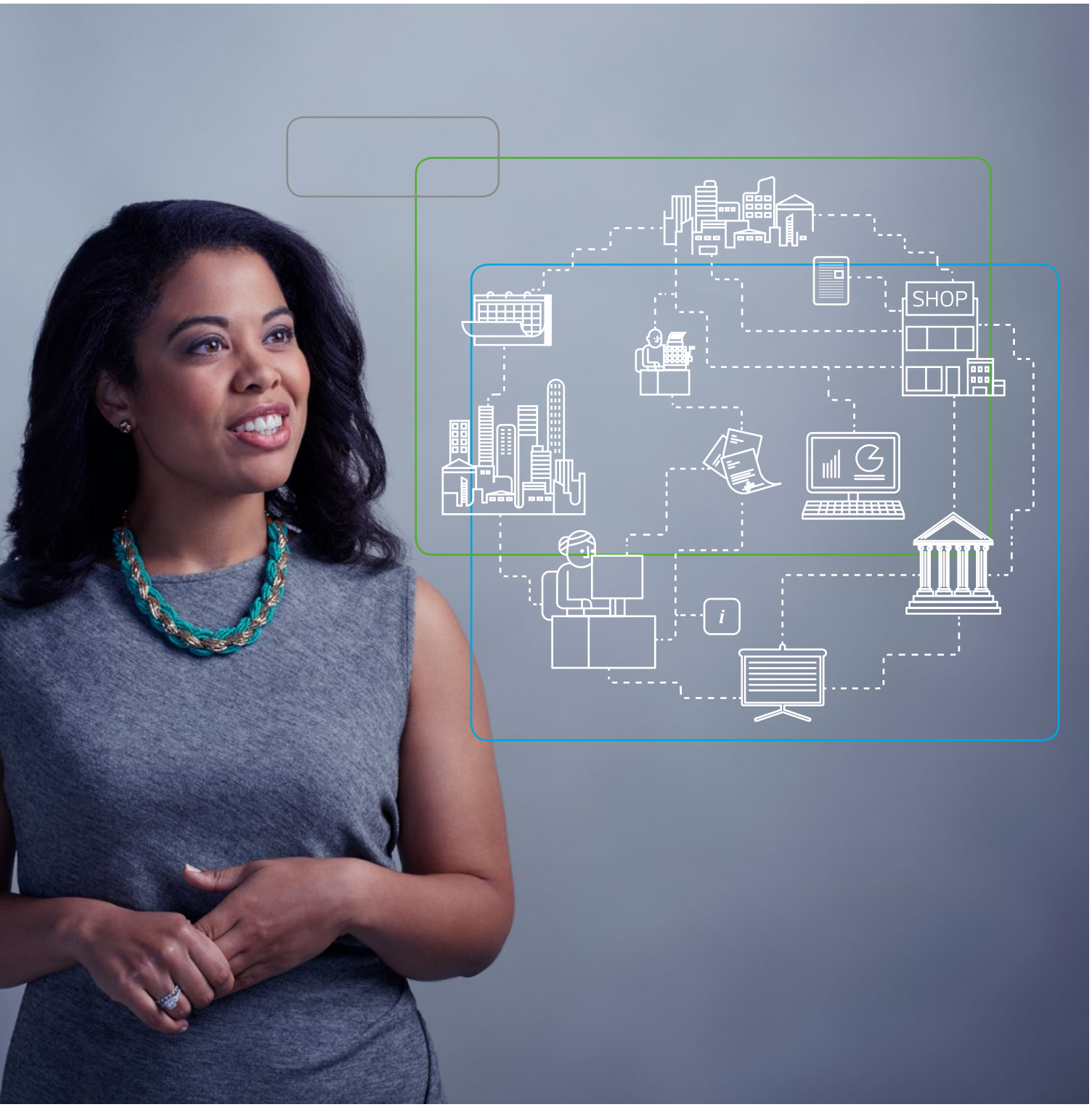

FINANCIAL REPORTING GUIDE TO IFRS 15

Revenue from contracts with customers

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INTRODUCTION

In May 2014, the International Accounting Standards Board (IASB) published IFRS 15 which replaces IAS 18 Revenue, IAS 11 Construction Contracts and their associated Interpretations.

Developed in conjunction with the US GAAP standard Topic 606, IFRS 15 seeks to remove inconsistencies and weaknesses in previous revenue requirements, provide a more robust framework and improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. It is intended to provide more useful information to users of financial statements through improved disclosure requirements and to simplify the preparation of financial statements by reducing the number of separate documents to which an entity must refer.

This guide takes you through each of the key steps involved in recognising revenue under IFRS 15 (and looks at some of the practical implications), the two transition methods (together with their comparative advantages and disadvantages) and available practical expedients. In addition, it includes a detailed look at the disclosures that will need to be provided under the new standard.

This is not an easy standard to apply. In April 2016 amendments were published to clarify some of its requirements and provide additional transitional relief (see section 5).

When is it effective?
IFRS 15 comes into effect for periods commencing on or after 1 January 2018 with early adoption of the main standard permitted as long as that fact is disclosed. As yet, the clarifications to some of the requirements and the provision of additional transitional relief (published in April 2016) have not been endorsed by the European Union. This needs to be taken into account if opting for early adoption.

In a nutshell
IFRS 15 sets out a single framework for revenue recognition. Its core principle is that an entity recognises 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. IFRS 15 sets out five key steps to follow in applying this core principle.

Additional guidance
IFRS 15 also contains guidance on accounting for certain contract costs, payments to customers, and a cohesive set of disclosure requirements for revenue and associated contract balances.

STEP 1

Identify the contract(s) with a customer

STEP 2

Identify the performance obligations in the contract

STEP 3

Determine the transaction price

STEP 4

Allocate the transaction price to the performance obligations in the contract

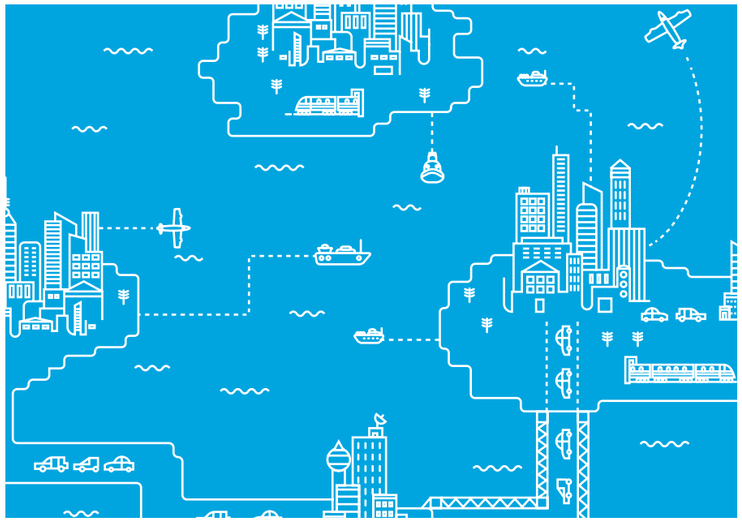
STEP 5

Recognise revenue when (or as) the entity satisfies a performance obligation

How will it impact?
The changes will impact entities to varying degrees, depending on the nature and terms of their customer contracts.

