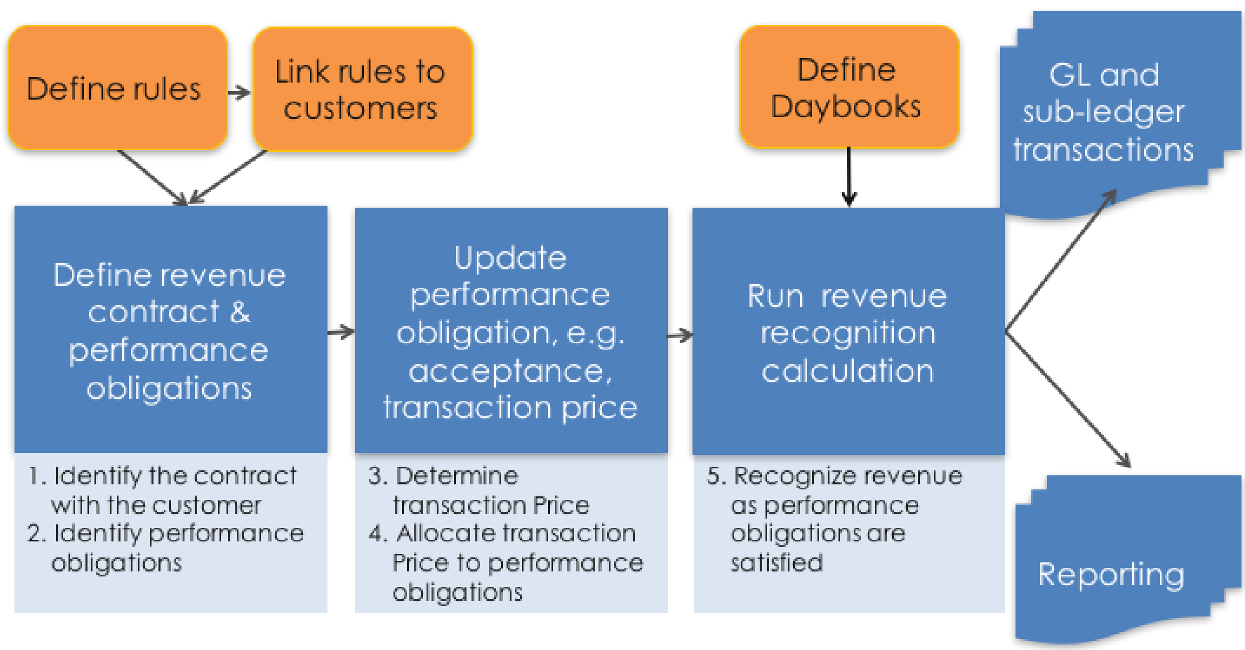
QAD Revenue Recognition Module

QAD is developing a Revenue Recognition module. The module is being developed for QAD Financials 2017 and will also run on any prior version of Enterprise Edition. Enterprise Financials was selected as a target edition for its support of Dual Books which is an important component of the solution.

The Revenue Recognition module makes it easier for Manufacturers to meet the requirements associated with the new rules. It provides for greater visibility, real time reporting, an audit trail, one integrated enterprise system for revenue recognition, and the ability to report both under the new rules and without them.

The solution delivers the software components to define and store rules, link the rules to customers and performance obligations, define daybooks, and create associated Gl and Sub-ledger transactions.

The following QAD Process flow maps the steps outlined in the standards set forth by FASB and the IASB.



Key components of the solution are outlined below.

