

Revenue Recognition will never be the same again

The big picture – what will change?

The IASB recently issued its first major new standard in more than 3 years which will result in some significant changes to revenue recognition. Just about every entity that generates revenue will be affected, with major accounting changes likely in a diverse range of industries including: construction, telecommunications and entertainment & media.

IFRS 15, 'Revenue from contracts with customers', replaces all previous IFRS revenue guidance so construction contracts that were previously in the scope of IAS 11, 'Construction contracts', will no longer be subject to different revenue recognition requirements. For all contracts with customers, revenue will be recognised when control of the promised goods or services is transferred to the customer, not when risks and rewards pass. The measurement of the total contract consideration, and how it is split between multiple elements deliverable under a single contract, will also change for many entities upon adoption of IFRS 15.

As well as changes to the timing and measurement of revenue recognised, entities should also be prepared for a significant increase in the volume of disclosures required in both annual and interim financial statements. Even entities that suffer minimal changes to their revenue recognition policies will need to give careful thought as to how they will gather the information necessary to satisfy the disclosure requirements.

While the accounting and disclosure impact of IFRS 15 is likely to be significant for a number of entities, the impact of this standard will not be confined to companies' financial reporting functions. In order to gather the necessary data to implement the new standard, new systems may be required which in turn require associated internal controls. Also, employee incentive plans are often linked to financial performance so changes to revenue recognition may leave companies having to redesign their remuneration plans. Changes to recorded revenue will result in changes to profit and hence tax, either from a current tax perspective if the SARS aligns the tax treatment with the new accounting treatment, or from a deferred tax perspective if the SARS tax treatment remains unchanged. Some entities may seek to redesign their contracts to avoid what might be seen as undesirable accounting consequences which will require the input of legal advisers. And finally, 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.

Effective date for the new standard

The mandatory effective date of IFRS 15 is for years beginning on or after 1 January 2017, so with most companies needing to restate comparatives upon adoption, entities have only 18 months to get ready for the new standard. This does not leave much time for companies to coordinate input from technical accountants, IT specialists, internal audit, legal advisers, remuneration consultants, tax experts, and investor relations. IFRS 15 is a converged standard issued jointly with the US's Financial Accounting Standards Board (FASB). Consequently entities in the US, where two years of comparatives are required, will have even less time to prepare their processes to be in a position to capture the information to restate comparatives.

The new accounting model

While IFRS 15 will apply to most revenue contracts, its scope is drafted in such a way that it is a “residual” standard. This means that any arrangement that falls into the scope of another standard such as leasing, financial instruments, insurance etc will be dealt with under those standards. Any contracts that do not fall within the scope of another standard will be dealt with in IFRS 15.

Once an entity determines that a contract is within the scope of IFRS 15, the standard sets out a 5-step process for revenue recognition:

- Step 1 – Identify the contract with a customer
- Step 2 – Identify the performance obligations
- Step 3 – Determine the contract consideration
- Step 4 – Allocate consideration to the performance obligations
- Step 5 – Recognise revenue when transfer of control occurs

Assuming that the entity expects that it is probable that the customer will pay the contract consideration, step 1 requires that the entity consider whether two or more legal contracts should be aggregated together to account for the substance of the arrangement in a similar way to existing IFRS. Step 1 also includes detailed guidance on how contract modifications should be accounted for, which are a common feature in many construction type contracts.

Having set the contract boundary, step 2 is focussed on identifying the deliverables promised in the contract or, to use IFRS 15 terminology, the performance obligations. Performance obligations can be implicit or explicit and may be documented in writing or agreed orally. IFRS 15 requires that performance obligations are accounted for separately when the goods or services promised are distinct. A good or service is distinct if the customer is capable of using the deliverable by itself, or in conjunction with other goods and services generally available in the market. A deliverable that has no use to the customer without further purchases of goods and services from the same supplier is not distinct. Goods or services that are not distinct should be aggregated together until a distinct deliverable emerges. Even if a good or service is capable of being distinct, the requirements of IFRS 15 might require aggregation of those goods or services if they are not distinct in the context of the contract. For example a construction company building a house aggregates the bricks, timber, and tiles because, although those goods are capable of being distinct, in the context of a contract to build a house, they do not transfer the promised good or service to the customer on their own. The requirement to identify all of the performance obligations in a contract could impact industries that currently treat these promises as marketing costs, for example in the retail and automotive industries.

Usually the amount of consideration is easy to determine but the two areas where challenges may arise in step 3 are in respect of the time value of money and contingent consideration. IFRS 15 grants a practical expedient that discounting is not required when receipt of cash and performance occur within 12 months of each other, or when the date of performance is at the customer’s discretion such as in the case of a customer loyalty programme. However, outside of this 12 month window, entities will now need to consider whether they should charge themselves interest on consideration received in advance in addition to discounting consideration received in arrears. The treatment of contingent consideration (e.g. where the amount of consideration can vary because of an entity’s performance or customer return

rights) will be broadly similar to IAS 18, but further guidance will increase consistency between entities. Contingent amounts will be recognised as revenue under IFRS 15 if it is highly probable that the amount recognised will not result in a significant reversal of revenue in subsequent periods. Investment management companies are likely to be particularly affected by the revised contingent consideration guidance.

