BDO

IFRS 15

# REVENUE FROM CONTRACTS WITH CUSTOMERS

IFRS 15 brings a new and detailed approach to accounting for revenue, and is likely to have far reaching effects across a wide range of industries. It is based around a new '5 step' model and contains a comprehensive set of requirements which are different from the current guidance in IFRS. Some of the differences are more obvious, while others arise from subtle changes in the detail that are not immediately apparent.

While IFRS 15 will affect almost all entities in all industry sectors, the most significant changes to date have arisen at larger entities in the telecommunications, software, technology, real estate, pharmaceutical, construction and engineering, aerospace and defence, and automotive sectors. However, this is likely to be because those entities were aware that IFRS 15 would have a significant effect on them and have moved relatively quickly with their implementation projects. Entities in other sectors, and medium sized and smaller entities, are lagging and are running out of time. The adoption of IFRS 15 requires a detailed review to be carried out of all contracts that have been entered into.

Although a comprehensive review will be required of all of the requirements of IFRS 15, three topics which will have a particularly pervasive effect are:

## Identification of Goods and services provided to customers

IFRS 15 requires the identification of all goods and services that meet specific criteria to be regarded as being 'distinct'. In practice, this can result in the identification of separate goods and service that were not previously accounted for separately and a requirement to allocate specific amounts of revenue to them using a prescribed methodology. In some cases, this will include items which have previously been treated as marketing costs or a deferred expense, such as a 'free' extended warranty, helpdesk service, training or goods. For example, in the telecommunications sector, the cost of 'free' handsets has frequently been deferred over the period of a related contract for services; under IFRS 15, some of the revenue from the contract is allocated to the handset and recognised when the handset is delivered to the customer. Under IFRS 15, each 'distinct' good or service will be allocated a portion of revenue, with this revenue only being recognised when the related good or service is provided to the customer.

## Combining goods and services that are not 'distinct'

As well as requiring additional goods and services to be accounted for separately, IFRS 15 requires two or more goods or services to be combined and accounted for as one overall obligation if an entity sells what in reality is a single overall item. In this way, IFRS 15 cuts through the legal form of contractual arrangements and requires what is really being provided to the customer to be accounted for.

This is best illustrated by an example. A company agrees to construct a wall for a customer. Instead of raising a single invoice, it raises an invoice for the supply of bricks which are delivered on 31 December (the last day of the company's financial year) and an invoice for bricklaying services that are provided in January of the following year. Under IFRS 15, it is clear that the company is providing a service to construct a wall, with revenue being recognised on that basis and not separately for the supply of bricks and construction services.

This principle will have a significant effect in the software sector, where an entity supplies software licences and provides integration and hosting services, and technical updates. If the software functionality is linked to those other services, revenue will be recognised over the period during which the services are supplied to the customer and not when the software is supplied. In comparison with current practice, there could be a significant deferral in the timing and profile of revenue recognition. In many cases, major changes will be required to internal systems and processes in order appropriately to identify the goods and services provided to customers, and to allocate revenue in accordance with the requirements of IFRS 15.

## Variable consideration

Where the amount of consideration receivable from a customer is not fixed, but instead could vary in amount, IFRS 15 contains strict requirements. In particular, it contains a 'reversal constraint' under which revenue can only be recognised if it is highly probable that there will not be a subsequent reversal. This is particularly relevant to entities with contracts that include bonuses, penalties and volume rebates, or where there is past practice of providing customers with price concessions (which might be by way of credit notes).

The variable consideration constraint is strengthened for licences of intellectual property, in particular those where the income receivable is dependent on the amount of usage, or revenue generated, by a customer from the use of the intellectual property. In those cases, revenue can only be recognised to the extent that the underlying use has taken place or the customer's own sales revenue has been generated.

In many cases, we expect the timing of revenue recognition to be deferred in comparison with current practice. The effect will be particularly pronounced for start-up entities, or those entering new markets, where there is a lack of an established track record of delivering on projects.

## Transition

On transition, there is a choice of two approaches:

- Fully retrospective application, under which IFRS 15 is applied to each prior reporting period with these being restated
- A cumulative catch up approach under which IFRS 15 is applied on a retrospective basis with the cumulative effect being recognised as an adjustment on 1 January 2018 with comparative information not being restated.

Four practical expedients are available if fully retrospective application is selected. If the cumulative catch up approach is adopted, only the one of these is available:

Although fully retrospective application will require more work, it will give a clearer picture because current and comparative year information will be prepared in accordance with IFRS 15. In contrast, although the cumulative catch up method might appear attractive, amounts reported for the current and comparative year will not be comparable. In addition, for entities that have contracts that span the date of initial application, some revenue may be double counted or may not be recorded at all, due to the different recognition requirements of existing IFRSs and IFRS 15.

## For the adoption of IFRS 15, questions which should be asked include:

Project management, Board sponsorship and communication with those charged with governance:

- What is the plan for transition?
- Which transitional approach and options are being adopted and why?
- What is the timeline?
- Who is responsible?
- What resources are available?
- What sponsorship does the project have at executive board level?
- How has the audit committee been briefed?

Detailed effects:

- What is the effect on the timing and profile of revenue recognition? (accelerate/defer, increase/decrease?)
- How will changes in the timing and profile of revenue recognition affect bonus payments, share option plans, banking covenants and costs, and dividend policy?
- How will brokers and analysts react?
- Do current/future sales contracts need to be changed?
- Do current/future sales and marketing methods need to be changed?
- What changes are required to systems and processes?
- What are the staff training requirements (including sales and marketing staff, as well as finance staff)?
- How will sales, marketing, and finance departments need to liaise and communicate with each other in future?

# Find out more

If you would like to speak to us about any of these changes and determine how they may impact you, please get in touch with our team of experts who will be happy to help.

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