

IFRS

First Impressions: Revenue from contracts with customers

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A new global framework for revenue

On 28 May 2014, the IASB and FASB published a new joint standard on revenue recognition¹, which replaces most of the detailed guidance on revenue recognition that currently exists under US GAAP and IFRS. Publishing a joint standard on revenue recognition is a major achievement for the standard setters, but for companies the real work is just beginning.

The new standard comes over five years after the standard setters published the first version of their joint revenue recognition proposals. The long project timescales have caused many companies to postpone thinking about how they will be impacted. It is natural that some have taken a 'believe it when I see it' approach to news that accounting requirements are about to change. But now it's here, we have a new standard on one of the most important financial reporting metrics – revenue – and it will apply to almost all companies reporting under IFRS and US GAAP.

The new requirements will affect different companies in different ways. Companies that sell products and services in a bundle, or those engaged in major projects – e.g. in the telecom, software, engineering, construction and real estate industries – could see significant changes to the timing of revenue recognition. For others, it will be more a case of 'business as usual'.

However, all companies need to assess the extent of the impact, so that they can address the wider business implications. In particular, the new disclosure requirements are extensive and might require changes to systems and processes to collect the necessary data – even if there is no change to the headline numbers in the financial statements.

The new standard takes effect in January 2017, although IFRS preparers can choose to apply it earlier. While the effective date may seem a long way off, decisions need to be made soon – namely, when and how to transition to the new standard. An early decision will allow companies to develop an efficient implementation plan and inform their key stakeholders.

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¹ IFRS 15 and FASB ASC Topic 606 *Revenue from Contracts with Customers*.

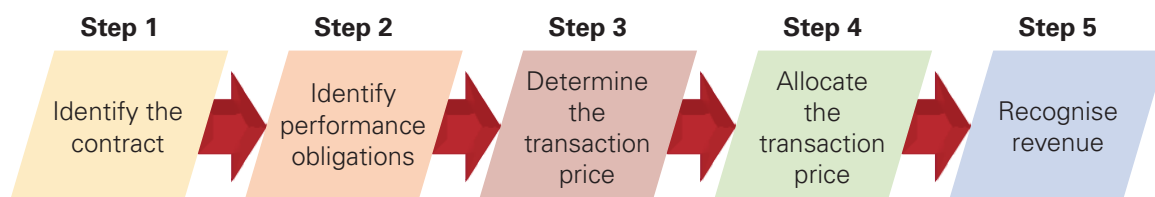
1 Key facts

The new standard provides a framework that replaces existing revenue recognition guidance in US GAAP and IFRS. It moves away from the industry- and transaction-specific requirements under US GAAP, which are also used by some IFRS preparers in the absence of specific IFRS guidance.

New qualitative and quantitative disclosure requirements aim to enable financial statement users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Entities will apply a five-step model to determine when to recognise revenue, and at what amount. The model specifies that revenue should be recognised when (or as) an entity transfers control of goods or services to a customer at the amount to which the entity expects to be entitled. Depending on whether certain criteria are met, revenue is recognised:

- over time, in a manner that depicts the entity's performance; or
- at a point in time, when control of the goods or services is transferred to the customer.



The new standard provides application guidance on numerous topics, including warranties and licences. It also provides guidance on when to capitalise costs of obtaining or fulfilling a contract that are not addressed in other accounting standards – e.g. for inventory.

For some entities, there may be little change in the timing and amount of revenue recognised. However, arriving at this conclusion will require an understanding of the new model and an analysis of its application to particular transactions.

For entities applying IFRS, the new standard is effective for annual periods beginning on or after 1 January 2017. For public business entities applying US GAAP, the new standard is effective for annual periods beginning after 15 December 2016. Early adoption is permitted only under IFRS.

The impact of the new standard will vary by industry. Those steps of the model that are most likely to affect the current practice of specific industries are summarised below.

	Step				
	1	2	3	4	5
Aerospace and defence	✓		✓		✓
Asset managers			✓		
Building and construction			✓		✓
Contract manufacturers					✓
Health care (US)	✓		✓		
Licensors (media, life sciences, franchisors)	✓*	✓			✓
Real estate	✓	✓			✓
Software		✓		✓	✓
Telecommunications (mobile networks, cable)		✓		✓	

* In particular, life sciences.

2 Key impacts

- **Revenue may be recognised at a point in time or over time.** Entities that currently use the stage-of-completion/percentage-of-completion or proportional performance method will need to reassess whether to recognise revenue over time or at a point in time. If they recognise it over time, the manner in which progress towards completion is measured may change. Other entities that currently recognise revenue at a point in time may now need to recognise it over time. To apply the new criteria, an entity will need to evaluate the nature of its performance obligations and review its contract terms, considering what is legally enforceable in its jurisdiction.
- **Revenue recognition may be accelerated or deferred.** Compared with current accounting, revenue recognition may be accelerated or deferred for transactions with multiple components, variable consideration or licences. Key financial measures and ratios may be impacted, affecting analyst expectations, earn-outs, compensation arrangements and contractual covenants.
- **Revisions may be needed to tax planning, covenant compliance and sales incentive plans.** The timing of tax payments, the ability to pay dividends in some jurisdictions, and covenant compliance may all be affected. Tax changes caused by adjustments to the timing and amounts of revenue, expenses and capitalised costs may require revised tax planning. Entities may need to revisit staff bonuses and incentive plans to ensure that they remain aligned with corporate goals.
- **Sales and contracting processes may need to be reconsidered.** Some entities may wish to reconsider current contract terms and business practices – e.g. distribution channels – to achieve or maintain a particular revenue profile.
- **IT systems may need to be updated.** Entities may need to capture additional data required under the new standard – e.g. data used to make revenue transaction estimates and to support disclosures. Applying the new standard retrospectively could mean the early introduction of new systems and processes, and potentially a need to maintain parallel records during the transition period.
- **New estimates and judgements will be required.** The new standard introduces new estimates and judgemental thresholds that will affect the amount or timing of revenue recognised. Judgements and estimates will need updating, potentially leading to more financial statement adjustments for changes in estimates in subsequent periods.
- **Accounting processes and internal controls will need to be revised.** Entities will need processes to capture new information at its source – e.g. executive management, sales operations, marketing and business development – and to document it appropriately, particularly as it relates to estimates and judgements. Entities will also need to consider the internal controls required to ensure the completeness and accuracy of this information – especially if it was not previously collected.
- **Extensive new disclosures will be required.** Preparing new disclosures may be time-consuming, and capturing the required information may require incremental effort or system changes. There are no exemptions for commercially sensitive information.
- **Entities will need to communicate with stakeholders.** Investors and other stakeholders will want to understand the impact of the new standard on the overall business – probably before it becomes effective. Areas of interest may include the effect on financial results, the costs of implementation, any proposed changes to business practices, the transition approach selected and – for IFRS preparers and entities other than public business entities and certain not-for-profit entities reporting under US GAAP – whether they intend to early adopt.

