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Special Edition on Revenue

MFRS Hot Topics

August 2014

A shift in the top line – the new global revenue standard is here at last

The IASB has published IFRS 15 'Revenue from Contracts with Customers'.
IFRS 15:

- replaces IAS 18 'Revenue', IAS 11 'Construction Contracts' and some revenue-related Interpretations
- establishes a new control-based revenue recognition model
- changes the basis for deciding whether revenue is recognised at a point in time or over time
- provides new and more detailed guidance on specific topics
- expands and improves disclosures about revenue.

This special edition of MFRS Hot Topics explains the key features of the new Standard and provides practical insights into its application and impact.

We have covered the introduction and scope of IFRS 15 in the July 2014 issue.
In this issue, the details of Five Steps of Revenue Recognition under IFRS 15 are discussed.

The five steps

Step 1: Identify the contract(s) with a customer

The first step in IFRS 15 is to identify the "contract," which IFRS 15 defines as "an agreement between two or more parties that creates enforceable rights and obligations." A contract can be written, oral, or implied by an entity's customary business practices.

In addition the general IFRS 15 model applies only when or if:

- the contract has commercial substance
- the parties have approved the contract
- the entity can identify
  - each party's rights
  - the payment terms for the goods and services to be transferred
- it is probable the entity will collect the consideration.

If a customer contract does not meet these criteria, revenue is recognised only when either:

- the entity's performance is complete and substantially all of the consideration in the arrangement has been collected and is non-refundable
- the contract has been terminated and the consideration received is non-refundable.

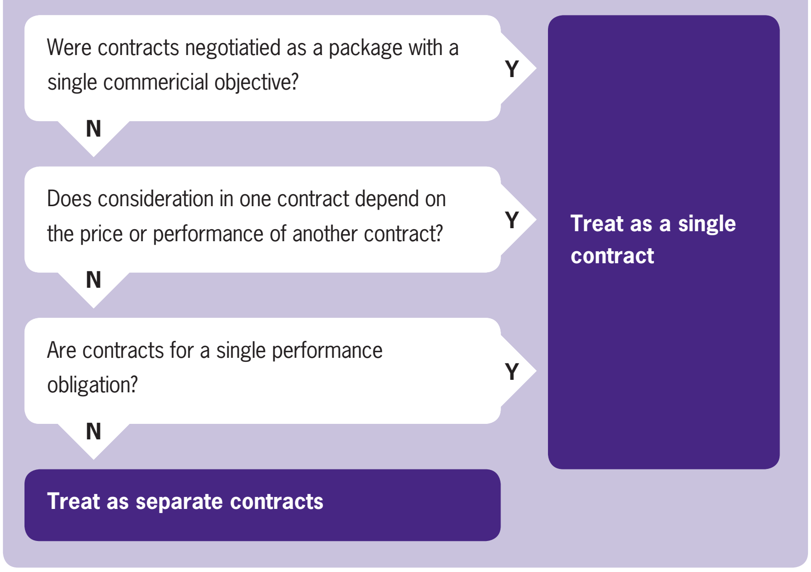
For purposes of IFRS 15, a contract does not exist if each party has an enforceable right to terminate a wholly unperformed contract without compensating the other party.

Combining contracts

An entity is required to combine two or more contracts and account for them as a single contract if they are entered into at or near the same time and meet one of the following criteria:

- the contracts were negotiated as a package with one commercial objective
- the amount paid under one contract is dependent on the price or performance under another contract
- the goods or services to be transferred under the contracts constitute a single performance obligation.

