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Published on:

June 4, 2014

IASB issues new Standard on revenue recognition

Introduction

The International Accounting Standards Board (IASB) has published a new Standard, IFRS 15 Revenue from Contracts with Customers ('the Standard'). The Standard replaces IAS 11 Construction Contracts, IAS 18 Revenue, 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. This IFRS in Focus provides an overview of the new Standard. More detailed and industry-specific communications are available at www.iasplus.com.

The Standard is the result of a convergence project started in 2002 by the IASB and the US Financial Accounting Standards Board (FASB) (collectively 'the Boards'). A Discussion Paper was issued in 2008, followed by an Exposure Draft (ED) in 2010, and a second ED in 2011. The final Standard is nearly fully converged: the main differences relate to interim disclosures, the collectability threshold for contracts, and timing of adoption. The Boards have also formed a "joint transition resource group", which is intended to help the boards resolve any diversity in practice and address implementation issues as they arise. Therefore, the Boards may issue additional revenue guidance or interpretations before the Standard's effective date in 2017.

Scope

The new revenue model applies to all contracts with customers except those that are within the scope of other IFRSs, such as leases, insurance contracts and financial instruments. Transfers of assets that are not related to the entity's ordinary activities (such as the sale of property, plant and equipment, real estate or intangible assets) will also be required to follow some of the recognition and measurement requirements of the new model.

The recognition of interest and dividend income are not in the scope of the new Standard. Furthermore, the new Standard does not apply to non-monetary exchanges between entities in the same line of business where this is done to facilitate sales to customers, or potential customers.

When a contract includes multiple performance obligations (deliverables), some of which are within the scope of other IFRSs, any separation and initial measurement requirements of the other Standards are applied first, and the deliverables within the scope of the revenue model are ascribed any residual amount. If there are no separation or initial measurement requirements in those other Standards, the requirements of IFRS 15 are applied.

An entity may contract with a counterparty to participate in an activity or process in which the parties to the contract share the risks and benefits resulting from that activity or process, often referred to as a 'collaborative arrangement'. Where this is the case, the entity will have to assess whether the other entity is its 'customer' in order to establish whether the transactions with the other entity are within the scope of the new Standard.

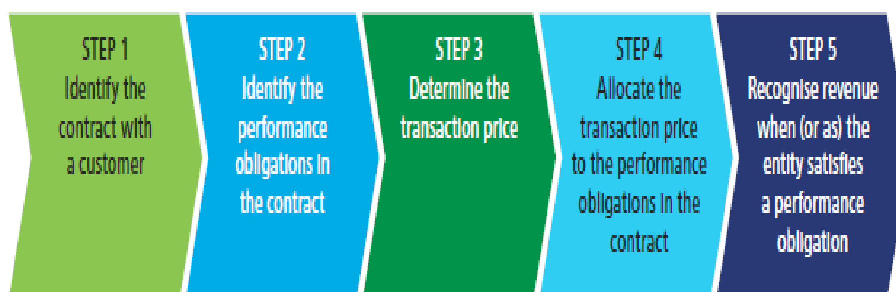
Observation

'Contract' and the 'customer' are defined terms in the Standard. The new revenue model that has been adopted by the IASB requires that there is a contract which gives rise to enforceable rights and obligations. The Standard sets out criteria that must be met for this to be the case (see Step 1 below). A 'customer' is not any counterparty, but rather one that has contracted to acquire goods or services that are an output of the entity's ordinary activities in exchange for consideration. In some cases, careful consideration may be required to assess whether a contract is in the scope of IFRS 15, particularly for collaborative arrangements.

Overview of the new revenue model

The core principle is that an entity recognises 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. The Standard is to be applied on an individual contract basis. However, a portfolio approach is permitted provided it is reasonably expected that the impact on the financial statements will not be materially different from applying the Standard on an individual contract basis.

