IFRS 15 Revenue from Contracts with Customers

Introduction

- IFRS 15 Revenue from Contracts with Customers, issued in April 2014:
    - Introduces a single revenue model for entities to apply in accounting for revenue arising from contracts with customers.
    - Supersedes IAS 18 *Revenue,* IAS 11 *Construction contracts,* IFRIC 13 *Customer Loyalty Programmes,* IFRIC 15 *Agreements for the Construction of Real Estate,* IFRIC 18 *Transfers of Assets from Customers* and SIC-31 *Revenue – Barter Transactions Involving Advertising Services.*
- The core principle is that an entity should recognise revenue to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.
- IFRS 15 is effective for annual periods beginning on or after 1 January 2017 with early application permitted. Entities are allowed to choose whether to apply IFRS 15 retrospectively to each prior period presented (with optional practical expedients) or retrospectively with the cumulative effect of initially applying IFRS 15 recognised at the date of initial application.
- IFRS 15 will affect all entities applying the standard whether they are public or non-public, for-profit or not-for-profit.

This guidance paper should be read with the following PKF resources, which are available from http://www.pkf.com/ifrs or, for PKF member firms, from PKF-365:
- Accounting Update 15 – Revenue
- IFRS Summary – IFRS 15 Revenue
- IFRS Snapshot – IFRS 15 Revenue

Planning for adoption of the new standard

Entities are allowed to choose whether to apply IFRS 15 retrospectively to each prior period presented (with optional practical expedients) or retrospectively with the cumulative effect of initially applying IFRS 15 recognised at the date of initial application.

Under the retrospective application, an entity restates its prior period comparatives in the financial statements as if the guidance had always existed.

Under the alternative transition method, restatement of comparative years is not required but the cumulative effect of initially applying IFRS 15 should be recognised as an adjustment to the opening retained earnings on the effective date (in the year of initial application). Additional disclosures are then required to illustrate the effects of applying the standard. Although this method offers a simpler alternative, the challenges of applying IFRS 15 remain.

The transition could prove to be difficult for entities that have multi-year contracts. If an entity opts to retrospectively apply IFRS 15, it should consider starting to accumulate the necessary records now.

Illustration – Multi-year contracts

This is to illustrate how three different contracts would be treated under the different methods at transition date. Note that the standard is effective for periods beginning on or after 1 January 2017.

	Contract Term	Retrospective approach	Modified Approach
Contract A	1 January 2014 to 31 December 2019	Adjust the opening balance of each affected component of equity in the balance sheet for the earliest prior period presented.	Adjust the opening balance of each affected component of equity at initial application and make the required disclosures. 2016 figures are not restated
Contract B	1 January 2014 to 31 December 2016	Adjust the opening balance of each affected component of equity in the balance sheet for the earliest prior period presented.	Contract completed before effective date therefore do not apply IFRS 15.
Contract C	1 January 2016 to 31 December 2016	Practical expedient available as it begins and ends in the same annual reporting period.	Contract completed before effective date therefore do not apply IFRS 15.

Preparing for the changes

Almost all entities that generate revenue will be affected by the issue of this new standard as it may result in substantial changes to the timing and measurement of revenue recognition, and introduces significantly revised disclosure requirements. Entities should begin the process of assessing the impact of the standard and the changes that will be required well before implementation.

The following are suggested steps in making this assessment and preparing for application of the new standard:

Identify important accounting and tax issues

The standard includes more prescriptive guidance than was included in the previous standards and their related interpretations. Due to the complexity of applying this approach, modifications to the existing accounting process may be required.

Most entities have well established and documented accounting policies for revenue recognition. These policies will have to be re-visited and amended based on the new requirements.

Revenue streams

IFRS 15 places emphasis on the need to assess revenue streams in order to identify all the individual performance obligations that are present in each stream. It is important to properly assess revenue streams to identify such obligations as they play an important part in determining the timing and magnitude of revenue recognition.

Transfer of control

According to IFRS 15, an entity shall recognise revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer, which is when control is passed, either over time or at a point in time. Control of an asset means having the ability to direct the use of, and obtain substantially all of the remaining benefits from the asset. Transfer of control is not the same as transfer of risks and rewards as per IAS 8. This could have a significant impact on the timing of revenue recognition.

Tax implications

Tax payments could be affected as a result of the timing changes of revenue recognition, therefore these payments may need to be made earlier or later depending on when revenue is recognised. From the implementation of the new standard new differences between financial reporting and tax accounting may arise as corresponding changes to tax laws may not be made, therefore changing the amount of deferred tax recognised.

