

1 IFRS 15 Revenue from Contracts with Customers (Lecture A666 - 20.09 minutes)

1.1 Background to IFRS 15

IFRS 15 *Revenue from Contracts with Customers* deals with the accounting and disclosure requirements in respect of revenue recognition, but specifically in connection with revenue from contracts with customers.

It took effect for accounting periods commencing on or after 1 January 2018. The standard was endorsed by the European Financial Reporting Advisory Group (EFRAG) on 22 September 2016 and was available for use after that date.

Even though the standard is new, clarification amendments have already been made, which try to deal with situations raised by entities preparing their financial statements under the standard to ensure their systems can cope with it. Whilst for some, IFRS 15 may have limited impact, for others it radically changes the revenue recognition process, with consequential changes needed in both the accounting systems and the contracts used by those companies.

Prior to the issuance of IFRS 15, issues concerning revenue recognition were dealt with in IAS 18 *Revenue* and IAS 11 *Construction Contracts*. Neither were written taking into account many of the complexities of contracts which are now commonplace, and companies sometimes referred to US rules to determine an appropriate recognition pattern. However, these US rules were developed without an overall principles-based approach so each new revenue type had to be considered separately. To deal with these problems the IASB and the US Financial Accounting Standards Board (FASB) embarked upon a joint project to establish a standard on revenue recognition for revenue from all sorts of contracts with customers. The converged requirements are now dealt with in IFRS 15 and US Topic 606 of the FASB Accounting Standards Codification.

1.2 UK GAAP (FRS 102)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* at Section 23 *Revenue* is much briefer than IFRS 15 and does not use the same revenue recognition model. While FRS 102 uses similar ideas to IFRS 15, and often gives the same answers, it is a different standard using different language.

Every now and again it does give different answers.

When FRS 102 is next updated it is possible that it could be converged further with IFRS 15 but this is unlikely to happen in the foreseeable future.

1.3 IFRS 15 'carve out' for FRS 102 users?

Some companies which have adopted FRS 102 as their financial reporting framework have asked if they could use IFRS 15 rather than Section 23 of FRS 102, whilst continuing to adopt the rest of FRS 102 for everything else. The objective is sometimes to achieve convergence with a parent who reports under IFRS 15, or to seek the added clarity and certainty of the detailed rules in IFRS 15.

However, this is not permitted. IFRS 15 cannot be 'carved out' in this way. An alternative approach in the group scenario is for the subsidiary to adopt FRS 101, which means that the recognition and measurement will be under full IFRS, but there are a number of disclosure exemptions. Do not under-estimate the work required to transition to IFRS in order to achieve this though!

1.4 IFRS 15 - The five-step model to recognising revenue

The core principle of IFRS 15 is that an entity recognises revenue on the transfer of goods or services to customers at the amount the entity **expects to be entitled to** in respect of that transfer. Importantly, there is a five-step approach to this to help with identification of both the amounts due and the timing of recognition. Below is an outline of the steps:

1.5 Step 1 – Identify the contract(s) with the customer

The requirements of the standard apply to each contract that has been agreed with a customer and meets specified criteria. In some cases, contracts need to be combined and accounted for as a single contract. Key issues occur as follows:

Combination of contracts

Two or more contracts entered into at, or near, the same time with the same customer (or related parties of the customer) are accounted for as a single contract if:

- (a) the contracts are negotiated as a single package with a single commercial objective;
- (b) the amount of the consideration to be paid on one contract is dependent on the price or performance in the other; or
- (c) the goods or services promised in the contract/s are a single performance obligation.

Contract modifications

A contract modification (e.g. a change to the order or variation to the contract) is accounted for as a separate contract if:

- (a) the scope of the contract increases because of additional promised goods or services which are distinct; or
- (b) the price of the contract increases by an amount that reflects the entity's standalone selling prices of the additional goods/services (although there can be an element of discount to the existing customer).

1.6 Step 2 – Identify the performance obligations in the contract

A contract will include promises to transfer goods or services to a customer. If these are distinct then each is a performance obligation that is accounted for separately. A good/service is distinct if the customer can benefit from it on its own, or together with other resources that are readily available to the customer and the entity's promise to transfer the good or service to the customers is separately identifiable from other promises in the contract.