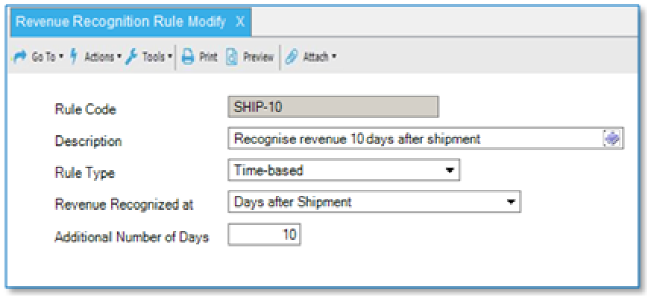
Rule Maintenance

The module provides a means for rule maintenance and provides pre-defined rule types including:

- Acceptance

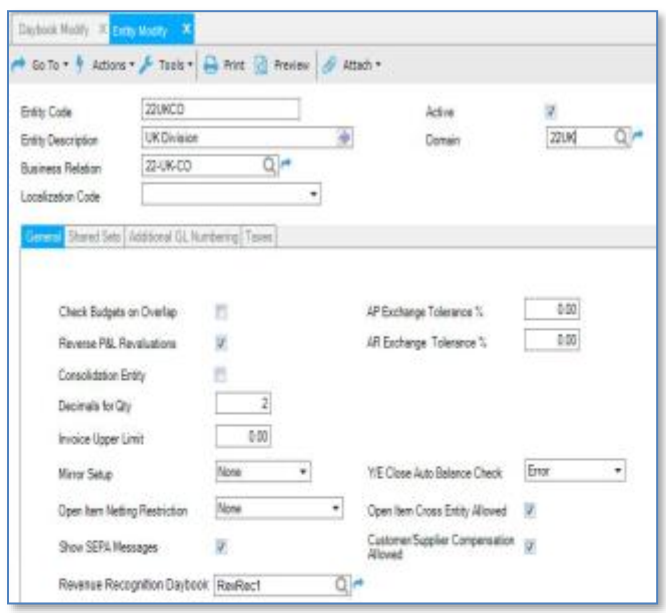
- Payment
- Number of days from shipment/invoice
- Percentage of completion
- Periodic recognition, e.g. for services

Beyond the pre-defined rule types, customization options are available. By default, rules link to customer then to performance obligations.



