

IFRS 15: an overview of the new principles of revenue recognition

December 2014



In May 2014, the IASB published IFRS 15, Revenue from Contracts with Customers. Simultaneously, the FASB published ASU 2014-09 (Topic 606). These two broadly identical texts represent the culmination of the Boards' work on a major joint project that has taken many years to complete.

Given the volume of innovations and clarifications introduced by IFRS 15, it is important to identify its impact as early as possible, both to prepare for the transition and to anticipate the accounting consequences on future contracts or contracts currently under negotiation.

What exactly is involved?

“ IFRS 15 PRESENTS A SINGLE REVENUE RECOGNITION MODEL APPLICABLE TO ALL TYPES OF CONTRACTS WITH CUSTOMERS AND ALL BUSINESS SECTORS, IMPROVING THE COMPARABILITY OF FINANCIAL STATEMENTS. ”

IFRS 15 will replace IAS 11 on Construction Contracts, IAS 18 on Revenue (for the sale of goods and the rendering of services) and related interpretations (IFRIC 13 on Customer Loyalty Programmes, IFRIC 15 on Agreements for the Construction of Real Estate, etc.).

IFRS 15 consists of a standard (including application guidance with clarifications on a number of topics such as licensing, a sale with a right of return, customer options for additional goods or services, etc.), illustrative examples and basis for

conclusions. In total, this represents more than 300 pages on revenue recognition.

In a completely new due process, a joint working group known as the Transition Resource Group (TRG) has been set up by the IASB and the FASB. This will inform the Boards of any difficulties of implementation that may be raised by IFRS 15 (and Topic 606) between now and its effective date. Stakeholders would do well, therefore, to follow the TRG's discussions closely.



IFRS 15

will replace all the existing standards and interpretations on Revenue Recognition

More than **300** *pages*
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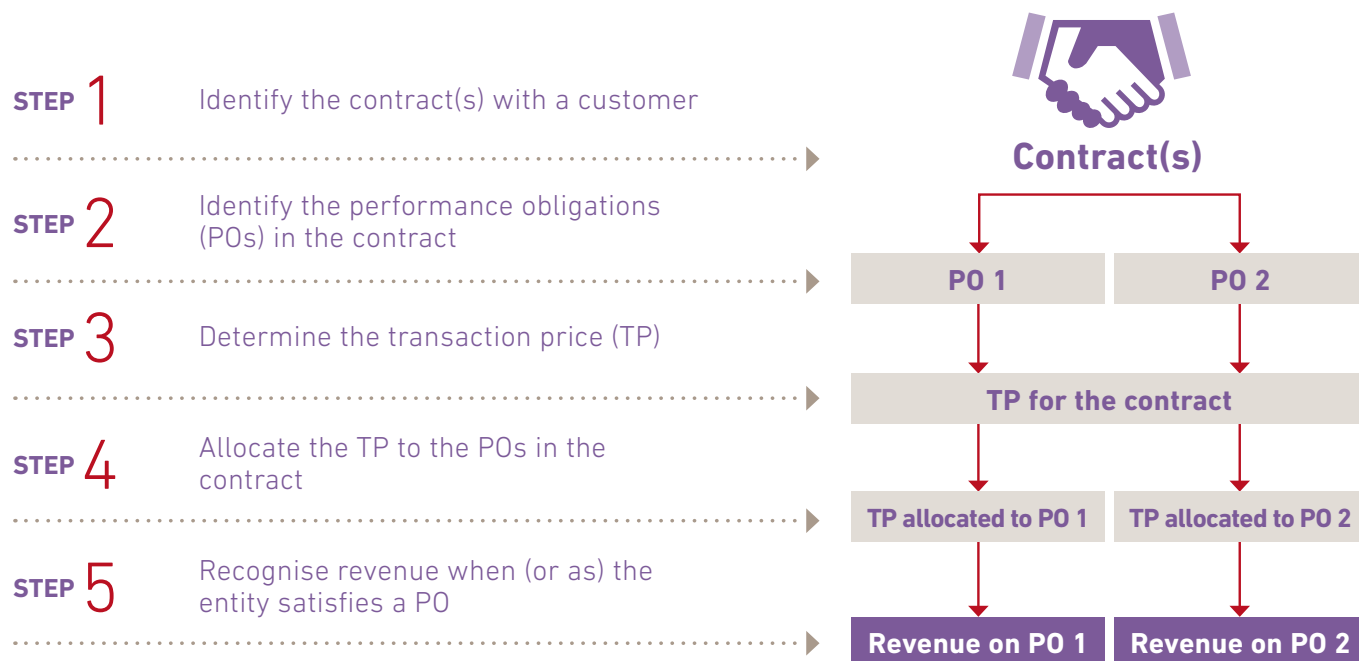
A recognition model in 5 steps



> The core principle of IFRS 15 is that revenue recognition must 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 transfer of goods or services is based on the concept of transfer of control¹ to the customer. This may occur at a point in time (for example when a good is delivered) or over time (for example as a service is rendered or as a good is being constructed).

