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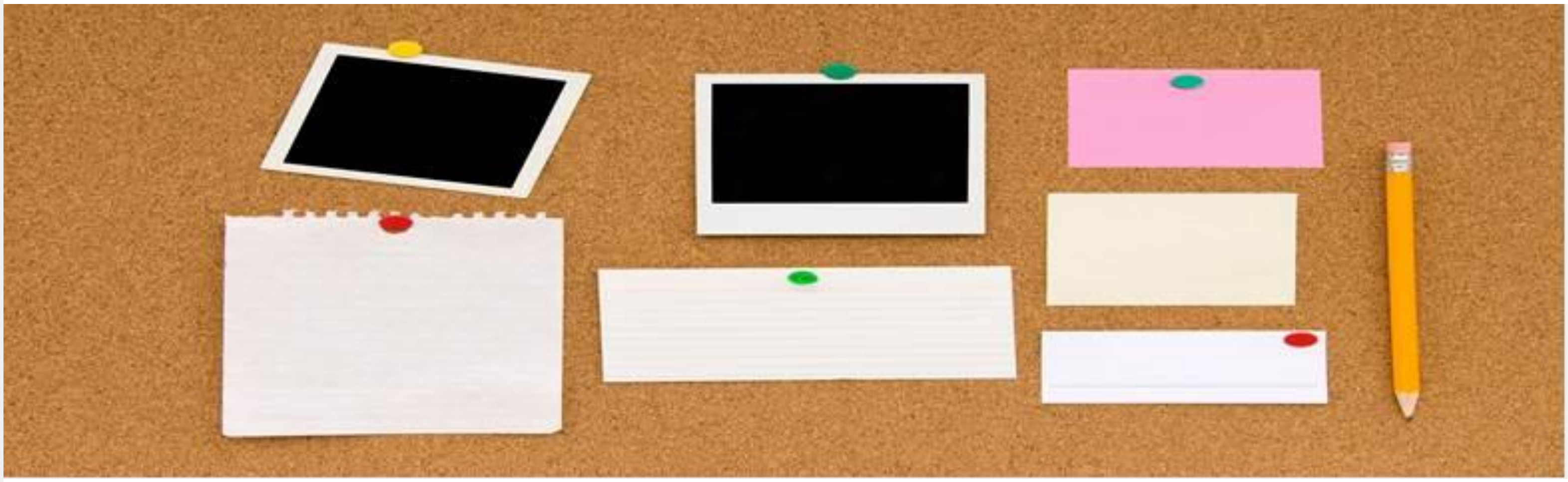

Accounting & Auditing News

IFRS 15 — *Revenue from Contracts with Customers*: Part 2B – Differences vs. IAS 18 — *Revenue*

<u>Type of Revenue Impacted</u>

Under IAS 18, *Revenue* *(IAS 18.1-6)*

This Standard shall be applied in accounting for revenue arising from the following transactions and events: *(IAS 18.1)*

a) the sale of goods;
b) the rendering of services; and
c) the use by others of entity assets yielding interest, royalties and dividends.

Under IFRS 15, *Revenue from Contracts with Customers* *(IFRS 15.5-8, IN7)*

An entity shall apply this Standard to all contracts with customers, except the following: *(IFRS 15.5)*

a) lease contracts within the scope of IAS 17 Leases;
b) insurance contracts within the scope of IFRS 4 Insurance Contracts;
c) financial instruments and other contractual rights or obligations within the scope of IFRS 9 Financial Instruments, IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures; and
d) non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, this Standard would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.

The core principle of IFRS 15 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. An entity recognizes revenue in accordance with that core principle by applying the following steps: *(IFRS 15.IN7)*

a. **Step 1: Identify the contract(s) with a customer**—a contract is an agreement between two or more parties that creates enforceable rights and obligations. The requirements of IFRS 15 apply to each contract that has been agreed upon with a customer and meets specified criteria. In some cases, IFRS 15 requires an entity to combine contracts and account for them as one contract. IFRS 15 also provides requirements for the accounting for contract modifications.

b. **Step 2: Identify the performance obligations in the contract**—a contract includes promises to transfer goods or services to a customer. If those goods or services are distinct, the promises are performance obligations and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service 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 customer is separately identifiable from other promises in the contract.

c. **Step 3: Determine the transaction price**—the transaction price is the amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash. The transaction price is also adjusted for the effects of the time value of money if the contract includes a significant financing component and for any consideration payable to the customer. If the consideration is variable, an entity estimates the amount of consideration to which it will be entitled in exchange for the promised goods or services. The estimated amount of variable consideration will be included in the transaction price only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

d. **Step 4: Allocate the transaction price to the performance obligations in the contract**—an entity typically allocates the transaction price to each performance obligation on the basis of the relative stand-alone selling prices of each distinct good or service promised in the contract. If a stand-alone selling price is not observable, an entity estimates it. Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to a part of the contract. The requirements specify when an entity allocates the discount or variable consideration to one or more, but not all, performance obligations (or distinct goods or services) in the contract.

e. **Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation**—an entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). The amount of revenue recognized is the amount allocated to the satisfied performance obligation. A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For performance obligations satisfied over time, an entity recognizes revenue over time by selecting an appropriate method for measuring the entity's progress towards complete satisfaction of that performance obligation.

