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Bringing clarity to an IFRS world

IFRS 15 – *Revenue from Contracts with Customers*

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Agenda

1. Introduction
2. Scope
3. The revenue model
4. Other matters
5. Impacts, challenges and issues
6. Resources
7. Questions and answers

Important caveats

- **This webcast does not provide official Deloitte interpretive accounting guidance.**
- **Check with your advisor before taking any action.**

Introduction
Background

- IFRS 15 – *Revenue from Contracts with Customers* (“IFRS 15”) was issued on May 28, 2014
- Culmination of joint IASB/FASB project to develop high quality global accounting standard
- Converged with US GAAP with some minor differences
- Consistent across industries and capital markets
- IASB and FASB have established a joint Transition Resource Group to inform the Boards about interpretive issues that could lead to diversity in practice

Introduction (cont'd)

Single comprehensive framework

Current requirements	
Revenue recognition	
IAS 11 **IAS 18** **IAS 18** **IFRIC 15**	Construction contracts Sales of goods Sales of services Real estate sales
IAS 18	Royalties
IFRIC 13	Customer loyalty programmes
IFRIC 18 **SIC 31**	Transfers of assets from customers Advertising barter transactions
IAS 18 **IAS 18**	Interest Dividends

New requirements	
Revenue from contracts with customers	
IFRS 15	Point in time or over time
	New guidance on royalty revenue
	New guidance on options for additional goods and services and breakage
	Guidance on non-cash consideration
Other revenue	
IAS 39 or **IFRS 9**	Interest Dividends

Introduction (cont'd)
Effective date and transition options

- **Effective date**
  - Annual reporting periods beginning on or after January 1, 2017, including interim reporting periods **therein** (FY 2017)
  - Early application **is** permitted under IFRS
- **Transition options**
  1. Retrospective Approach
     A. Full retrospective application – Restate prior periods
     B. Retrospective with optional practical expedients
  2. Modified Approach
     A. Apply revenue standard to contracts not completed as of date of initial application of standard and record cumulative catch-up
     B. Additional disclosure requirements apply

Introduction (cont'd)
Transition examples

Full retrospective approach (note: practical expedients available)

January 1, 2017 Initial application year	2017 Current year	2016 Prior year 1	2016 Opening B/S
New Contracts	IFRS 15	IFRS 15	IFRS 15
Existing Contracts	IFRS 15	IFRS 15	IFRS 15

Modified approach

Cumulative catch-up

January 1, 2017 Initial application year	2017 Current year	2016 Prior year 1
New Contracts	IFRS 15	
Existing Contracts	IFRS 15 + cumulative catch up	Existing IFRS
Completed Contracts		Existing IFRS

Scope

- Applies to an entity's **contracts** with customers
- Some key aspects of the guidance apply to a transfer or sale of non-financial assets
- Contracts with collaborators or partners require assessment

- Does not apply to:
  - Lease contracts
  - Insurance contracts
  - Financial instruments and other contractual rights or obligations within the scope of other Standards
  - **Non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers**

The revenue model

Core principle: Recognise revenue to depict the **transfer of promised goods or services to customers** in an amount that reflects **the consideration the entity expects to be entitled** in exchange for those goods or services

Recognition
Para. 9–21

Identify the contract with a customer
(Step 1)

Recognition
Para. 22–30

Identify the performance obligations in the contract
(Step 2)

Measurement
Para. 46–72

Determine the transaction price
(Step 3)

Measurement
Para. 73–90

Allocate the transaction price to performance obligations
(Step 4)

Recognition
Para. 31–45

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

This revenue recognition model is based on a **control approach** which differs from the risks and rewards approach applied under existing IFRS.

The revenue model (cont'd)
Step 1: Identifying the contract

A legally enforceable contract must meet all of the following requirements:

- The parties have approved the contract and are committed to perform ✓
- The entity can identify the payment terms for the goods or services to be transferred ✓
- The contract has commercial substance ✓
- The entity can identify each party's rights regarding goods or services ✓
- It is probable 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 ✓

The revenue model (cont'd)
Step 2: Identifying performance obligations

Step 1 | **Step 2** | Step 3 | Step 4 | Step 5

The Standard defines a **performance obligation** as a promise to transfer to the customer a good or service (or a bundle of goods or services) that is **distinct**.

Identify all (explicit or implicit) promised goods and services in the contract

Are promised goods and services distinct from other goods and services in the contract?

