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Special Edition on Revenue

# MFRS Hot Topics

**September** 2014

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

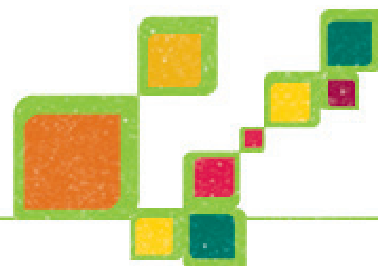
The IASB has published IFRS 15 'Revenue from Contracts with Customers'.
IFRS 15:

- 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.

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

In this issue, we will present to you the other topics relevant to IFRS 15, namely:

- Contact costs
- Warranties
- Licensing
- Rights of return and repurchase obligations
- Presentation and disclosures
- Effective date and transition



# Other topics

## Contract costs

### Costs to fulfil a contract

If costs incurred in fulfilling a contract with a customer are covered under another Standard (such as IAS 2 'Inventory' and IAS 16 'Property, Plant, and Equipment'), an entity accounts for those costs in accordance with those Standards. If not, an entity recognises an asset for such costs, provided all of the criteria in the adjacent table are met.

### Incremental costs of obtaining a contract

Under IFRS 15, an entity capitalises the incremental costs of obtaining a contract if it expects to recover those costs. Incremental costs of obtaining a contract are costs that an entity would not have incurred if it had not obtained the contract. Costs that an entity incurs regardless of whether it obtains a contract are expensed as incurred, unless the costs are explicitly chargeable to the customer regardless of whether the entity obtains the contract.

As a practical expedient, IFRS 15 allows an entity to expense the incremental costs of obtaining a contract as incurred if the amortisation period of the asset that the entity would have otherwise recognised is one year or less.

**Costs to fulfil a contract**

**Costs are capitalised if the following conditions are met:**

- the costs relate directly to a contract, including:
  - direct labour
  - direct materials
  - allocations that relate directly to the contract or contract activities (for example, contract management and supervision costs and depreciation of tools and equipment used in fulfilling the contract)
  - costs that are explicitly chargeable to the customer
  - other costs that the entity incurs only because it entered into the contract (eg payments to subcontractors)
- the costs generate or enhance resources of the entity that will be used to satisfy performance obligations in the future
- the entity expects to recover the costs.

**Costs to be expensed as incurred:**

- general and administrative costs that are not explicitly chargeable to the customer
- costs of wasted materials, labour, or other resources that were not reflected in the contract price
- costs that relate to satisfied performance obligations
- costs related to remaining performance obligations that cannot be distinguished from costs related to satisfied performance obligations.

### Amortisation and impairment

Under IFRS 15, an entity amortises capitalised contract costs on a systematic basis consistent with the pattern of transferring the goods or services related to those costs. If an entity identifies a significant change to the expected pattern of transfer, it updates its amortisation to reflect that change in estimate in accordance with IAS 8.

An entity recognises an impairment loss in earnings if the carrying amount of an asset exceeds the remaining amount of consideration that the entity expects to receive in connection with the related goods or services less any directly related contract costs yet to be recognised. When determining the amount of consideration it expects to receive, an entity ignores the constraint on variable consideration previously discussed, and adjusts for the effects of the customer's credit risk.

Before recognising an impairment loss under the revenue recognition guidance, an entity recognises impairment losses associated with assets related to the contract that are accounted for under other guidance, such as IAS 2. An entity would reverse a previously recognised impairment loss when the impairment conditions no longer exist or have improved.

### Practical insight – contract costs

IFRS 15's guidance on contract fulfilment costs is similar to IAS 11's. However, IFRS 15 applies to all customer contracts not only to construction contracts. The treatment of contract costs for services is somewhat mixed under IAS 18, and depends in part on the extent to which service providers apply IAS 11's guidance (IAS 18 states that the requirements of IAS 11 are "generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services").

IFRS 15's guidance on the costs of obtaining or securing a contract appear more restrictive than IAS 11's but apply to a broader range of contracts. IFRS 15 requires immediate expensing of those costs that will be incurred regardless of whether a contract is won or lost (eg most bid costs). By contrast, under IAS 11 the costs of securing a contract are included in contract costs if they relate directly to a contract, can be separately identified and measured reliably and it is probable that the contract will be obtained.

# Warranties

If a customer has the option to separately purchase a warranty, then an entity accounts for that warranty as a performance obligation. If a customer does not have the option to separately purchase a warranty, then the entity accounts for the warranty using the cost accrual guidance in IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' unless all or part of the warranty provides the customer with an additional service beyond the assurance that the product will comply with agreed-upon specifications.