> Having established this principle, IFRS 15 sets out a 5-step recognition model. The graphic below presents these steps in simplified form.



This model is applicable to all contracts within the scope of the standard. IFRS 15 may, however, be applied to a portfolio of contracts, under certain conditions.

1. IFRS 15 defines control of an asset as the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

Step 1

Identify the contract(s) with a customer



This step consists of ensuring that the contracts signed with customers are valid and represent genuine transactions. An agreement with a customer is a contract under IFRS 15 **if it creates enforceable rights and obligations**. In practice, the following five criteria must be met:

- the parties have approved the contract and are committed to perform their respective obligations;
- each party's rights regarding the goods or services to be transferred can be identified;
- the payment terms for the goods or services to be transferred can be identified;
- the contract has commercial substance;
- it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services. This criterion will be assessed in relation to the customer's ability and intention to pay the consideration.

Combination of contracts

In some cases, two or more contracts shall be combined and accounted for as a single contract. This is the case when:

- the contracts are entered into at or near the same time with the same customer (or a related party of the customer); and

- at least one of the following conditions is met:
 - the contracts were 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 each of the contracts) are a single "performance obligation" (this concept is defined in step 2).

The requirements of IFRS 15 as regards combinations of contracts are slightly different from the arrangements under IAS 11. These principles also apply to transactions that are currently recognised in accordance with IAS 18, which gives little guidance on this subject.

Contract modifications

IFRS 15 also stipulates the accounting treatment of contract modifications, depending on whether these modifications are to be linked with the existing contract or not. In the event that these changes are to be linked with the initial contract, IFRS 15 sets out the circumstances under which they must be recognised prospectively or retrospectively (on a cumulative catch-up basis at the modification date).

Step 2

Identify the separate performance obligations in the contract

A performance obligation corresponds to a good or a service (or a bundle of goods or services) promised to the customer that can be regarded as **'distinct'** from the other goods or services promised in the contract.

The promise to transfer a good or a service will be considered as distinct if the **two** following criteria are met:

- the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer (the fact that the entity regularly sells a good or service separately is an indicator for this criterion);
- the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract. IFRS 15 gives a list of factors to be used when assessing whether a good or a service is distinct within a contract:
 - Does the entity 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?
 - Does the good or service significantly modify or customize another good or service promised in the contract?
 - Is the good or service highly dependent on, or highly interrelated

with, other goods or services promised in the contract?

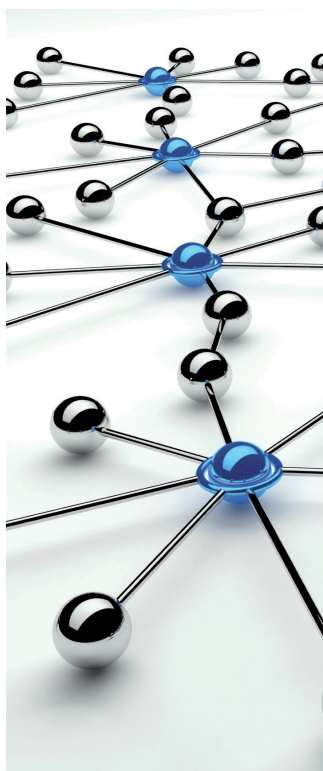
The identification of performance obligations is to be made at contract inception. Promises to provide goods or services to a customer may arise under explicit clauses in the contract, but may also be implied by an entity's customary business practices, published policies or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer.

For example, the sale of a motor vehicle associated with a contract to maintain the vehicle (going beyond a legal warranty, which will continue to be accounted for under IAS 37) contains two distinct components (and hence two performance obligations to be recognised separately): the sale of a good (the vehicle) and the sale of a service (the maintenance).

Identifying the separate performance obligations may prove more difficult in the case of construction, engineering or consulting contracts. In these cases the seller delivers a bundle that integrates the different goods and services sold to the customer and/or customises them in accordance with the customer's specifications. It is precisely this integration or customisation that comprises the added value of the contract. Taking account of the indicators listed above, the extent of integration and/or

" A PERFORMANCE OBLIGATION CORRESPONDS TO A GOOD OR A SERVICE (OR A BUNDLE OF GOODS OR SERVICES) PROMISED TO THE CUSTOMER THAT CAN BE REGARDED AS 'DISTINCT' FROM THE OTHER GOODS OR SERVICES PROMISED IN THE CONTRACT"

Step 2: identify the separate performance obligations in the contract



customisation of the goods and services delivered to the customer will determine whether we should identify one or several performance obligations. This stage will therefore require the exercise of judgment.