Capable of being distinct

And

Distinct in context of contract

New

Can the customer benefit from the good or service on its own or together with other readily available resources?

Is the good or service separately identifiable from other promises in the contract?

Yes

Account for as a performance obligation

No

Combine 2 or more promised goods or services and reevaluate

The revenue model (cont'd)

Example: Good or service is distinct

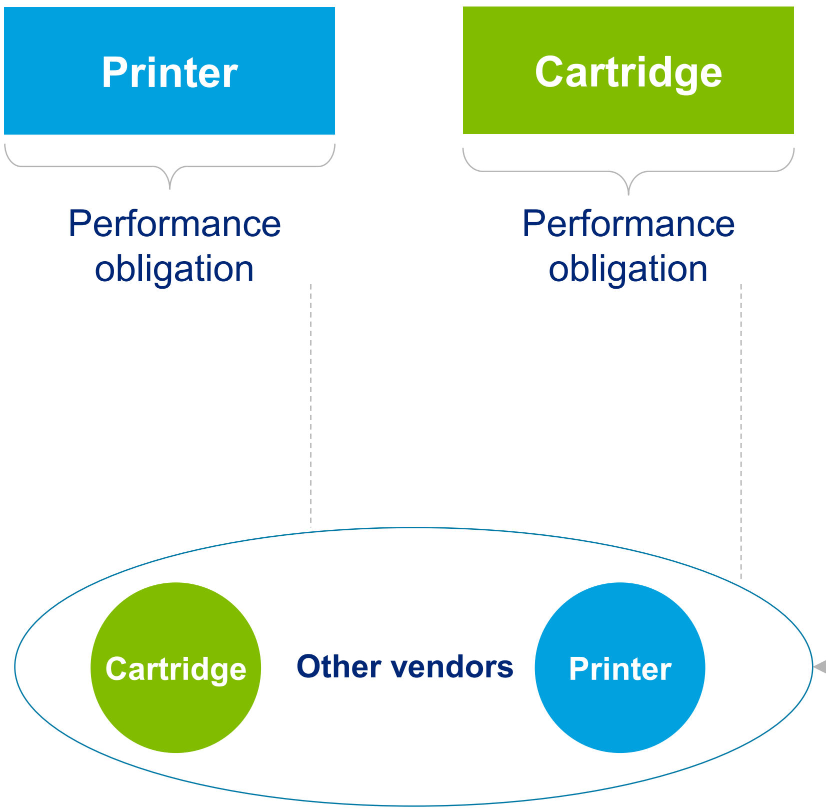
- **An entity, a manufacturer, enters into a contract to sell a customer a printer and an ink cartridge that is shipped two weeks later.**
  - The printer cannot print without the ink cartridge.
  - Both the printer manufacturer and sellers of generic ink cartridges sell ink cartridges for the printer separately.

Identify the performance obligation(s).

The revenue model (cont'd)

Example: Good or service is distinct

Q. Identify the performance obligation(s).



A. Both the printer and the cartridge represent distinct goods, meaning that :

1. The customer can benefit from the good either on its own or together with other resources that are readily available to the customer **and**
2. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract

The revenue model (cont'd)

Step 3: Determining the transaction price

Step 1 | Step 2 | Step 3 | Step 4 | Step 5

Principle: The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.

- Transaction price shall include …
  - Fixed consideration
  - Variable consideration (estimated and potentially constrained)
  - Non-cash consideration
  - Adjustments for a significant financing component (time value of money)
  - Adjustments for consideration payable to a customer
- Transaction price does **not** include …
  - Effects of customer credit risk

The revenue model (cont'd)

Step 3: Determining the transaction price – Variable consideration

- **Variable consideration** includes all consideration that is subject to uncertainty for reasons other than collectability
  - Examples include discounts, rebates, refunds, credits, incentives, performance bonuses/penalties, contingencies, price concessions, or other similar items

- **When accounting for variable consideration an entity shall…**
  - Estimate using expected value (probability weighted) or most likely amount methods

    Subject to the following **"constraint":**

    Include some or all of the amount of variable consideration in the transaction price to the extent that it is **"highly probable"** that a subsequent change in the estimate would not result in a **significant revenue reversal**

The revenue model (cont'd)