Criteria for combining two or more contracts

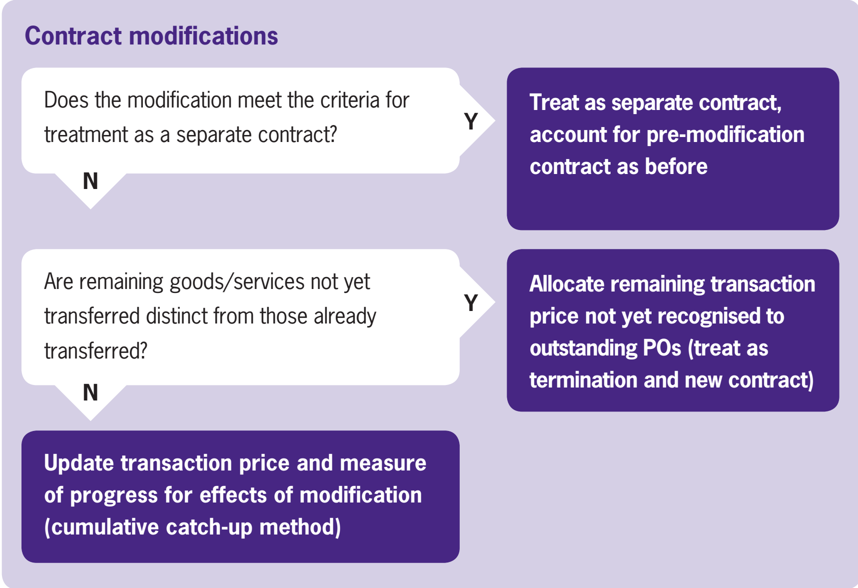


Contract modifications

A contract modification arises when the parties approve a change in the scope and/or the price of a contract (eg a change order). The accounting for a contract modification depends on whether the modification is deemed to be a separate contract or not.

An entity accounts for a modification as a separate contract, if both:

- the scope changes due to the addition of 'distinct' goods or services (see below)
- the price change reflects the goods' or services' stand-alone selling prices under the circumstances of the modified contract.



In this case, only future revenue is impacted as the entity will continue to account for the pre-modification contract as before.

The accounting for a contract modification that is not a separate contract depends on whether the remaining goods and services to be delivered under the modified contract are 'distinct' from those already transferred to the customer at the modification date:

- if the remaining goods or services are distinct, then the modification is treated as a termination of the original contract and the creation of a new contract. The transaction price to be allocated to the remaining separate performance obligations is the (modified) total consideration promised by the customer less the amount already recognised as revenue.

  No adjustments are made to the amount of revenue recognised for separate performance obligations satisfied on or before the modification date. If a change to an amount of variable consideration arises subsequently and relates to performance prior to the modification the entity applies the guidance on variable consideration
- if the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied as of the modification date, the entity adjusts both the transaction price and the measure of progress toward completion of the performance obligation. Revenue recognised to date is adjusted for the contract modification on a 'cumulative catch-up' basis
- if the remaining goods or services are a combination of these scenarios the entity accounts for the effects of the modification on unsatisfied or partially satisfied obligations consistently with the guidance above. No adjustments are made to the amount of revenue recognised for separate performance obligations satisfied on or before the modification date.

If the parties approve a change in scope but the price change has not yet been determined, the entity applies the relevant guidance to the modified contract using an estimate of the change in transaction price arising from the modification. The guidance on variable consideration applies in such cases – see Step 3.

Step 2: Identify the performance obligations

Having identified a contract, the entity next identifies the performance obligations within that contract. A performance obligation is a promise in a contract with a customer to transfer either (1) a good or service, or a bundle of goods or services, that is 'distinct' (see below); or (2) a series of distinct goods or services that are substantially the same and meet certain criteria.

Performance obligations are normally specified in the contract but could also include promises implied by an entity's customary business practices, published policies or specific statements that create a valid customer expectation that goods or services will be transferred under the contract.

Performance obligations do not include administrative-type tasks that do not result in a transfer of a good or service to a customer (eg some set-up activities).