Step 4 introduces a significant change to many entities' existing practice under IAS 18. Consideration must be allocated on a "relative stand-alone selling price" basis to each of the performance obligations in the contract. The stand-alone selling price of a good or service is the price that a customer would pay for that good or service if it was acquired on its own. In other words, any discount in a bundled arrangement is allocated pro-rata to each deliverable based on that deliverable's relative stand-alone selling price. The free choice to apply a residual method under IAS 18, whereby the entire discount in a bundled arrangement is allocated to the delivered goods, is not acceptable under IFRS 15. This will have a significant impact on mobile telecommunication companies because this new guidance will force more consideration to be allocated to the handset and recognised up-front. Subsequent revenue recognised over the contract period will consequently be lower than the monthly bills issued. Entities with customer loyalty programmes will also be affected by this because most entities currently apply the residual method to the loyalty points under IFRIC 13, 'Customer loyalty programmes'.

Finally in step 5, revenue is recognised when control of goods or services is transferred to the customer. For sales of goods, a list of indicators provides guidance as to when control transfers. For sales of services, control transfers over time and so revenue is recognised over time. When revenue is recognised over time, the new standard requires companies to critically consider what the most appropriate measure of progress is to depict faithfully the transfer of the promised goods or services. Consequently entities will need to assess whether using "input methods" (such as costs incurred compared to total expected costs) is the most appropriate measure of progress. This could impact entities in the construction and engineering industries.

Existing IFRS has no guidance in determining what is a good and what is a service. Under IFRS 15 the arrangement is a service with revenue recognised over time if any of the following 3 criteria are met:

- The customer receives and consumes the benefits of the entity's performance as the entity performs (e.g. a cleaning or security service);
- The entity's performance creates or enhances an asset that the customer clearly controls as the asset is created or enhanced (e.g. construction of a building on the customer's land); or
- The entity's performance does not create an asset with an alternative use to the entity (because of the asset is specific to the customer or because of a contractual restriction), and the entity has a right to payment for any performance completed to date (e.g. audit services and some types of contract manufacturing and construction contracts).

It is this final criterion that is of most interest to the construction sector because it reverses the conclusion arrived at under IFRIC 15, 'Agreements for the construction of real estate', for a number of contracts, and leads to revenue recognition over time rather than upon completion for many real estate developers.

Specific guidance has also been included in the new standard in respect of licences with some licences being seen as similar to the sale of goods while others being services. Indicators are included in the new standard to help entities differentiate between the two different types of licence. Entities in the entertainment & media and software industries should pay particular attention to this distinction because it may require changes to existing practice for some entities.

In addition to dealing with revenue, IFRS 15 also includes guidance as to when costs incurred as part of a revenue contract must be capitalised and carried forward against future contract performance. More of these contract costs will be capitalised under IFRS 15 than existing IFRS, and industries with significant up-front costs such as outsourcing should carefully consider the revised guidance. In addition, entities in the software and telecommunications industries may also experience a change in current practice as a result of mandatory capitalisation of some contract costs.

Don't leave it too late

In summary, IFRS 15 introduces a completely 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, don't leave it too late to find out how it will affect you.

Bios of the authors:

Gary Berchowitz is an Associate Director in PwC's Accounting and Consultancy Services division in South Africa. For two years from 2011 - 2013, Gary was on secondment at the IASB, where he was part of the project staff responsible for the development of IFRS 15. Prior to his IASB secondment, Gary spent 5 years abroad at PwC's Global, UK, and US Accounting and Consultancy Services divisions, where he helped companies interpret and implement IFRS requirements in a broad range of areas. Gary has also contributed to the development of the revenue and share-based payments chapters of PwC's global IFRS Manual of Accounting.

Simon Whitehead is an Associate Director in PwC's Accounting Consulting Services division, specialising in revenue recognition. Simon has worked as an IFRS accounting expert within PwC for the past 6 years in both the UK and South Africa. In this role he has provided accounting advice and training to clients on a wide range of topics and has been an author and reviewer of the PwC IFRS Manual of Accounting. He has also contributed to the standard setting process by drafting letters to the IASB on behalf of the PwC Global Network and the South African Institute of Chartered Accountants.

SAICA and IFRS Foundation IFRS Conference:

Hear Gary Berchowitz debate this new standard with Philisiwe Sibiyi, CFO of MTN South Africa, JP Davids, Co-head of Equity Research, Barclays Africa; Yona Killagane from Tanzania and IASB members Stephen Cooper and Wei-Guo Zhang at the SAICA and IFRS Foundation IFRS Conference on 13 - 14 August 2014, and take the opportunity to discuss your implementation concerns at a dedicated breakout session on this topic. Book for the conference by going to the SAICA website seminars and events section.