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an SME near you!**



The crux for the tax practitioner of IFRS 15 *Revenue from Contracts with Customers*

YOUR KEY TO THE TAX COMMUNITY

Approach for this session...

- We only have one hour 😊
- We cannot refer to all the details contained in IFRS 15
- Slides may contain details that you can refer to subsequently for your own benefit, but are not addressed in the session
- We will provide exposure at a high level to important considerations relating to IFRS 15

Why a new standard for revenue recognition?

- Issued May 2014, effective 1 Jan 2017 for entities using full IFRS
- Six other pronouncements superseded by IFRS 15 (e.g., IAS 18, IAS 11, IFRIC 13/15/18, SIC-31 etc.)
- Single model for revenue recognition
 - Before: IAS 18 versus IAS 11, plus other interpretations issued
- IFRS 15 is principle-based (a focus on liabilities, i.e., SOFP approach)
- A new **5-step model** to be applied to all contracts with customers

Scope exclusions from IFRS 15

IFRS 15 **applies to ALL contracts with customers**, except the following:

- Leases within scope of IFRS 16 *Leases*
- Contracts within the scope of IFRS 17 *Insurance Contracts*
- Financial instruments (and other contractual rights and obligations) within the scope of IFRS 9 *Financial Instruments*
- Investments governed by:
 - IAS 27 *Separate Financial Statements*
 - IFRS 10 *Consolidated Financial Statements*
 - IFRS 11 *Joint Arrangements*
 - IAS 28 *Investments in Associates and Joint Ventures*
- Non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers (e.g., “stock lending”)

*IFRS 15 is only applied to contracts where the counterparty is a **customer** (i.e., no mutual sharing of risks and benefits, e.g., collaboration agreements (in the latter there is no party that is a customer that benefits from the outputs of the entity's ordinary activities))*

The 5-step revenue recognition model

1

- Identify the contract(s) with the customer

2

- Identify all performance obligations in the contract

3

- Determine/estimate the transaction price

4

- Allocate the transaction price to the performance obligations in the contract

5

- Recognise revenue when/as performance obligations are satisfied

Step 1: Identifying a qualifying contract

- A **contract** with a customer will be within the scope of IFRS 15 when ALL of the below are met:
 - The contract has been approved by the parties to the contract
 - Each party's rights in relation to the goods/services to be transferred, can be identified
 - The payment terms for the goods/services to be transferred, can be identified
 - The contract has commercial substance (risk, timing or amount of future cash flows is expected to change because of the contract)
 - It is probable that the consideration to which the entity is entitled to in exchange for the goods/services, will be collected

Step 1: issues relating to “contracts” definition

- Contracts that don't meet the previous criteria as yet, are to be re-assessed on an ongoing basis until they do, and then IFRS 15 is applied from that point on
 - *Contracts that meet criteria at inception, are not re-assessed, unless significant changes are identified (e.g., customer can no longer pay)*
- If criteria not met by contract, and consideration is received from customer, revenue shall only be recognised if:
 - *Contract was terminated and the consideration received, is not refundable; or*
 - *The entity has no remaining obligations to transfer goods/services to the customer and all (or substantially all) of the consideration has been received and is not refundable*
 - ***A liability is recognised until one of these two events occurs/ contract criteria are satisfied***

Step 1: issues relating to “contracts” definition

- Contract modifications can occur – two options exist:
 - A separate contract can arise
 - Scope of the contract increases (addition of distinct promised goods/services), AND
 - The price of the contract increases (based on stand-alone prices of goods/services)
 - The existing contract can be amended
 - Two accounting possibilities can arise for the modification:
 - Modification is a termination of existing contract, and creation of a new contract (if remaining goods/services are distinct from goods/services transferred before the modification)
 - Modification is part of existing contract (remaining goods/services are not distinct from goods/services transferred before modification) and there is a partially-satisfied single performance obligation at date of modification – an adjustment to revenue is therefore made on a cumulative catch-up basis

Step 2: identify the performance obligations (P/O's)

- At the inception of the contract, the entity assesses the goods/services promised to the customer, and identifies each promise to transfer to the customer either:
 - A good/service (or bundle of goods/services) that is distinct; or
 - A series of distinct goods/services that are substantially the same and have the “same pattern of transfer” to the customer (i.e. on monthly basis), which is if:
 - Each distinct good/service would be a P/O satisfied over time; **and**
 - The same method would be used to measure progress towards complete satisfaction of the P/O

What is a “promise”?

- Goods/services to be transferred to the customer are *usually* explicitly stated in a contract (legal obligation)
- May also be IMPLIED by customary business practices, published policies or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer, that the entity will transfer a good/service to the customer (constructive obligation)
(assess i.t.o. IAS 37)
- Only activities that transfer a good/service to a customer, are included in P/O's (i.e., admin and set-up activities for contracts and contract fulfilment activities are not P/O's)

What is a “distinct good/service”?