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

- the customer can benefit from the good or service either on its own or with other resources readily available to them. A readily available resource is a good or service that is sold separately (by the entity or by another entity) or that the customer has already obtained
- it is separately identifiable from other promises in the contract. Indicators of separate identifiability include:
  - significant integration services are not provided (ie the entity is not using the good or service merely as an input to produce the specific output called for in the contract)
  - the good or service does not significantly modify or customise other promised goods or services in the contract
  - the good or service is not highly dependent on, or interrelated with, other promised goods or services in the contract.

Meaning of 'distinct'

Customer can benefit from goods/services + **Separately identifiable from other contract promises** = **Distinct**

Practical insight – performance obligations

The concept of performance obligations is a cornerstone of the IFRS 15 model. The timing of revenue recognition is based on satisfaction of performance obligations rather than the contract as a whole. This area is sometimes referred to as 'multiple element arrangements' – a topic on which IAS 18 and IAS 11 are lacking in guidance. Practice has therefore been somewhat mixed under current IFRSs and in some industries, such as software, many entities have turned to much more detailed US GAAP for guidance.

Entities applying IFRSs will need to analyse all but the simplest customer contracts to identify whether they include more than one performance obligation, based on the 'distinct' principle described above. That said, we expect that many long-term construction and service contracts will be identified as single performance obligations because they often include a significant integration service. By contrast, the calculation of revenue attributable to free or discounted mobile phones delivered by telecommunications companies as part of an airtime or data package will change if those companies previously applied a 'cash limit' by analogy to US GAAP when assessing the probability of receipt.

IFRS 15 also includes specific guidance on some contract elements such as warranties and customer loyalty schemes.

Step 3: Determine the transaction price

Under IFRS 15, the "transaction price" is defined as the amount of consideration an entity expects to be entitled to in exchange for the goods or services promised under a contract, excluding any amounts collected on behalf of third parties (for example, sales taxes). The transaction price is not adjusted for effects of the customer's credit risk, but is adjusted if the entity (eg based on its customary business practices) has created a valid expectation that it will enforce its rights for only a portion of the contract price.

An entity must consider the effects of all the following factors when determining the transaction price:

- variable consideration
- the constraint on variable consideration
- time value of money
- non-cash consideration
- consideration payable to the customer.

Practical insight – customer credit risk

Under IAS 18 and IAS 11 collectability is a recognition principle because an entity cannot recognise revenue until it is probable that the economic benefits will flow to it. IFRS 15 is somewhat similar in that the model applies only if collection is probable.

Once the entity has determined that the IFRS 15 model applies, the transaction price is based on the contractual entitlement such that expected losses are not treated as variable consideration for revenue recognition purposes (although an expectation of granting a price concession may arise in circumstances of high customer credit risk). Instead IFRS 15 requires that an entity would measure credit losses under the financial instruments standards. The IASB plans to shortly issue a new section of IFRS 9 'Financial Instruments' that will generally require the immediate recognition of lifetime expected losses on both contract assets and short-term trade receivables.

Under IFRS 15 credit losses (initial and subsequent) on both contract assets and receivables must either be presented on the face of the statement of comprehensive income or disclosed in the footnotes – but need not be presented adjacent to revenue as proposed in the 2011 Exposure Draft.

Variable consideration

The amount of consideration received under a contract might vary due to discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties and similar items. IFRS 15's guidance on variable consideration also applies if:

- the amount of consideration received under a contract is contingent on the occurrence or non-occurrence of a future event (eg a fixed-price contract would be variable if the contract included a return right)
- the facts and circumstances at contract inception indicate that the entity intends to offer a price concession.

To estimate the transaction price in a contract that includes variable consideration, an entity determines either:

- the expected value (the sum of probability-weighted amounts) or
- the most likely amount of consideration to be received,

whichever better predicts the amount of consideration to which the entity will be entitled.

The expected value might be the appropriate amount in situations where an entity has a large number of similar contracts. The most likely amount might be appropriate in situations where a contract has only two possible outcomes (for example, a bonus for early delivery that either would be fully received or not at all).

An entity should use the same method to estimate the transaction price throughout the life of a contract.