- Current contract terms (explicit and implicit) and business practices may need to be reconsidered in order to avoid unintended consequences.
- Estimates and judgements previously made in the absence of specific financial reporting guidance may need to be revised to comply with the specific guidance given by IFRS 15. For example: where it is necessary to allocate a transaction price between the goods/services it has promised to deliver ('performance obligations'), an entity will need to consider whether its existing allocation method is consistent with the specific hierarchy of possible methods set out in IFRS 15.
- Revenue may be accelerated or deferred. This is more likely to affect entities which provide a bundle of goods and services, or provide licences, or for those for whom consideration receivable is variable in nature eg because of discounts, rebates and other price concessions, incentives and performance bonuses, penalties or other similar items.
- The timing of revenue recognition may change even when there is only one performance obligation, particularly for those involved in providing services. Entities will need to determine whether revenue should be recognised over time or at a point in time.
- Existing accounting software may need to be adapted or replaced to ensure it is capable of capturing data to deal with the new accounting requirements; particularly for use in making estimates or supporting the extensive disclosures.

Entities should carefully consider as soon as possible the impact of the available transitional options and practical expedients on reported profit, covenant arrangements, dividend policy, performance related remuneration and narrative reporting.



1 APPLYING THE CHANGES IN IFRS 15

IFRS 15 addresses revenue from contracts with customers and so is only applied to a contract in its scope if the counterparty to the contract is a customer.

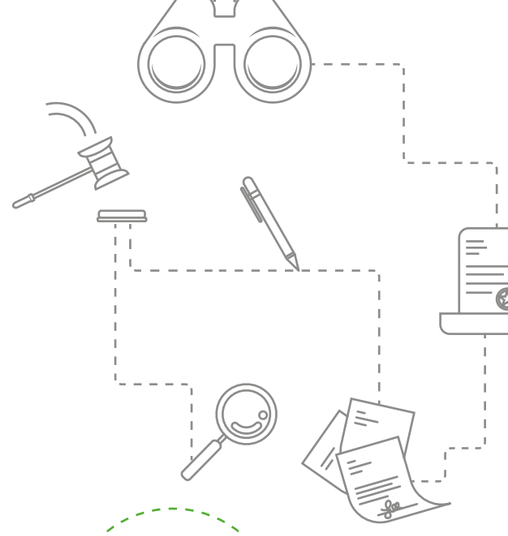
IFRS 15 specifically excludes collaborative (and certain other) agreements, eg two companies agree to collaborate on the development of a new drug, from its scope. However, such agreements can sometimes contain a vendor–customer relationship component and so judgement may be required to determine whether IFRS 15 should be applied to certain collaborative arrangements from its scope where the collaborator or partner meets the definition of a customer for at least some of the arrangement.

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

- The contract must create enforceable rights and obligations.
- An entity only accounts for a contract when it meets all of the following five specified criteria:
  - » It has been agreed by its parties, who are committed to perform their respective obligations;
  - » it identifies each party's rights regarding the goods or services to be transferred;
  - » it identifies the payment terms;
  - » it has commercial substance; and
  - » it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

These criteria represent the 'attributes' of a valid contract in respect of a genuine transaction.

- Termination rights can affect the duration of a contract (IFRS 15.11–12). A contract can only exist to the extent the parties have present enforceable rights and obligations.
- Individual contracts entered into at or near to each other with the same customer may need to be combined for accounting purposes, when one or more of the three specified criteria in IFRS 15.17 are met.
- Special rules apply to the subsequent accounting for a contract where its scope or price (or both) are modified. These depend on a number of factors, including how the change has been priced and the distinctness of the new goods/services added or remaining performance obligations (IFRS 15.20–21).



Step 2: Identify the performance obligations in the contract

- This critical step involves the identification and assessment of promises in the contract (explicit or implied) to determine what, and how many, performance obligations exist. Some promises may not lead to performance obligations (see section 4).
- Once the promises have been identified, an entity needs to consider whether they are performance obligations.
- A performance obligation may be a promise to transfer a single 'distinct' good/service, a 'distinct' bundle of goods/services, or a 'series' of 'distinct' goods/services.

Good/ service is capable of being distinct + Promise is separately identifiable = Separate performance obligations

A good/service is capable of being distinct if the customer can benefit from it (eg by use, consumption or sale) either on its own or together with other resources readily available to the customer (eg those already owned, or which can be acquired from the entity or another entity).

For example: if an entity sold a TV package that included a television and DVD player, these would be considered distinct goods because the television is capable of being used by the customer without the DVD player. Whilst the DVD player could not be used without the television, the customer could obtain an alternative television from another supplier or use their existing television.

In assessing whether a promise is separately identifiable, an entity considers whether the nature of its promise is to transfer each promised good/service individually or instead to transfer a combined item(s).

This is a critical assessment which may trip up the unwary, and is considered in more detail in section 5.

- Some contracts provide a customer with an option to acquire additional goods/services in the future, often at a discount or even for free. These options come in many forms including sales incentives, loyalty programmes and renewals. Such options must now be assessed to determine whether they provide the customer with a 'material right'. If they do, that right (but not the underlying additional goods/services) is a performance obligation. This is an area where we expect to see an additional performance obligation compared to legacy IFRS. We also expect the need for judgement (see section 4).
- A 'portfolio' approach may be possible, in specified circumstances, for similar performance obligations across multiple customers for accounting purposes. (see section 4).

Note: This has proved to be a challenging step ie assessing whether a promise is separately identifiable requires significant judgement. The requirements of this step have been clarified (see section 5).

Step 3: Determine the transaction price

- The transaction price is estimated at inception, assuming the contract is fulfilled in accordance with its terms and customary business practices, and is not cancelled, renewed or modified.
- Variable consideration is included in the transaction price using either 'expected value' or 'most likely amount', but may need to be 'constrained'. The 'constraint' applies to prevent too much revenue being recognised when it is too uncertain and runs the highly probable risk of resulting in a significant reversal. IFRS 15 .57 sets out some factors that may help with this determination.
- An exception applies to sales or usage based royalties receivable from a licence for the use of Intellectual Property (IP) (or where the IP is the predominant item in the contract) (IFRS 15.B63). (more details in section 5).
- IFRS 15 contains specific guidance on accounting for some of the causes of variability in a transaction price ie refunds/sales with a right of return and 'breakage' (IFRS 15.B20–B27 and B44–47).
- Significant financing benefits are taken into account (subject to a practical expedient) not only when an entity provides credit to its customers but, also when it receives a benefit due to payments received in advance (IFRS 15.60–65).
- Non-cash consideration is measured at fair value and variability in this is only taken into account when it arises due to reasons other than the form of the consideration (eg a change in the exercise price of a share option due to the entity's performance).
- Sometimes an entity pays consideration to its customer, or indeed to its customer's customers. That consideration might be in the form of cash in exchange for goods or services received from the customer (eg slotting fees paid to a retail customer), or the provision of a credit such as a voucher or coupon for goods or services to be provided to the customer or end consumer (eg money-off coupons against future purchases by consumers), or a combination of both. IFRS 15 requires an entity to determine whether the consideration payable is for a 'distinct' good or service; a reduction of the contract's transaction price; or a combination of both. Consideration payable is only accounted for as an expense (in the same way as for other purchases from suppliers), rather than as a reduction in revenue, if the entity receives a good or service that is 'distinct'.

Note: Some of the requirements of this step have been clarified (see section 5).