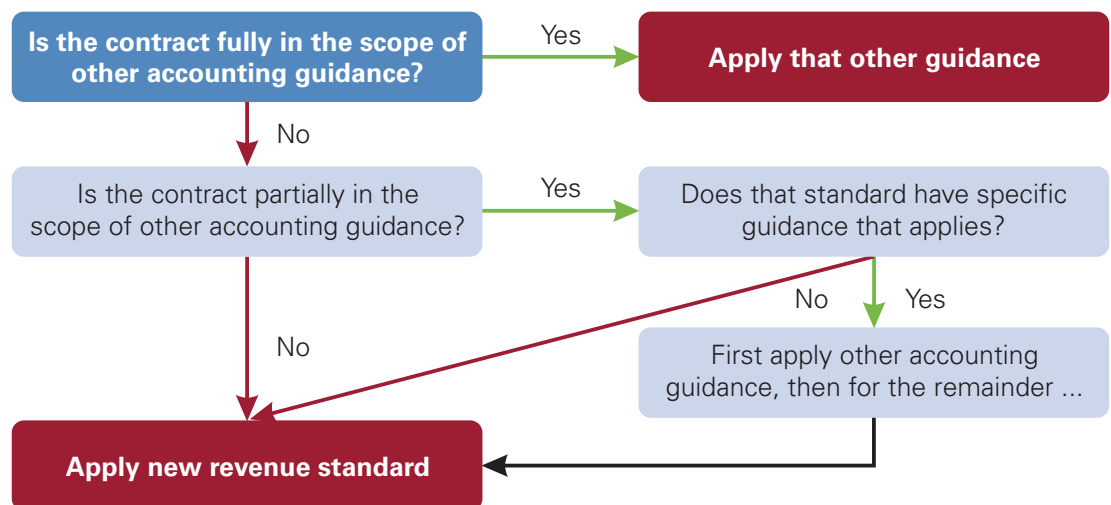


3 When to apply the new standard

The new standard applies to contracts to deliver goods or services to a customer, except when those contracts are for:

- leases;
- insurance;²
- rights or obligations that are in the scope of certain financial instruments guidance – e.g. derivative contracts;
- guarantees other than product or service warranties (US GAAP only);³ or
- non-monetary exchanges between entities in the same line of business that facilitate sales to customers other than the parties to the exchange.

A contract with a customer may be partially in the scope of the new standard and partially in the scope of other accounting guidance – e.g. a contract for a lease of an asset and maintenance of the leased equipment or a financial services contract with a cash deposit and treasury services.



Parts of the new standard – identifying a contract, determining the transaction price, determining when control is transferred – also apply to sales of intangible assets and property, plant and equipment, including real estate, that are not an output of an entity's ordinary activities. Contracts with a collaborator or partner are in the scope of the new standard only to the extent that the counterparty is a customer or if the entity determines that there is not more relevant authoritative guidance to apply.

The new standard also includes a practical expedient allowing entities to apply the requirements to a portfolio of contracts with similar characteristics if they do not expect the outcome to be materially different from accounting for the contracts individually.

² The FASB version of the revenue recognition standard only scopes out insurance contracts issued by insurance entities that are in the scope of ASC Topic 944 *Financial Services—Insurance*.

³ The FASB version of the revenue recognition standard scopes out guarantees that are in the scope of ASC Topic 460 *Guarantees*.

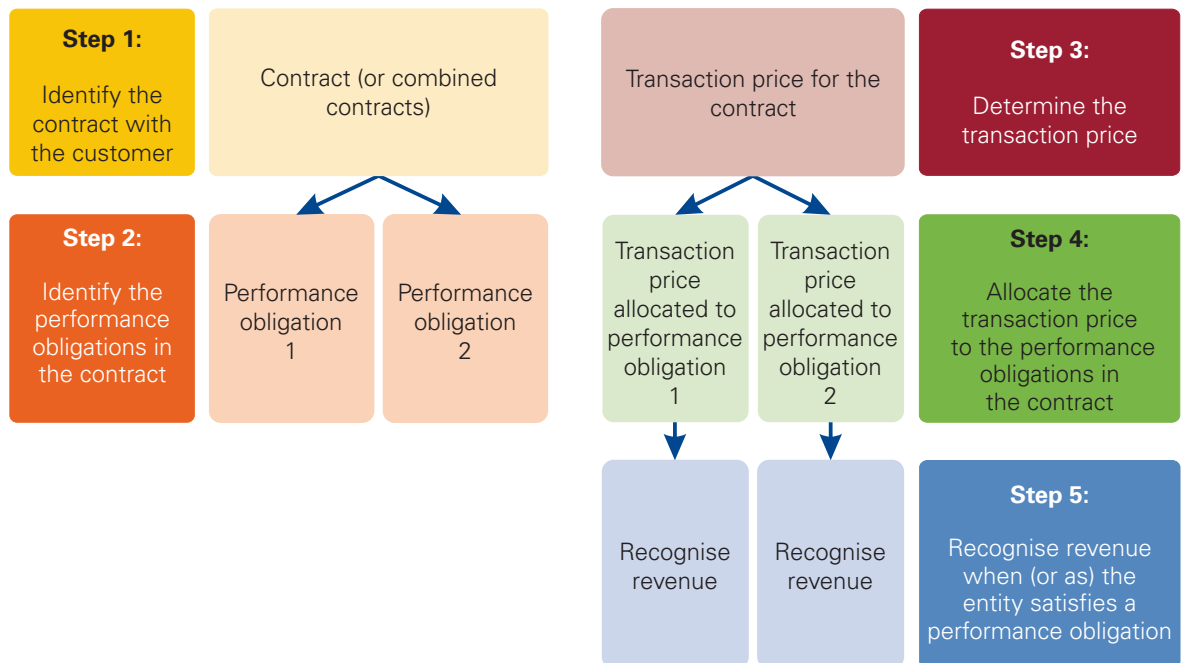
What are the implications?

It is not clear how much relief the portfolio approach will provide

While the portfolio approach may be more cost-effective than applying the new standard on an individual contract basis, it is not clear how much effort may be needed to evaluate which similar characteristics constitute a portfolio (e.g. the impact of different offerings, periods of time or geographic locations), assess when the portfolio approach may be appropriate, and develop the process and controls needed in accounting for the portfolio.

4 How to apply the five-step model

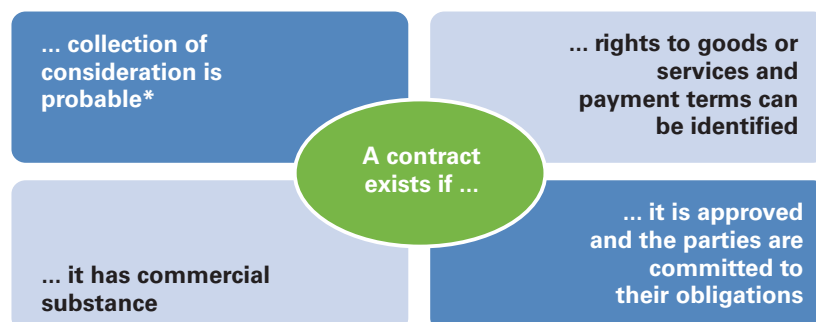
The core principle of the new standard's five-step model is that entities should recognise revenue to depict the transfer of promised goods or services to customers – and the amount of revenue should reflect the consideration to which they expect to be entitled in exchange for those goods or services.



Step 1 – Identify the contract with a customer

Sectors likely to be significantly affected: Aerospace and defence, health care (US), life sciences, real estate

The new standard defines a contract as an agreement between two or more parties that creates enforceable rights and obligations and specifies that enforceability is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. In some instances, two or more contracts are combined and accounted for as a single contract with a customer. A contract with a customer also needs to meet all of the following criteria.



* The threshold differs under IFRS and US GAAP due to different meanings of the term 'probable'.

If a contract meets all of the above criteria at contract inception, an entity does not reassess those criteria unless there is an indication of a significant change in the facts and circumstances.

What are the implications?