An entity that expects to refund a portion of the consideration to the customer would recognise a liability for the amount of consideration it reasonably expects to refund. The entity would update the refund liability each reporting period based on current facts and circumstances.

Constraint on variable consideration

If the amount of consideration from a customer contract is variable, an entity is required to evaluate whether the cumulative amount of revenue recognised should be constrained. The objective of the constraint is for an entity to recognise revenue only to the extent that it is highly probable that there will not be a significant reversal (ie significant downward adjustment) when the uncertainty about the variable consideration resolves.

Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, the following:

- the amount of consideration is highly susceptible to factors outside the entity's influence
- the uncertainty is not expected to be resolved for a long time
- the entity's experience with similar contracts is limited
- the entity has a practice of offering a broad range of price concessions
- there are a large number and wide range of possible consideration amounts in the contract.

Sales-based or usage-based royalties

An exception to the general principles on variable consideration applies to revenue for a sales-based or usage-based royalty promised in exchange for a licence of intellectual property. Revenue is recognised only on the later of:

- when the customer makes the subsequent sales or use that triggers the royalty
- the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

Time value of money

Under IFRS 15, an entity must reflect the time value of money in its estimate of the transaction price if the contract includes a significant financing component. The objective in adjusting the transaction price for the time value of money is to reflect an amount for the selling price as though the customer had paid cash for the goods or services when they were transferred.

To determine whether a financing component is significant, an entity considers several factors, including, but not limited to, the following:

- the difference, if any, between the promised consideration and the cash price
- the combined effect of:
  - the expected length of time between delivery of the goods or services and receipt of payment
  - the prevailing interest rates in the relevant market.

A contract may not have a significant financing component if:

- advance payments have been made but the transfer of the good or service is at the customer's discretion
- the consideration is variable based on factors outside the vendor's and customer's control (eg a sales-based royalty)

Variable consideration and the revenue constraint

1. Estimate variable consideration and include in transaction price
2. Apply constraint

Expected value

Or

Most likely amount

≤

Limited to the extent that it is 'highly probable' that there will not be a significant revenue reversal

Practical insight – uncertainty in the transaction price

Under IASs 18 and 11, uncertainty in the transaction price is partly a recognition issue. If the revenue amount cannot be measured reliably then no revenue can be recognised (or revenue is limited to the costs incurred when their recovery is probable). If a reliable estimate is available then the uncertain consideration would typically be measured at fair value. Assessing reliability may involve considerable judgement.

IFRS 15 has more specific and detailed guidance and will change some current practices. That said, in highly uncertain situations (eg some success fee-type arrangements when the outcome of the relevant contingency is unpredictable) the practical effect is likely to be the same – ie revenue is recognised only when the uncertainty is resolved. In situations involving multiple similar transactions, such that the entity has relevant, predictive experience, we believe that IFRS 15 could lead to earlier recognition in some cases.

- a difference between the promised consideration and the cash price relates to something other than financing such as protecting one of the parties from non-performance by the other.

As a practical expedient, an entity can ignore the impact of the time value of money on a contract if it expects, at contract inception, that the period between the delivery of goods or services and customer payment will be one year or less.

To adjust the amount of consideration for the time value of money, an entity applies the discount rate that would be used in a separate financing transaction between the entity and the customer at contract inception. That rate reflects the credit risk of whichever party is receiving credit (ie the customer if payment is deferred and the vendor if payment is in advance) and any collateral or security provided by the customer or the entity, including assets transferred under the contract.

An entity presents the effects of financing separately from revenue as interest expense or interest income in the statement of comprehensive income.

Non-cash consideration

If a customer promises consideration in a form other than cash, an entity measures the non-cash consideration at fair value in determining the transaction price. This includes arrangements in which the customer transfers control of goods or services (eg materials, equipment, labour) to facilitate the entity's fulfilment of the contract.

If an entity is unable to reasonably measure the fair value of non-cash consideration, it indirectly measures the consideration by referring to the stand-alone selling price of the goods or services promised under the contract.