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

- When a contract comprises more than one performance obligation, the transaction price is allocated to each obligation on the basis of directly observable stand-alone selling prices (determined only at contract inception and not changed).
- Exceptions exist for allocating discounts and variable consideration that can be shown to be related to one or more but not all performance obligations (IFRS 15.81–86).
- Three alternative approaches can be applied in the absence of a directly observable stand-alone selling price (IFRS 15.76–80):
  - » An adjusted market assessment;
  - » expected cost plus a margin; or
  - » a residual approach.
- Specific rules apply if the transaction price changes, depending on the reason for the change ie the resolution of an uncertainty or as a result of a contract modification (IFRS 15.87)
- Specific guidance is provided in respect of warranties (IFRS 15.B28–B33). A distinction is made between those warranties which provide the customer with a service ('service-type warranty') in addition to the assurance or guarantee that the related product/service complies with the agreed-upon specifications ('assurance-type warranty'). If a warranty is separately priced or negotiated then it is a distinct service and therefore a performance obligation. If not, then an entity will need to assess whether the warranty it is supplying provides the customer with a service in addition to a guarantee.
- IFRS 15 provides guidance on making this assessment, which takes into account whether the warranty is required by law, the length of its coverage period, and the tasks the entity promises to perform under it. When a service warranty is provided, an entity allocates the transaction price between the related product/service and the warranty service using the allocation guidance noted above. Current practice may change under IFRS 15 in respect of service-type warranties depending on judgements made in applying the warranty-type assessment guidance, and the guidance on allocating transaction prices. However, in respect of assurance-type warranties current practice is unaffected.

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

- The focus here is on the transfer of 'control' rather than 'risks and rewards' when determining when to recognise revenue. This control concept also applies when determining whether an entity is acting as principal or agent (see section 5).
- Timing of revenue recognition requires the evaluation of whether control transfers (and therefore the performance obligation is satisfied) over time or at a point in time. If a performance obligation is not satisfied over time, then it is satisfied at a point in time.

Revenue recognition over time

A performance obligation is satisfied over time if any of the following criteria are met:

- Additional guidance is provided in respect of licenses to determine whether revenue should be recognised over time or a point in time. Where a licence is a separate performance obligation, an entity considers whether its promise is to provide the customer with either a 'right to access' the entity's IP, or a 'right to use' the IP as it exists at the point the licence is granted. A 'right to access' is an obligation that is satisfied over time, and a 'right to use' is satisfied at a point in time.
- In making this assessment, the entity is required to consider different criteria to those applied to other performance obligations. These different criteria are necessary in the case of licences because it is difficult to assess when the customer obtains control of assets in a licence (as they could be changing) without first identifying the nature of the entity's performance obligation. Essentially these criteria require an entity to consider whether its activities significantly affect the IP to which the customer has rights. If they do, and those activities are not a separate performance obligation in their own right, then an entity is providing access to its IP over time. (See section 5 for more details).
- If a licence is not distinct, then it is accounted for by evaluating when control transfers.
- A method must be selected by which to measure an entity's progress towards satisfying a performance obligation over time. IFRS 15 contains guidance on both output and input methods but ultimately it will be the entity's judgement call as to which method provides the most reasonable and reliable estimate of the measure of its progress.
- Where an output method is most appropriate, a 'right to invoice' practical expedient may be applied when this invoicing corresponds directly with the value of each incremental good/service that is transferred to the customer (eg a fixed hourly rate for each hour of service provided).

Accounting for certain contract costs

- Incremental costs of obtaining a contract that are expected to be recovered must be recognised as an asset unless the amortisation period would be one year or less, in which case they can be expensed as a practical expedient.
- Costs incurred in fulfilling a contract that are not in the scope of another standard must be recognised as an asset if they meet all three specified criteria:
  - » Directly attributable to a specific contract or specific anticipated contract;
  - » generate or enhance resources to be used in the future in satisfying performance obligations; and
  - » be expected to be recovered.

These costs must be amortised on a systematic basis consistent with the transfer of those goods/services to the customer to which the costs relate.

WHAT DISCLOSURES ARE REQUIRED?

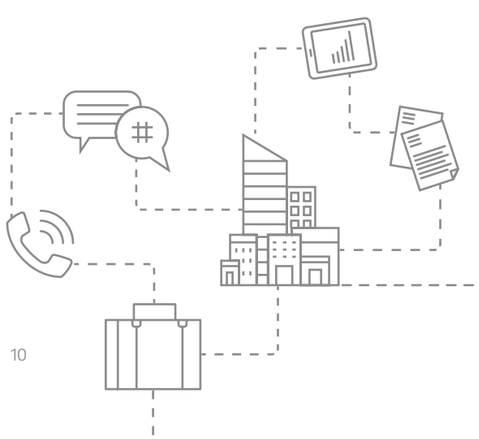
It is important not to underestimate the importance of the disclosure requirements in IFRS 15. The Basis for Conclusions which accompanies IFRS 15 explains that one of the goals of the IASB and the FASB was to provide users of financial statements with more useful information through improved disclosure about an entity's revenues.

Disclosure objective

To enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows.

Although the disclosure requirements are extensive (more than previously required), they are not prescriptive; rather, they require the disclosure of quantitative and qualitative information about: the nature of the entity's revenues; how much is recognised and when; and any uncertainties about those revenues and related cash flows.

An entity is not expected to make disclosures that are irrelevant or immaterial to them, or to duplicate disclosures made elsewhere in the financial statements (in accordance with other IFRS standard).



Summary of information requirements

Revenue

Disaggregation of revenue

Revenue from opening contract liability

Amounts recognised relating to performance in previous periods

Contracts

Information about contract balances and changes

Information about performance obligations

Amounts allocated to remaining performance obligations

Significant judgements

Timing and methods (input or output) of recognition

Determining transaction price and allocating to performance obligations

Costs to obtain or fulfil contracts

Disaggregation of revenue

Disaggregation of revenue is a key disclosure. It will require decisions to be made about how revenues should be analysed. Whilst there is guidance in appendix B of IFRS 15 and the accompanying illustrative examples indicate how such disclosures may look, it is important to remember that these are simply examples, and that in order to meet the disclosure objective, and be effective, the categories chosen for the analysis should take into account your users' needs.

The disclosures should be entity specific, industry relevant, reflect the entity's business model and depict the effect of economic factors. The acid test would be whether the user can tell from the disclosures what the entity actually does.

Furthermore, such disclosures ought to be consistent with other communications an entity makes about its revenues (eg press releases, other public filings, narrative reports included with the financial statements), and must be reconcilable with any disclosures made under IFRS 8 Operating Segments. It may be that the IFRS 8 disclosures are already sufficient to meet the disclosure objective in IFRS 15 concerning disaggregation, but this will need to be considered by each entity.

