IFRS 15 REVENUE FROM CONTRACTS WITH CUSTOMERS – PRACTICAL ISSUES
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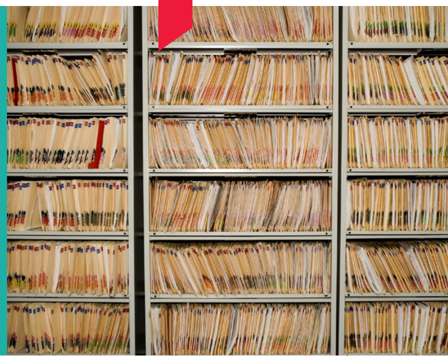

Background

In May 2014, the International Accounting Standards Board published IFRS 15 *Revenue from Contracts with Customers*. The new Standard contains comprehensive guidance for accounting for revenue and will replace existing requirements which are currently set out in a number of different Standards and Interpretations.

IFRS 15 is fully converged with equivalent new US GAAP guidance and contains significantly more prescriptive and precise requirements in comparison with existing IFRS. This means that for many entities, the timing and profile of revenue recognition will change. In some areas the changes will be very significant and will require careful planning, including for commercial effects.

IFRS 15 also introduces significantly more disclosures about revenue recognition. It is possible that new and/or modified internal processes will be needed in order to obtain the necessary information.

This publication sets out an initial analysis that highlights certain areas that are of particular significance for the first time application of IFRS 15 and looks briefly at the commercial effects that are likely to be relevant. These commercial effects may be very significant, meaning that entities would be well advised to carry out an assessment of the likely effects of IFRS 15 at an early stage.

STATUS
Final

EFFECTIVE DATE
1 January 2017

ACCOUNTING IMPACT
Wide and potentially very significant effects on the timing and profile of revenue and profit recognition in comparison with current guidance. Significantly increased disclosure requirements.

Overview

The core principle is that a vendor should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the vendor expects to be entitled in exchange for those goods or services.

Revenue will now be recognised by a vendor when or as control over the goods or services is transferred to the customer. In contrast, IAS 18 *Revenue* based revenue recognition around an analysis of the transfer of risks and rewards; this now forms one of a number of criteria that are assessed in determining whether control has been transferred.

The application of the core principle in IFRS 15 is carried out in five steps.

The first step is to identify the contract(s) with the customer. Whatever the form, a contract creates enforceable rights and obligations between a vendor and its customer.

After identifying the contract(s) with the customer, a vendor identifies the 'performance obligations'. A performance obligation is a promise by the vendor to transfer goods or services to a customer. Each performance obligation is 'distinct', being either:

– a good or service from which the customer can benefit on its own (or in combination with other readily available goods and services); or
– two or more distinct goods and services (such as the supply of construction material and labour) are combined if, in reality, they represent one overall obligation.

In the third and fourth steps, a vendor determines the transaction price of the entire contract and then allocates the transaction price among the different performance obligations that have been identified.

In the fifth step, a vendor assesses when it satisfies each performance obligation (which may be at a point in time, or over time) and recognises revenue. The principle is based around the point at which the customer obtains control of the good or service.

Effective Date

IFRS 15 is required to be applied retrospectively for periods beginning on or after 1 January 2017. Early application is permitted. The retrospective application can be made using one of the following methods:

i. Retrospective application to each reporting period presented in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (that is, full restatement of comparative figures)
ii. Retrospective application with practical expedients which simplify the transition
iii. Retrospective application with the cumulative effect of initially applying IFRS 15 recognised directly in equity (retained earnings).

If an entity chooses the latter method, additional disclosures need to be provided stating the amount by which each financial statement line item is affected as compared to IAS 11 *Construction Contracts* and IAS 18 and their related Interpretations. Additionally, the entity is required to explain the reasons for significant changes identified.