Collectibility is only a gating question

Currently, entities generally assess collectibility when determining whether to recognise revenue. Under the new standard, entities apply the revenue recognition model if, at the start of a contract, it is 'probable' that they will collect the consideration to which they expect to be entitled. In making this assessment, entities consider the customer's ability and intention, which includes assessing its ability to pay that amount of consideration when it is due. The criterion is designed to prevent entities from applying the revenue model to problematic contracts and recognising revenue and a large impairment loss at the same time. For most sectors, the new gating question is unlikely to have a significant effect on current practice.

Example – Assessing the existence of a contract to sell real estate

In an agreement to sell real estate, Company X assesses the existence of a contract, considering factors such as:

- the buyer's available financial resources;
- the buyer's commitment to the contract, which may be determined based on the importance of the property to the buyer's operations;
- the seller's prior experience with similar contracts and buyers under similar circumstances;
- the seller's intention to enforce its contractual rights; and
- the payment terms of the arrangement.

If Company X concludes that it is not probable that it will collect the amount to which it expects to be entitled, then no revenue is recognised. Instead, Company X applies the new guidance on consideration received before a contract exists, and is likely to initially account for any cash collected as a deposit liability.

Next steps

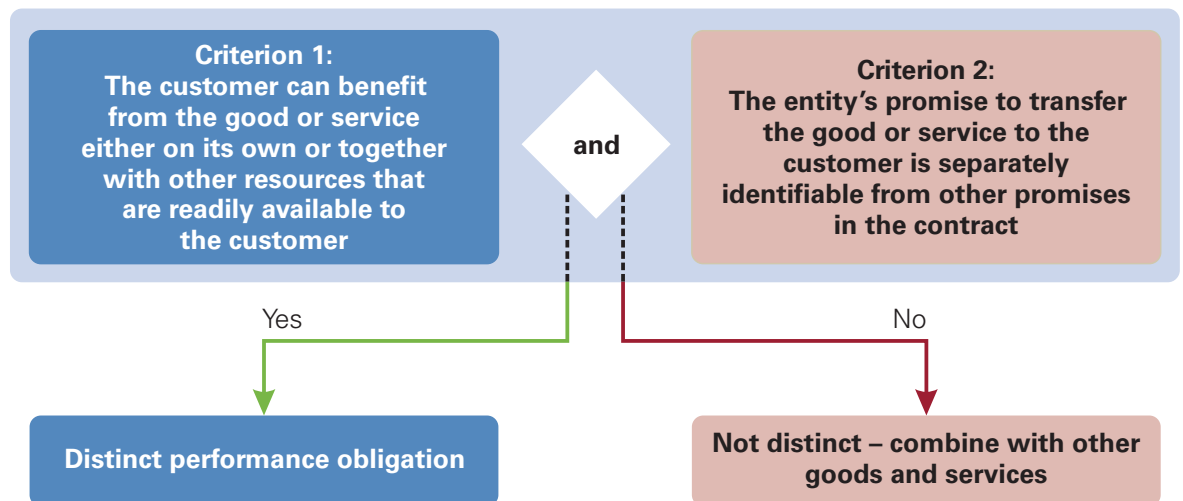
Entities will need to review the terms of all of their contracts in detail and assess whether a contract exists under the new standard, considering what is legally enforceable in their jurisdiction.

They may also wish to assemble a cross-functional project team – e.g. financial reporting, legal and credit-risk monitoring – to analyse contracts and establish policies for assessing credit risk.

Step 2 – Identify the performance obligations in the contract

Sectors likely to be significantly affected: Licensors, real estate, software, telecommunications

Entities identify each promise to deliver a good or provide a service in a contract with a customer. A promise constitutes a performance obligation if the promised good or service is distinct. A promised good or service is distinct if it meets *both* of the following criteria.



The new standard includes additional guidance to help determine whether the above criteria are met. Indicators that a performance obligation is separately identifiable include the following.

- The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract.
- The good or service does not significantly modify or customise another good or service promised in the contract.
- The good or service is not highly dependent on or highly inter-related with other goods or services promised in the contract.

A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer – e.g. a fixed energy supply contract – constitutes a single performance obligation.

What are the implications?

Promised goods or services may be unbundled (or bundled) more frequently

A version of Criterion 1 is widely used today. Criterion 2 is a new concept that will require entities to think differently about promised goods or services. Compared to current practice, it may result in more goods or services being unbundled from others in a contract. Alternatively, an entity might bundle together promised goods or services that have stand-alone value to the customer today because they are highly inter-related with other promised goods or services in the contract.

For US GAAP reporters that currently apply the vendor-specific objective evidence (VSOE) requirement for separating undelivered software elements from delivered elements, it will be easier to separate and recognise revenue up-front for the delivered elements of the arrangement.

The promise is not separately identifiable

Currently, US GAAP software revenue recognition guidance specifies that if undelivered elements are *essential* to the functionality of the delivered element, then the software and related services are treated as a single unit of account.⁴ It is unclear whether 'highly dependent' or 'highly inter-related' as used in the new standard are the same as 'essential to the functionality' as used under current US GAAP for software arrangements.

Example – Identification of performance obligations

Company Y has a contract to build a house, a process that requires a number of different goods and services. Generally, those goods would meet Criterion 1, because the customer could benefit from each individual brick or window in conjunction with other readily available resources. However, Criterion 2 is not met for each brick and window, because Company Y provides a service of integrating those goods into a combined output. The goods and services used to build the house are therefore combined and accounted for as one performance obligation.

By contrast, Company Z has a contract to license and jointly promote a drug in a specified region. The licence may be deemed a performance obligation because its use is not highly dependent on or highly inter-related with the co-promotion activity. This is because another party could provide the co-promotion activity and the licence could be used without it.

Next steps

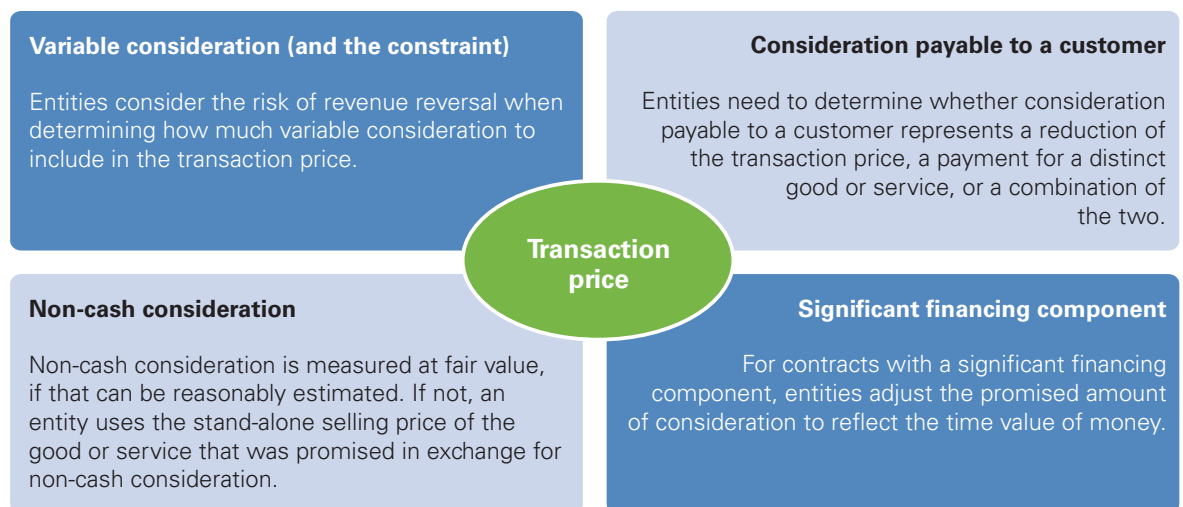
Entities will need to identify all of their contracts to deliver multiple goods or services, and evaluate which promised goods or services are accounted for separately under the new model. Entities may therefore wish to develop indicators to evaluate the degree of integration, customisation or inter-relatedness needed for a contract to be accounted for as a single performance obligation.

