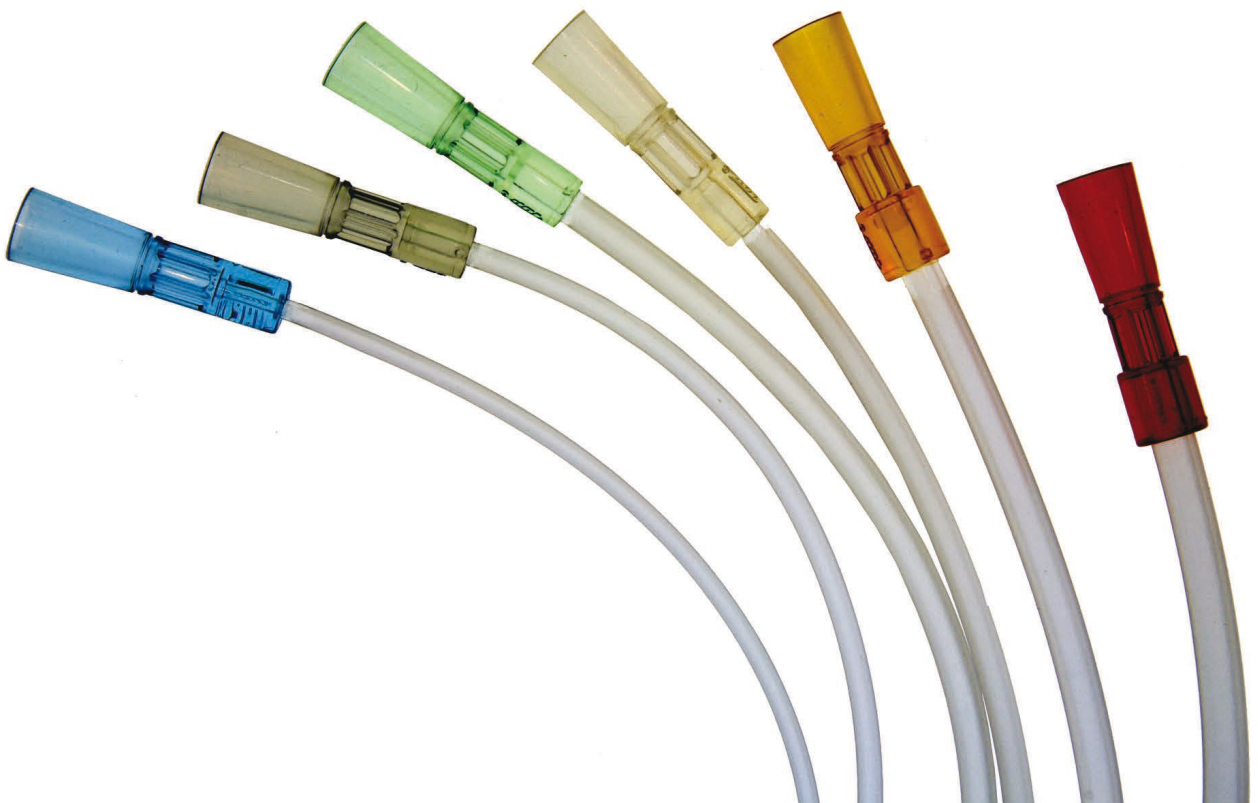


Implementing IFRS 15 *Revenue from
Contracts with Customers*

A practical guide to implementation
issues for the industrial products and
services sector



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About this guide

A new revenue recognition accounting standard, IFRS 15 *Revenue from Contracts with Customers* ('the new Standard'), has been issued. For those contracts within its scope, it will apply for entities' accounting periods beginning on or after 1 January 2017 (early adoption is permitted). As at the date of this publication, the new Standard has not yet been adopted by the EU.