Significant issues

Our initial analysis of IFRS 15 indicates that the following areas may be of particular significance:

– Is revenue recognised at a single point in time, or over a period of time?
– If revenue is recognised over time, how should progress towards completion be measured and recognised?
– Will a contract need to be 'unbundled' into two or more components, or two or more contracts 'bundled' into a single overall obligation?
– How should contracts which include variable amounts of consideration (including rights of return) be dealt with?
– How should modifications to contracts be dealt with?
– Should costs associated with obtaining a contract be capitalised, or expensed immediately?
– What adjustments are required for the effects of the time value of money (a 'financing component')?

Figure 1: Five-step approach

Is revenue recognised at a point in time, or over a period of time?

IFRS 15 contains specific, and more precise, guidance to be applied in determining whether revenue is recognised over time (often referred to as 'percentage of completion' under existing guidance) or at a point in time.

There are three criteria, each of which would result in recognition over time. These are:

- The customer simultaneously receives and consumes the benefits provided by the vendor's performance as the vendor performs the service
- The vendor's performance creates or enhances an asset (for example, work in progress) that is controlled by the customer as work progresses
- The vendor's performance creates an asset which does not have an alternative use to the vendor, and the vendor has an enforceable right to be paid for work completed to date.

The first criterion applies to certain contracts for services, and in some cases it will be straightforward to identify that it has been met. For example, for routine or recurring services it will be clear that there is simultaneous receipt by the customer of the vendor's performance. The concept of control of an asset applies, because services are viewed as being an asset (if only momentarily) when they are received and used.

The second criterion is most likely to be relevant when an asset is being constructed on the customer's premises. The asset being sold by the vendor could be tangible or intangible (for example, a building that is being constructed on land owned by the customer, or customised software that is being written into a customer's existing IT infrastructure).

For the third criterion, the first question which needs to be addressed is whether the asset being created has what is termed 'an alternative use to the vendor'. The vendor may not have an alternative use for the asset if contractually restricted from using the asset for any purpose other than selling it to the specific customer. This might be the case if the asset is being manufactured to the customer's specification and could not readily be sold to any other customer without significant modifications being made and significant additional costs incurred. Alternatively, if creation takes a substantial period of time (even if the asset is to a relatively standard specification) the contract with the customer may have specified timing. This could have the effect that the asset to be transferred to that customer is specifically identified from the point at which creation commences.

If the first part (no alternative use to the vendor) of the third criterion is met, there will then be significant focus on whether the vendor has, at all stages of the contract, an enforceable right to be paid for the work which has been completed to date. This will require careful analysis of the precise terms of each contract, including in particular the effect of any terms that permit the customer to cancel, curtail or significantly modify the existing contract. This analysis may also require consideration of the general (or common) law in each jurisdiction. The focus is on whether in all circumstances, other than the vendor's failure to fulfil its obligations under the contract, the customer will be required to pay for performance to date. This needs to be an amount that approximates the selling price of the goods or services that have been provided to date; compensation for loss of profit does not satisfy this condition. Alternatively, the vendor may have the legal right and practical ability to require completion of the contract and payment by its customer.

If revenue is recognised over time, how should progress towards completion be measured and recognised?

If revenue is recognised over time, the overall principle is that revenue is recognised to the extent that each of the vendor's performance obligations has been satisfied.

IFRS 15 permits either output or input methods to be used to calculate the amount of revenue to be recognised. An output method results in revenue being recognised on the basis of direct measurement of the value of goods or services transferred to date, while input methods result in revenue being recognised based on measures such as resources consumed, costs incurred, time records or machine hours.

It is noted explicitly that when input methods are used, there may not be a direct relationship between the inputs being used, and the transfer of goods or services to a customer. Consequently, any inputs that do not relate directly to the vendor's performance in transferring those goods or services are excluded when measuring progress to date.

Certain contracts require administrative or other set-up activities to be carried out in order that an entity is in a position to carry out the services specified in a contract. Under IFRS 15, these activities do not give rise to revenue. Instead, consideration is given to whether the costs incurred in setting up a contract meet the criteria to be capitalised as a contract asset.