At the inception of a contract the entity assesses the goods or services promised in a contract with a customer and identifies as a performance obligation each promise to transfer to the customer either:

- goods or services (or a bundle of them) that is distinct; or
- a series of goods or services that are substantially the same and that have the same pattern of transfer to the customer. A series of goods or services has the same pattern of transfer if each distinct good/service is a performance obligation satisfied over time and the same method would be used to measure the entity's progress towards completion of the performance obligation.

1.7 Step 3 – Determining the transaction price

This is the amount of consideration in a contract to which the entity expects to be entitled in exchange for the goods/services supplied. This may be a fixed price or include variable or non-cash consideration. The transaction price is adjusted for the time value of money if there is a significant financing element. It is also adjusted for any amounts payable to the customer. If the amount is variable an estimate is made of the amount of consideration and included only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue will not occur when the variable amount is subsequently resolved.

If the customer has an option to purchase a warranty separately, it is a distinct service in addition to the product. In these cases, the entity accounts for the promised warranty as a performance obligation and allocates a portion of the transaction price to that performance obligation. If a customer does not have the option to purchase a warranty separately, an entity accounts for the warranty in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, unless the warranty provides the customer with a service in addition to the assurance that the product works as described.

1.8 Step 4 – Allocate the transaction price to the performance obligations in the contract

An entity usually allocates the transaction price to each performance obligation on the basis of standalone selling prices of each distinct good/service. If this is not observable an estimate is made by the entity. If a discount or variable amount of consideration relates entirely to a particular part of the contract, the entity allocates it to that performance obligation and not all of the performance obligations in the contract.

The objective is for the entity to allocate the transaction price to each performance obligation (distinct good/service) to reflect the amount of consideration that the entity expects to be entitled to in exchange for transferring the promised goods or services.

The transaction price is allocated to each performance obligation identified in the contract on a relative standalone selling price basis. Exceptions exist though, for the allocation of discounts and consideration that includes variable amounts.

1.9 Step 5 – recognise revenue when (or as) the entity satisfies a performance obligation

An entity recognises revenue when a performance obligation is met, by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). The amount recognised is the amount allocated to that performance obligation. Some performance obligations are satisfied at a point in time (typically for goods transferred to a customer). Others are satisfied over time and so revenue is also recognised over a period of time by the entity selecting an appropriate method for measuring progress towards completion of the performance obligation.

This last point is particularly crucial, as it may fundamentally change the way in which revenue is recognised for some entities or contracts. Because revenue is recognised when the customer takes control of a good/service, this might mean revenue recognition is delayed on longer contracts until the final contract is completed.

However, there are also situations in which revenue is recognised over a period of time and determining which contracts need to be dealt with in which way will be crucial to ensure correct application of the standard.

1.10 Impact of IFRS 15

Different sectors or industries are affected in many different ways along the 5-step model.

However, it should be noted that potentially all entities reporting under IFRS 15 will be impacted in some way or another by the standard – some more than others!

Below are four industries that will face probably the biggest challenges:

- Telecommunications (identifying individual performance obligations and allocating the transaction price).
- Manufacturers (contract modifications).
- Real estate and property development (revenue over time/at the point of time).
- Software development and technology (splitting the contract into two separate obligations).

Example 1 – Distinct obligations

A contractor enters into a contract to build a hospital for a customer. The entity is responsible for the overall management of the project and identifies various promised goods and services, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment and finishing.

These obligations are not sufficiently distinct from each other to recognise the income separately. The contract should be treated as a single obligation, recognising the income over time.

Example 2 – Distinct obligations

A software developer enters into a contract with a customer to transfer a software licence, perform an installation service and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the licence, installation service and technical support separately.

Because these services can be provided separately, the obligations are sufficiently distinct from each other to separately recognise income on each as the obligations are met.

On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

1. the software licence;
2. an installation service;
3. software updates; and
4. technical support.

Example 3 – At a point in term versus over time

A health club grants a customer one year of access to all of its facilities for £600 a year.

The club promises to provide a service of making the health clubs available for the customer to use as and when the customer wishes. The club concludes that the customer simultaneously receives and consumes the benefits of the entity's performance as it performs by making the health clubs available. Consequently, the entity's performance obligation is satisfied over time in accordance with paragraph 35(a) of IFRS 15.