Although 2017 may seem some way off, the implementation date has been set because some entities will need significant time to prepare for the impact of the new Standard. In some cases, the Standard will require significant system changes or will significantly affect other aspects of operations (e.g. internal controls and processes, Key Performance Indicators, compensation and bonus plans, bank covenants, tax etc.), and, therefore, it is imperative that entities identify any such impacts early on.

This guide is intended to provide an overview of applying IFRS 15 within the industrial products and services sector. The guidance provided here is not intended to be exhaustive, but aims to highlight some of the potential issues to consider and to indicate how those issues might be approached.

We hope you will find this implementation guide helpful and encourage you to reach out to one of our professionals identified in this guide for additional support as needed.

Overview

The International Accounting Standards Board ('IASB') has issued a new Standard on accounting for revenue recognition, IFRS 15, which will be applicable for entities reporting in accordance with International Financial Reporting Standards ('IFRSs') for periods beginning on or after 1 January 2017 with early application permitted. The new Standard is the result of a joint project by the IASB and the Financial Accounting Standards Board ('FASB') (collectively the 'Boards') to develop a converged set of accounting principles to be applied under both IFRSs and US generally accepted accounting principles ('US GAAP'). As at the date of this publication, IFRS 15 has not yet been adopted by the EU. The guidance is relevant across all industries and for most types of revenue transactions.

As a result of the issuance of IFRS 15, the following existing requirements in IFRSs have been superseded:

- IAS 11 *Construction Contracts*;
- IAS 18 *Revenue*;
- IFRIC 13 *Customer Loyalty Programmes*;
- IFRIC 15 *Agreements for the Construction of Real Estate*;
- IFRIC 18 *Transfers of Assets from Customers*; and
- SIC-31 *Revenue – Barter Transactions Involving Advertising Services*.

At a glance

Current requirements		New requirements	
Revenue recognition		Revenue from contracts with customers	
IAS 11	Construction contracts	IFRS 15	Point in time or over time
IAS 18	Sales of goods		
IAS 18	Sales of services		New guidance on royalty revenue
IFRIC 15	Real estate sales		New guidance on options for additional goods and services and breakage
IAS 18	Royalties		Guidance on non-cash consideration
IFRIC 13	Customer loyalty programmes		New guidance on costs of obtaining and fulfilling a contract
IFRIC 18	Transfers of assets from customers		
SIC 31	Advertising barter transactions		
	Previously little guidance on costs of obtaining and fulfilling a contract		
Other revenue		Other revenue	
IAS 18	Interest	IAS 39 or	Interest
IAS 18	Dividends	IFRS 9	Dividends

The new Standard outlines a single comprehensive model of accounting for revenue arising from contracts with customers. Based around a five-step model, it is more detailed and prescriptive than the existing guidance. There are two significant impacts that entities will need to consider when implementing the new Standard.

The timing of revenue and profit recognition

Whereas previously IFRSs allowed significant room for judgement in devising and applying revenue recognition policies and practices, IFRS 15 is more prescriptive in many areas relevant to the industrial products and services sector. Applying these new rules may result in significant changes to the profile of revenue and, in some cases, cost recognition. This is not merely a financial reporting issue. As well as **preparing the market and educating analysts** on the impact of the new Standard, entities will need to consider wider implications. Amongst others, these might include:

- changes to **key performance indicators** and other **key metrics**;
- changes to the **profile of tax cash payments**;
- availability of **profits for distribution**;
- for **compensation and bonus plans**, the impact on the timing of targets being achieved and the likelihood of targets being met; and
- potential non-compliance with **loan covenants**.

Current accounting systems may require significant changes to cope with the new Standard

As explained throughout this document, IFRS 15 introduces new requirements to move to a more prescriptive approach based around a five-step model. The complexity of applying this approach and of producing the detailed disclosures required by the new Standard in the industrial products and services sector may require modifications to existing accounting processes and, in some cases, entities may conclude that they should develop new systems solutions.