Significant judgements

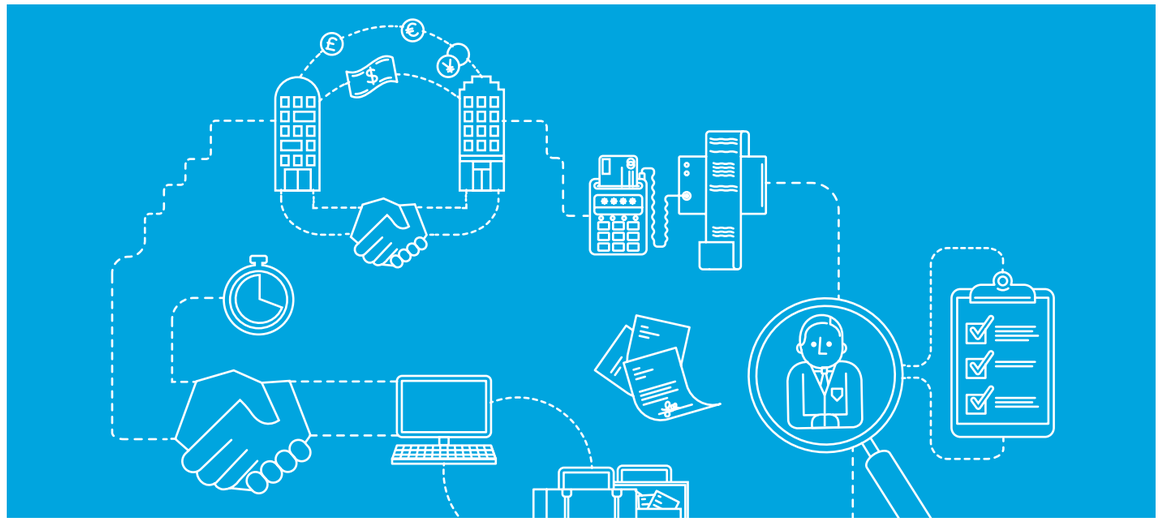
It is useful for users of the financial statements to understand if significant judgements have been made in determining when and how much revenue should be recognised. Clearly some judgement will always be necessary by all entities when applying the standard, but what these disclosures should do is enable the user to understand where significant judgements, or changes in judgements, have been necessary in applying IFRS 15 to the entity's specific contracts.

Practical expedients

To aid comparison with other entities, the use of any practical expedients used in determining revenue recognition must be disclosed.

There is a practical expedient available in respect of disclosures, sometimes referred to as the 'Backlog practical expedient'. Disclosure about amounts allocated to remaining performance obligations is not required if either:

- The performance obligation is part of a contract that has an original expected duration of one year or less (because such information is only relevant when a contract is long-term); or
- revenue is recognised from the satisfaction of the performance obligation as it is invoiced in accordance with the 'right-to-invoice' practical expedient (see section 1, step 5).



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TRANSITION DECISIONS

The table below summarises the two transition methods available for an entity with a 31 December reporting date, applying IFRS 15 from its mandatory effective date of 1 January 2018.

Both methods require retrospective application, but rather than requiring restatement of comparatives, the Cumulative catch-up method requires the cumulative effect of initially applying IFRS 15 to be adjusted against opening reserves at the beginning of the period in which it is first applied, with comparatives left as previously reported under legacy IFRS.

Transition methods

	FULL RETROSPECTIVE (Five optional practical expedients)	CUMULATIVE CATCH- UP Retrospective with cumulative catch up at date of initial application (One optional practical expedient)
	Cumulative catch- up	
Previous year (2017)	All contracts under new Standard Contracts restated, except where practical expedients applied	Contracts not restated
		Cumulative catch- up
Current year (2018)		Existing uncompleted/completed contracts and new contracts under new Standard
Current year disclosures	Disclose expedients used and qualitative assessment of estimated effect to the extent reasonably possible	Impact of IFRS 15 compared to legacy standard for each line item affected

Full retrospective method

The full retrospective method has the advantage of comparability between periods presented and so shows the trend in revenue. It may be costly and onerous for some entities but five practical expedients are available which either reduce the number of contracts that need to be restated on transition or simplify the restatement by allowing the use of hindsight.

Practical expedients on transition – full retrospective method

1. No need to restate completed contracts (as defined in IFRS 15.C2.b) that begin and end within the same annual reporting period.
   This expedient reduces the number of contracts which have to be restated so significantly reduces the burden when an entity has a lot of short-term contracts but:
   - It may result in a lack of comparability with the current period; and
   - it may also lead to a lack of comparability if interim reporting.
2. No need to restate completed contracts (as defined in IFRS 15.C2.b) at the beginning of the earliest period presented.
   This expedient reduces the population of contracts which have to be restated and therefore the level of cost and effort involved.
3. May apply hindsight and use the actual transaction price on completion rather than estimating variable consideration amounts in the comparative reporting periods for completed contracts that have variable consideration.
   This relief simplifies how contracts are restated.
4. Apply hindsight and recognise the aggregate effect of modifications since contract inception at the beginning of the earliest period presented rather than assessing and accounting for each modification.
   This expedient is intended to reduce the burden of accounting for multi-year contracts that have been modified many times prior to adopting IFRS 15.
5. No need to disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognise that amount as revenue for comparative periods.
   This is because the effort involved would not result in useful information since it is out of date, and it would require significant use of hindsight to estimate the transaction price and expected timing.

Cumulative catch-up method

The cumulative catch up method may appear to be less costly and onerous but, because the cumulative effect is adjusted against opening reserves and the comparatives remain as reported under legacy IFRS, there will be a lack of comparability. This will need to be explained by additional disclosures and simply being able to elect to use this method could result in a lack of comparability with an entity's peers.

There is also a decision to be made in respect of completed contracts at the date of initial application. These are contracts under which the entity has already fully performed but has not recognised all of the revenue (perhaps because it was contingent). Under the cumulative catch-up method, an entity has a choice between:

- Recognising the remaining revenue under existing legacy accounting policies and only applying IFRS 15 to incomplete and new contracts, or
- restating completed contracts under IFRS 15 so that IFRS 15 is applied to all contracts.

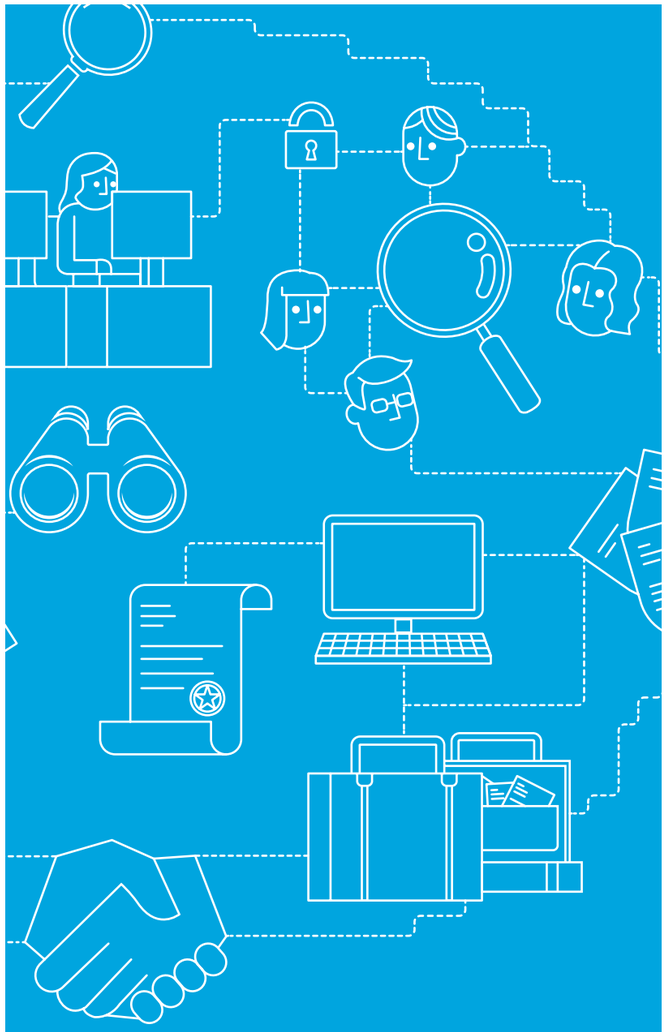
The consequence of electing method 1 is the requirement to maintain two accounting systems, but on the flipside, in practice the number of completed contracts ought not to be an issue for most entities.