⁴ FASB ASC Subtopic 985-605 *Software Revenue Recognition*.

Step 3 – Determine the transaction price

Sectors likely to be significantly affected: Aerospace and defence, asset managers, building and construction, health care (US)

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. To determine this amount, an entity considers multiple factors.



An exception exists for sales- and usage-based fees – e.g. royalties – arising from licences of intellectual property. Under the new standard, entities cannot include estimates of such fees in the transaction price; instead, the revenue from these fees is recognised at the later of:

- the subsequent sale or usage; and
- the satisfaction or partial satisfaction of the performance obligation to which the royalties relate.

However, this exception applies only for licences of intellectual property.

Two key areas to be considered when determining the transaction price are variable consideration and the existence of a significant financing component.

Variable consideration (and the constraint)

Items such as discounts, credits, price concessions, returns or performance bonuses/penalties may result in variable consideration. Depending on the facts and circumstances, entities estimate the amount of variable consideration using either the expected value or the most likely amount.

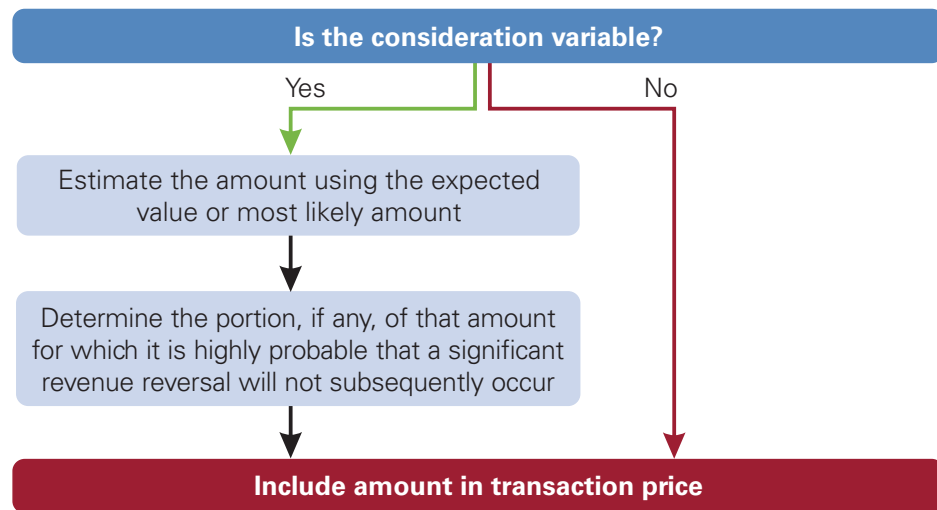
However, an entity may have to constrain the amount of variable consideration that it includes in the transaction price. When this ‘constraint’ applies, entities include variable consideration in the transaction price only to the extent that it is ‘highly probable’⁵ that a significant reversal – i.e. a significant downward adjustment in the amount of cumulative revenue recognised – will not subsequently occur.

To assess whether – and to what extent – they should apply this constraint, entities will consider both:

- the likelihood of a revenue reversal arising from an uncertain future event; and
- the magnitude of the reversal if that uncertain future event were to occur.

⁵ The IFRS version of the revenue recognition standard uses the term ‘highly probable’ – which is a significantly higher threshold than ‘more likely than not’ – with the intention of converging with the meaning of the term ‘probable’ as used in US GAAP.

This assessment needs to be updated at each reporting date. The flow chart below sets out how entities will determine the amount of variable consideration to be included in the transaction price, except for sales- or usage-based royalties from distinct licences of intellectual property.



What are the implications?

Estimating the amount of variable consideration may affect the timing of revenue recognition

Currently, entities determine whether the amount of consideration can be measured reliably, or is fixed or determinable – i.e. the recognition of consideration is either precluded or allowed. By contrast, the new standard sets a ceiling, which limits rather than precludes revenue recognition. As a result, estimating variable consideration and applying the constraint may lead to earlier revenue recognition for some entities.

Example – Timing of recognition of variable consideration

Company R has a contract to sell products through a distributor where:

- the distributor has a right of return if it cannot sell the products; and
- revenue is currently recognised by Company R when the distributor resells the products to end users – i.e. sell-through.

Under the new standard, revenue may be recognised by Company R earlier on the sale to the distributor – i.e. sell-in – based on historical experience of the number of products for which it is highly probable that they will not be returned.

By contrast, Company M has an asset management contract under which it is entitled to performance bonuses. Company M may conclude that any bonus based on the performance of an asset management contract compared to a market index would be subject to a risk of significant reversal, because of market volatility during the performance period. In this case, revenue may not be recognised by Company M until the end of the performance period – unless the asset manager determined before the end of the performance period that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur.

Significant financing component

To estimate the transaction price in a contract, an entity adjusts the promised amount of consideration if that contract contains a significant financing component. The objective is to recognise revenue at an amount that reflects what the cash selling price of the promised good or service would have been if the customer had paid on obtaining control of that good or service. The discount rate used is the rate that would be used in a separate financing transaction between the entity and the customer. The guidance applies to payments received both in advance and in arrears.

The new standard adopts an indicator approach for assessing whether a contract contains a significant financing component and when it does not – e.g. the difference between promised consideration and selling price arises for reasons other than financing. As a practical expedient, an entity need not adjust the transaction price in a contract for the effects of a significant financing component if it expects to receive payment within 12 months of transferring the promised goods or services.

What are the implications?

Calculations for significant financing components may be complex

Evaluating contracts to determine whether they contain an element of financing may affect the amount of revenue recognised for contracts that have a significant financing component – e.g. long-term construction and manufacturing contracts. Many entities will be considering for the first time whether advance payments represent a significant financing component. The calculations can be complex, particularly for long-term contracts that are satisfied over time or contracts with multiple performance obligations. Entities with long-term contracts that include retainage – i.e. a portion of the contract price that is held back until completion or an agreed-upon point in time – may conclude that the payment terms were structured for reasons other than financing, and therefore do not include a significant financing component.

Example – Adjustment for a significant financing component

Company M has a contract to transfer a piece of equipment to a customer for consideration of 100. Under the terms of the contract, payment is made two years before the equipment transfers to the customer. On applying the indicators in the new standard, Company M concludes that the contract includes a significant financing component. A contract liability of 100 is recognised when the consideration is received, and interest expense of 10 is recognised over the two-year period based on the rate that would be used in a separate financing transaction between Company M and the customer. Revenue of 110 is recognised when control of the equipment transfers to the customer.

Next steps

Entities will need to evaluate contracts with variable consideration and analyse relevant data to determine whether – and to what extent – the constraint applies. They will also need processes to update the estimate of variable consideration and application of the constraint throughout the contract period.

After assessing whether their contracts contain a significant financing component and deciding whether the practical expedient applies, entities will need to evaluate whether their existing systems can identify this component and calculate the necessary adjustments.