IFRS 15 provides the following examples of factors that an entity must consider in determining whether a warranty provides a customer with an additional service:

### Accounting for warranties

Does the customer have the option to separately purchase a warranty?

Y → Account for the warranty as a performance obligation

N ↓

Does all or part of the warranty provide the customer with an additional service beyond the assurance that the product will comply with agreed-upon specifications?

Y → Account for the service as a separate performance obligation

N ↓

Account for the warranty using the cost accrual guidance in IAS 37

**Warranty obligations**

| Factor | Description |
|---|---|
| **Whether the warranty is required by law** | A legal requirement to provide a warranty indicates that it is not a performance obligation because such laws are typically intended to protect the customer from the risk of purchasing a defective product |
| **Term of the warranty coverage period** | The longer the coverage period, the more likely a warranty is a performance obligation |
| **Nature of the tasks the entity promises to perform under the warranty** | If an entity must perform certain tasks to provide assurance to the customer that the product complies with agreed-upon specifications, those services do not likely constitute a separate performance obligation. |

If an entity determines that a warranty provides a service that is separate from assurance on the product's compliance with agreed-upon specifications, that service is considered to be a separate performance obligation. The entity allocates a portion of the transaction price to that service unless it cannot reasonably account for the assurance and service portions of the warranty separately. If an entity determines that it cannot reasonably separate the assurance and service components of a warranty, it accounts for both together as a single performance obligation.

**Practical insight – warranty obligations**

IAS 18 and IAS 11 have no specific guidance on whether warranty obligations are separate deliverables. However, although IFRS 15 has more detailed guidance we believe it is largely consistent with accepted practices for standard and extended-type warranties under existing IFRSs.

In our experience standard-type warranties are not typically regarded as separate deliverables and are instead accounted for by accruing estimated costs under IAS 37. For extended-type warranties the application of IAS 11 and 18 requires judgement but in our experience these are commonly identified as separate deliverables, with allocated revenue recognised over the coverage period.

# Licensing

Under IFRS 15 revenue from licensing rights to the entity's intellectual property (eg software, technology, motion pictures, music, franchises, patents, trademarks and copyrights) is recognised either over time or at a point in time, depending on:

- the separability or non-separability of any other promises in the contract
- the nature of the entity's performance under the license.

If the contract includes other promises that are non-separable from the right of access or use, the license is not distinct. The entity then accounts for the bundle of promises as a single performance obligation. It applies the control guidance to determine if transfer takes place (and revenue is then recognised) over time or at a point in time.

**Revenue from licensing**

Does contract include promises that are non-separable from license?

Y → **License is not distinct and is accounted for together with other promises as a single performance obligation.** **Entity assesses whether control transfers over time or at a point in time**

N → **License is distinct and is accounted for separately from other promises**

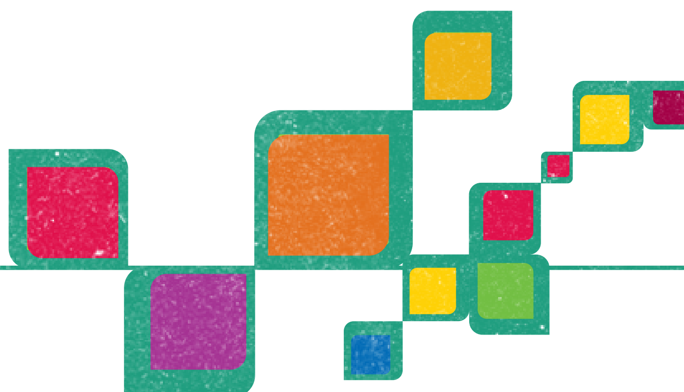
**Assess nature of entity's promise related to the license**

Right to use the entity's intellectual property as it exists when licence is granted.

Y → **Control is transferred at a point in time**

Right to access the entity's intellectual property as it exists throughout the licence period.

Y → **Control is transferred over time**



If the license is distinct, the nature of the promise (as either a right to access or a right to use the entity's intellectual property) determines whether the license results in a performance obligation that is satisfied over time or at a point in time. If the license is a promise to provide a right to access the intellectual property, the performance obligation is satisfied over time. A license is a promise to provide *access* to the entity's intellectual property if all of the following conditions are met:

- there is a requirement or implicit understanding that the entity will undertake activities that will significantly change the underlying intellectual property
- the customer is exposed to positive or negative effects as those activities take place
- the activities do not transfer a good or service to the customer as they occur.