Practical expedients on transition – cumulative catch-up method

May use hindsight, and recognise the aggregate effect of modifications at:

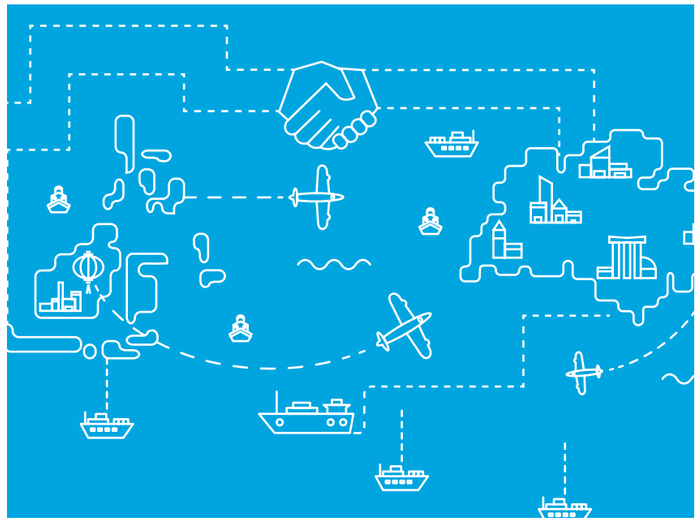
- The beginning of the earliest period presented (ie not having to wait until initial application); or
- the date of initial application of IFRS 15.

This expedient is intended to reduce the burden of accounting for multi-year contracts that have been modified many times prior to adopting IFRS 15.



Key points to consider on transition

- Explore the differences between the two transition methods before making a decision, including the disclosures that will be needed for each method.
- Consider the use of practical expedients on transition, as these could make the process easier and so influence the decision between the two methods.
- Consider how the disclosure objective can best be met. Even if the numbers cannot be populated at this stage, decisions about how revenue should be disaggregated can still be made. It may be helpful to discuss the possibilities with key stakeholders to ensure that their needs and expectations will be met, and will be consistent with existing communications about revenues.
- Don't be afraid to challenge current revenue recognition policies – transition is an opportunity to take a fresh look, taking the time to fully understand the contractual terms and conditions applying to revenue transactions.
- Build time into the transition process to fully understand the disclosure requirements, which are more extensive than under legacy IFRS.
- Don't underestimate the challenge the disclosure requirements may present (for example if operating in multiple segments with different product or service lines).
- Be aware that systems may need to be changed to capture the necessary detail for disclosure, or to allocate transaction prices and these will need to be implemented and tested sooner rather than later.



4 DEALING WITH AREAS OF JUDGEMENT

IFRS 15 is a comprehensive and complex standard and entities may find that its detailed guidance conflicts with certain judgements and interpretations made when applying legacy IFRS. Furthermore, whilst IFRS 15 is intended to remove inconsistencies and improve comparability, there remains considerable scope for judgement.

Applying the 'portfolio approach'

This is a practical expedient intended to allow IFRS 15 to be applied at a portfolio level for contracts (or performance obligations) with similar characteristics rather than on a contract-by-contract basis. However, its use is conditional on it being reasonably expected that the effects on the financial statements of applying IFRS 15 to the portfolio will not differ materially from applying it to the individual contracts (or performance obligations) within that portfolio.

Other than stating when the approach may be used, and it being clear from the Basis for Conclusions that it is intended for very large populations, there is no further reference to the portfolio approach within the standard.

It will therefore be necessary for entities to use their judgement:

- To evaluate what 'similar characteristics' constitute a portfolio (eg the impact of different offerings, periods of time, or geographic locations);
- in deciding how large the population should be;
- in assessing when the portfolio approach may be appropriate; and
- in deciding to what stage(s) of the revenue recognition process it applies.

IFRS 15 provides no guidance on how to assess whether the outcome of using the approach is similar to that which would result if the contracts were assessed individually, nor the extent to which it is necessary to go to make that assessment.

As an alternative to using the portfolio approach, it may be easier for some entities to instead use a portfolio of transactions as a source of data to develop estimates to apply to individual contracts.

Identifying the performance obligations – assessing the nature of an entity's promise

Under IFRS 15, an entity is required to assess the promises in its contracts to determine whether they are performance obligations. However, it may not always be the case that certain promises are performance obligations, or that they need be assessed to determine whether they are. For example: Do certain promises actually represent a performance obligation or are they simply a fulfilment activity? Are they immaterial? What about pre-production activities?

It may be tempting to assume that all promises in a contract are a performance obligation, however, the concept of assessing promises to determine the performance obligations is not expected to result in many more than would have been identified as deliverables under legacy IFRS.

Activities that an entity must undertake in order to fulfil a contract are not performance obligations unless they transfer a good/service to the customer. For example, both the promise to provide a customer statement on a periodic basis and a promise to provide a hotline to answer customers' questions about a product would be fulfilment activities with respect to a promise to sell a service/good rather than a separate performance obligation in their own right. Furthermore, any benefit these promises provide to the customer is likely to be viewed by the customer as minor and, consistently with IFRS generally, immaterial items/promises need not be considered.

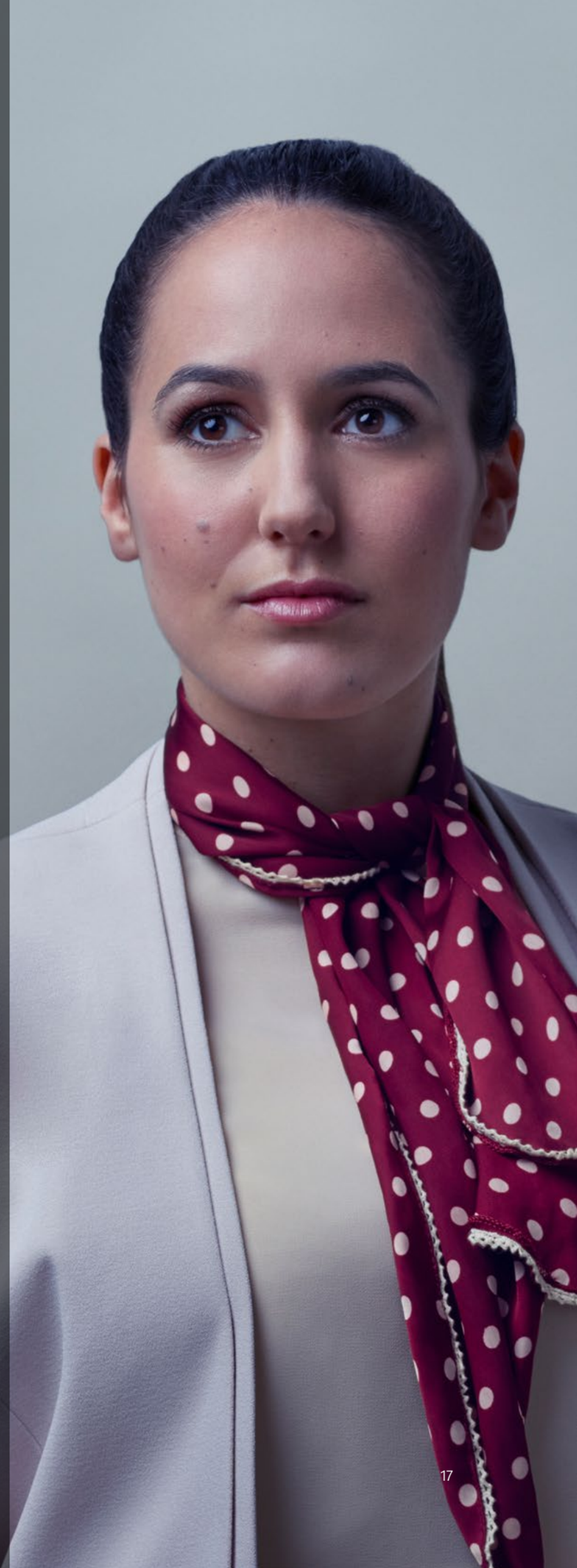
On the other hand, determining whether a pre-production activity is a fulfilment activity or a performance obligation will require more judgement.

