

IASB and FASB issue new revenue recognition standard – IFRS 15

What you need to know

- ▶ The IASB and FASB have issued their joint revenue recognition standard, IFRS 15 *Revenue from Contracts with Customers*, which replaces all existing IFRS and US GAAP revenue requirements.
- ▶ The standard applies to all revenue contracts and provides a model for the recognition and measurement of sales of some non-financial assets (e.g., disposals of property, plant and equipment).
- ▶ Application is required for annual periods beginning on or after 1 January 2017, but early adoption is permitted under IFRS.
- ▶ Early preparation will be key to a successful implementation of the new standard.

Background

The requirements for recognising revenue are changing. The International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) (collectively, the Boards) have issued new requirements for recognising revenue under both IFRS and US GAAP. The new standard is the final product of more than a decade of efforts, including multiple documents exposed for public comment, numerous roundtables, other discussion forums and extensive deliberations by the Boards.

The core principle of IFRS 15 is that revenue is recognised 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.

Scope

IFRS 15 establishes a five-step model that will apply to revenue earned from a contract with a customer (with limited exceptions), regardless of the type of revenue transaction or the industry. The standard's requirements will also apply to the recognition and measurement of gains and losses on the sale of some non-financial assets that are not an output of the entity's ordinary activities (e.g., sales of property, plant and equipment or intangibles).

Extensive disclosures will be required, including disaggregation of total revenue; information about performance obligations; changes in contract asset and liability account balances between periods and key judgements and estimates.

The new revenue standard will affect all entities in all industries.



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Adopting the new requirements will be a significant undertaking for most entities.

Effective date

The standard will apply to annual periods beginning on or after 1 January 2017 (15 December 2016 for public entities reporting under US GAAP). Early adoption is permitted under IFRS, but not for public entities reporting under US GAAP. Entities will transition following either a full retrospective approach or a modified retrospective approach. The modified approach will allow the standard to be applied to existing contracts beginning with the current period. No restatement of the comparative periods will be required under this approach, as long as comparative disclosures about the current period's revenues under existing IFRS are included.

The five-step model

The principles in the standard will be applied using a five-step model. Entities will need to exercise judgement when considering the terms of the contracts and all relevant facts and circumstances. The requirements will need to be applied consistently to contracts with similar characteristics and in similar circumstances.

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

Contracts may be written, verbal or implied by customary business practices, but must be enforceable and have commercial substance. The model applies to each contract with a customer once it is probable¹ the entity will collect the consideration to which it will be entitled. In evaluating whether collection is probable, the entity would consider only the customer's ability and intention to pay the consideration when due.

An entity may combine two or more contracts that are entered into at or near the same time with the same customer, and account for them as a single contract, provided they meet specified criteria.

The standard provides detailed requirements for contract modifications. Depending on the specific facts and circumstances, a modification may be accounted for as a separate contract or a modification of the original contract.

Step 2: Identify the separate performance obligations in the contract

Once the contract has been identified, an entity will need to evaluate the terms and customary business practices to identify which promised goods or services, or a bundle of promised goods or services, should be accounted for as separate performance obligations.

The key determinant for identifying a separate performance obligation is whether a good or service, or a bundle, is distinct. A good or service is distinct if the customer can benefit from the good or service on its own or together with other readily available resources and the good or service is separately identifiable from other promises in the contract. Each distinct good or service will be a separate performance obligation.

An entity may provide a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. Examples could include services provided on an hourly or daily basis. Provided specified criteria are met, such a series is a single performance obligation.

¹ While the same threshold of 'probable' applies in both IFRS and US GAAP, the threshold differs because definitions of 'probable' in IFRS and US GAAP differ.

Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled and includes:

- ▶ An estimate of any variable consideration (e.g., it may vary due to rebates or bonuses), using either a probability-weighted expected value or the most likely amount, whichever better predicts the amount of consideration to which the entity will be entitled
- ▶ The effect of the time value of money, if there is a financing component that is significant to the contract
- ▶ The fair value of any non-cash consideration
- ▶ The effect of any consideration payable to the customer, such as vouchers and coupons

The transaction price is generally not adjusted for credit risk. However, it may be constrained because of variable consideration. That is, an entity can include variable consideration in the transaction price only to the extent it is highly probable² that a subsequent change in estimated variable consideration will not result in a significant revenue reversal. A significant reversal occurs when a change in the estimate results in a significant downward adjustment in the amount of cumulative revenue recognised from the contract with the customer.

For sales and usage-based royalties from the licence of intellectual property, the standard specifies that an entity does not include such consideration in the transaction price before the subsequent sale or usage occurs.

Step 4: Allocate the transaction price to the separate performance obligations

An entity must allocate the transaction price to each separate performance obligation on a relative stand-alone selling price basis, with limited exceptions. One exception in the standard permits an entity to allocate a variable amount of consideration, together with any subsequent changes in that variable consideration, to one or more (but not all) performance obligations, if specified criteria are met.

When determining stand-alone selling prices, an entity must use observable information, if it is available. If stand-alone selling prices are not directly observable, an entity will need to use estimates based on reasonably available information. Examples of reasonably available information include an adjusted market assessment approach or an expected cost plus a margin approach. Only when the stand-alone selling price of a good or service is highly variable or uncertain (as explained in the standard), can a residual approach be used.

Revenue will be recognised when, or as, control of a good or service transfers to a customer.

How we see it

In most instances, an entity will be able to make estimates of stand-alone selling prices that represent management's best estimate considering observable inputs. However, it could be more difficult if goods or services are not sold independently by the entity or others.

Current IFRS does not explicitly address the accounting for multiple-element arrangements, which has resulted in diversity in practice. IFRS 15 provides detailed requirements for transactions with multiple elements, but does not eliminate the need to exercise judgement to determine the appropriate performance obligations and allocate the consideration to those performance obligations.

² The FASB standard uses 'probable', which has the same meaning as 'highly probable' in IFRS.

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

An entity satisfies a performance obligation by transferring control of a promised good or service to the customer, which could occur over time or at a point in time. A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case, it is satisfied over time:

- ▶ The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs
- ▶ The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced
- ▶ The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date

Revenue is recognised in line with the pattern of transfer. Revenue that is allocated to performance obligations satisfied at a point in time will be recognised when control of the good or service underlying the performance obligation has transferred. If the performance obligation is satisfied over time, the revenue allocated to that performance obligation will be recognised over the period the performance obligation is satisfied, using a single method that best depicts the pattern of the transfer of control over time. Additional application guidance is provided to assist entities when determining whether a licence of intellectual property transfers to a customer over time or at a point in time.

Contract costs and other application guidance

In addition to the five-step model, the standard specifies how to account for the incremental costs of obtaining a contract and the costs directly related to fulfilling a contract. Provided those costs are expected to be recovered, they can be capitalised and subsequently amortised and tested for impairment.

Application guidance is provided in the standard to assist entities in applying its requirements to common arrangements, including: licences; warranties; rights of return; principal-versus-agent considerations; options for additional goods or services and breakage.

How we see it

IFRS 15 is a significant change from current IFRS. Although it provides more detailed application guidance, entities will need to use more judgement in applying its requirements, in part, because the use of estimates is more extensive.

The potential changes to revenue recognition for some entities may be significant, so it is important for entities to start assessing the impact immediately.

Further resources

- ▶ *Thought Center* webcast scheduled for 10 June 2014; registration details are available on www.ey.com/ifrs
- ▶ Our *Applying IFRS* series provides an in-depth discussion of the requirements of IFRS 15 including illustrative examples

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