Will a contract need to be 'unbundled' into two or more components, or two or more contracts 'bundled' into a single overall obligation?

Previously, IFRS had little guidance for 'unbundling' contracts into components. In contrast, IFRS 15 contains detailed guidance and it is likely that many entities will need to amend their current accounting policies and approaches. This may have a significant effect on the pattern of revenue and profit recognition. Items that may need to be accounted for separately include incentives offered at the time of sale (such as free periodic servicing and maintenance for a specified period, or a warranty that goes beyond providing assurance that the item being supplied conforms with its agreed upon specification).

IFRS 15 also requires two or more contracts to be combined and accounted for as a single contract if one or more of the following conditions are met:

- The contracts are negotiated as a package with a single commercial objective
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract
- The goods or services promised in the contracts (or some of them) are a single performance obligation.

The purpose of this guidance is to ensure that, for a particular good or service, regardless of the legal form of a contract (or contracts) with a customer, the accounting will be the same. Consequently, careful consideration will be required of the commercial objectives of, and item(s) covered by, one or more contract(s) with the same customer.

How should contracts which include variable amounts of consideration be dealt with?

Contracts for the sale of goods or services often contain clauses which can give rise to variations in the amount of consideration receivable by the vendor. For example, a customer might be granted a retrospective rebate if a specified quantity of a particular good is purchased during a specified period. Alternatively, for a more complex contract under which a good or service takes some time to complete, a bonus payment might be receivable if the good or service has been completed before a specified date, with penalties being deducted from the sales price if completion is late. In other contracts, a customer may be able to return goods and receive a refund, credit or another product in exchange.

These clauses give rise to what IFRS 15 calls 'variable consideration'. This is significant, because when consideration is variable IFRS 15 places a limit on the amount that can be recognised. This limit means that revenue is only recognised when it is highly probable that there will not be a significant reversal in the cumulative amount of revenue recognised to date (for example, because the criteria that were expected to be met for a bonus payment are not, in fact, satisfied). This may result in later recognition of revenue and profit in comparison with current accounting.

In assessing the amount of variable consideration which should be recognised, IFRS 15 permits two approaches. One, which applies to circumstances in which a large number of similar contracts exist, is to look at the expected value over the portfolio. The other, which would generally be applied when there are only two possible outcomes (for example, a bonus payment will or will not be received), is the most likely outcome – subject to the constraint over recognition.

To the extent that the vendor expects customers to exercise a right of return, revenue is not recognised for the related goods even though these may already have been transferred to the customer. Instead, a refund liability is recognised together with an asset (and corresponding adjustment to cost of sales) for the right to recover the original asset (depending on whether the item recovered would have any value).

How should modifications to contracts be dealt with?

It is common for the scope and/or price of contracts to be modified, due to changes in the number of items to be supplied, or the addition of new items to an order. For larger contracts, changes might be made to the specifications of the goods or service to be supplied under an existing contract and to similar goods or services to be supplied in future.

IFRS 15 has detailed guidance to be applied in determining whether, from an accounting perspective, contract modifications result in changes to the existing contract or the creation of a new contract, and whether there is either an adjustment to the amount of revenue recognised to date (resulting in a 'true up' in the income statement) or to revenue to be recognised in future. These new requirements may result in significant changes to the pattern of revenue recognition.

Should costs associated with obtaining a contract be capitalised, or expensed immediately?

In addition to the substantially more detailed guidance for revenue recognition, IFRS 15 contains prescriptive criteria to be applied when determining whether costs associated with the acquisition of a contract should be recognised as an asset, or expensed as incurred. This extends to cover all contract acquisition costs, such as bid costs incurred prior to the award of a contract, as well as sales commissions.