If these conditions are not present, then the promise is a right to *use* the intellectual property as it exists when the licence is granted. In this case, the performance obligation is satisfied at a point in time, similar to the sale of a good. IFRS 15 explains that other promises in the contract, restrictions on time, geography or use and guarantees that the entity has a valid patent over the intellectual property are not considered in making this determination.

**Practical insight – licensing arrangements**

IAS 18 provides limited guidance on licensing arrangements. IAS 18's guidance is consistent with IFRS 15 in as far as revenue is sometimes recognised over time (eg on a straight-line basis over the life of the agreement) and sometimes at a point in time. Under IAS 18 this depends on the "substance of the agreement", although there is little explanation as to how substance should be assessed.

IAS 18 also notes that an assignment of rights for a fixed fee under a non-cancellable contract which permits the licensee to exploit those rights freely and where the licensor has no remaining obligations to perform is, in substance, a sale (eg a licensing agreement for the use of software when the licensor has no obligations subsequent to delivery, or granting of rights to exhibit a motion picture film in markets where the licensor has no control over the distributor and expects to receive no further revenues from the box office receipts).

Accordingly, under both IFRS 15 and IAS 18 the existence of continuing obligations is a critical factor.

# Rights of return and repurchase obligations

An entity may sell goods and also:

- grant the customer a right to return the asset
- promise, or obtain an option to repurchase the asset (a repurchase agreement).

**Practical insight – product exchanges**

Exchanges by customers of one product for another of the same type, quality, condition, and price (for example, one colour or size for another) are not considered returns for the purposes of IFRS 15.

### Sale with a right of return

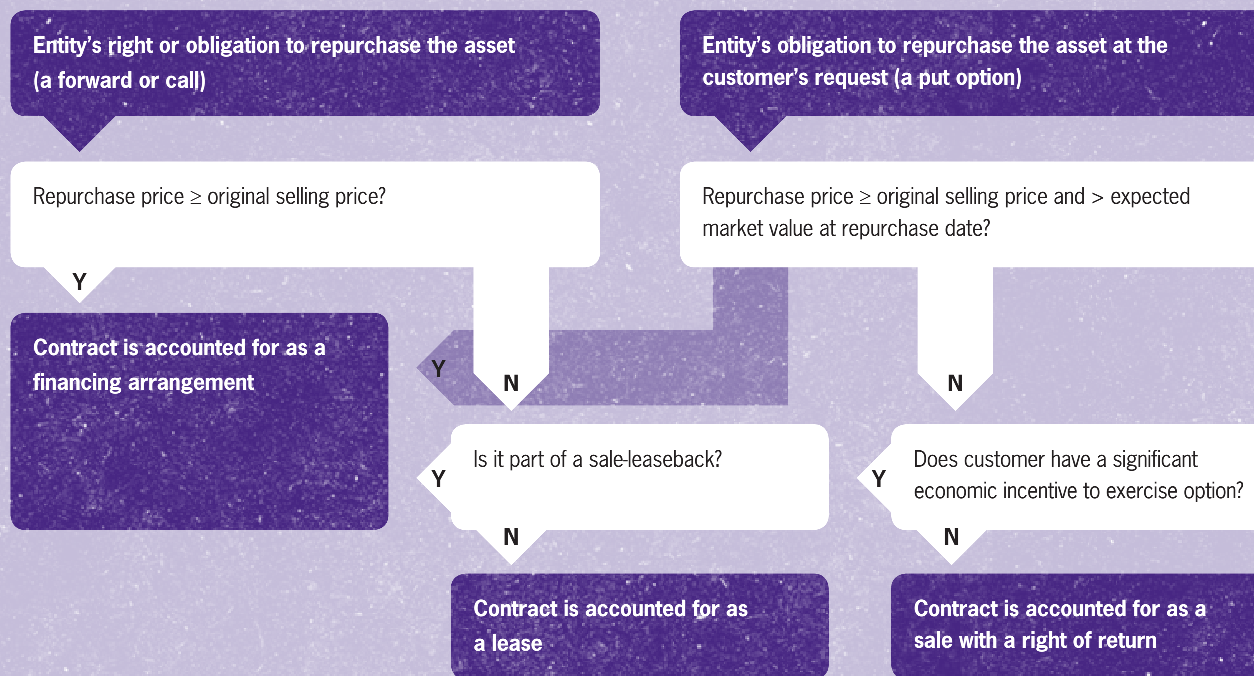
In some contracts, an entity transfers control of a product to a customer and also grants the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:

- full or partial refund of any consideration paid
- a credit that can be applied against amounts owed, or that will be owed, to the entity
- another product in exchange.