Step 3: Determining the transaction price – Variable consideration

- Need to assess the **likelihood** and **magnitude** of a significant revenue reversal. Consider the following factors (e.g.,) in doing so:

Consideration is highly susceptible to factors outside entity's influence

Yes

Uncertainty related to amount of consideration is not expected to be resolved for a long time

Yes

Entity's experience with the type of contract is limited or experience has limited predictive value

Yes

Entity typically offers a broad range of price concessions or changing payment terms and conditions

Yes

The contract has a large number and a broad range of possible consideration amounts

Yes

Significant revenue reversal

Do **not** include in transaction price

The revenue model (cont'd)
Example: Implicit price concessions

- **An entity sells a prescription drug for $1 million payable in 90 days to a customer in a region of the world that is experiencing economic difficulty.**
  - At the time of entering into the contract, the entity assesses that there is a significant risk that the customer will accept the product and attempt to settle the receivable with less than full payment as is customary in the region.
  - The entity estimates that the customer and the entity will ultimately settle on a price of $400,000 (which the entity is willing to do because $400,000 is in excess of its cost).
  - The entity assesses the collectability of the $400,000 to which it is entitled and deems collectability to be probable.

1. **Is the transaction price variable?**
2. **Does the contract meet the criteria in step 1 of the revenue model?**

The revenue model (cont'd)
Example: Implicit price concessions

Q. Is the transaction price variable?

A. Yes; the entity expects at contract inception to offer a price concession and to lower its price to $400,000.

Q. Does the contract meet the criteria in step 1 of the revenue model ?

A. As noted above, the entity expects to offer a price concession at contract inception and has determined that it will accept $400,000 in exchange for providing the promised goods in the contract.

Accordingly, the entity determines that the criteria in step 1 are met for the following reasons:

- ✓ The parties have approved the contract and are committed to perform their respective obligations
- ✓ The entity believes it is probable that it will collect, however expects to offer a price concession and has identified the amount that it expects to be entitled to for providing the goods ($400,000)
- ✓ The contract has commercial substance
- ✓ The entity can identify each party's rights regarding the goods
- ✓ The payment terms have been identified

The revenue model (cont'd)
Step 4: Allocating the transaction price

Step 1 | Step 2 | Step 3 | Step 4 | Step 5

- Allocate transaction price on a relative stand-alone selling price basis (estimate stand-alone selling price if not observable).
  – The expected cost-plus margin method, adjusted market assessment method, or residual method (only if price is highly variable or uncertain) are acceptable.
- Allocate changes in the transaction price to all performance obligations (based on initial allocation) unless a portion of the change in transaction price relates entirely to one (or more) obligations and certain criteria are met.
- Do not reallocate for changes in stand-alone selling prices.
- If certain criteria are met, a discount or variable consideration may be allocated to one or more, but not all, of the performance obligations in a contract.

The revenue model (cont'd)
Step 5: Recognising revenue

- Evaluate if control of a good or service transfers over time, if not, then control transfers at a point in time.
- An entity satisfies a performance obligation over time if…

The customer receives and consumes the benefit as the entity performs.
(e.g., cleaning service)

or

Performance creates or enhances a customer controlled asset.
(e.g., home addition)

or

Performance does not create an asset with an **alternative use** and the entity has both an **enforceable right to payment** for performance completed to date and expects to fulfil contract as promised.

Measure progress towards completion using input/output methods

The revenue model (cont'd)

Step 5: Recognising revenue

- For performance obligations satisfied at a point in time, indicators that control transfers include, but are not limited to, the following:

1	Entity has a present right to payment for the asset
2	The customer has legal title to the asset
3	The entity has transferred physical possession of the asset
4	The customer has the significant risks and rewards of ownership of the asset
5	The customer has accepted the asset

The revenue model (cont'd)

Example: Point in time or over time

- **An entity, a manufacturer, enters into a contract with a customer to produce 52,000 units of a customized part which cannot be sold to any other customer without substantial re-work.**
- The production cycle allows the entity to produce and ship 1,000 units per week.
- If the customer cancels for reasons other than the entity's failure to perform, the contract terms require the customer to pay the entity's cost plus a reasonable margin for each unit produced or partially produced but not yet delivered.

1. **Does the product have an alternative use?**
2. **Does the entity have an enforceable right to payment that approximates the selling price of the goods transferred to date**?