The steps to be applied in the model are as follows:



Observation

The steps to recognising revenue have remained unchanged since the first ED in 2010. However, there have been many changes to the detailed requirements in respect of their specific application. Entities should consider the details of the new revenue model carefully, and not rely on previous analysis, as previous conclusions as to the effects of the model on their business may no longer be appropriate.

Step 1 – Identify the contract with a customer

A contract can be written, verbal, or implied but for the Standard to apply the following criteria must be met:

• 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;

• the entity can identify each party's rights regarding the goods or services to be transferred;

• the entity can identify the payment terms for the goods or services to be transferred;

• the contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract); and

• it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

Although each contract would usually be accounted for separately, entities may be required to combine a group of contracts entered into at or near the same time with the same customers (or parties related to the customer) if:

• 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; or

• the goods or services promised in the contracts (or some goods or services promised in the contracts) are a single performance obligation.

Sometimes, prices or scope of a contract may be revised. A contract modification that has been "approved" (i.e. the terms of the modification create enforceable rights and obligations) is accounted for as a separate contract if both (i) it results in a separate performance obligation that is "distinct" (as defined in the Standard – see Step 2 below) and (ii) the additional price reflects the stand-alone selling price of that separate performance obligation.

Otherwise, the modification is treated as an adjustment to the original contract. In many cases, the impact is accounted for prospectively, by allocating the remaining revised transaction price to the remaining performance obligations in the contract. However, for certain performance obligations that are satisfied over time (see Step 5 below), the impact is accounted for retrospectively, which results in a cumulative catch up adjustment to revenue.

Step 2 – Identify the performance obligations in the contract

Step 5 (see below) requires that revenue should be recognised when, or as, the entity satisfies a performance obligation. It is therefore necessary first to identify the distinct performance obligations (sometimes called "unbundling"), and this is done at inception of a contract.

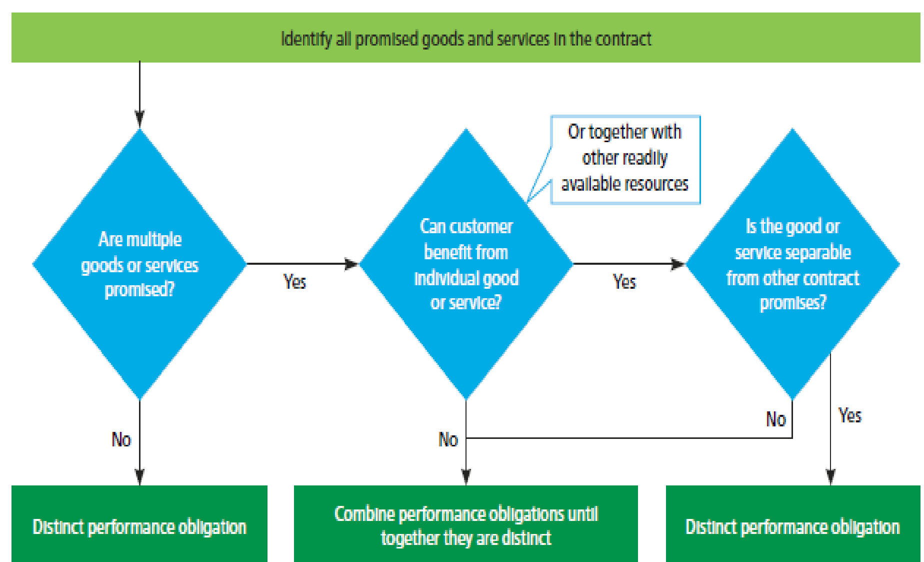
Distinct performance obligations are goods or services promised in a contract that satisfy both of the following conditions:

• the customer can benefit from the good or service either on its own or in combination with other resources available to the customer (i.e. it is capable of being distinct); and

• the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e. it is distinct in the context of the contract).

In addition, if certain criteria are met, the Standard requires a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer to be regarded as a single performance obligation.