Example

Consider a long-term production contract which includes some up-front engineering and design.

To assess whether it is an activity to fulfil the production contract or a separate performance obligation in its own right, it may be helpful to apply the criteria for determining when an entity transfers control of a good or service over time. In other words, determine whether the customer is simultaneously obtaining control of something as the entity undertakes the pre-production activities.

In this scenario, if the customer obtained the product from the contract and obtains the IP (patents) from the engineering and design activities, these would be considered as two separate performance obligations.



Accounting for options

IFRS 15 contains specific guidance which makes it clear that if a contract contains an option for the customer to acquire additional goods/services, then it is only a performance obligation if it provides the customer with a 'material right' that it would not receive without entering into that contract. For example, because the customer receives a discount on future selling prices that is incremental to the range of discounts normally given for those goods or services to that class of customer in that geographical area or market.

If the customer does not receive a material right (eg because the customer will have to pay the normal stand-alone selling price at that time) then the entity is simply deemed to have made a marketing offer.

However, when the option does provide a 'material right', the customer is effectively paying for the right as part of the current transaction (ie in advance) and so a portion of the transaction price is allocated to the option and recognised when the option is exercised or expires. IFRS 15.B42 provides guidance on how to make the allocation.

There are two fundamental questions in accounting for such options which IFRS 15 does not address:

- Firstly, it doesn't define a 'material right' and so entities will need to exercise judgement in deciding what factors to take into account when making such an assessment. Such factors may include rights obtained/expected from past/future transactions with the same customer in addition to those that will be obtained from the current transaction. Both quantitative and qualitative factors should be considered – including whether a right accumulates, as in some loyalty programmes.
- Secondly, it doesn't explain how to account for any consideration received when such an option is exercised. Two possibilities exist:
  - » To treat the exercise as a continuation of the contract and add the proceeds from exercise to the price allocated originally to the material right and recognise when the option is exercised; or
  - » to treat it as a modification of the original contract.

Applying the 'series 'provision

When identifying performance obligations, IFRS 15 requires a series of goods/services that are substantially the same and have the same pattern of transfer to the customer to be treated as a single performance obligation even if they are distinct. This is intended to simplify the application of the model (eg avoid the need to allocate the transaction price to each increment of service or product delivered when they are identical), and to promote consistency in identifying performance obligations. It's important to note that, whilst the series provision does simplify the model, it is a requirement rather than an optional practical expedient.

Whilst IFRS 15 helpfully specifies the criteria to be met in assessing whether the goods/services have the same pattern of transfer, it doesn't help in determining what a series comprises and therefore when goods/services are substantially the same.

Example

Entity A enters into an outsourcing arrangement with Entity B. To comply with the service level agreement Entity B may need to perform lots of different activities over a period of time and these could differ, day by day, month by month.

In accordance with IFRS 15.22, Entity B needs to assess the services promised in this arrangement and identify as a performance obligation, each promise to transfer either a service which is distinct or a series of distinct services that are substantially the same.

One way of making this evaluation could be to consider whether the entity's promise is to deliver a specified quantity of a service (service increment) or, because there is no specified quantity, to stand ready for a period of time or deliver a service over a period of time (time increment). However, other considerations may be appropriate and so judgement will be required.

So, if it is considered that the series comprises the individual activities (service increment) then the conclusion may well be that they are not substantially the same because there are so many different types of tasks involved in providing the service.

However, if it is considered that the series comprises distinct time increments, the conclusion is likely to be that each time increment is substantially the same as each other because the customer benefits from each day/month. It doesn't matter that each day/month's activities are different. The nature of the overall promise is to provide a daily/monthly outsourcing service.

Significant financing components

IFRS 15 requires the transaction price of a contract to be adjusted for the effects of the time value of money if the timing of payments provides either party with a significant financing benefit. IFRS 15.62 helpfully sets out factors which indicate when a contract would not have a significant financing component. It also provides a practical expedient which allows an entity to ignore the effects of a significant financing component if it is expected, at contract inception, that the period between transferring a promised good or service to a customer and the customer paying for it will be one year or less.

However, when there is a benefit that needs to be accounted for IFRS 15 does not address:

a) Where and how the benefit should be allocated where multiple performance obligations are present in a contract; and

b) which obligation the practical expedient can be applied to.

For issue a), it is likely that the benefit will be excluded from the transaction price and the net transaction price allocated according to the normal rules. However, it may, instead, be reasonable to attribute the benefit to one or more but not all performance obligations – similar to the guidance on allocating a discount or variable consideration.

In respect of issue b), it will be necessary to determine whether the payments are tied to one of the particular goods or services in the contract.

Assessing the duration of a contract

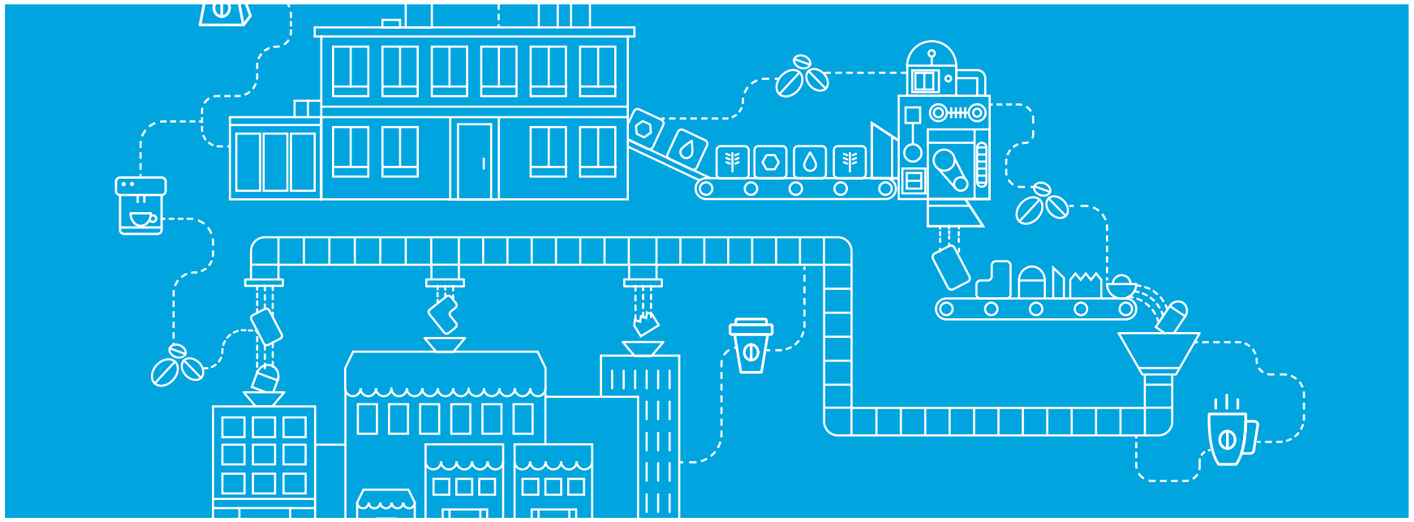
IFRS 15.11 provides that a contract can only exist to the extent the parties have present enforceable rights and obligations. Termination rights can affect the duration of a contract. In considering whether such rights are a determining factor, an entity will need to exercise judgement as to whether those termination rights are 'substantive'.