Broadly, the entity recognises revenue for these arrangements net of estimated returns. To do this it recognises:

- revenue for the sold products, reduced for estimated returns (the guidance on variable consideration applies)
- a refund liability
- an asset, initially measured at the carrying amount of the inventory less costs of recovery, and corresponding adjustment to cost of sales.

The refund liability and asset are updated at the end of each reporting period for changes in expectations, with corresponding adjustments as revenue (or reductions of revenue).




## Repurchase agreements

Sometimes an entity will enter into a contract to sell an asset and also promises or has the option to repurchase the asset (or an asset that is substantially the same or another asset of which the asset that was originally sold is a component).

An entity will need to evaluate the form of the promise to repurchase the asset in determining the accounting (for example, a forward, call or put option).

If a contract includes a forward (entity obligation to repurchase) or a call option (entity right to repurchase), an entity accounts for the contract (1) as a lease if it can or must repurchase the asset for an amount that is less than the original selling price; or (2) as a financing arrangement if it can or must repurchase the asset for an amount that is equal to or more than the original selling price.

If a customer is granted a right to require an entity to repurchase the asset (put option) at a price that is less than the original selling price, the entity assesses whether the customer has a significant economic incentive to exercise its right. This assessment considers various factors including the relationship between the repurchase price and the expected market value at the date of repurchase. If the repurchase price is expected to significantly exceed market value then a significant economic incentive exists. The agreement is then accounted for as a lease (because the customer is effectively paying the entity for the right to use the asset for a period of time), unless the contract is a part of a sale-leaseback (see below).

If the customer does not have a significant economic incentive to exercise the put option, the entity accounts for the agreement as a sale with a right of return (see guidance above).

If a contract grants the customer a put option and the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset, the contract is considered to be a financing arrangement. The entity continues to recognise the asset and recognises a liability initially measured at the original selling price of the asset.

### Sale-leaseback transactions

A sale-leaseback transaction with a put option that has an exercise price less than the original sales price is accounted for as a financing transaction rather than as a lease if the holder of the put option has a significant economic incentive to exercise the option.

### Customer options for additional goods or services

An entity may sell goods or services and also provide customers with options to acquire additional goods or services free or at a discount – for example sales incentives, award credits or points, renewal options or other discounts. Such options are a performance obligation for the purpose of IFRS 15 if, and only if, they represent a 'material right'. The following are not considered to be material rights:

- a discount or other right that the customer could receive without entering into the contract
- a discount that is no more than the range of discounts typically given for those goods or services to that class of customer in that geographical area or market
- an option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service.

### Practical insight – comparison with IFRIC 13 'Customer Loyalty Programmes'

IFRS 15's guidance in this area covers the same issues as IFRIC 13 (which it supersedes). The new guidance is generally similar and is expected to have little or no practical effect on the accounting for many loyalty schemes. However, IFRS 15:

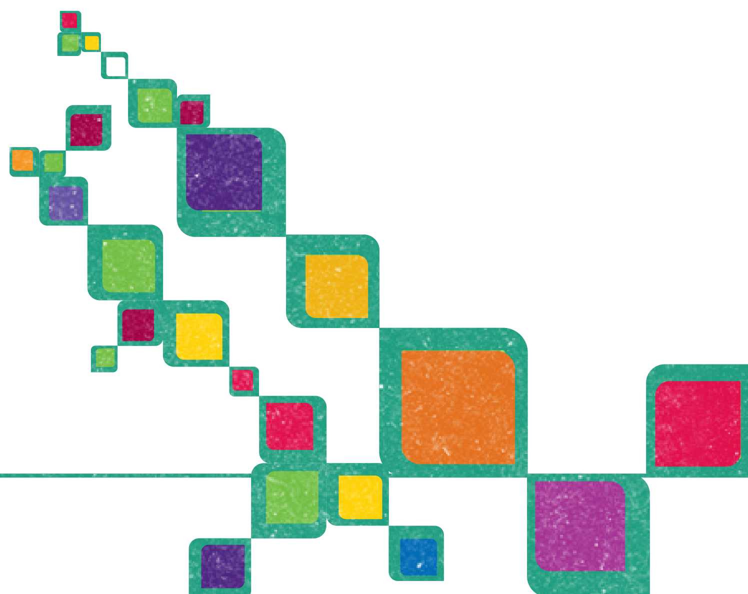
- addresses a broader range of arrangements (such as individual discount awards that might not be viewed as 'programmes' for IFRIC 13 purposes)
- has more guidance on when such arrangements are a 'material right'
- has more detailed requirements on allocating the transaction price.