In determining the extent to which modifications will be required, entities will wish to consider the need for sufficient flexibility to cope with future changes in the pricing and variety of product offerings made to customers. The 1 January 2017 effective date may set a challenging timeframe for developing new systems.

Issues of particular relevance to the industrial products and services sector

Issues that are likely to be of particular relevance to entities in the industrial products and services sector include the following, which are discussed in detail in subsequent sections of this publication:

- unbundling of multiple performance obligations within a single contract;
- the impact of variable consideration;
- assessing whether a significant financing component exists within a contract;
- allocating the transaction price to performance obligations;
- the impact of shipping terms;
- the implications of contract manufacturing;
- capitalisation of costs of obtaining or fulfilling a contract; and
- recognition of revenue for warranties.

Scope and core principle

Scope

IFRS 15 applies to all contracts with customers, except for those that are within the scope of other IFRSs. Examples of contracts that are outside the scope of IFRS 15 include, but are not limited to, leases (IAS 17 *Leases*), insurance contracts (IFRS 4 *Insurance Contracts*) and financial instruments (IFRS 9 *Financial Instruments* or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*). It is possible that a contract with a customer may be partially within the scope of IFRS 15 and partially within the scope of another standard.

The recognition of interest and dividend income is not within the scope of IFRS 15. However, certain elements of the new model will be applied to transfers of assets that are not an output of an entity's ordinary activities (such as the sale of property, plant and equipment, real estate or intangible assets).

Core Principle

The core principle underlying the new model is that an entity should recognise revenue in a manner that depicts the pattern of transfer of goods and services to customers. The amount recognised should reflect the amount to which the entity expects to be entitled in exchange for those goods and services. IFRS 15 provides five steps that entities will need to follow in accounting for revenue transactions.

The five steps of the revenue recognition model



The five steps are described in more detail in the following sections.

The five steps of the revenue recognition model

Step 1. Identify the contract with a customer

Summary of the requirements

What qualifies as a contract?

For many entities, Step 1 will be relatively straightforward. The key points are to determine when a contract comes into existence. A contract can be written, verbal, or implied. The following criteria are all required in order to qualify as a contract with a customer:

- the contract has been approved by the parties;
- the entity can identify each party's rights regarding the goods or services to be delivered;
- the entity can identify the payment terms for the goods or services to be delivered;
- the contract has commercial substance; and
- it is probable that the entity will collect the consideration to which it is entitled in exchange for the delivery of the goods or services.

Entities will additionally need to consider whether the contract should be combined with other contracts for accounting purposes, and how to account for any subsequent modifications that arise.

Contracts should generally be accounted for separately. However, contracts should be combined if:

- they are negotiated as a package with a single commercial objective;
- the amount of consideration to be paid in one contract depends on the goods or services to be delivered in another contract; or
- the goods or services promised in the contracts are considered to be a single performance obligation.

Combining contracts

Entities in the industrial products and services sector often enter into multiple contracts with the same customer around the same time but may not specifically evaluate whether those contracts are interdependent. After establishing controls to ensure that this evaluation is performed, entities may need to use judgement to determine whether IFRS 15's contract combination criteria are met. A conclusion that the criteria are met could significantly affect (1) how performance obligations are identified, (2) how consideration is allocated to those obligations, or (3) when revenue is ultimately recognised. Note that contracts with different customers (that are not related parties) would not be combined.