Other areas of judgement

Significant judgements and implementation issues are also expected in the following areas:

1. Identifying performance obligations (see step 1 p7);
2. principal vs agent considerations;
3. licensing;
4. collectability; and
5. measuring non-cash consideration.

To address these issues, in April 2016, the IASB made some clarifying amendments to IFRS 15 (see section 5). Applying a high hurdle in deciding what amendments to make and how to make them, the IASB made targeted amendments in respect of the first three areas. It concluded that no amendments were necessary in respect of collectability and it will consider non-cash consideration as part of a separate project.



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CLARIFYING AMENDMENTS MADE APRIL 2016

Identifying performance obligations

When assessing whether a promise represents a performance obligation, IFRS 15 requires an entity to first assess whether the promised good/service is capable of being distinct, and if it is, then to consider whether the promise to transfer that good/service is separately identifiable from other promises.

> ### Objective
>
> To consider whether, in the context of the contract, an entity can fulfil its promises by transferring each good/service individually or, instead, transferring a combined item(s) in which the promised goods or services are inputs.

To determine whether a promise is separately identifiable, an entity assesses whether there is a 'transformative' relationship between it and other promises rather than any 'functional relationship'.

- A 'transformative relationship' is one in which the individual items are transformed in the process of fulfilling the contract into something that is substantially different from or more than the sum of the individual items, eg the building of a wall from the supply of bricks and labour.
- A 'functional relationship' is one in which one item depends, by its nature, on another, eg the supply of a printer and related cartridges needed for the printer to function.

In making this assessment, an entity considers the level of integration, modification/customisation and interdependency/interrelation. Where a significant service of integrating goods/services is provided; one or more goods/services are significantly modified or customised; or the goods/services are highly interrelated or interdependent, a transformative relationship exists and the promises to transfer those goods/services are not separable and are therefore combined into a single performance obligation.

If there isn't a transformative relationship, then the promised goods/services will be outputs in their own right and the promises to deliver them will be separate performance obligations.

Example: Contract to provide a service of producing devices
IFRS 15 – Illustrative example 10 Case B

Facts

- Multiple units of a highly complex, specialised device unique to the customer.
- Required to establish a customised manufacturing process.
- Responsible for overall contract management including integration of various activities.

Analysis

- Each unit capable of being distinct.
- Significant integration service provided.
- Promised activities highly interdependent and highly interrelated.

Conclusions

- Promised goods and services are a single performance obligation — units not distinct within the context of the contract.
- Recognise revenue over time as services provided.

In summary, the amendments emphasise and clarify:

- The principle of assessing the 'separability' of the 'promises' rather than the promised goods/services.
- The objective in making this assessment.
- A single performance obligation can comprise more than one phase, element or unit.
- An entity considers the 'interdependency' rather than 'dependency' of goods/services when assessing separability.

By clarifying the objective in making the separability assessment, the IASB expects it to be clearer that the supporting factors in IFRS 15.29 are not a series of criteria to be met and that the list is not exhaustive.

Principal vs agent considerations

The amendments and new guidance clarify that an entity assesses whether its performance obligation is to provide the 'specified' goods/services (acting as principal) or to arrange for their transfer (acting as agent). It does so by assessing whether it has control of each specified good/service before it is transferred to the customer. An entity must therefore first appropriately identify the specified good/service.

Guidance has been added to help entities determine whether they are acting as principal or agent when they engage a third party to provide services to the customer. It has also been clarified that an entity considers its role in respect of each distinct good/service (or distinct bundle), rather than at the contract level, so that even in a single contract an entity could be acting as principal for some goods/services and agent for others.

IFRS 15 now sets out indicators of when an entity is acting as principal rather than agent, and explanatory text has been added to each of these to indicate how they reflect the control principle.

Entities should take care to remember the general control principle and consider the nature of the specified goods/services and contractual conditions when assessing whether they act as principal. The indicators in IFRS 15 should not be viewed in isolation because, as IFRS 15 now states, other indicators may exist which are more persuasive than those explicitly stated.

Licensing

When determining whether the revenue from granting a distinct licence should be recognised over time or at a point in time, an entity considers whether all of the following criteria have been met:

- Contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights;
- rights granted by the licence directly expose the customer to any positive or negative effects of the entity's activities identified above; and
- those activities do not result in the transfer of a good or a service to the customer as those activities occur.

When all of the above criteria are met, the revenue from a distinct licence is recognised over time. The area of difficulty for an entity in this assessment is determining whether its activities significantly affect the IP to which the customer has rights.

The guidance clarifies that an entity's activities significantly affect the IP when either:

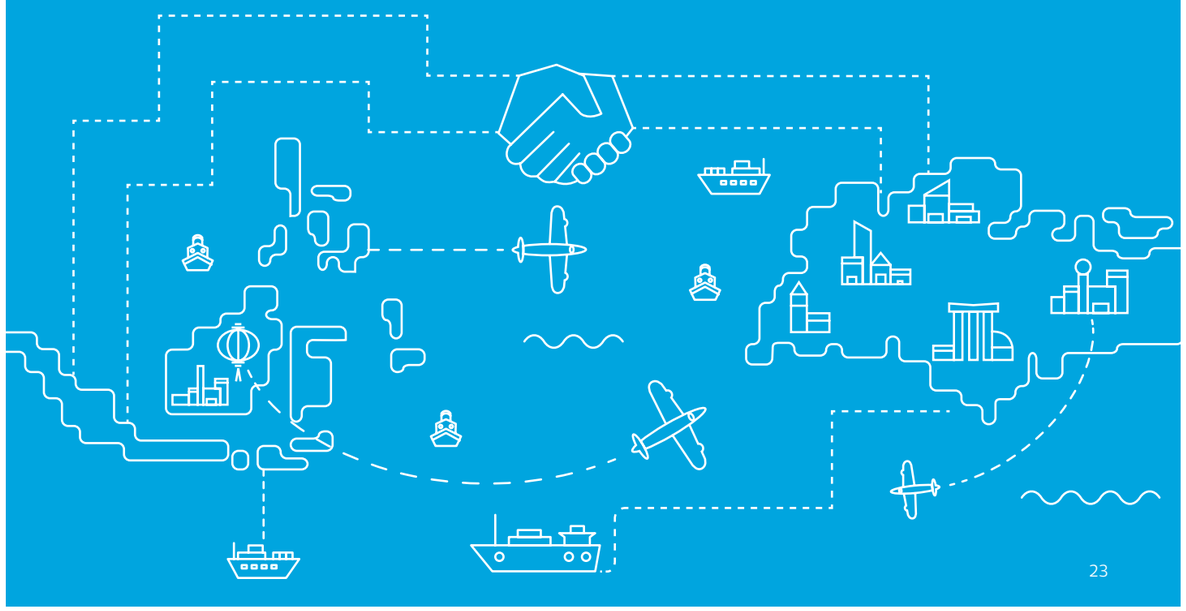
- They change its form (eg design) or functionality; or
- the customer's ability to benefit from the IP is substantially derived from, or dependent upon, the entity's activities (eg activities supporting or maintaining the value of a brand).