The following diagram illustrates how to identify the distinct performance obligations in a contract:



Applying the second condition – i.e. determining whether a promised good or service is separately identifiable from other promises in a contract – requires analysis of the contract terms and consideration of the specific facts and circumstances. Factors indicating that a promised good or service is separately identifiable from other promises include:

• 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;

• the good or service is not significantly modifying or customising another good or service promised in the contract;

• the good or service is not highly dependent on, or highly interrelated with, other promised goods or services in the contract.

Observation

A delivered good or service may not be distinct if it cannot be used without another good or service that has not yet been delivered – even if the second good or service would be distinct if it were delivered first.

Observation

The restriction on unbundling 'highly interrelated' elements of a contract may require careful consideration by, for example, entities that supply a core software product together with associated professional services such as customisation and integration. It is possible in such circumstances that the software licence and professional services may be combined and treated as a single performance obligation resulting in the recognition of all revenue over time (assuming this is the appropriate recognition basis as per Step 5 below). In evaluating whether a bundle of goods or services should be accounted for as distinct performance obligations, entities need to consider a number of factors including the extent of integration, the level of customisation and the sequence of when the performance obligations are satisfied because a customer may not be able to use a good or service until another good or service within the same contract is delivered.

Step 3 – Determine the transaction price

An entity must determine the amount of consideration to which it expects to be entitled in exchange for the promised goods or services in the contract in order to recognise revenue. The transaction price can be a fixed amount or it can vary because of discounts, rebates, price concessions, refunds, credits, incentives, performance bonuses, and other similar items. An entity estimates the transaction price by considering the effect of variable consideration, the time value of money (if a significant financing component is deemed to exist), non-cash consideration, and consideration payable to the customer. Entities should estimate the transaction price using either a probability-weighted approach (expected value) or an approach based on the single most likely amount – whichever is more predictive of the amount to which the entity expects to be entitled.

Observation

'Variable consideration' is wider than just consideration triggered by events outside the seller's control (sometimes referred to as ontingent consideration). Variable consideration encompasses any amount that is variable under a contract, including, for example, performance bonuses or penalties, discounts and the customer's right to return goods.

Variable consideration is only included in the transaction price if, and to the extent that, it is highly probable that its inclusion will not result in a "significant revenue reversal" in the future as a result of re-estimation. A significant revenue reversal occurs when a subsequent change in the estimate of variable consideration results in a significant reduction to the cumulative amount of revenue recognised from the customer. This constraint may have an impact when:

• the amount of consideration is susceptible to factors outside the entity's influence (e.g. volatility in a market, the judgement of third parties, or a high risk of obsolescence);

• the uncertainty is not expected to be resolved for a long period of time; or

• there is limited prior experience with similar performance obligations or there is a broad range of possible consideration amounts.

If an entity concludes, because of the potential for a significant revenue reversal, that it is not appropriate to include all of the variable consideration in the transaction price, it should assess whether it is instead appropriate to include part of the variable consideration, i.e. a lower amount. That lower amount of variable consideration should be included in the transaction price if it passes the constraint assessment (i.e. it is highly probable that there will not be a significant revenue reversal based on inclusion of that lower amount).

However, the new Standard introduces a separate rule in respect of sales- or usage-based royalties from licenses of intellectual property. An entity is not permitted to recognise revenue for such royalties until its customer has made the associated sale or usage that gives rise to the revenue. This restriction will apply even when the entity has past evidence supporting the level of onward sales or usage made by a customer.

Under the new model, revenue reflects the amount to which an entity expects to be entitled under a contract with a customer, rather than the amount it expects actually to collect. However, if an entity anticipates that it may ultimately accept an amount lower than that initially promised in the contract with the customer (i.e. it may grant a further discount or price concession), perhaps based on past business practice, the entity would initially estimate revenue at the lower amount and assess the collectability of that lower amount (see Step 1). Subsequently, if there is evidence to suggest that revenue already recognised is not collectable,

the Standard requires impairment losses to be presented separately as an expense in profit or loss.

When a contract contains a significant financing component, the effects of the time value of money are taken into account by adjusting the transaction price and recognising interest income or expense over the financing period, as relevant. This is not required if the time period between the transfer of goods or services and payment is less than one year.