The revenue model (cont’d)

Example: Point in time or over time

Q. Does the product have an alternative use?

A. No. The terms of the contract indicate that the entity is producing a customized part which cannot be sold to any other customer without substantial re-work. Consequently, the asset is deemed to not have an alternative use.

Q. Does the entity have an enforceable right to payment that approximates the selling price of the goods transferred to date?

A. Yes. The terms of the contract indicate that the entity has an enforceable right to be reimbursed for its costs plus a reasonable margin for each unit produced or partially produced, even if such products have not been delivered to the entity prior to cancellation.

Conclusion	In addition to the fact that the asset does not have an alternative use, because the entity does have an enforceable right to payment that approximates the selling price of the goods transferred to date, it **does meet the criteria to be recognised over time.**

The revenue model (cont'd)

Example: Point in time or over time

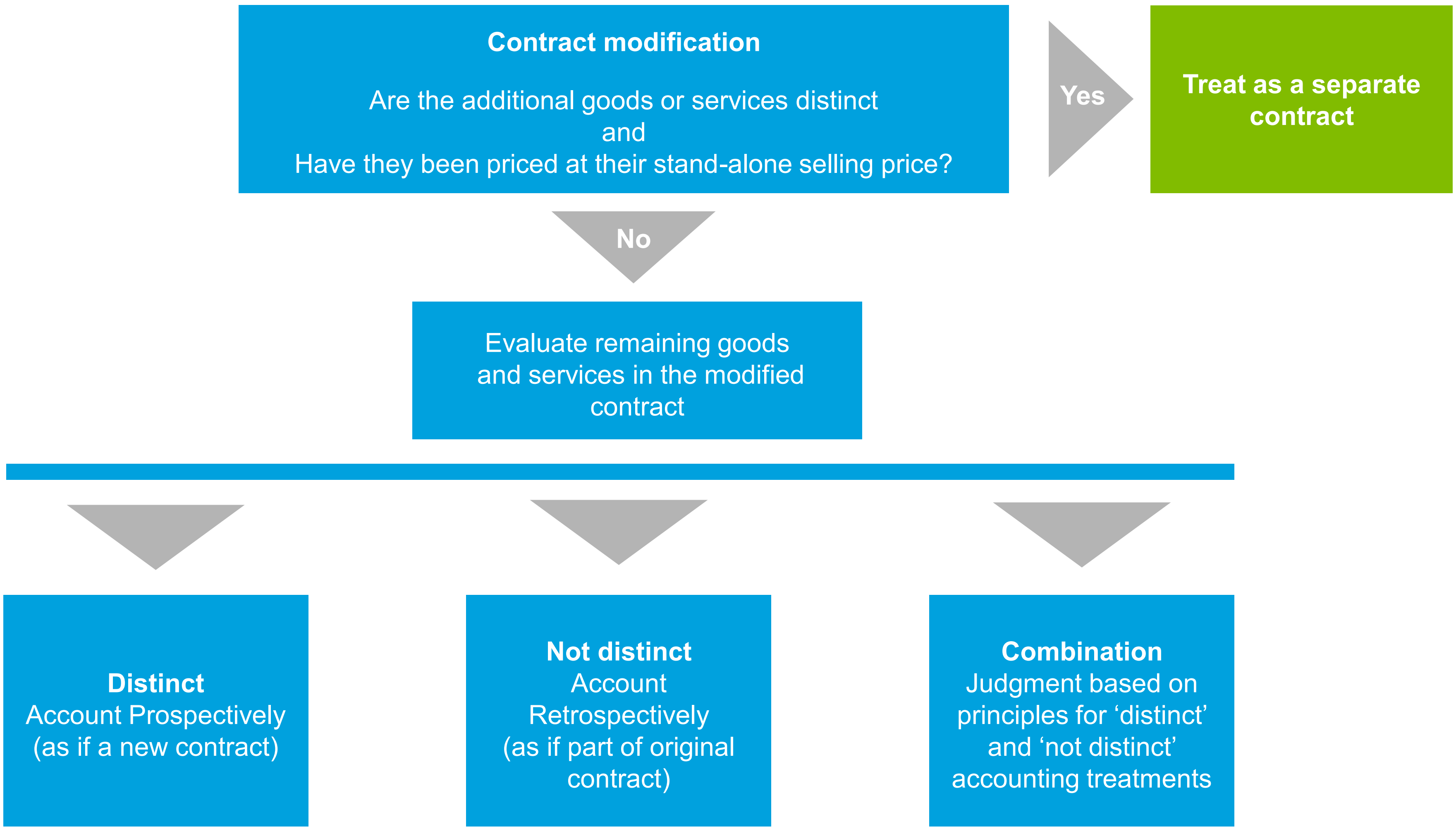
Q. What would the impact be if the contract terms require the customer to pay only the entity's cost for each unit produced or partially produced but not yet delivered?

