insights

In May 2014, almost 12 years since the work begun, the new standard on revenue recognition IFRS 15 Revenue from Contracts with Customers was published. The aim of this article is to present the key aspects of the new revenue recognition in a light and accessible way as well as to help in systematic preparation for the upcoming changes.

IFRS - 15

Revenue from Contracts with Customers

Reason behind IFRS 15 :

Sales revenue constitutes a company's key financial information presenting its current results, financial standing but also future prospects. It is a Key Performance Indicator essential not only for the management and owners but also for potential investors.

Despite their importance and the increasing globalization of financial markets, the already existing regulations of IFRS and GAAP differed considerably, what caused inconsistencies and difficulties in comparing entities which prepared financial statements in accordance with those standards.

IFRSs were criticized for being overly general and lacking guidelines on important and problematic issues, which caused difficulties when applying them.

US GAAP, on the other hand, were broad and approached the issues in a fragmented manner, which complicated their use. Neither standard was adjusted to the new reality.

Impact of IFRS 15 on companies:

The new standard should be of interest to companies which use IFRS or US GAAP and to those who plan to implement them in the near future. The American Financial Accounting Standards Board worked together with the International Accounting Standards Board on the standard which resulted in an almost identical outcome for both of those accounting regimes.

The biggest changes will be noticed by the entities offering products and services in multiple item packages; selling licenses; providing services in a form of long-term contracts and those which apply variable price or conditional remuneration in their contracts with clients.

Although every company reporting IFRS 15 or US GAAP is affected to a certain level, the following industries are impacted the most by IFRS 15:

- **Telecommunications**
- **Information Technology**
- **Technology**
- **Automotive**
- **Energy**
- **Real Estate**
- **Media and Entertainment**
- **Pharmaceuticals**
- **Construction**
- **Health Care**

How will IFRS 15 Impact?

When IFRS 15 came into operation, it replaced the following existing regulations relating to revenue:

- *IAS 18 Revenue;*
- *IAS 11 Construction Contracts;*
- *SIC 31 Revenue Barter Transactions;*
- *IFRIC 13 Customer Loyalty Programmes;*
- *IFRIC 15 Agreements for the Constructions; and*
- *IFRIC 18 Transfer of Assets from Customers.*

Change from previous to new standard

IAS 18 and IAS 11 distinguished three separate models of revenue recognition, dependent on the sale transaction type:

- *Construction contracts;*
- *Sales of products/ goods; and*
- *Sales of services.*

Whereas, IFRS 15 introduces five-step model of revenue recognition, common to all types of transactions, to all companies and industries.
This model will be applied in two versions, depending on how performance obligation is satisfied by focusing more on:

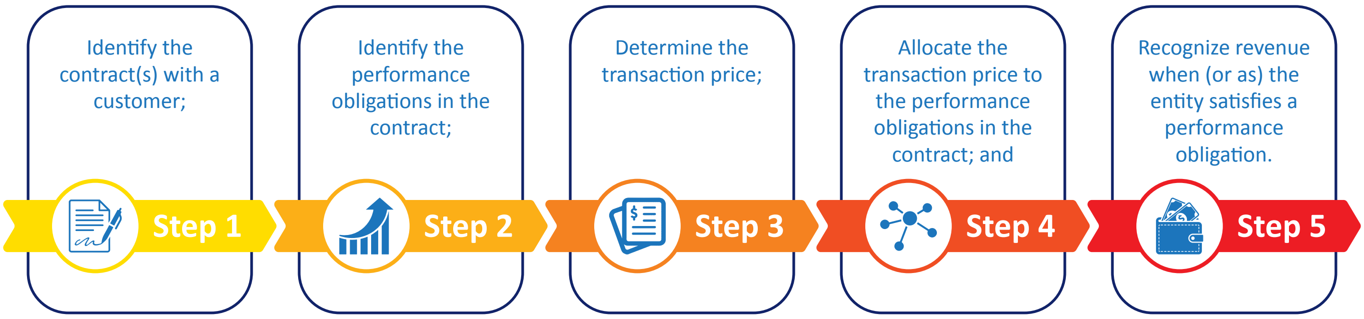
- *Over a period of time; and*
- *At a point in time*.*

*at a point in time is basically 'in a given moment'.