Step 4 – Allocate the transaction price to performance obligations

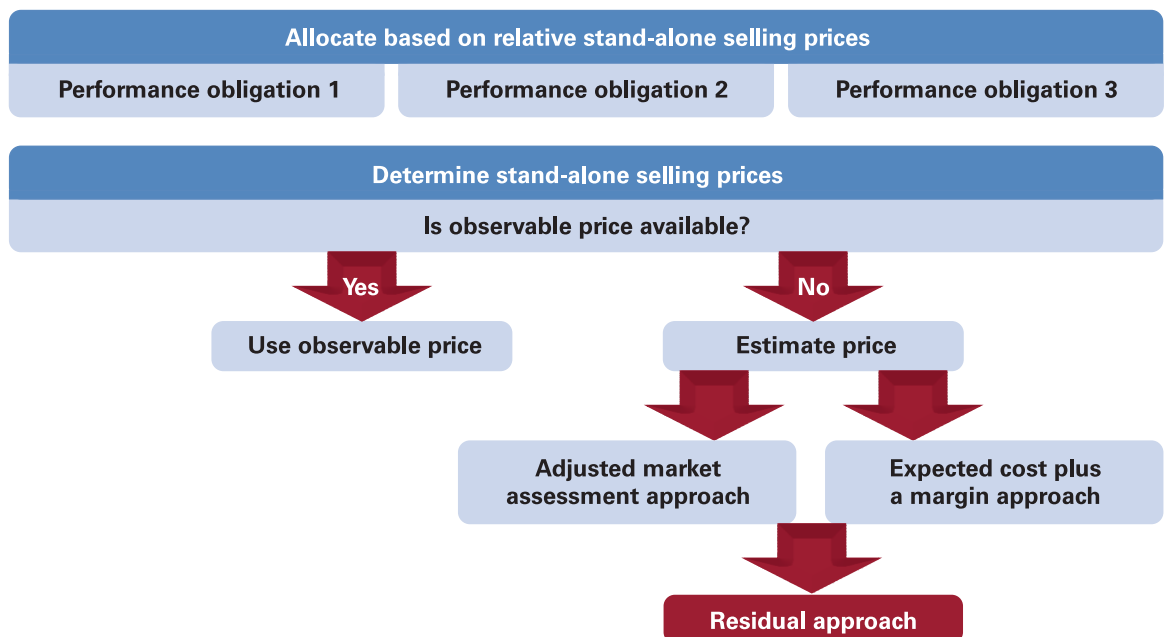
Sectors likely to be significantly affected: Software, telecommunications

Entities will generally allocate the transaction price to each performance obligation in proportion to its stand-alone selling price.

The best evidence of the stand-alone selling price is an observable price from stand-alone sales of that good or service to similarly situated customers. However, if the stand-alone selling price is not directly observable, entities should estimate it by either:

- evaluating the market in which they sell goods or services and estimating the price customers would be willing to pay;
- forecasting expected costs plus an appropriate margin; or
- in limited circumstances, subtracting the sum of observable stand-alone selling prices of other goods or services in the contract from the total transaction price.

The new standard provides guidance on determining the stand-alone selling price, as illustrated below.



When specified criteria are met, a discount or variable consideration may be allocated to one or more, but not all, distinct goods or services.

What are the implications?

Estimating the stand-alone selling price may be challenging

Entities may identify performance obligations for which stand-alone selling prices have not previously been determined. The new standard will allow more flexibility in establishing stand-alone selling prices than is currently available to entities using VSOE under US GAAP. In the absence of an observable price, if reliable information to estimate the stand-alone selling price is not available – e.g. for software vendors, whose pricing can vary greatly for licences – the residual approach may provide the best estimate of the stand-alone selling price of the licence. The highly variable or uncertain performance obligation to which the residual approach may be applied is not limited to delivered items – i.e. a reverse residual approach may be appropriate.

Example – Application of the residual approach

Company S has a contract to sell a software product and post-contract customer support (PCS) for the product. The stand-alone selling price of the PCS is observable based on services sold separately in similar circumstances to similar customers, and although they do not have the tight band of prices that would have constituted VSOE under current US GAAP, the observable prices are not highly variable. However, the software is not sold separately and, based on past transactions, its selling price is highly variable. Therefore, Company S applies the residual approach, estimating the stand-alone selling price of the software using the total transaction price less the stand-alone selling price of the PCS. In this case, any discount in the arrangement is allocated to the software product.

Next steps

Entities should consider whether they have observable stand-alone selling prices for their goods or services. If not, they should begin to consider how they will estimate stand-alone selling prices and develop processes needed to make those estimates – e.g. gathering market and cost data. Entities may also need to evaluate the changes needed to their existing systems and processes to allocate the transaction price based on stand-alone selling prices.

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

Sectors likely to be significantly affected: Aerospace and defence, building and construction, contract manufacturers, licensors, real estate, software

An entity recognises revenue when (or as) it satisfies a performance obligation by transferring control of a good or service to a customer. Control may be transferred either at a point in time or over time.

First, the entity assesses whether it transfers control over time, using the following criteria.

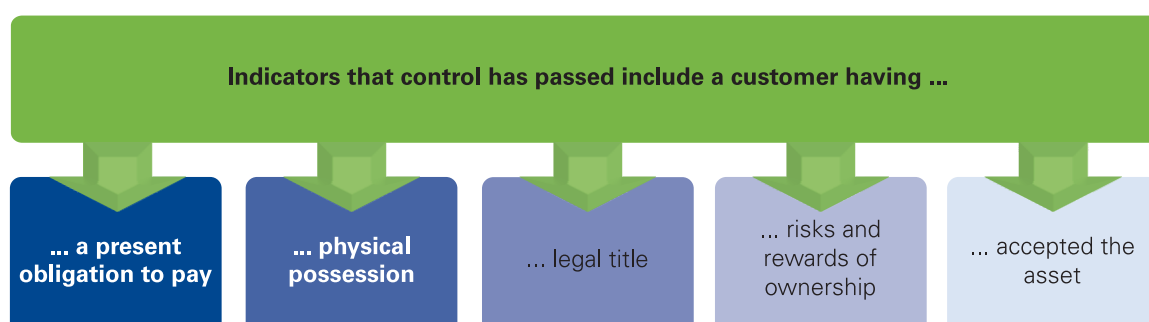
	Criterion	Example
1	The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.	Routine or recurring services.
2	The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.	Building an asset on a customer's site.
3	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.	Building a specialised asset that only the customer can use, or building an asset to a customer order.

If one or more of these criteria is met, the entity recognises revenue over time, using a method that depicts its performance. This may be either an output method (e.g. units produced) or an input method (e.g. costs incurred or labour hours). The objective is to depict the entity's performance in transferring control of goods or services to the customer.

If an entity's performance has produced a material amount of work in progress or finished goods that are controlled by the customer, then output methods such as units of delivery or units produced will not faithfully depict progress. This is because not all of the work performed is included in measuring the output.

If an entity uses an input method based on costs incurred, it considers the need to adjust for uninstalled goods and significant inefficiencies in the entity's performance that were not reflected in the price of the contract – e.g. wasted materials, labour or other resources. If the entity transfers to the customer control of a good that is significant to the contract but will be installed later, and if certain criteria are met, then the entity recognises the revenue on that good at zero margin.

If none of the three criteria for recognising revenue over time are met, then the entity recognises revenue at the point in time at which it transfers control of the good or service to the customer.



What are the implications?