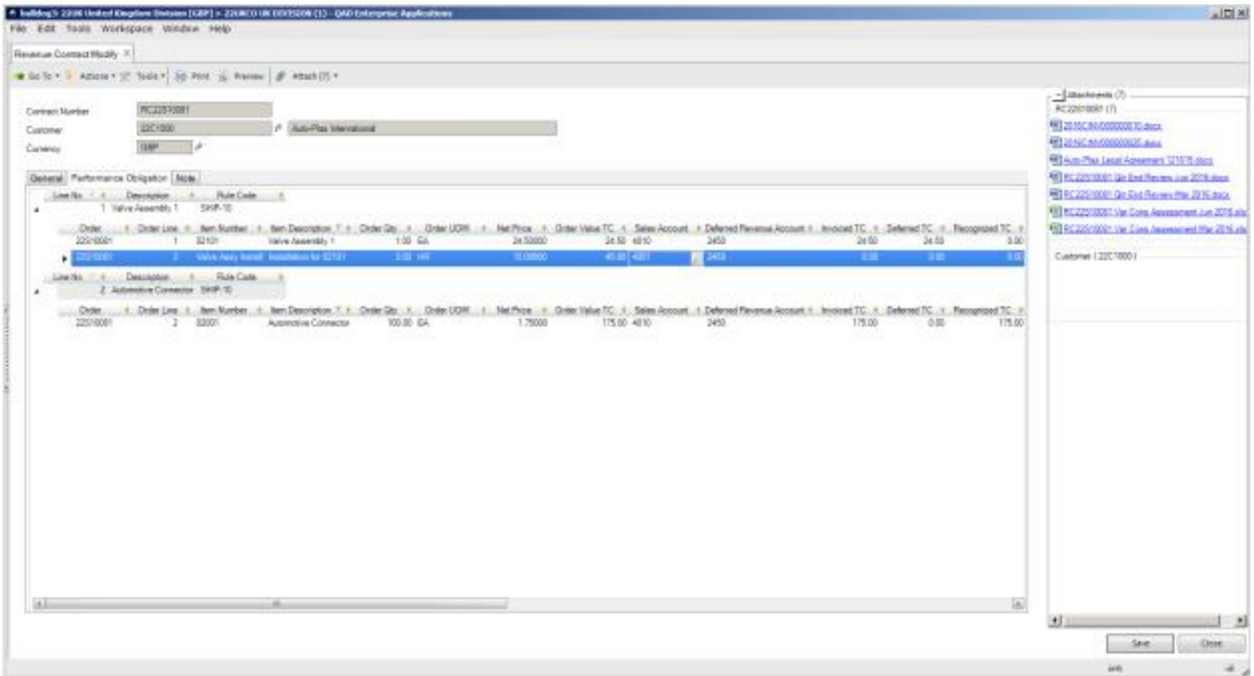
Daybooks

Revenue Recognition in stored in a separate sub-ledger and requires a separate daybook type. Multiple daybooks of this type are allowed and provide for posting to official or management layers. Daybooks can also be configured for auto posting per entity.



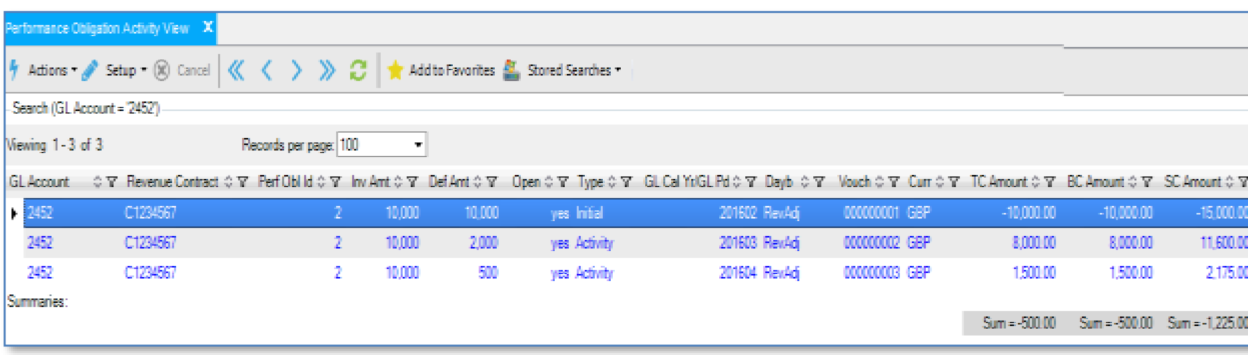
Revenue Contracts

Revenue contracts are created within the Revenue Recognition module. Each contract can link to sales orders, operational and financial invoice records. One contract can contain several orders. One order/invoice can be split between two or more revenue contracts. The associated contract documents and recognition calculation worksheets can be stored in the system as attachments.



Revenue Recognition Sub-Ledger

The sub-ledger stores detailed revenue recognition transactions at performance obligation level. It provides a full audit trail of movements on deferred revenue accounts and allows for “as of date” reporting.



Performance Obligation Activity View

Actions Setup Cancel Add to Favorites Stored Searches

Search (GL Account = '2452')

Viewing 1 - 3 of 3 Records per page: 100

GL Account	Revenue Contract	Perf Obl Id	Inv Amt	Def Amt	Open	Type	GL Cal Yr/GL Pd	Dayb	Vouch	Curr	TC Amount	BC Amount	SC Amount
2452	C1234567	2	10,000	10,000	yes	Initial	201602	RevAdj	000000001	GBP	-10,000.00	-10,000.00	-15,000.00
2452	C1234567	2	10,000	2,000	yes	Activity	201603	RevAdj	000000002	GBP	8,000.00	8,000.00	11,600.00
2452	C1234567	2	10,000	500	yes	Activity	201604	RevAdj	000000003	GBP	1,500.00	1,500.00	2,175.00
Summaries:											Sum = -500.00	Sum = -500.00	Sum = -1,225.00

Conclusion

New Revenue recognition rules are coming into effect that will change the way some companies recognize revenue. Changes in these provisions may make revenue recognition more complicated for manufacturers.

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If you are unable to move to Enterprise Financials other options exist.

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For more information, please contact QAD at revrec@qad.com