If a customer option is a material right then the entity should allocate part of the transaction price to that performance obligation on a relative standalone selling price basis. If the standalone selling price is not directly observable, as is often the case, it must be estimated. The estimate should reflect the discount the customer would obtain when exercising the option, adjusted for:

- any discount that the customer could receive without exercising the option
- the likelihood that the option will be exercised.

Revenue allocated to customer options is recognised when the options are exercised or expire.

IFRS 15 also provides a practical expedient that applies to some customer rights to renew a contract on pre-agreed terms. In such cases the entity is permitted to allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration.



# Presentation and disclosure

## Presentation

Under IFRS 15, an entity presents a contract in its statement of financial position as a contract liability, a contract asset, or a receivable, depending on the relationship between the entity's performance and the customer's payment at the reporting date.

An entity presents a contract as a contract liability if the customer has paid consideration, or if payment is due as of the reporting date but the entity has not yet satisfied a performance obligation by transferring a good or service. Conversely, if the entity has transferred goods or services as of the reporting date but the customer has not yet paid, the entity recognises either a contract asset or a receivable. An entity recognises a contract asset if its right to consideration is conditioned on something other than the passage of time; otherwise, an entity recognises a receivable.

## Disclosure

IFRS 15 requires many new disclosures about contracts with customers. The following table provides a summary:

**Disclosures**

| Disclosure area | Summary of requirements |
|---|---|
| **General** | • revenue recognised from contracts with customers, separately from its other sources of revenue<br>• impairment losses on receivables or contract assets. |
| **Disaggregation of revenue** | • categories that depict the nature, amount, timing, and uncertainty of revenue and cash flows<br>• sufficient information to enable users of financial statements to understand the relationship with revenue information disclosed for reportable segments under IFRS 8 'Operating Segments'. |
| **Information about contract balances** | • including opening and closing balances of contract assets, contract liabilities, and receivables (if not separately presented)<br>• revenue recognised in the period that was included in contract liabilities at the beginning of the period and revenue from performance obligations (wholly or partly) satisfied in prior periods<br>• explanation of relationship between timing of satisfying performance obligations and payment<br>• explanation of significant changes in the balances of contract assets and liabilities. |
| **Information about performance obligations** | • when the entity typically satisfies performance obligations<br>• significant payment terms<br>• nature of goods and services<br>• obligations for returns, refunds and similar obligations<br>• types of warranties and related obligations<br>• aggregate amount of transaction price allocated to remaining performance obligations at end of period*. |
| **Information about significant judgements** | • judgements impacting the expected timing of satisfying performance obligations<br>• methods used to recognise revenue for performance satisfied over time, and explanation<br>• the transaction price and amounts allocated to performance obligations (eg estimating variable consideration and assessing if constrained and allocating to performance obligations). |
| **Assets recognised from the costs to obtain or fulfil a contract** | • judgements made in determining costs capitalised<br>• amortisation method used<br>• closing balances by main category and amortisation expense. |

* not required if (i) performance obligation is part of a contract which has an original expected duration of less than one year; or (ii) entity applies expedient to recognise revenue at amount it is entitled to invoice when this corresponds directly with value to the customer from entity's performance

# Effective date and transition

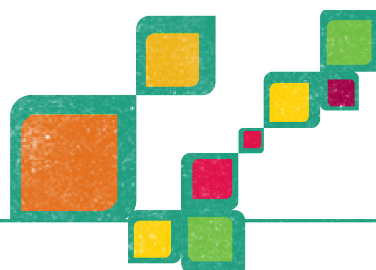
IFRS 15 is effective for annual reporting periods beginning on or after 1 January 2017. Early adoption is permitted.

Entities are required to apply the new revenue standard either:

- retrospectively to each prior period presented, subject to some practical expedients or
- retrospectively, with the cumulative effect of initial application recognised in the current period.

An entity that chooses to restate only the current period is required to provide the following additional disclosures in the initial year of adoption:

- by financial statement line item, the current year impact of applying the new revenue standard
- an explanation of the reasons behind the significant impacts.



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