Consideration payable to a customer

Consideration payable to a customer includes amounts that an entity pays or expects to pay to a customer in the form of cash or non-cash items. This includes credit or other items that the customer can apply against amounts owed to the entity. An entity reduces the transaction price by the amount it owes to the customer, unless the consideration owed is in exchange for distinct goods or services transferred from the customer to the entity.

If the customer transfers distinct goods or services to an entity in exchange for payment, the entity accounts for the purchase of these goods or services similarly to other purchases from suppliers. If the amount of consideration owed to the customer exceeds the fair value of those goods or services, the entity reduces the transaction price by the amount of the excess. If the entity cannot estimate the fair value of the goods or services it receives from the customer, it reduces the transaction price by the total consideration owed to the customer.

An entity recognises any reduction in revenue associated with adjusting the transaction price for consideration payable to a customer at the later of the following dates:

- the date the entity recognises revenue for the transfer of goods or services to the customer
- the date the entity pays or promises to pay the consideration to the customer. That promise may be implied by the entity's customary business practices.

Consideration payable to a customer

Is consideration payable to the customer for a distinct good or service?

Y

Account for the purchase of distinct good or service similarly to purchases from suppliers
- **if consideration owed to the customer > fair value of goods/services: reduce transaction price by that excess**
- **if entity cannot estimate fair value of goods/services received from customer: reduce transaction price by total consideration owed to the customer**

N

Reduce the transaction price by the amount owed to the customer at later of:
- **related revenue is recognised**
- **consideration is paid or promised to customer**

Step 4: Allocate the transaction price to the performance obligations

Under IFRS 15, an entity allocates a contract's transaction price to each separate performance obligation within that contract on a relative stand-alone selling price basis at contract inception. IFRS 15 defines a stand-alone selling price as "the price at which an entity would sell a promised good or service separately to a customer." The best evidence of the stand-alone selling price is the observable selling price charged by the entity to similar customers and in similar circumstances, if available. If not, the stand-alone selling price is estimated using all reasonably available information (including market conditions, entity-specific factors, and information about the customer or class of customer), maximising the use of observable inputs.

IFRS 15 suggests, but does not require, the following three methods as suitable for estimating the stand-alone selling price:

Possible methods to estimate the stand-alone selling price

Method	Description
Adjusted market assessment approach	Involves evaluating the market in which the entity sells goods or services and estimating the price that customers in that market would pay for those goods or services. An entity might also consider price information from its competitors and adjust that information for the entity's particular costs and margins.
Expected cost plus margin approach	An entity would forecast its expected costs to provide goods or services and add an appropriate margin to the estimated selling price.
Residual approach	Involves subtracting the sum of observable stand-alone selling prices for other goods and services promised under the contract from the total transaction price to arrive at an estimated selling price for a performance obligation. This method is permitted only if the entity: • sells the same good/service to different customers (at or near the same time) for a broad range of amounts; or • has not yet established price for the good/service and the good/service has not previously been sold on a stand-alone basis.

Allocating discounts and variable consideration

If the sum of the stand-alone selling prices for the promised goods or services exceeds the contract's total consideration, an entity treats the excess as a discount to be allocated to the separate performance obligations on a relative stand-alone selling price basis. However, an entity would allocate a discount to only some of the performance obligations only if it has observable evidence of the obligations to which the entire discount belongs. IFRS 15 sets out criteria that must be met to satisfy this requirement.

If a discount is allocated entirely to one or more, but not all, performance obligations in a contract, then IFRS 15 requires an entity to allocate that discount before using a residual approach to estimate a stand-alone selling price for a good or service.

Variable consideration may be attributable to the entire contract or only to a specific part. IFRS 15 requires that variable consideration is allocated entirely to a single performance obligation (or to a distinct good or service that forms part of a performance obligation) if and only if both of the following conditions have been met:

- the terms of the variable payment relate specifically to the entity's efforts towards, or outcome from, satisfying that performance obligation (or distinct good or service)
- the result of the allocation is consistent with the amount of consideration to which the entity expects to be entitled in exchange for the promised goods or services.