A. Because the entity does not have an enforceable right to payment that approximates the selling price of the goods transferred to date, it does not meet the criteria to be recognised over time. Therefore, revenue would be recognised at a point in time. The entity should consider the indicators that control has transferred to the customer in order to determine the appropriate point(s) in time to recognise revenue.

The entity considers the following five indicators of control and determines that the customer has obtained control of the asset:

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

Other matters
Contract modifications



Other matters (cont'd)

Example: Contract modifications

- An entity enters into a 3-year contract for daily cleaning services.
- Customer pays the stand-alone selling price of $100,000 at the beginning of each year.
- At the end of the second year, the contract is modified and the fee for the third year of services is reduced to $80,000 plus an additional $200,000 to extend the contract for three additional years.
- Stand-alone selling price of the services at the beginning of the third year is $80,000 per year.
- The entity's stand-alone selling price multiplied by the number of years is deemed to be an appropriate estimate of the stand-alone selling price of the multi-year contract (the stand-alone selling price is 4 years × $80,000 per year = $320,000).

1. Are the services added distinct?
2. Is the additional consideration reflective of the stand-alone selling price of the services?

Other matters (cont'd)
Example: Contract modifications

Q. Are the services added distinct?

A. Yes, as the customer can benefit from the service on its own and it is separately identifiable.

Q. Is the additional consideration reflective of the stand-alone selling price of the services?

A. No, the amount of remaining consideration to be paid ($280,000, C) does not reflect the stand-alone selling price of the services to be provided ($320,000).

≠ **Separate contract**

Year	Initial Amount (in '000s)	Modified Amount (in '000s)	
1	$100	$100	
2	$100	$100	
3	$100	$80	A
4	0		
5	0	$200	B
6	0		
Total	**$300**	**$480**	

A + B = $280,000 (C)

- Hence, the entity accounts for the modification in accordance with paragraph 21(a), as a termination of the original contract and the creation of a new contract with consideration of $280,000 for 4 years of cleaning services. As a result, the entity recognises revenue of $70,000 per year ($280,000/4 years) as the services are provided.

Other matters (cont'd)
Licences

- Consider whether the licence is distinct or not distinct as part of step 2 of the model.

Hosted software may not represent a distinct licence

What is the nature of the entity's promise in granting the licence?

Right to access IP throughout the licence term → **Recognise over time**

Right to use IP as it exists when licence granted → **Recognise at a point in time**

Consider

- Will the entity undertake activities that significantly affect the IP?
- Do rights granted by the licence directly expose customer to positive or negative effects of the entity's activities?
- Do the activities result in the transfer of a good or service as they occur?

Other matters (cont’d)
Contract costs

- Costs to obtain a contract
  - Capitalize costs of obtaining a contract if they are incremental and expected to be recovered (e.g., sales commissions)
- Costs to fulfill a contract
  - Recognise assets in accordance with other Standards (inventory, PP&E, intangibles, etc.), otherwise capitalize costs that:
    - Relate directly to the contract (or specific anticipated contract)
    - Generate/enhance a resource that will be used to satisfy obligations in the future, and
    - Are expected to be recovered

Amortization	Assets amortized on a systematic basis consistent with the transfer of the related goods or services
Impairment	Recognise immediately if costs deemed not recoverable, and reverse if facts and circumstances change

Other matters (cont'd)

Product warranties

- Assurance warranties (those that assure past performance was as specified) use a cost accrual accounting model
- Optional purchase or go beyond normal assurance would be a potential separate performance obligation

Options to acquire additional goods/services

- Represents a performance obligation (requiring the deferral of revenue) if it provides **a material right** that would not have been received

Repurchase agreements

- If entity has an **obligation or right to repurchase** the asset, the customer **generally does not obtain control** and is accounted for as a lease or a financing arrangement

Customers' unexercised rights

- Recognise "breakage" based on the pattern of rights exercised by customer if entity expects to be entitled (otherwise defer until probability of customer exercising rights is remote)