The timing of revenue recognition may change

Subtle differences in contract terms could result in different assessment outcomes – and therefore significant differences in the timing of revenue recognition. In particular, Criterion 3 for transferring control over time will be relevant for some property developers that currently apply IFRIC 15 *Agreements for the Construction of Real Estate*, contract manufacturers and entities in the aerospace and defence sector.

Licences

Specific application guidance is provided on assessing whether revenue from a distinct licence of intellectual property is recognised at a point in time or over time. If the licence is not distinct from other promises in the contract, then the general model in Step 5 is applied. Otherwise, the entity applies different criteria to determine what the distinct licence provides to the customer, and therefore when to recognise the revenue.

What is provided by the licence	When revenue is recognised
A right to use the intellectual property as it exists at the time the licence is granted.	Point in time
A right to access the intellectual property as it exists throughout the licence period.	Over time

If the underlying intellectual property licensed to the customer changes throughout the licence period because the entity continues to be involved with its intellectual property and undertakes activities that significantly affect the intellectual property, then the licence transfers to the customer over time. If the intellectual property does not change, a customer obtains control at the point in time at which the licence is granted.

A licence provides access to the entity's intellectual property if:

- the 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;
- the rights granted by the licence directly expose the customer to any positive or negative effects of the entity's activities; and
- those activities do not result in the transfer of a good or service to the customer as those activities occur.

What are the implications?

The pattern of revenue recognition from licences may change

The requirement to assess whether a licence provides a right to use intellectual property or access to intellectual property is a new concept. Entities will need to think differently about which features of the licence they focus on when determining the appropriate pattern of revenue recognition. Assessing the criteria could be highly judgemental – and the outcome may result in revenue that is currently recognised over time being recognised at a point in time, or vice versa.

Example – Licence for the right to use intellectual property

Company X has a contract to license software, on a non-exclusive basis, to a customer for three years.

The customer's right to the software is an output of Company X's intellectual property – i.e. the underlying software programme – similar to a tangible good. The customer can determine how and when to use the right without further performance by Company X and does not expect that Company X will undertake any activities that significantly affect the intellectual property to which the customer has rights. Therefore, the software licence provides a right to use Company X's intellectual property as it exists at the point in time at which it is provided. Revenue is therefore recognised at that point in time.

Example – Licence for access to intellectual property

By contrast, Franchisor Y licenses the right to open a store in a specified location to a franchisee. The store will bear Franchisor Y's trade name and the franchisee will have the right to sell Franchisor Y's products for 10 years. The franchisee promises to pay an up-front fixed fee.

The franchisee has licensed access to Franchisor Y's intellectual property as it exists at any point during the licence period because:

- the franchise contract requires Franchisor Y to maintain the brand through product improvements, marketing campaigns etc;
- any action by Franchisor Y may have a direct positive or negative effect on the customer; and
- these activities do not transfer a good or service to the customer.

The up-front fixed fee is therefore recognised over the term of the franchise right (10 years).

Next steps

Entities need to reconsider whether revenue will be recognised over time or at a point in time based on the new criteria and specific guidance for licences. Systems, processes and controls may need to change to cope with the new criteria and any change in the timing of revenue.

Entities will also need to decide what changes are required for reporting systems, either by redesigning them or through a work-around, such as period-end adjustments.

Application guidance

The new standard also provides guidance on applying the general requirements of the model to particular items. Besides licences (discussed above), guidance is provided on the following topics.

Sales with a right of return	<p>Entities recognise revenue at the amount to which they expect to be entitled, by applying the variable consideration and constraint guidance set out in Step 3 of the model.</p> <p>Entities also recognise a refund liability and asset for any products that they expect to be returned.</p>
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Warranties	<p>Warranties are accounted for as a performance obligation if:</p> <ul style="list-style-type: none"> • the customer has an option to purchase the warranty separately; or • additional services are provided as part of the warranty. <p>Otherwise, warranties will continue to be accounted for under existing standards.⁶</p> <p>The new standard provides some factors to help assess whether a warranty provides the customer with an additional service, including:</p> <ul style="list-style-type: none"> • whether the warranty is required by law; • the length of the warranty coverage period; and • the nature of the tasks that the entity promises to perform.
Principal versus agent considerations	<p>If the entity obtains control of the goods or services of another party before it transfers control to the customer, then the entity's performance obligation is to provide the goods or services itself. Therefore, the entity is acting as principal.</p> <p>The new standard provides a list of indicators for evaluating when an entity's performance obligation is <i>not</i> to provide the goods or services itself and the entity is therefore acting as agent.</p>
Repurchase agreements	<p>Depending on its nature and terms, a sales contract that includes a repurchase agreement may be accounted for as a sale with a right of return, a lease or a financing arrangement.</p> <p>To determine the treatment of the repurchase agreement, entities consider:</p> <ul style="list-style-type: none"> • whether the repurchase agreement is: <ul style="list-style-type: none"> – a put option, in which case the customer may have control; or – a call option or forward, in which case the entity retains control; and • the likelihood of the customer exercising its put option, which will include consideration of pricing and whether the customer has a significant economic incentive to exercise.
Other application topics	<p>Application guidance is also provided on the following topics:</p> <ul style="list-style-type: none"> • performance obligations satisfied over time; • methods for measuring progress towards complete satisfaction of a performance obligation; • bill-and-hold arrangements; • consignment arrangements; • customer acceptance; • customer options for additional good or services; • customers' unexercised rights; • non-refundable up-front fees; and • disaggregation of revenue disclosures.

⁶ FASB ASC Topic 460 *Guarantees* for US GAAP preparers and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for IFRS preparers.

5 Contract costs

The new standard provides guidance on accounting for incremental costs of obtaining a contract and some costs to fulfil a contract.

Costs to obtain a contract

An entity capitalises incremental costs incurred only as a result of obtaining a contract – e.g. sales commissions – if the entity expects to recover these costs. However, a practical expedient allows an entity to expense such costs as incurred if the amortisation period of the asset is one year or less.

Costs to fulfil a contract

If the costs incurred in fulfilling a contract are not in the scope of other guidance – e.g. inventory, intangibles or property, plant and equipment – then an entity recognises an asset only if the fulfilment costs meet the following criteria:

- they relate directly to an existing contract or specific anticipated contract;
- they generate or enhance resources of the entity that will be used to satisfy the performance obligations in the future; and
- they are expected to be recovered.

The following are examples of costs that may and may not be capitalised when these criteria are met.

✓ Direct costs that are eligible for capitalisation if other criteria are met	✗ Costs to be expensed when incurred
Direct labour – e.g. employee wages	General and administrative costs – unless explicitly chargeable under the contract
Direct materials – e.g. supplies	Costs that relate to satisfied performance obligations
Allocation of costs that relate directly to the contract – e.g. depreciation and amortisation	Costs of wasted materials, labour, or other contract costs
Costs that are explicitly chargeable to the customer under the contract	Costs that do not clearly relate to unsatisfied performance obligations
Other costs that were incurred only because the entity entered into the contract – e.g. subcontractor costs	

Amortisation and impairment of capitalised costs

Capitalised costs are amortised on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates, and are subject to impairment testing. The amortisation period includes expected contract renewal periods.

What are the implications?

The amount of costs capitalised may change

The requirement to capitalise the costs of obtaining a contract will be a change for entities that currently expense those costs. It may also be complex to apply, especially for entities with many contracts and a variety of contract terms and commission structures.