Resolve areas that will require interpretation or judgement

The new standard entails interpretation and judgement to be applied and requires management to document their basis and rationale for such interpretations and judgements. A few examples have been included below.

Variable fees

Variable fees arise when an entity provides goods or services for a consideration that varies based on the occurrence or non-occurrence of a future event. The timing of recognition of variable fees may now change and need to be recognised sooner as a result of the new standard. Revenues for industries like construction, asset management, technology, life sciences, entertainment and media and engineering may have a significant portion of revenue that is made up of variable fees, such as performance bonuses and other forms of contingent consideration.

Per the previous standard such industries had to delay revenue recognition for variable fees until they were earned, received or the contingency resolved. Based on the new standard, revenue may be recognised earlier, **if** an entity can point to experience with similar arrangements. As a result of this, a new process may need to be established to estimate these variable amounts each year.

Time value of money

Time value of money plays an important role in the new standard. This is especially prevalent when a contract contains a significant financing component (explicit or implicit) as the transaction price will be affected. As a result, entities may face operational challenges associated with measuring the time value of money if they do not already apply this approach.

In addition, judgement will play a role in deciding what is considered to be significant. Although the standard does provide some relief in certain areas, in some situations it may be difficult to determine if a significant financing component exists.

As stated, the standard does provide relief in the form of a practical expedient which allows an entity to disregard the time value of money if the time between transfer of goods or services and payment is less than 12 months.

Licenses

Entities that license their intellectual property (IP) to customers will be greatly affected. Licenses allow a customer to use an entity’s IP such as trademarks, media and copyrights. An entity will need to determine whether the license transfers to the customer over time or at a point in time.

If the license is transferred over time, it allows a customer access to the IP as it exists during the licensing period. This is known as a dynamic license as the provider of the IP continues to undertake activities related to the IP and the customer is exposed to the effects of that activity. As a result the revenue would be recognised over the period of the license term.

If the license is transferred at a point in time, it allows a customer access to the IP as it existed when the license was sold. This is known as a static license as the IP does not change after the license is transferred to the customer. As a result the revenue would be recognised when the license is sold to the customer.

Disclosure

The new standard requires extensive disclosure that will provide a greater understanding about the revenue that has been recognised and the revenue that is expected to be recognised from existing contracts in the future. This ensures that there is sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve this, qualitative and quantitative information about revenue recognised, significant judgements and changes in those judgements and any assets recognised from the costs to obtain or fulfil a contract with a customer should be provided.

Entities will have to think carefully about how they communicate their results to their stakeholders on transition to IFRS 15 to ensure that the market understands the entity's performance.

Examine overall effect on financial arrangements

Compensation and bonus plans

Revenue recognition is the catalyst that triggers payments like bonuses in many entities. Many existing financial arrangements may need to be re-examined as it is important to consider how the timing changes for revenue recognition will affect these and other internal arrangements.

Contracts

Terms set out in existing contracts can take on a new meaning under the new standard. Debt covenants are often based on a measure of net income, however the timing of net income could change when IFRS 15 is applied. As a result of this an entity may need to re-negotiate debt covenants or customer contracts to maintain the original intent as they may unintentionally violate a debt covenant if their results change. In addition, an entity might want to reconsider how its customer agreements are structured as this could impact on whether revenue is recognised over time rather than at a point in time.

Evaluate controls, processes and systems affected

An entity's controls, processes and systems will most likely be impacted by the new standard and implementation of change may be a time consuming process. Most systems are automated and are designed to extract revenue amounts directly from the billing system.

When the new standard becomes effective, information from the billing system will need to be analysed to determine the separate performance obligations and the revenue to be recognised from those performance obligations. Many entities' revenue will be based on estimates as a result of accounting for variable considerations and reflecting the time value of money. For entities not accustomed to making such estimates, it will take time for them to collect and analyse the information before arriving at an estimate.

It is therefore important for entities to evaluate if their systems, processes and internal controls are currently adequate. When performing this evaluation an entity should consider whether its systems are ready to capture and process the data needed for forming and monitoring new estimates as well as its capability to track revenue differences for accounting and tax purposes. The new standard also requires many new disclosures and the current system may not be ready or suited to capture these.

Controls may need to be modified to reflect changes that have been made to the entity's processes and systems. New accounting and disclosure requirements lead to new controls being designed and implemented.

Assess training needs

The implementation of IFRS 15 may potentially not only mean a substantial change for an entity's financial statements, but also a change in the roles and responsibilities of individuals within the entity. Training of staff is essential to the successful implementation of IFRS 15.