Analysis of the Change

IFRS 15 only specifies how to account for revenue which arises as a result of contracts from customers; moreover, certain contracts with customers are scoped out because they are dealt with other standards. (Interest income and dividend income, which were within the scope of the previous revenue standard, will now be within the scope of the financial instruments standard, but it is not expected that this will impact the accounting for such income streams.)

Timing of Revenue Recognition

Under IAS 18, *Revenue* *(IAS 18.14-19)*

Revenue from the sale of goods shall be recognized when all the following conditions have been satisfied: *(IAS 18.14)*

a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
c) the amount of revenue can be measured reliably;
d) it is probable that the economic benefits associated with the transaction will flow to the entity; and
e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

Under IFRS 15, *Revenue from Contracts with Customers* *(IFRS 15.31-45)*

An entity recognizes revenue by applying the 5 steps process as indicated above. Under step 1, one of the criteria to be met is that the parties to the contract have approved the contract (in writing, orally or in accordance with other customary business practices) and are committed to perform their respective obligations *(IFRS 15.9)*. Although IFRS 15 also indicated that revenue can be still recognized to the extent of the consideration received even if the criteria indicated under paragraph 9 has not been met. These conditions are when: (1) no remaining obligation are to be performed or contract has been terminated; and (2) the consideration received is non-refundable *(IFRS 15.15)*.

An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset *(IFRS 15.31)*.

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met: *(IFRS 15.35)*

a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs B3–B4);
b) 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 (see paragraph B5); or
c) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and the entity has an enforceable right to payment for performance completed to date (see paragraph 37) *(IFRS 15.31)*.

If a performance obligation is not satisfied over time in accordance with paragraphs 35–37, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the requirements for control in paragraphs 31–34 *(IFRS 15.38)*.

Analysis of the Change

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 the title passes to the customer at the point of shipment but, as a matter of business practice, may compensate customer for loss or damage during shipping (either through credit or replacement). Previously, revenue may have been recognized 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 recognized at a different time. If revenue is recognized 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 recognized when service is provided.

How to Identify and Allocate to Different Goods and Services within a Contract?

Under IAS 18, *Revenue* *(IAS 18.13)*

The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognized as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.

Under IFRS 15, *Revenue from Contracts with Customers* *(IFRS 15.22-30)*

Factors that indicate that an entity's promise to transfer a good or service to a customer is separately identifiable (in accordance with paragraph 27(b)) include, but are not limited to, the following: *(IFRS 15.29)*

a) the entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted. In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer.
b) the good or service does not significantly modify or customize another good or service

promised in the contract.

c) the good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or services.

Analysis of the Change

Previously, given the lack of specific guidance in IFRSs, there was greater room for judgment when identifying the goods and services within a contract and then allocating the revenue to those goods and services identified. Entities may have to amend their current accounting policies as a result of the more detailed guidance in IFRS 15. The new standard requires the revenue from a contract to be allocated to each distinct good or service provided on a relative standalone selling price basis, though a 'residual' approach is permitted in limited circumstances.

This may significantly change the profile of revenue recognition for some entities where, for example, they offer a 'free' maintenance period to customers as part of a transaction. Where entities have a large number of customers with different options, there may be some significant practical challenges to overcome in order to ensure systems are in place to deal with the new requirements.

Effect of Time Value of Money on Revenue

Under IAS 18, *Revenue* *(IFRS 18.11)*

In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest-free credit to the buyer or accept a note receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest. The imputed rate of interest is the more clearly determinable of either:

a) the prevailing rate for a similar instrument of an issuer with a similar credit rating; or
b) a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services. The difference between the fair value and the nominal amount of the consideration is recognized as interest revenue in accordance with paragraphs 29 and 30 and in accordance with IFRS 9.

Under IFRS 15, *Revenue from Contracts with Customers* *(IFRS 15.60-65)*

In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract *(IFRS 15.60)*.

Analysis of the Change

IFRS 15 introduces new and more extensive on financing arrangement and the impact of the time value of money. 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.

Accounting for Warranties

Under IAS 18, *Revenue*

No specific guidance.

Under IFRS 15, *Revenue from Contracts with Customers* *(IFRS 15.B28-B33)*

If a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, an entity shall account for the promised warranty as a performance obligation in accordance with paragraphs 22–30 and allocate a portion of the transaction price to that performance obligation in accordance with paragraphs 73–86 *(IFRS 15.B29)*.

If a customer does not have the option to purchase a warranty separately, an entity shall account for the warranty in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets unless the promised warranty, or a part of the promised warranty, provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications *(IFRS 15.B30)*.

If a warranty, or a part of a warranty, provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service is a performance obligation. Therefore, an entity shall allocate the transaction price to the product and the service. If an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity shall account for both of the warranties together as a single performance obligation *(IFRS 15.B32)*.

Analysis of the Change

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 chose 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).

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.

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.

Note: The above is based on the existing provisions of the related standards. Additional differences may still be noted upon actual implementation. See attached summary in word file.

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