- Goods/services are **distinct** if BOTH the following are met:
 - The customer can benefit from the goods/services on its own or in conjunction with other readily available resources (i.e., the good/service is capable of being distinct); **and**
 - The entity's promise to transfer the good/service is separately identifiable from other promises in the contract (i.e., the good/service is also distinct within the context of the contract), which is, for example when:
 - The entity does **not** provide a significant service of integrating the good/service with other goods/services promised in the contract (stand-alone)
 - The good/service does **not** significantly modify or customise another good/service promised in the contract
 - The good/service is **not** highly interrelated with or highly dependent on other goods/services promised in the contract

“Distinct goods/service” – example

Real estate development company ABC Limited enters into a contract with one customer in terms of which a mini-lifestyle estate is to be built by ABC Limited for R100 million. The customer will sell the units to approved buyers after construction. There will be 20 similar units (even size but different interior layouts), a large communal entertainment area including pool, 8-foot perimeter walls, one entrance gate containing a guard house and communal paved roads to access all units. The R100 million is payable three months after completion of the estate, to allow for quality checks to be done by the customer.

Challenge: How do we identify the number of performance obligations relating to distinct goods/services?

Step 3: determining the transaction price (TP)

- The TP is the amount to which an entity **expects** to be entitled in exchange for the transfer of goods/services
 - Entity will consider past customary business practices too, to determine TP (e.g., early settlement discounts granted not specified in T&Cs)
 - Amounts collected on behalf of 3rd parties, are excluded (e.g., VAT, commissions)
 - Consideration promised in a contract with a customer may include fixed amounts, variable amounts or both
- Two aspects to focus on:
 - Dealing with **variable consideration** (NB)
 - Constraining the 'estimates of variable consideration' (limitation on inclusion of variable consideration)
 - Existence of a **significant financing component** in the contract

Variable consideration

- If consideration **promised in a contract** includes 'variable consideration', the entity shall **ESTIMATE** the **amount of consideration** to which **it will be entitled** in exchange for **transferring** the **promised goods/services to a customer**:
 - *Only to extent that it is 'HIGHLY PROBABLE' that a significant reversal in the amount of cumulative revenue recognised, will not occur when the uncertainty is subsequently resolved*
 - *Royalty from usage of licence of intellectual property: only when sales/usage occur (stricter!!)*
- Variability can be explicit (legal terms) or implied (constructively)
- Variable consideration (examples):
 - Discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties
 - If entity's entitlement to consideration is contingent on the occurrence or non-occurrence of a future event
 - Products sold with a right of return, or fixed amount is promised as a performance bonus on achievement of a specified milestone etc.
- Measurement of variable consideration – two methods (whichever is most appropriate):
 - **The expected value** (the sum of probability-weighted amounts in a range of possible consideration amounts) (especially for large number of contracts with similar outcomes)
 - **The most likely amount** (the single most likely outcome of the contract) (e.g., the entity either achieves a performance bonus, or not) (not many outcomes to choose from)

Significant financing components

- If the timing of payments agreed to by the parties to the contract (either explicitly, or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods/services to the customer:
 - The contract then contains a significant financing component and consideration shall be adjusted
- Goal is to recognise revenue relating to the transfer of the goods/services at an amount that reflects the price that the customer would have paid if the customer had paid CASH for those goods/services
- Two main issues to be considered to assess existence of significant financing component:
 - The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods/services; **and**
 - The combined effect of:
 - The length of time between when the entity transfers the promised goods/services to the customer and when the customer pays for those goods/services; **and**
 - The prevailing interest rates in the relevant markets
- **Practical expedient (relief):** An entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at inception of the contract, that the period between when the promised goods/services are transferred by the entity and the customer pays for the goods/services to be **one year or less**

Step 4: Allocate the TP to P/O's

- To what amount of consideration does the entity **expect to become entitled** when transferring the promised goods/services to the customer (i.e., satisfying the P/O)?
(refer .73 to .80)
- Allocation will happen on a **relative stand-alone selling price basis**
- Not applicable when only one P/O exists...

Stand-alone selling price basis

- The selling price for each distinct good/service underlying each P/O, must be determined at contract inception
- The contract price is then allocated in proportion to those stand-alone selling prices
- **“Stand-alone selling price”** = the price at which an entity would sell a promised good/service SEPARATELY to a customer (best indicator: observable selling price in separate transactions with similar customers under similar circumstances)
 - Not always the listed price... but could be! Rather focus on similar transactions!
- If stand-alone selling price is not available, the entity shall ESTIMATE the stand-alone selling price using maximum observable inputs:
 - Adjusted market assessment approach (assess the market and competitors, and adjust)
 - Expected cost plus margin approach (costs to satisfy P/O, plus appropriate margin)
 - Residual approach (total TP less the sum of observable stand-alone selling prices of other goods/services in the contract = residual approach)

Step 5: recognise revenue when/as P/O's are satisfied

- Revenue is recognised as control is passed, either **over time** or **at a point in time**
- Control = ability to **direct the use** of and **obtain substantially all of the FEB** from the asset (i.e., the goods/services)
 - This includes the ability to prevent others from directing use/obtaining the FEB from the asset! Contractual protection, legal protection etc.
- FEB from an asset are obtained directly, or indirectly:
 - Using the asset to produce goods/services
 - Using the asset to enhance the value of other assets
 - Using the asset to settle liabilities or reduce expenses
 - Selling or exchanging the asset
 - Pledging the asset to secure a loan
 - Holding the asset (e.g., for capital growth)