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

When a contract contains more than one distinct performance obligation, an entity allocates the transaction price to each distinct performance obligation on the basis of relative stand-alone selling price.

The best evidence of stand-alone selling price is the price at which the good or service is sold separately by the entity. If that is not available, an entity is required to estimate the stand-alone selling price by using an approach that maximises the use of observable inputs (e.g. adjusted market assessment, expected cost plus a margin, or – in certain limited circumstances – using a residual approach).

Where the transaction price includes a variable amount, consideration needs to be given as to whether that variable amount relates to all or only some of the performance obligations in the contract. Unless the criteria in the Standard for treating the variable amount as relating only to specific performance obligations are met, the variable amount should be allocated across all of the performance obligations in the contract.

Often, where an entity promises more than one distinct good or service within a contract, a discount is applied to the total contract price when compared to the amount that would have been charged to the customer if those goods or services were purchased separately. Unless the entity has observable evidence (which satisfies certain criteria in the Standard) that the entire discount applies only to some of the distinct performance obligations, it is required to allocate that discount proportionately to all of the performance obligations in the contract.

Observation

For some entities this will be a major practical issue when mplementing the Standard. Previously, there was limited guidance on this topic and so entities were able to apply judgement in choosing an appropriate method for allocating revenue between goods and services within a contract. The new requirements may require a separate calculation and allocation exercise to be performed for each contract, which will be particularly challenging for entities with a very large number of different contracts. For example, for telecom operators, a mobile telephone contract typically bundles together the handset and subsequent services (e.g. connectivity to the network). Under the requirements of the new Standard it will be necessary to allocate the transaction price (i.e. the amount payable by the customer under the contract) to the distinct performance obligations, typically separating the initial delivery of the handset from the provision of network services. If an operator has a very large number of differently priced contracts, it may be necessary to consider systems changes in order to cope with the volume of calculations required.

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

A performance obligation is satisfied when control of the underlying goods or services (the “assets”) for the particular performance obligation is transferred to the customer. “Control” is defined as “the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset” underlying the good or service. This differs from the approach under IAS 18 where, for example, revenue in respect of goods is recognised when the significant risks and rewards of ownership of the goods are transferred to the customer.

Furthermore, under IAS 18 different guidance is provided on when to account for revenue depending on whether a good or a service is being supplied to the customer. The new Standard takes a different approach to assess whether revenue should be recognised at a point in time or over time, through consistent guidance that applies equally to sales of goods and of services.

Revenue recognised over time

A performance obligation is satisfied, and revenue should be recognised, over time when at least one of the following criteria is met.

- The customer receives and consumes the benefits of the entity’s performance as the entity performs.

- The entity’s performance creates or enhances an asset (e.g. work in process) that the customer controls as the asset is created or enhanced.

- The entity’s performance does not create an asset with an alternative use to the entity and the entity has a right to payment for performance completed to date.

When considering whether an asset has an alternative use, a seller will need to assess at inception of the contract whether, both contractually and practically, it is able to use the asset for a purpose other than that set out in the contract with the customer.

If any of the above criteria are met, an entity is required to recognise revenue over time in a manner that best depicts the transfer of goods or services to the customer.

Observation

Whether an entity recognises revenue over the period during which it manufactures a product or on delivery to the customer will depend on the specific terms of the contract. For example, with some contract manufacturing, an entity will be required to recognise revenue during production (rather than upon delivery) of the components if the products have no alternative use and the contract does not allow the customer to avoid paying for the manufacturing work performed by the entity.

Revenue recognised at a point in time

If a performance obligation does not meet the criteria to be satisfied over time, the following indicators are considered in evaluating the point in time at which control of the asset has been transferred to the customer.

- The entity has transferred physical possession of the asset.
- The entity has a present right to demand payment for the asset.
- The customer has accepted the asset.
- The customer has the significant risks and rewards of ownership of the asset.
- The customer has legal title to the asset.