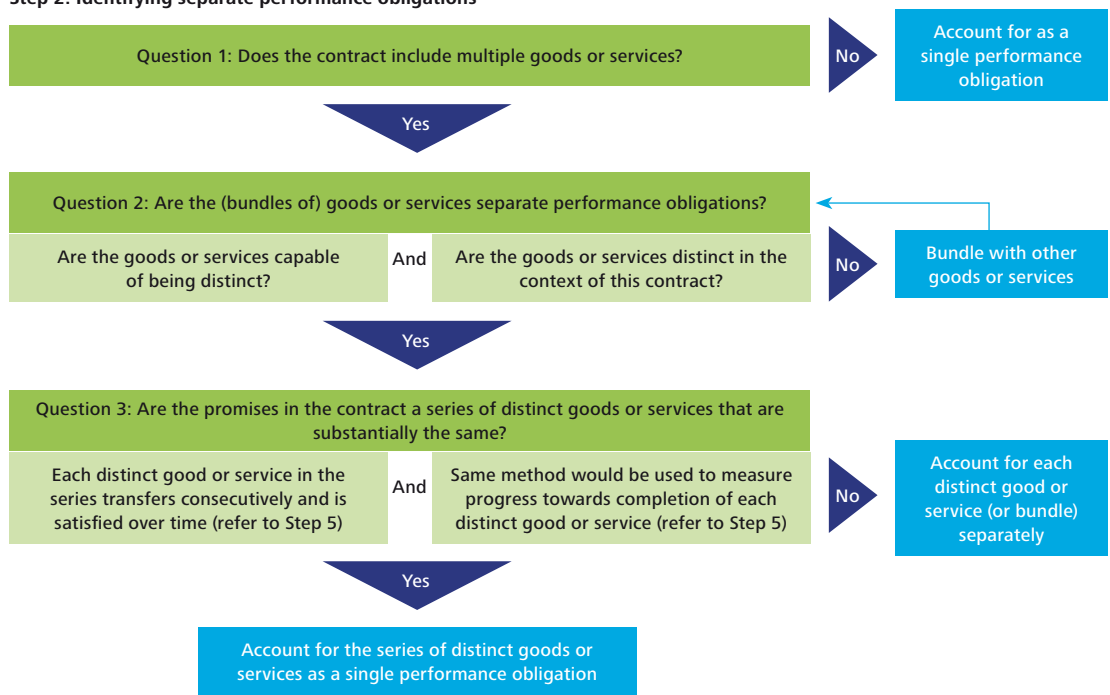
Step 2. Identify the performance obligations in the contract

Summary of the requirements

What is 'unbundling'?	Step 2 is concerned with how to identify those deliverables that are accounted for separately ('performance obligations'). This process is sometimes called 'unbundling'. For many entities, this will be a key judgement in recognising revenue. Previously, apart from the guidance in IAS 11 on segmentation of construction contracts, IFRSs contained little guidance on this topic; therefore the requirements of IFRS 15 may lead to a significant change in practice for some entities.
When should 'unbundling' happen?	The performance obligations need to be determined at contract inception, by identifying the 'distinct' goods or services in the contract. If distinct goods or services cannot be identified, entities should combine goods or services until they identify a bundle of goods or services that is distinct.
How do we identify separate performance obligations?	<p>In order to do this, an entity will typically first identify all the goods or services, or contract deliverables, which have been promised. These may be implicitly or explicitly promised in a contract. For example, a contract with a customer may also include promises that are implied by an entity's customary business practices or published policies. This requirement highlights the need to analyse the commercial objective of the contract in order to identify all the deliverables.</p> <p>An entity will then determine which of its promised goods or services should be accounted for as performance obligations, by determining which promised goods or services are distinct. For a good or service to be 'distinct', it must satisfy both of the following conditions:</p> <ul style="list-style-type: none">• the customer can benefit from the good or service either on its own or in combination with other resources available to the customer; and• the entity's promise to transfer the good or service to the customer is separable from other promises in the contract, as discussed further below. <p>Customers are able to benefit from a good or service if that good or service can be used, consumed, sold for an amount other than scrap value, or otherwise held in a way that generates economic benefits.</p>
What else needs to be considered?	<p>Whether an entity's promise to transfer a good or service is separable from other promises in the contract is a matter that requires judgement and will depend on the facts and circumstances specific to each scenario. Factors that indicate a promised good or service is separable from other promises include, but are not limited to, the following:</p> <ul style="list-style-type: none">• the entity does not use the good or service as an input to produce the combined output specified by the contract;• the good or service does not significantly modify or customise another good or service promised in the contract; and• the good or service is not highly dependent on, or highly interrelated with, other promised goods or services. <p>In certain circumstances, the provision of a series of distinct goods or services that are substantially the same and have the same pattern of transfer is to be treated as one performance obligation.</p>
Why does it matter?	The identification of performance obligations will have consequences in Steps 4 and 5 of the Standard's revenue model. These are discussed in further detail below.