Changes in estimated transaction price

If the estimated transaction price changes, an entity allocates the change to the performance obligations on the same basis as at contract inception (subject to the specific guidance on contract modifications). Amounts allocated to a satisfied performance obligation are recognised either as revenue or as a reduction in revenue in the period the change occurs.

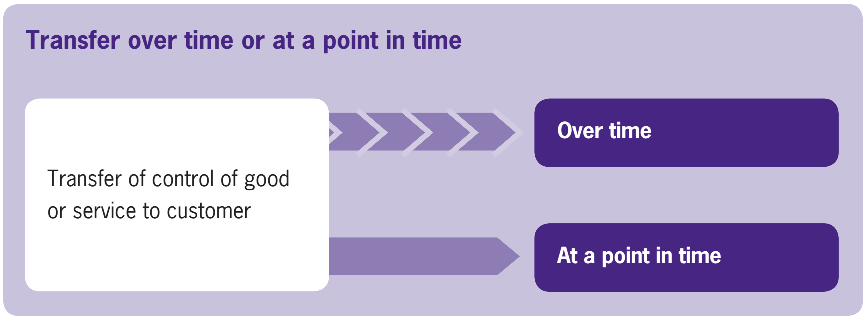
Changes in the transaction price are allocated entirely to one performance obligation (or only some of the total performance obligations) using the same criteria applied to allocation of variable consideration to a single performance obligation.

Step 5: Recognise revenue when or as an entity satisfies performance obligations

Under IFRS 15, an entity recognises revenue when or as it transfers promised goods or services to a customer. A "transfer" occurs when the customer obtains control of the good or service.

A customer obtains control of an asset (good or service) when it can direct the use of and obtain substantially all the remaining benefits from it. Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset. The benefits of an asset are the potential cash flows that can be obtained directly or indirectly from the asset in many ways.

A key part of the model is the concept that for some performance obligations control is transferred over time while for others control transfers at a point in time.



Control transferred over time

An entity determines at contract inception whether each performance obligation will be satisfied (that is, control will be transferred) over time or at a specific point in time.

Control is considered to be transferred over time if one of the following conditions exists:

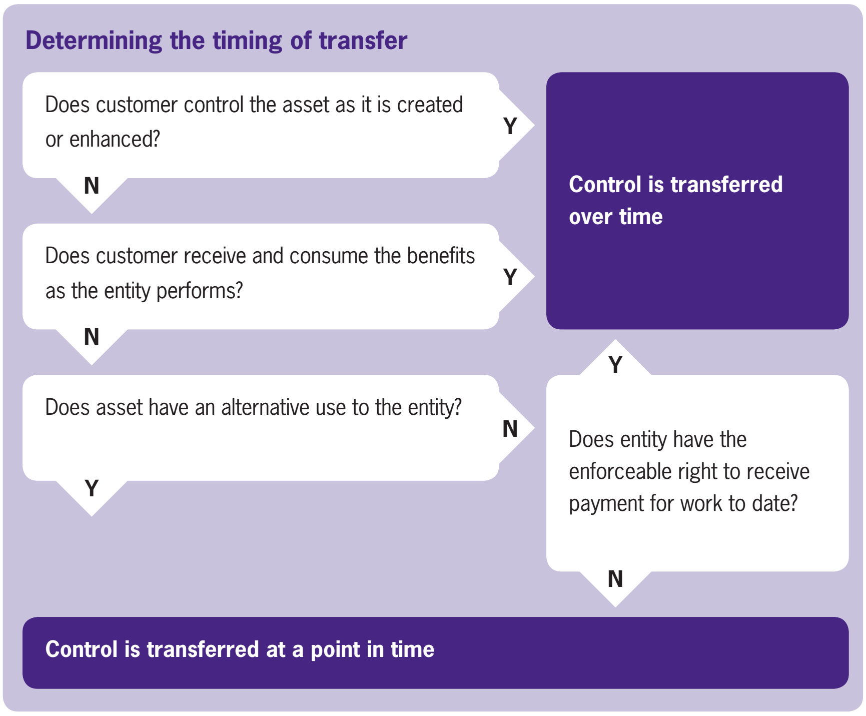
- the customer controls the asset as it is created or enhanced by the entity's performance under the contract
- the customer receives and consumes the benefits of the entity's performance as the entity performs. A customer receives a benefit from the entity's performance as the entity performs if another entity does not have to substantially reperform the work completed to date if it stepped in to complete the remaining obligation(s) under the contract