Note also that a contract for a sale of a series of distinct but similar goods or services (for example, the sale of a series of similar trains) may constitute a single performance obligation if each good or service in this series fulfils the criteria in the standard (i.e. transfer to the customer of control over these goods or services over time, and application of a consistent method of measuring progress for all the goods or services in the series, for example on the basis of costs incurred to date).

This step of identifying the performance obligations in the contract is crucial because:

- the transaction price determined in step 3 must then be allocated to the separate performance obligations (step 4);
- the breakdown of the contract(s) directly influences the path at which revenue is recognised (step 5), since different performance obligations may be satisfied at different dates. For example, in the case of the combined sale of a vehicle and a maintenance contract described above, the vehicle is transferred/sold in June 20X5 but maintenance will be performed between June 20X5 and June 20X7.

This also has a *de facto* incidence on the recognition of the profit margin, which will in future be separately identified for each performance obligation. However, IFRS 15 contains no requirements for the case where a separate performance obligation is loss-making. In practice, therefore, onerous contracts with customers shall be identified by applying the provisions of IAS 37. This means that a contract which is profitable as a whole but which contains some onerous performance obligations will not require the recognition of a provision for expected losses (as long as the contract remains profitable).

Step 3

Determine the transaction price

The transaction price is the amount of consideration to which an entity **expects to be entitled** in exchange for transferring the goods or services. Determining the transaction price may be complex when the contract includes a variable consideration (such as bonuses, penalties, refunds, price revision clauses, etc.), a significant financing component, non-cash consideration or amounts payable to the customer. IFRS 15 provides very specific guidance for determining these components.

Thus, a variable consideration, measured using either the expected value method or the most likely amount method, will only be taken into account (wholly or in part) when it is highly probable that it will not result in a significant reversal in the amount of cumulative revenue recognised when the uncertainty associated with the variable consideration is subsequently resolved.

The transaction price must also take account of any financing component in the contract in the event of advance or deferred payments, insofar as this has a material impact on the amount of consideration that is received. In practice, this means that any significant financing component included in the transaction must be accounted for in financial income and expense. However, it is not mandatory to adjust the amount of revenue to be recognised if the period between the transfer of the good or service and the payment by the customer is less than 12 months.

Finally, note that the customer credit risk should not be reflected in the measurement of revenue, and any impairment loss relating to contract assets or receivables (determined in accordance with IAS 39 / IFRS 9) will be presented separately in the notes if this information is not separately presented in the income statement.

“ DETERMINING THE TRANSACTION PRICE MAY BE COMPLEX WHEN THE CONTRACT INCLUDES A VARIABLE CONSIDERATION ”



Step 4

Allocate the transaction price to the separate performance obligations

“ THE RESIDUAL APPROACH MAY ONLY BE APPLIED IN A LIMITED NUMBER OF CASES WHEN THE CONDITIONS LISTED IN IFRS 15 ARE MET. ”

The general principle is to allocate the transaction price to each distinct performance obligation in an amount that reflects the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

In practice this allocation is generally made on the basis of **the relative stand-alone selling price** of each distinct good or service.

If the stand-alone selling price of a good or service is not directly observable (in accordance with IFRS 15), the entity is required to estimate the stand-alone selling price using one of the appropriate methods, such as:

- an adjusted market assessment approach (e.g. referring to competitors' prices, adjusted to reflect the entity's circumstances) or

- an expected cost plus a margin approach.

If it is not possible to estimate a stand-alone selling price using one of those methods because this price is uncertain or highly variable, an entity may use the residual approach (i.e. an estimate based on the difference between the total transaction price and the sum of the observable stand-alone selling prices of other goods or services promised). The residual approach may therefore only be applied in a limited number of cases when the conditions listed in IFRS 15 are met.

Finally, IFRS 15 identifies the situations in which a discount or a variable consideration must be allocated not in proportion to stand-alone selling prices, as is normally the case, but to one or several specific performance obligations.



Step 5

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

Determining whether revenue is recognised over time or at a point in time

Revenue is recognised when the seller satisfies a performance obligation by transferring the control of a good or service to the customer. Revenue is therefore recognised either at a point in time, or over time.

IFRS 15 takes a restrictive approach to identifying situations where revenue will be recognised as progress is made towards satisfaction of a performance obligation. This constitutes a significant change in comparison to the existing IFRSs, since this method of recognising revenue was automatic in IAS 11 (for construction contracts) and IAS 18 (for services).