It clarifies that when IP has significant stand-alone functionality, then the customer is deriving benefit from that functionality and would not be significantly affected by the entity's activities unless they change that functionality. Although 'significant' stand-alone functionality is not defined in the standard, examples of types of IP that often have significant stand-alone functionality have been added. These include software, biological compounds or drug formulas, and completed media content such as films, TV shows and music recordings.

New guidance has also been added to clarify the application of the royalties' constraint/exception to sales/usage based royalties. The standard requires revenue for sales-based or usage-based royalty promises to be recognised only when the later of the following events occur:

- The subsequent sale or usage occurs; and
- the performance obligation to which some or all of the royalty has been allocated has been satisfied (partially satisfied) (IFRS 15.B63).

The new guidance clarifies that the royalties' constraint/exception only applies when the royalty relates to a licence of IP or the licence of IP is the predominant item to which the royalty relates.



CASE STUDY ILLUSTRATING THE REQUIREMENTS

Entity A is an IT solutions provider and enters into a contract with a customer to provide:

- 750 user licences for 4 software modules
- 'go live' support, including training, for the software;
- outsourced hosting services; and
- additional professional services support where required (training support and other services).

Initial contract period is for 2 years. Contract will extend for a further 3 years unless break clause invoked and termination fee paid.

Customer pays an annual licence fee on a per user basis for the software, training and 'go live' support, and hosting services. Any additional professional services support will be charged at the daily fee rates stipulated in the contract.

Step 1: Identify the contract with the customer
Entity A determines that it has a valid contract which creates enforceable rights and obligations for a 5 year period. The contract term has been determined as 5 years because a termination fee is payable if the customer invokes the break clause, indicating that this is the period for which the parties have present enforceable rights and obligations.

Step 2: Identify the performance obligations
In accordance with IFRS 15.22, Entity A must assess the goods and services promised in the contract and identify as a performance obligation each promise to transfer to the customer, either 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.

In the contract Entity A must deliver:

1. Four modules of software;
2. 'go live' support including training;
3. outsourced hosting services; and
4. ongoing services as and when required.

Are the four modules of software separate performance obligations?
Each module would be treated as a separate performance obligation if each is capable of being 'distinct' ie the customer can benefit from each module on its own or together with other resources that are readily available to the customer and Entity A's promise to transfer the good or service to the customer is separately identifiable from the other promises in the contract (IFRS 15.27).

For Entity A, each module can be purchased separately or as a package and hence each is capable of being used without the others. However, in order to be separate performance obligations, the promise to deliver each module must be separately identifiable from the promise to deliver the other modules.

To determine whether they are separately identifiable Entity A needs to assess whether there is a transformative or functional relationship between the modules.

In this scenario, Entity A determines that within the context of the contract it is delivering a tailored software package containing four modules because it will perform significant activities to integrate the modules so that they interact with each other and function in a way that is different than if they were bought separately.

Are the hosting service and other services separate performance obligations?
In this example, the customer is not required, but has chosen, to purchase the hosting service. they could, alternatively, take physical delivery of the software and run it on their own systems.

The software package and services are capable of being distinct, and the software can be delivered with or without the hosting and other services. None of the promises are therefore interdependent or interrelated with another. Entity A therefore concludes that the hosting service and the other services are separate performance obligations.

Is the hosting service one performance obligation (ie a series of distinct services that are substantially the same and that have the same pattern of transfer to the customer) or are there separate performance obligations within the service?
Entity A determines that the hosting service comprises a series of distinct time increments to be provided over the contract period and these would be recognised in the same way. Accordingly it treats the service as a single performance obligation.

Decision
Entity A concludes that in its specific circumstances, there are 3 present performance obligations:

- Licensed software package;
- 'go live' support, including training, for the software; and
- outsourced hosting services.

The additional professional services are optional and will only become a performance obligation if the customer decides to purchase these services. Therefore they do not feature in the accounting for the current contract.

Step 3: Determine the transaction price
The transaction price comprises the annual licence fee for 5 years. The licence fee covers the software, training and 'go live' support and hosting services.

The additional professional services are optional and so do not represent a present obligation for Entity A. Furthermore, Entity A does not expect its daily rates to increase significantly over the next 5 years and so judges that the daily rates for optional services that have been agreed at contract inception will not provide the customer with a significant discount on prevailing rates and so do not represent a material right. Accordingly the fees do not feature in the accounting for the current contract.

Step 4: Allocate the transaction price to the performance obligations
Using the hierarchy set out in IFRS 15.76–80, Entity A observes that standalone selling prices exist for the training and 'go live' support services as they are similar in nature to any additional professional services for which agreed daily rates are stipulated in the contract. It also observes that the hosting service will be outsourced at a known cost. The licences are not considered to have a standalone selling price as they are sold to different customers for a broad range of prices.

Entity A allocates the contract transaction price between the three present obligations as follows:

- 'Go live' support, including training, for the software – based on daily rates for similar services;
- outsourced hosting services – 'cost plus' basis; and
- licensed software package – residual approach.

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation
The software licence is distinct and so Entity A assesses whether the nature of its promise is to provide a 'right of access' to the software (IP) as it exists throughout the licence period or a 'right to use' the software (IP) as it exists when granted. Entity A observes that whilst the modules need to be integrated, the software package is functional at the time the licence transfers to the customer and it is not reasonably expected to undertake activities that would significantly affect its utility by the customer from the IP. Entity A therefore concludes that the transaction price allocated to the licensed software package should be recognised at a 'point in time'.

Entity A determines that the other services are provided 'over time' and that an input method best reflects its progress in satisfying these performance obligations. Entity A chooses a time based method to measure the progress towards satisfying the performance obligation.

Having determined the transaction price and the timing of its transfer of the goods/services, Entity A observes that the timing of its transfer of the licence does not coincide with the payment terms. Accordingly it considers whether it has provided a significant financing benefit in respect of the licence. Entity A concludes that such a benefit does exist because the customer is effectively paying for the software over a 5 year period. Entity A judges that the significant financing component relates only to the software as the payment of fees and the timing of the provision of other services is not greater than one year. For this same reason, Entity A is not required as a practical expedient to assess whether a significant financing benefit has been provided in respect of the other services. Accordingly it adjusts the contract price allocated to the provision of the software and recognises interest income.

HOW CAN RSM HELP?

Guide you through IFRS 15, explaining the requirements and providing insight; highlighting where key judgements will be required and making you aware of available practical expedients (eg 'right-to-invoice' or 'portfolio approach') and practical alternatives (eg for valuing customer options).

Compare and contrast the requirements of IFRS 15 with existing accounting policies.

Assist in reviewing material prepared for communication with stakeholders about the impact of implementing IFRS 15, including the costs of the implementation process.

Explain the detailed disclosure requirements and help to identify where system changes may be required to capture the necessary data and where effort will be needed in clearly disclosing the impact of IFRS 15 on first time application.

Assess whether your existing systems will be able to cope with the implementation of the new standard and, if not, advise on a selection of software vendors.

Develop an implementation plan that will ensure a smooth and cost effective transition and if required assist in project managing the implementation.

If you have already started the implementation process, we can help you to determine whether the recent clarifications change your understanding of the impact of IFRS 15 or your choice of practical expedients on transition.

Support you in the data capture of your contracts, processing and presentation of the results.

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