IFRS 15 is restrictive, in that it permits only incremental costs of obtaining a contract to be considered. Consequently, only those costs which would not have been incurred if the contract had not been obtained are eligible to be considered. An example is a sales commission which is only payable in the event that a contract is awarded. In contrast, ongoing costs of running the business, such as a legal department, are not eligible to be considered because these costs would have been incurred regardless of whether a specific contract had been obtained. Although it might be argued that the legal department would not be needed unless an entity was involved in obtaining sales contracts, IFRS 15 does not permit those contracts to be analysed on a portfolio basis. Instead, the focus is on whether costs attributable to each individual contract are incremental.

Once incremental costs have been identified, these are recognised as an asset if there is an expectation that they will be recovered, typically through profits to be generated from the related contract. This asset is then amortised on a basis that is consistent with the transfer of the goods or services specified in the contract. It will be necessary for judgement to be applied in determining an appropriate amortisation period and profile.

What adjustments are required for the effects of the time value of money (a 'financing component')?

Contracts can involve cash receipts from customers which do not correspond with the timing of the recognition of revenue. If a financing component is significant, IFRS 15 requires an adjustment to be made for the effect of implicit financing.

As a practical expedient, adjustments for a financing component are not required when there is a period of less than one year between the transfer of goods or services and the receipt of payment from a customer.

In a major change from existing practice, adjustments for a financing component are required for circumstances in which customers pay in advance, as well as in arrears. Payments in arrears will result in finance income and a reduction in revenue (because the vendor is providing finance to its customer), while payments in advance will result in a finance expense and an increase in (deferred) revenue (because the vendor is, in effect, borrowing funds from its customer).

The purpose of this approach is to reflect the 'cash selling price' of the underlying good or service at the point at which it is transferred to the customer. It also results in transactions which involve a significant financing component being split into two parts; one for the sale of the good or service and the other for the financing arrangement. However, the implications for the internal processes and systems that are needed in order to identify when a financing component is to be recognised, and to account for this, may be significant.

Commercial Effects

The adoption of IFRS 15 may lead to significant changes in the pattern of revenue and profit recognition. Careful consideration and planning will be needed for a wide range of issues, including the effect on:

- Compliance with bank covenants
- Performance based compensation (including share-based payments)
- Internal budgeting processes
- Corporate tax obligations
- Market and investor communications, including compliance with regulatory requirements (which might arise from significant expected future changes to an entity's reported financial position or performance).

A review of the terms and conditions of existing contracts will be needed (in particular long term contracts which extend into periods covered by financial statements affected by the adoption of IFRS 15) as well as those which are to be entered into in future. In some cases, entities may wish to consider whether changes should be made to contracts.

It is also likely that sales departments will need to liaise more closely with the accounting department in future, in order that the effects of any proposed contractual terms on the related financial statements can be understood in advance.

Other potential issues to consider

Different businesses will be affected by various elements of the standard depending on their individual circumstances including how they operate. Much of this may be driven by specific industry sector dynamics and methods of operation.

BDO's *IFRS Industry Issues* publications highlight how businesses in specific industry sectors may be affected. These publications can be accessed through the IFRS section of our international website (bdointernational.com) or via the links below:

- **Manufacturing**
- **Construction & Real Estate**
- **Media**
- **Professional Services**
- **Retail**
- **Software**
- **Telecommunications**.

Disclosures

Comprehensive disclosure requirements have been included in IFRS 15. Even if an entity concludes that the effect of the new standard on revenue recognition is not significant, changes to internal systems and processes may be required to enable the necessary information to be collected for disclosures. These disclosures include quantitative and qualitative information about a vendors:

- Contracts with customers
- Significant judgements, and changes in the judgements, made in applying IFRS 15 to those contracts
- Assets recognised in respect of costs of obtaining contracts, and in fulfilling contracts.

In addition to the detailed guidance, an overall disclosure objective has been included together with an explicit statement that immaterial information does not need to be disclosed and the disclosure requirements should not be used as a checklist. This is because some disclosures may be very relevant for certain entities or industries, but irrelevant for others. It is also intended to encourage entities to give careful consideration to the information that they will include in their financial statements in order to meet the disclosure objective. However, this again brings the need for careful planning, well in advance of adoption of the new requirements.

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