Due to the wide impact of IFRS 15, changes within an organisation may be extensive and it is likely that the effects of the implementation will not only be the finance team's concern. It is important that others within an entity understand the impact of this standard. For example, the human resource department must understand the impact of IFRS 15 on any revenue-based compensation and bonus plans, and management needs to develop a deep understanding of the impacts so that they can adequately explain it to investors. Those responsible for training will need to identify such staff members, assess their needs and educate them on IFRS 15 based on their needs.

Overall implementation tips

Assign senior resources to lead effort

In addition to the possible financial effects of the new standard, there are many strategic decisions that need to be made. This encompasses having a holistic view of the entire business and therefore it is recommended that a senior resource lead the effort. In making these strategic decisions, the senior resource may require input from business unit heads such as operations, sales, legal, finance, IT and tax. The senior resource will then need to determine how revenue recognition affects each function and the entity as a whole.

When making these strategic decisions, the senior resource must be capable of identifying where changes might occur with existing revenue arrangements, contract terms and business practices. Changes can be identified when considering the following questions:

- Will the entity have to re-consider customer negotiations?
- Should the entity re-consider the way in which it sells its products?
- How would compensation and benefit plans look now?
- What information does the entity need to communicate to its investors?
- Are there any business opportunities resulting from the new model?

IT department involvement

Software may need to be updated or procured as it may not be capable of being customised to capture new information that was not necessary before. To facilitate this challenge, the IT department will be involved as they may need to modify, remap, reconfigure or even implement new information systems.

Assess in-house resource allocation and competency (honestly)

A cost-benefit analysis should be performed to identify the following:

- Does the entity have the resources to apply the new standard?
- Based on the resources that the entity has on hand, will it be more effective for the entity to apply one method over the other?
- What does the entity's investors expect and does the entity still have the resources to meet their expectations?
- What are the entity's competitors doing and does the entity have the capability to keep up or be ahead of them?

Sectors that will be affected most

There are certain sectors or industries that will feel the impact more than others, some of which are highlighted below.

Real estate/Construction

The real estate and construction industry currently applies IAS 11 and guidance providing specific models for recognising revenue in different situations. IFRS 15 will supersede these and in many circumstances, the timing of revenue recognition, either at a point in time or over time, will change.

Example:

An entity's normal business is the construction and sale of flats, simplexes and/or duplexes in residential housing developments. Its standard contract contains clauses that stipulate in event of default that a deposit of 10% of the contract value and the dwelling itself will be retained.

Previously these contracts were recognised using the stage of completion method as per IAS 11 p.23:

- *total contract revenue can be measured reliably;*
- *it is probable that the economic benefits associated with the contract will flow to the entity;*
- *both the contract costs to complete the contract and the stage of contract completion at the end of the reporting period can be measured reliably; and*
- *the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.*

Under the new standard these contracts would be recognised at a point in time as the contract does not satisfy the requirements for recognition over time per IFRS 15 p.35 namely:

- *the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs* [The customer does not take possession of the dwelling until it is completed at which stage legal title is passed];
- *the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced* [The customer does not control the asset until legal title passes]; or
- *the entity's performance does not create an asset with an alternative use to the entity* [This is met as contractually the entity has to sell the asset to the customer unless the customer defaults] *and the entity has an enforceable right to payment for performance completed to date* [This is not met as the entity can only claim the 10% deposit for the work completed to date.].

Other challenges specific to this industry are:

- the new and potentially complex disclosures;
- the increased significant judgements in the accounting for claims and change orders that will need to be exercised; and
- determining whether certain elements of a contract are recognised separately when a multi-element contract is present.

To comply with the new standard and arrive at the "transaction price", a reconciliation, both conceptually and in value, will need to be done to the current well understood term of "contract value". In addition, some thought will need to be given to how variable amounts, such as award fees and liquidated damages, are factored into determining the transaction price.

Entertainment and media

Entities that licence their IP to customers will need to determine whether they are providing a right to use the IP or access to the IP. This determination will be challenging, especially if they enter into unique arrangements rather than standard ones which will need to be analysed. Licenses were expanded on earlier in this paper.

Telecommunications

The telecom industry may provide bundles to its customers that are made up of multiple products and services. Based on the current standard, the revenue allocated to the delivered handset may be limited, dependant on the policies of the entity. However, the new standard requires revenue to be recognised in proportion to the standalone selling price of each good or service provided. This may therefore result in the timing of revenue recognition changing for entities in the telecom industry.