Observation

For revenue that is recognised at a point in time, IFRS 15 seeks to identify the point at which control transfers to the customer, whereas IAS 18 focuses instead on the point at which risks and rewards are transferred. As a consequence, the timing of revenue recognition may change for some 'point in time' transactions when the new Standard is adopted.

Costs relating to a contract

The Standard contains specific criteria for determining which costs relating to a contract should be capitalised, distinguishing between those costs associated with obtaining a contract and those costs associated with fulfilling a contract. Specifically, costs of obtaining a contract are capitalised when and only when such costs are incremental

to obtaining a contract (e.g. sales commissions) and are expected to be recovered. As a practical expedient, entities are permitted to expense qualifying costs to obtain a contract as incurred when the expected amortisation period is one year or less.

Costs to fulfil a contract are capitalised when and only when they relate directly to a contract, generate or enhance resources that will be used to satisfy performance obligations, and are expected to be recovered (unless the costs to fulfil a contract are within the scope of other IFRSs, in which case the requirements of those other IFRSs apply).

In both cases, capitalised costs are amortised in a manner consistent with the pattern of transfer of the goods or services to which the capitalised costs relate. In certain circumstances, the amortisation period may extend beyond the original contract term with the customer (e.g. future anticipated contracts, expected renewal periods).

Additional guidance

The new Standard provides some detailed guidance to assist entities in applying the Standard in certain areas, some of which differs from the previous accounting applied under IAS 18. In particular:

- **Warranties** – where an entity grants a warranty to a customer, the nature of that warranty will determine the accounting impact. Where the customer can choose whether or not to purchase the warranty, or the warranty provides the customer with an additional service, it will be accounted for as a distinct performance obligation. A warranty that merely provides assurance that the item supplied meets the agreed-upon specifications will not be accounted for as a distinct performance obligation;

- **Customers' unexercised rights** – in some circumstances, customers are not expected to claim all the goods or services to which they have become entitled: a common example is unclaimed loyalty points. The failure by customers to exercise all of their rights under a contract is referred to as 'breakage'. When a level of breakage is expected, the associated amounts paid are treated as variable consideration and recognised as revenue in proportion to the pattern of rights expected to be exercised by the customer (i.e. by comparing the goods or services delivered to date with those expected to be delivered overall). In scenarios in which a level of breakage is not initially expected, an entity will recognise revenue associated with breakage amounts only when the likelihood of the customer exercising its remaining rights becomes remote;

- **Customer options for additional goods or services** – some contracts include an option for the customer to purchase additional goods or services at a discount. Where this represents a 'material right' for the customer (e.g. the option gives the customer the right to acquire additional goods at a substantial discount), an entity must allocate a portion of the transaction price to the option and recognise revenue when control of the additional goods or services associated with the option is transferred to the customer, or when the option expires; and

• **Licensing** – the Standard requires an entity to assess the nature of a promised license over intellectual property, and specifically whether the license gives the customer the "right to use" or "right to access" the entity's intellectual property. The Standard includes criteria to determine whether a license is a right to access the intellectual property and thus control transfers over time. If these criteria are not met, the licence represents a right to use an entity's intellectual property for which control passes at a point in time. The application of these criteria is critical in determining the manner in which revenue related to such licenses is recognised.

Guidance is also included for the following topics:

• methods for measuring progress towards complete satisfaction of a performance obligation;

• sale with a right of return;

• principal versus agent considerations;

• nonrefundable upfront fees;

• repurchase arrangements;

• consignment arrangements;

• bill-and-hold arrangements;

• customer acceptance; and

• disclosures of disaggregated revenue.