The new standard gives some – albeit not comprehensive – guidance on what types of costs to fulfil a contract are capitalised. Existing cost guidance in US GAAP and IFRS generally remains unchanged, although entities that made an accounting policy election under current US GAAP to expense certain fulfilment costs – e.g. set-up costs – may be required to capitalise those costs under the new standard.

Next steps

Entities need to evaluate whether there are differences between their current practices and the cost guidance in the new standard. Entities that have not historically tracked costs to acquire a contract and have expensed them as incurred may need to develop new systems, processes and controls to start determining the amount of costs to capitalise both in applying the standard once adopted and in determining the transition amounts.

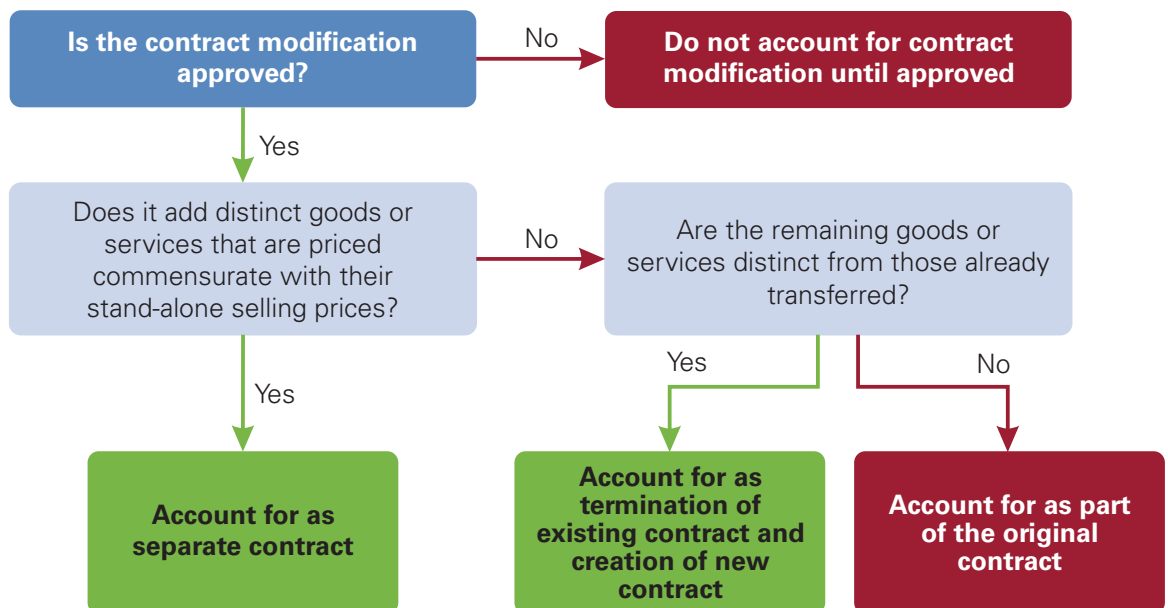
6 Contract modifications

A contract modification is any change in the scope or price of a contract (or both). It exists when the parties to a contract approve a modification that creates new, or changes existing, enforceable rights and obligations of the parties to the contract.

Consistent with the identification of a contract, a contract modification has to be legally enforceable. A modification could be approved:

- in writing;
- by oral agreement; or
- as implied by customary business practices.

The following flow chart illustrates how contract modifications are accounted for under the new standard.



What are the implications?

The timing of revenue recognition may change

Currently, guidance on contract modifications exists for construction-type and production-type contracts, but under the new standard the contract modification guidance applies to all contracts with customers. When modifications are made to existing contracts, all entities need to evaluate whether the modification is approved, and whether it is accounted for as a separate contract. Depending on this assessment, the timing of revenue recognition may be affected.

Example – Contract modification to construction plans

Company C agrees to construct a specialised cruise ship for a customer. Halfway through the project, the customer decides to modify the original plans to accommodate additional passengers. The change is communicated orally and no written change order for the additional material, design services or labour has been executed. Company C has built ships for the customer before, and the customer has been willing to pay for the incremental services and materials, together with a margin, as long as Company C can show that the costs are reasonable given the changes requested.

Although there has been no formal agreement with the customer on the change in scope, Company C may currently be able to recognise revenue for construction-type and certain production-type contracts to the extent of costs incurred plus a reasonable margin, if it is probable that the costs will be recovered through a change in contract price.⁷

However, under the new standard, revenue would not be recognised until Company C is able to demonstrate that the contract modification was approved or is legally enforceable. This may or may not be when the customer asks for the change in design.

Next steps

Entities need to evaluate whether there are differences between their current practices and the contract modifications guidance in the new standard. They may also find that changes to existing systems and processes are needed to identify and track modifications to contracts on an ongoing basis.

⁷ Paragraph 35-25-28 of FASB ASC Topic 605 *Revenue Recognition*.

7 Presentation and disclosures

Presentation of contract assets and liabilities

A contract asset or contract liability, respectively, is recognised when:

- the entity performs by transferring goods or services; or
- the customer performs by paying consideration to the entity.



An unconditional right to consideration is presented as a receivable and accounted for as a financial instrument.

Disclosure requirements

At a high level, the objective of the disclosure requirements in the new standard is to enable users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

The new standard requires both qualitative and quantitative disclosures that fall into the following categories:

- contracts with customers:
 - disaggregation of revenue;
 - changes in contract assets, liabilities and costs;
 - performance obligations; and
 - transaction price allocated to remaining performance obligations;
- significant judgements, and changes in judgements, in applying the requirements:
 - determining the timing of satisfaction of performance obligations; and
 - determining the transaction price and amounts allocated to performance obligations; and
- assets recognised from the costs to obtain or fulfil a contract with a customer.

The new standard permits entities other than public business entities and certain not-for-profit entities to make reduced disclosures under US GAAP.

Interim requirements

Public business entities and certain not-for-profit entities reporting under US GAAP need to comply with the new standard's quantitative disclosures in each interim period. However, IFRS reporters only need to provide a disaggregation of revenue in interim periods, and follow IAS 34 *Interim Financial Reporting* to determine whether any other disclosures are required. Entities other than public business entities and certain not-for-profit entities reporting under US GAAP are exempt from any revenue-specific disclosure requirements for interim periods.

What are the implications?

Additional information required

Entities will have to disclose more information about contracts with customers under the new standard than under current requirements.

Although much of the disclosure effort will be qualitative, there are several quantitative disclosures – e.g. disaggregated revenue and remaining performance obligations – that may require significant changes to data-gathering processes and IT systems. In planning how to collect the additional information, public business entities and certain not-for-profit entities will need to consider the fact that disclosures are also required in interim periods.

The disaggregation disclosure aims to show how economic factors affect the nature, amount, timing and uncertainty of revenue and cash flows. Although example categories are provided in the application guidance, the new standard does not prescribe the disaggregation categories needed to meet this objective, so management will need to use judgement. The number of categories required to meet the objective will depend on the nature of the entity's business and its contracts.

Next steps

Entities should identify data gaps between what is presently available and what is required for the disclosures in the new standard. A good way for an entity to do this may be to prepare an early mock-up of its financial statements. If there is information that is not available from existing systems, then it should become apparent through this exercise, and should help to scope a project to modify the systems and processes to capture the required information.

8 Effective date and transition

For entities applying IFRS, the new standard is effective for annual periods beginning on or after 1 January 2017. Early adoption is permitted only under IFRS.

For entities applying US GAAP, the effective dates are as follows.