Other matters (cont'd)
Disclosures

Disclosures about contracts with customers

- **Disaggregation of revenue** *
- **Information about contract balances**
- **Remaining performance obligations**
- **Information about performance obligations**

Disclosures about significant judgments and estimates

- **Description of significant judgments**
- **Transaction price, allocation methods and assumptions**

Other required disclosures

- **Policy decisions – Time value of money and costs to obtain a contract**
- **Contract costs**

***This is the only disclosure requirement (in addition to IAS 34 – *Interim Financial Reporting* requirements) for interim statements.**

Impacts, challenges and issues

Impacts – Consider **some** of the significant changes

IFRS 15

Requirement			Impact/considerations
Separate performance obligations	• New • Specific requirements	?	• How to identify? • Do standard policies need to be developed to ensure consistent identification?
Allocating the transaction price	• Amended • Focus on stand-alone selling price	?	• How to determine stand-alone selling price? • Does this information exist? • Can this be an automated calculation?
Variable consideration	• Amended • Specific requirements	?	• What method will be used for estimating? • How to determine probability of a 'significant revenue reversal'?
Contract costs	• New • Specific requirements	?	• Identification? • What does 'incremental cost' mean for your organization?
Contract modifications	• New • Specific requirements	?	• What process will be in place to identify a modification compared to a change in variable consideration?
Licences	• New • Specific requirements	?	• How to determine whether licences are recognised over time or at a point in time?
Disclosure requirements	• Amended • Extensive disclosures	?	• How to track disclosure requirements? • How to identify and capture required data?

Impacts, challenges and issues (cont'd)

Common implementation steps

	Assessment	Business Analysis	Implementation
Technical accounting	Assess accounting impact	Develop policies and determine adoption method	Prepare disclosures Auditor concurrence
Data and systems Controls	Identify systems impacted	Develop system requirements Determine impact on controls	Systems testing
Program management and other	Develop project plan including communication requirements	Evaluate training requirements Update stakeholders Consider tax implications	Roll out training Update stakeholders

Impacts, challenges and issues (cont'd)

Broader impacts

Stakeholder	Impacts: Perception and understanding of analysts and broader market impacts	Impacts: Availability of profits for distribution	Impacts: Changes to KPIs and other key metrics	Impacts: Potential non-compliance with loan covenants	Impacts: Compensation and bonus plans – meeting targets?
Lenders			✖	✖	
Markets	✖				
Investors		✖	✖		
Employees			✖		✖
Board	✖	✖	✖	✖	✖

Impacts may be broader than you think

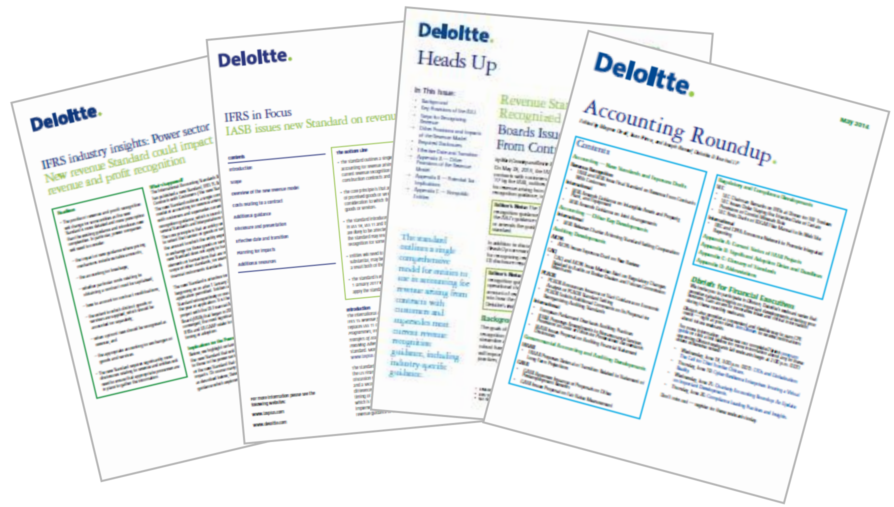
Resources

Deloitte resources

- IASPlus
  - IFRS Industry Insights
  - IFRS in Focus
  - Accounting Roundup
  - Heads Up
- Center for Corporate Governance

Other resources

- IASB website



Resources (cont'd)
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Questions and answers