Due to this, the moment of revenue recognition may shift. Revenue which as per previous standard was recognized over a period of time throughout the duration of the contract, may now be recognized once, at the end of the contract and vice versa.

Accounting requirements for revenue - The five-step model framework

The core principle of IFRS 15 is that an entity will recognize 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. This core principle is delivered in a five-step model framework:



Application of this guidance will depend on the facts and circumstances present in a contract with a customer and will require the exercise of judgment.

Explanation of Five-step model:

Step 1: Identify the contract with the customer

A contract with a customer will be within the scope of IFRS 15 if all the following conditions are met:

- *the contract has been approved by the parties to the contract;*
- *each party's rights in relation to 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; and*
- *it is probable that the consideration to which the entity is entitled to in exchange for the goods or services will be collected.*

If a contract with a customer does not yet meet all of the above criteria, the entity will continue to re-assess the contract going forward to determine whether it subsequently meets the above criteria. From that point, the entity will apply IFRS 15 to the contract.

Step 2: Identify the performance obligations in the contract

At the inception of the contract, the entity should assess the goods or services that have been promised to the customer, and identify as a performance obligation:

- *a good or service (or bundle of goods or services) that is distinct; or*
- *a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.*

A series of distinct goods or services is transferred to the customer in the same pattern if both of the following criteria are met:

- *each distinct good or service in the series that the entity promises to transfer consecutively to the customer would be a performance obligation that is satisfied over time (see below); and*
- *a single method of measuring progress would be used to measure the entity's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.*

A good or service is distinct if both of the following criteria are met:

- *the customer can benefit from the good or services on its own or in conjunction with other readily available resources; and*
- *the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.*

Factors for consideration as to whether a promise to transfer goods or services to the customer is not separately identifiable include, but are not limited to:

- *the entity does provide a significant service of integrating the goods or services with other goods or services promised in the contract;*
- *the goods or services significantly modify or customize other goods or services promised in the contract;*
- *the goods or services are highly interrelated or highly interdependent.*

Step 3: Determining the transaction price

The transaction price is the amount to which an entity expects to be entitled in exchange for the transfer of goods and services. When making this determination, an entity will consider past customary business practices.

Where a contract contains elements of variable consideration, the entity will estimate the amount of variable consideration to which it will be entitled under the contract. Variable consideration can arise, for example, as a result of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. Variable consideration is also present if an entity's right to consideration is contingent on the occurrence of a future event.

Step 4: Allocate the transaction price to the performance obligations in the contracts

Where a contract has multiple performance obligations, an entity will allocate the transaction price to the performance obligations in the contract by reference to their relative standalone selling prices. If a standalone selling price is not directly observable, the entity will need to estimate it. IFRS 15 suggests various methods that might be used, including:

1. *Adjusted market assessment approach*
2. *Expected cost plus a margin approach*
3. *Residual approach (only permissible in limited circumstances)*

Any overall discount compared to the aggregate of standalone selling prices is allocated between performance obligations on a relative standalone selling price basis. In certain circumstances, it may be appropriate to allocate such a discount to some but not all of the performance obligations.

Where consideration is paid in advance or in arrears, the entity will need to consider whether the contract includes a significant financing arrangement and, if so, adjust for the time value of money. A practical expedient is available where the interval between transfer of the promised goods or services and payment by the customer is expected to be less than 12 months.

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

Revenue is recognized as control is passed, either over time or at a point in time.

Control of an asset is defined as the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. This includes the ability to prevent others from directing the use of and obtaining the benefits from the asset. The benefits related to the asset are the potential cash flows that may be obtained directly or indirectly. These include, but are not limited to:

01. *Using the asset to produce goods or provide services;*
02. *Using the asset to enhance the value of other assets;*
03. *Using the asset to settle liabilities or to reduce expenses;*
04. *Selling or exchanging the asset;*
05. *Pledging the asset to secure a loan; and*
06. *Holding the asset.*

An entity recognizes revenue over time if one of the following criteria is met:

- *the customer simultaneously receives and consumes all of the benefits provided by the entity as the entity performs;*
- *the entity's performance creates or enhances an asset that the customer controls as the asset is created; or*
- *the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.*

If an entity does not satisfy its performance obligation over time, it satisfies it at a point in time. Revenue will therefore be recognized when control is passed at a certain point in time. Factors that may indicate the point in time at which control passes include, but are not limited to:

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

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