In practice, an entity may only recognise revenue over time **if one of the three following criteria is met:**

- the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs or
- the customer obtains control of an asset as the asset is created or enhanced, or
- the entity's performance does not create an asset with an alternative use (i.e. contractual or practical limitations prevent the entity from readily redirecting the asset for

another use) and the entity has an enforceable right to payment for performance completed to date.

The provision of services alone will generally be recognised over time like today. Likewise, the sale of goods for which the transfer of control occurs over time (for instance, when an agreement for the construction of real estate specifically stipulates that the customer obtains control of the work in progress) may be recognised over time.

However, for construction, engineering or even consulting contracts where the transfer of control of the good or service is not continuous, in order to be able to recognise revenue over time it must be certain that the seller is entitled to payment for performance completed to date in order to recognise the revenue over time.

This will be the case if the seller has an enforceable right (to be determined with reference to the contractual term as well as any legislation or legal precedent) to be paid for the work completed to date in the event that the customer terminates the contract (for reasons other than the seller's failure to perform as promised). The amount of compensation must correspond to a proportion of the transaction price, and thus include a reasonable margin. If none of the three criteria listed above is satisfied, the entity must recognise its revenue at a point in time, that is to say,

“ IFRS 15 TAKES A RESTRICTIVE APPROACH TO IDENTIFYING SITUATIONS WHERE REVENUE WILL BE RECOGNISED AS PROGRESS IS MADE TOWARDS SATISFACTION OF A PERFORMANCE OBLIGATION. ”

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



when the customer obtains control of the good or service.

To determine the time at which the entity satisfies its performance obligation, account must be taken of the definition of control in IFRS 15 (see above) and of the indicators of transfer of control, including those listed in the standard:

- does the entity have a present right to payment for the asset?
- has the customer obtained legal title to the asset?
- has the physical possession of the asset been transferred to the customer?
- have the significant risks and rewards of ownership of the asset been transferred to the customer?
- has the customer accepted the asset?

Recognising revenue over time

For each performance obligation satisfied over time, an entity shall recognise revenue over time by measuring the progress towards complete satisfaction of that performance obligation. The possible methods listed in IFRS 15 for measuring progress are based either on outputs (that is, on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised

under the contract), or on inputs (i.e. on the basis of the efforts or inputs already invested by the entity relative to the total expected inputs that the entity expects to use to satisfy a performance obligation completely).

In practice, progress may still be measured via milestones reached if this method faithfully depicts the progress of transfer of control of the goods or services promised to the customer (that is, the extent to which the performance obligation is satisfied).



What does IFRS 15 say about contract costs?

- > IFRS 15 makes a distinction between the **costs of obtaining a contract** and the **costs to fulfil a contract**.
- > The costs of obtaining a contract must be recognised as an asset if they correspond to the **incremental costs** that the entity would not have incurred if the underlying contract had not been obtained (for example, a sales commission) and if these costs are expected to be recovered.
- > For the costs of fulfilling the contract IFRS 15 refers first to the criteria for recognising an asset set out in IAS 2 on Inventories, IAS 16 on Property, Plant and Equipment or IAS 38 on Intangible Assets. In order to recognise costs that do not fall within the scope of these three standards, **three criteria** must be met:
 - the costs must relate directly to a contract or to an anticipated contract that the entity can specifically identify;
 - the costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future;
 - the costs are expected to be recovered by the entity.
- > IFRS 15 stipulates that contract costs shall be amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. Further, where applicable, an asset accounted for under IFRS 15 may have to be impaired.

What disclosures shall be provided in the notes?

- > **The objective of IFRS 15 is for an entity to disclose 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.**
- > **The disclosures required are both qualitative and quantitative and relate to contracts signed with customers, the significant judgements made in applying this standard and any assets recognised from the costs to obtain or fulfil a contract.**
- > **IFRS 15 requires entities to disclose much more information than is currently required by IAS 18, IAS 11 and the associated interpretations.**
- > **All entities are encouraged to begin as of now to identify the impacts of IFRS 15 and the data to be collected, as this could lead to significant changes to their information systems.**

What are the transition requirements on initial application?

- > **IFRS 15 will be of mandatory application for reporting periods beginning on or after 1 January 2017 subject to endorsement by the European Union. Early application is permitted.**
 - or to apply an alternative method only by restating contracts not completed at 1 January 2017 (which means that comparative periods presented will not be restated).
- > **An entity will have the choice:**
 - either to apply IFRS 15 retrospectively (with some practical expedients possible), the impact of the application of the new standard being determined at the beginning of the earliest comparative period presented (with an impact on the opening equity for this period);
- > **Each method has advantages and drawbacks which should be assessed in the light of an entity's particular circumstances in order to choose the most relevant approach.**

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