Satisfaction of P/O's

- An entity shall recognise revenue when/as the entity satisfies a P/O by transferring a promised good/service to a customer
 - Goods/services are assets, even if momentarily (e.g., services)
 - An asset is transferred when/as the customer **obtains control** of that asset
 - Control is the ability to direct the use of and obtain substantially all of the FEB
- For each P/O identified, the entity shall determine at contract inception whether it will satisfy the P/O:
 - Over time (this is the first assumption and must be disproven); or
 - At a point in time (if not over time, then automatically at a point in time)

Satisfaction of P/O's “over time”

- This is identified if ONE of the following criteria is met:
 - The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs
 - OR**
 - The entity's performance creates or enhances an asset (e.g., WIP) that the customer controls, as the asset is created or enhanced
 - OR**
 - The entity's performance does NOT create an asset with an alternative use and the entity has an enforceable right to payment for performance completed to date (read IFRS 15.36 and .37 in this regard)


Progress measurement

- Progress towards complete satisfaction of a P/O (which is satisfied over time) is used as a measure for revenue recognition
 - The entity's performance in transferring control of a good/service is measured
 - A single method for measuring progress towards complete satisfaction shall be applied to each P/O
- Methods for measuring progress = **NB**
 - IFRS 15 does not prescribe, but measure must be reasonable to result in revenue recognition (e.g., must not lack reliable information)
 - Input or output methods may be used, whichever is most appropriate
 - Changes to the entity's measure of progress over time, is a change in accounting estimate (i.e., due to changes in circumstances)
 - In the early stages of a contract, the entity may not be able to reasonably measure the progress/outcome of the P/O – if costs are recoverable, revenue recognised shall be limited to recoverable costs incurred (until reasonable measurement can occur)

Satisfaction of P/O's “at a point in time”

- Automatically identified if the entity does not satisfy P/O's over time (use criteria to determine, as per previous slide)
- Transfer of “control” = important = determines point in time at which P/O's are satisfied
- Indicators of ‘transfer of control’:
 - The entity has a present right to payment for the asset
 - Customer has a 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

Contract costs (new section in IFRS 15)

- **TYPE 1:** Incremental costs to **obtain** a contract with a customer, are to be **recognised as an asset** if those costs are expected to be recovered
 - Such costs are LIMITED to the costs the entity would NOT have incurred if the contract had not been successfully obtained (e.g., sales commission)
 - *Practical expedient: expense the costs if the asset would have been amortised over one year or less anyway*
 - **TYPE 2:** If not within a standard such as IAS 2, IAS 16 or IAS 38, the costs to **fulfil** a contract are recognised as an asset if, and only if, **ALL** of the following criteria are met:
 - The costs relate directly to a contract or a specific anticipated contract;
 - The costs generate or enhance resources of the entity that will be used in satisfying (or continuing to satisfy) P/O's in the future; and
 - The costs are expected to be recovered
- 
- The asset recognised i.r.o. the costs to obtain/fulfil a contract, is **amortised on a systematic basis** that is consistent with the pattern of transfer of goods/services to which the asset relates
 - Recognise **impairment loss** in P/L, to the extent that contract cost's carrying amount exceeds:
 - The remaining consideration the entity expects to receive in exchange for the goods/services to which the asset relates (*use principles for determining transaction price, but ignore constraining estimates of variable consideration, and adjust the amount to reflect customer's credit risk*), **less**
 - The costs that directly relate to providing those goods/services and that have not yet been recognised as expenses

IFRS 15 versus IAS 18?

Principle/difference	IFRS 15 (new)	IAS 18 (old)
IFRS 15 scope	All contracts with customers	Sale of goods Rendering of services Use of entity' assets (interest, royalties, dividends)
Basic premise	Control passes to buyer	Goods and services are delivered, and risks and rewards pass to buyer
Contract costs	Recognise as asset, amortise and test for impairment	Expense and don't capitalise
Performance obligations	Identify separate P/O's in contract and allocate revenue to each	No such guidance
Variable consideration	Estimate and include in transaction price	Limited guidance on variable consideration
Contract modifications	Separate contracts OR modify existing contracts – guidance	Adjust revenue amount, but no clear guidance

IFRS 15 versus IAS 18?

Principle/difference	IFRS 15 (new)	IAS 18 (old)
Judgements and estimates	Significant reliance	Less reliance
Convergence with US GAAP	Developed in line with US GAAP, convergence expected	Not developed in line with US GAAP
Disclosure requirements	Nature of P/O's and timing of revenue recognition	Less extensive disclosure requirements
Time value of money	To be considered	Not considered
P/O's satisfied 'over time'	Detailed guidance, and on progress measurement	Less guidance provided
Contract scope	Contract characteristics inside/outside scope of IFRS 15	No such requirement
Consistency across industries	More consistency, revenue recognition practices even amended	Less consistency across industries

Thank you for attending!

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