- For public business entities and certain not-for-profit entities⁸, the standard is effective for annual periods – and interim periods within those annual periods – beginning after 15 December 2016.
- For all other entities, the standard is effective for annual periods beginning after 15 December 2017, with a further one-year deferral for interim periods. However, such entities may choose to adopt at the same time as public business entities.

An entity may choose to adopt the new standard either retrospectively or through a cumulative effect adjustment as of the start of the first period for which it applies the new standard.

Retrospective approach

An entity may adopt the new standard on a full retrospective basis, although any of the following practical expedients are available:

- for contracts completed before the initial application date, an entity need not restate contracts that begin and end within the same annual reporting period;
- for contracts with variable consideration that are completed on or before the initial application date, an entity can use the transaction price at the date of completion rather than estimating the amount of variable consideration; and
- for periods presented before the initial application date, an entity can elect not to disclose the amount of the transaction price allocated to the remaining performance obligations or an explanation of when that revenue will be recognised.

If an entity applies one or more practical expedients, then it needs to do so consistently for all applicable periods and provide disclosures about the options it has elected.

If an entity applies the retrospective approach, then it is required to provide the relevant disclosures under its current GAAP for a change in accounting principle or policies.⁹

Cumulative effect approach

An entity may choose not to retrospectively adjust comparative periods, and instead adopt the new standard as of the application date, adjusting retained earnings. In this case, it would only have to adjust for contracts open under previous GAAP as of the date of initial application.

If an entity elects this approach, it is required to disclose the amount by which each financial statement line item is affected in the year of adoption as a result of applying the new standard, along with an explanation of significant changes from previous GAAP.

⁸ This applies to not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market.

⁹ FASB ASC Topic 250 *Accounting Changes and Error Corrections* for US GAAP preparers and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for IFRS preparers. IFRS preparers may choose to only present the quantitative information required by paragraph 28(f) of IAS 8 for the immediately preceding annual period.

Summary of transition approaches

Approach	Pre-adoption	Comparative year	Current year	Date of equity adjustment
Full retrospective – no practical expedients	Legacy GAAP	New GAAP	New GAAP	1 January 2016*
Partial retrospective – practical expedients	Legacy GAAP	Mixed requirements	New GAAP	1 January 2016*
Cumulative effect	Legacy GAAP	Legacy GAAP	New GAAP	1 January 2017

* If an entity with a calendar year end provides two years of comparatives, the date of equity adjustment will be 1 January 2015.

First-time adopters of IFRS

First-time adopters of IFRS may choose to apply the new standard either retrospectively, using the practical expedients available, or on a cumulative effect basis from the date of transition to IFRS.

What are the implications?

Retrospective application provides comparability but may be challenging

Retrospective application would provide comparable financial information for the periods presented. However, despite the practical expedients, this might require significant historical analysis, and could be costly and challenging – especially for entities with long-term contracts. Entities that choose retrospective application – including the use of practical expedients – would need to update the other areas of their filings, including management discussion and analysis, to reflect this fact. Securities and Exchange Commission (SEC) registrants electing retrospective application will need to consider the requirement to present five years of annual selected financial data. The SEC staff is thought to be considering whether to issue guidance or relief on the application of the new standard in the five-year summary; however, they have not yet announced any decisions on this question.

Analysts and investors will need to be alert to the practical expedients selected by different entities, because the number of transition options available could affect comparability across jurisdictions and within sectors.

Next steps

Entities should consider the different transition approaches available and elect the option that is the best fit for the organisation. It may be useful to consider which approaches other entities in their industry are planning to elect.

Many entities will have to perform an historical analysis of their contracts. In the case of retrospective application, they may need to develop a transition plan for parallel runs, including reconciliations, to track the data needed to provide comparative information.

Investors and other stakeholders will want to understand the impact of the new standard on the overall business. Entities should consider communication plans for key areas of interest such as the transition approach selected, the effect on financial results, the costs of implementation, any proposed changes to business practices and, for IFRS preparers and entities other than public business entities and certain not-for-profit entities reporting under US GAAP, whether they intend to early adopt.

About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

Content

Our *First Impressions* publications are prepared on the release of a new IFRS, interpretation or other significant amendment to the requirements of IFRS. They include a discussion of the key elements of the new requirements and highlight areas that may result in a change of practice. Examples are provided to help assess the impact of implementation.

This edition of *First Impressions* considers the requirements of IFRS 15 *Revenue from Contracts with Customers* and other IFRSs in issue at 31 May 2014.

In many cases, further analysis and interpretation may be needed in order for an entity to apply IFRS to its own facts, circumstances and individual transactions. Furthermore, some of the information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change as practice develops.

Keeping you informed

Visit kpmg.com/ifrs to keep up to date with the latest developments in IFRS and browse our suite of publications. Whether you are new to IFRS or a current user of IFRS, you can find digestible summaries of recent developments, detailed guidance on complex requirements, and practical tools such as illustrative disclosures and checklists. For a local perspective, follow the links to the IFRS resources available from KPMG member firms around the world.

All of these publications are relevant for those involved in external IFRS reporting. The *In the Headlines* series and *Insights into IFRS: An overview* provide a high-level briefing for audit committees and boards.

Your Need	Publication Series	Purpose
Briefing	In the Headlines	Provides a high-level summary of significant accounting, auditing and governance changes together with their impact on entities.
	IFRS Newsletters	Highlights recent IASB and FASB discussions on the financial instruments, insurance and leases projects. Includes an overview, an analysis of the potential impact of decisions, current status and anticipated timeline for completion.
	The Balancing Items	Focuses on narrow-scope amendments to IFRS.
	New on the Horizon	Considers the requirements of consultation documents such as exposure drafts and provides KPMG's insight. Also available for specific sectors.
	First Impressions	Considers the requirements of new pronouncements and highlights the areas that may result in a change in practice.
Application issues	Insights into IFRS	Emphasises the application of IFRS in practice and explains the conclusions that we have reached on many interpretive issues. The overview version provides a high-level briefing for audit committees and boards.
	IFRS Practice Issues	Addresses practical application issues that an entity may encounter when applying IFRS. Also available for specific sectors.
	IFRS Handbooks	Includes extensive interpretive guidance and illustrative examples to elaborate or clarify the practical application of a standard.

Your Need	Publication Series	Purpose
Interim and annual reporting	Guide to financial statements – Illustrative disclosures	Illustrates one possible format for financial statements prepared under IFRS, based on a fictitious multinational corporation. Available for annual and interim periods, and for specific sectors.
	Guide to financial statements – Disclosure checklist	Identifies the disclosures required for currently effective requirements for both annual and interim periods.
GAAP comparison	IFRS compared to US GAAP	Highlights significant differences between IFRS and US GAAP. The overview version provides a high-level briefing for audit committees and boards.
Sector-specific issues	IFRS Sector Newsletters	Provides a regular update on accounting and regulatory developments that directly impact specific sectors.
	Application of IFRS	Illustrates how entities account for and disclose sector-specific issues in their financial statements.
	Impact of IFRS	Provides a high-level introduction to the key IFRS accounting issues for specific sectors and discusses how the transition to IFRS will affect an entity operating in that sector.

For the new revenue standard, we also intend to publish *Talking about Revenue*, which will look at the key issues emerging from the implementation process, and *Issues In-Depth*, which will provide detailed analysis and observations on the new standard.

For access to an extensive range of accounting, auditing and financial reporting guidance and literature, visit KPMG's Accounting Research Online. This web-based subscription service can be a valuable tool for anyone who wants to stay informed in today's dynamic environment. For a free 15-day trial, go to aro.kpmg.com and register today.

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