- the entity's performance creates or enhances an asset that has no alternative use to the entity, and the entity has the right to receive payment for work performed to date. An entity evaluates whether a promised asset has an alternative use to it at contract inception by considering whether it can readily redirect the partially completed asset to another customer throughout the production process. In addition, the right to payment should be enforceable, and a vendor considers the contractual terms, as well as any legislation or legal precedent that could override those terms, in assessing the enforceability of that right.

An entity recognises over time revenue that is associated with a performance obligation that is satisfied over time by measuring its progress toward completion of that performance obligation. The objective of this measurement is to depict the pattern by which the entity transfers control of the goods or services to the customer. The entity must update this measurement over time as circumstances change and accounts for these changes as a change in accounting estimate under IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.

IFRS 15 discusses two classes of methods that are appropriate for measuring an entity's progress toward completion of a performance obligation:

- output methods and
- input methods.



Methods for measuring an entity's progress toward completion:

Method	Description	Examples
Output methods (revenue recognised by directly measuring the value of the goods and services transferred to date to the customer)	• revenue could be recognised at amount invoiced only if this corresponds directly with the value of the goods or services transferred to date • the units produced or units delivered method could provide a reasonable proxy for the entity's performance provided any work-in-process or finished goods controlled by the customer are appropriately included in the measure of progress.	• surveys of performance to date, milestones reached or units produced
Input methods (revenue recognised based on the extent of efforts or inputs toward satisfying a performance obligation compared to the expected total efforts or inputs needed)	• it may be appropriate to recognise revenue on a straight-line basis if efforts/inputs are expended evenly over the performance period • IFRS 15 requires that if an entity selects an input method such as costs incurred it must adjust the measure of progress for any inputs that do not depict performance, for example costs incurred that: – do not contribute to progress (eg wasted materials) – are not proportionate to progress (eg some non-distinct goods procured from another supplier with limited involvement by the entity).	• resources consumed, labour hours expended, costs incurred, machine hours used or time lapsed

Ability to reasonably measure progress

An entity recognises revenue for a performance obligation satisfied over time only if it can reasonably measure its progress toward completion of that performance obligation. An entity is not able to reasonably measure its progress toward completion if it lacks reliable information that is required to apply an appropriate method of measurement.

In some cases, such as during the early stages of a contract, an entity might not be able to reasonably measure its progress toward completion, but may still expect to recover its costs incurred in satisfying the performance obligation. An entity is then permitted to recognise revenue to the extent of costs incurred until it can reasonably measure its progress.

Control indicators

Control transferred at a point in time

In situations where control over an asset (goods or services) is transferred at a single point in time, an entity recognises revenue by evaluating when the customer obtains control of the asset.

In performing the evaluation, an entity should consider indicators of control, including, but not limited to, the following:

- the entity has a present right to receive payment for the asset
- the customer has legal title to the asset
- the customer has physical possession of the asset
- the customer has assumed the significant risks and rewards of owning the asset
- the customer has accepted the asset.

In the September 2014 issue, we will cover the other topics related to IFRS 15, namely:

- Contract costs
- Warranties
- Licensing, and
- Rights of return and repurchase obligations

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