Disclosure and presentation

The Standard significantly expands the current disclosure requirements about revenue recognition. The required disclosures include:

• a disaggregation of revenue to "depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors";

• certain information about changes in contract balances, e.g. opening and closing balances of receivables, contract assets and liabilities, revenue recognised in the current period that was previously included in the contract liability balance and revenue recognised in the current period that relates to performance obligations satisfied in a prior period;

• for contracts that are expected to extend beyond one year, the aggregate amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that revenue;

• information about assets recognised for costs to obtain or fulfil a contract;

• qualitative descriptions of the types of goods or services, significant payment terms and typical timing of satisfying obligations of an entity's contracts with customers;

• a description of the significant judgements about the amount and timing of revenue recognition;

• policy decisions made by the entity related to the time value of money and costs to obtain or fulfil a contract; and

• information about the methods, inputs and assumptions used to determine the transaction price and to allocate amounts to performance obligations.

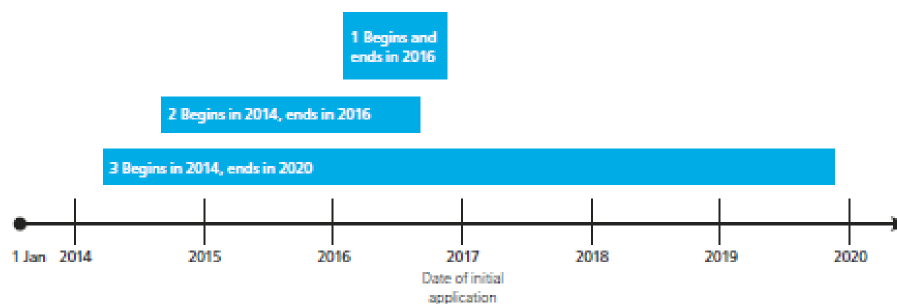
Effective date and transition

The new Standard is effective for reporting periods beginning on or after 1 January 2017 with early adoption permitted. It applies to new contracts created on or after the effective date and to existing contracts that are not yet complete as of the effective date. Therefore, the current year figures reported in the first year of adoption will be prepared as if the Standard's requirements had always been applied.

In respect of comparative periods, entities have the option of using either retrospective application (with certain practical expedients) or a modified approach in applying the new Standard. Under the modified approach comparative years are not restated. Instead, an entity recognises the cumulative effect of initially applying the Standard as an adjustment to the opening balance of retained earnings on the effective date. For example, if an entity applies the new Standard for the first time for the year ending 31 December 2017 and chooses to apply the modified approach, the cumulative effect resulting from the application of the new Standard will be adjusted against retained earnings as at 1 January 2017. The comparative figures for the year ending 31 December 2016 will not be restated. If an entity elects to use the modified approach it must disclose the impact of the change on the financial statement line items and include a description of the significant changes.

The following diagram illustrates how three different contracts would be treated on transition using both methods permitted in the Standard.

Assume 31 December year end



	Modified approach	Retrospective approach
Contract 1	Contract completed before date of initial application – do not apply IFRS 15	Begins and ends in same annual reporting period – practical expedient available
Contract 2	Contract completed before date of initial application – do not apply IFRS 15	Adjust opening balance sheet of each affected component of equity for earliest prior period presented (1 January 2016)
Contract 3	Adjust opening balance of each affected component of equity at date of initial application. Make specific required disclosures. Figures for 2016 are not restated.	Adjust opening balance sheet of each affected component of equity for earliest prior period presented (1 January 2016)

All entities will be required to disclose the impact of any changes in accounting policy resulting from the adoption of the new Standard.

Planning for impacts

Although the effective date of the Standard is still several years away, the Boards have set this date recognizing that some entities will need all of the intervening period to transition to the new requirements. In particular, some entities may need to change systems and processes, and to run two sets of systems concurrently in order to meet the transition requirements.

In addition to preparing the market and educating their investors and analysts on the impact of the new Standard, entities will need to consider the wider implications of changes to the timing of revenue recognition and, hence, profits. Amongst others, these may include:

- significant changes to key performance indicators and other key metrics;
- significant changes to the profile of tax cash payments;
- availability of profits for distribution;
- for compensation and bonus plans, impact of timing of targets being achieved and the likelihood of targets being met; and
- potential non-compliance with loan covenants.

Additional resources

See www.iasplus.com for further insights into this Standard.

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