Example:

An entity typically sells a phone, a 24 month service contract and 24 month phone insurance together as a package for CU 25 per month. The entity also sells the phone, the 24 month contract and the 24 month phone insurance independently at CU 408, CU 15 per month for 24 months and CU 4 per month for 24 months respectively. Lastly the entity also sells the phone and the 24 month phone insurance as a package for CU 480.

Under IAS 18 p.10 the entity is required to measure revenue for each good and service at "*the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity*" – but no guidance is given as to how the trade discount should be allocated. It is thus the practice of the entity to apply the entire discount of CU264 [CU15 * 24 + CU 4 * 24 + CU408 - CU25 * 24] to the purchase of the phone thus recognising only CU144 at the start of the bundled contract with the remainder recognised over the period of the contract.

Under IFRS 15 p.81 "…*Except when an entity has observable evidence in accordance with paragraph 82 that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity shall allocate a discount proportionately to all performance obligations in the contract…*", thus the discount would have to be allocated as follows:

- Determine if any portion of the discount relates specifically to one or more performance obligations – in this case CU24 [CU4 *24 + CU408 - CU480] relates specifically to the phone and the insurance as they are regularly sold together at this discount. This would result in an initial fair value for these two components of CU389 for the phone and CU91 for the insurance, by allocating the discount proportionally (Ignoring for this example decimal places) [CU480 / CU504 * component amount]
- The remaining discount of CU240 should then be split proportionally amongst the phone (CU389), the 24 month contract (CU360) and the 24 month insurance (CU91) which would result in final allocation of the

transaction price of CU278 for the phone, CU257 for the 24 month contract and CU65 for the 24 month insurance. [CU600 / CU840 * component amount]

Investment management

Significant variable elements exist in investment management contracts, such as performance bonuses and penalties. As the new standard introduces a different approach to variable and contingent consideration, a significant degree of judgement will need to be exercised to estimate the amount of consideration that should be taken into account.

It is common for entities to receive an initial ‘sign-on’ fee in this sector, and the new standard may lead to a change in timing of accounting for these fees. Unless control of distinct goods and services are transferred to the customer at the ‘sign-on’ phase, an upfront fee is regarded as an advance payment that should only be recognised when those future goods and services are provided. In practice, ‘sign-on’ fees are charged to cover initial costs, but this in itself is not sufficient to justify upfront revenue recognition.

Software

Software entities currently follow very strict guidelines that typically result in revenue recognition being delayed. The following business practices have developed as a result of these guidelines:

- limiting discounts provided to customers;
- including renewal rates in the contract; and
- not guaranteeing that future software will be provided.

When the new standard is effective, these rules will be superseded and entities will need to assess the nature of their contracts and the way these contracts are negotiated with customers.

Example:

A software supplier typically sells 10,000 copies of its program to retailers at an initial price of CU40 per copy. Due to the nature of the industry (fast moving with software quickly becoming out of date) the contract includes a price concession whereby the retailer will receive a refund of CU10 per unsold copy at a certain specified date.

Under IAS 18 the supplier only recognises the revenue for this transaction on the specified date – this is due to the requirement in IAs 18 p.14(c) that “*the amount of revenue can be measured reliably*”. The supplier is only able to reliably measure the revenue from the date it knows how many copies are unsold on this date.

Under IFRS 15 p.50 to 59 the supplier is allowed to recognise variable income to the extent that it is not constrained (or to extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur) and gives guidance on how this estimate may be made. The supplier thus assesses its historical data and determines that historically it pays refunds based on non-sales of between 0% and 20% of the initial purchase volume. The supplier thus determines it should initially recognise CU 385,000 [10,000 * 85% * CU40 + 10,000 *15% * CU30] as it has assessed that 15% is the level at which no significant reversal of revenue is expected.

Banking and securities

IFRS 15 specifies how to account for revenue which arises as a result of contracts from customers. Dividend income and interest income which were within the scope of IAS 18 (current revenue standard) will now be within the scope of the financial instruments standards, however no impact on the accounting for such income is expected.

Detailed guidance for banking entities was included in IAS 18 in respect of how to treat the receipt of different types of fees, therefore entities will need to consider whether any changes are required to the treatment of such fees in respect of identifying separate goods and services under IFRS 15. Practical implementation issues may however be experienced where services are integrated. Stand-alone selling prices should be considered when it is concluded that certain elements should be accounted for separately.

Conclusion

IFRS 15 introduces a new model for revenue recognition with a single principle that applies to all contracts. Some entities and industries will be impacted more than others, but with the potential for (significant) change and additional disclosure requirements, don’t delay finding out how it will affect you.