All entities will need to consider this requirement carefully to determine whether their current approach will continue to be appropriate under IFRS 15. By applying the following process to contracts, entities should be able to identify their performance obligations.

Step 2. Identifying separate performance obligations



Unbundling multiple performance obligations

Entities in the industrial products and services sector will often provide multiple products or services within one contract. For example, a number of different component parts, finished goods and servicing contracts may be integrated in one contract. Under the new Standard, an entity will be required to assess whether the deliverables it has promised to the customer give rise to separate performance obligations.

Determining what constitutes a performance obligation is an area in which management may have to exercise a greater level of judgement, considering the guidance included in IFRS 15 as noted in the diagram above.

When the entity has identified its performance obligations, it will have to follow the guidance in Step 4 to determine how to allocate the transaction price to the various performance obligations.

Step 3. Determine the transaction price

Summary of the requirements

What impacts the amount of revenue recognised? Step 3 is concerned with how to measure the total revenue arising under a contract. IFRS 15 typically bases revenue on the amount to which an entity expects to be entitled rather than the amounts that it expects ultimately to collect. In other words, revenue is adjusted for discounts, rebates, credits, price concessions, incentives, performance bonuses, penalties and similar items, but it is not reduced for expectations of bad debts. There is, however, an exception for transactions that include a significant financing component. For these transactions, revenue is recognised based on the fair value of the amount receivable, which will reflect the customer's credit risk as it is incorporated into the discount rate applied.

An entity will need to determine the amount of consideration to which it expects to be entitled in exchange for the promised goods or services (including both fixed and variable consideration). When determining the amount to which the entity expects to be entitled, consideration should be given to past business practices, published policies or specific statements that create a valid expectation in the customer that the entity will only enforce payment of a portion of the stated contract price. For example, if past business practices with a particular customer demonstrate that the entity typically only requires payment of ninety per cent of the stated contract price (i.e. it forgives the balance), for a new contract with the same customer, the transaction price may be determined to be ninety per cent of the stated contract price.

The key considerations in determining the transaction price are the effects of any variable consideration, the time value of money (if a significant financing component exists), non-cash consideration and any consideration payable to the customer.

Variable consideration Variable consideration is any amount that is variable under the contract. Variable consideration will only be included in the transaction price when an entity expects it to be 'highly probable' that the resolution of the associated uncertainty would not result in a significant revenue reversal. This assessment takes into account both the likelihood of a change in estimate and the magnitude of any revenue reversal that would result. If an entity is unable to include its full estimate of variable consideration, because that could give rise to a significant revenue reversal, it should recognise the amount of variable consideration that would be highly probable of not resulting in a significant revenue reversal. An exception to this exists when an entity earns sales or usage based royalty revenue from licences of its intellectual property. In these circumstances, the entity would typically only include revenue from these licences when the subsequent sale or usage occurs.

Time value of money If an entity determines that the contract provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer, then the consideration should be adjusted for the time value of money. This may lead to interest expense being recognised if the customer pays for goods or services in advance of the transfer of control and interest income when the goods or services are paid for in arrears.

Practical expedient

For contracts in which, at inception, the period between the performance of the obligations and the associated payment is expected to be less than a year, the entity can choose not to account for the time value of money. If the period between the performance of the obligations and the associated payment is expected to be more than a year, an entity will always need to consider if there is a significant financing component.

When determining whether a contract contains a significant financing component, an entity should consider, among other factors:

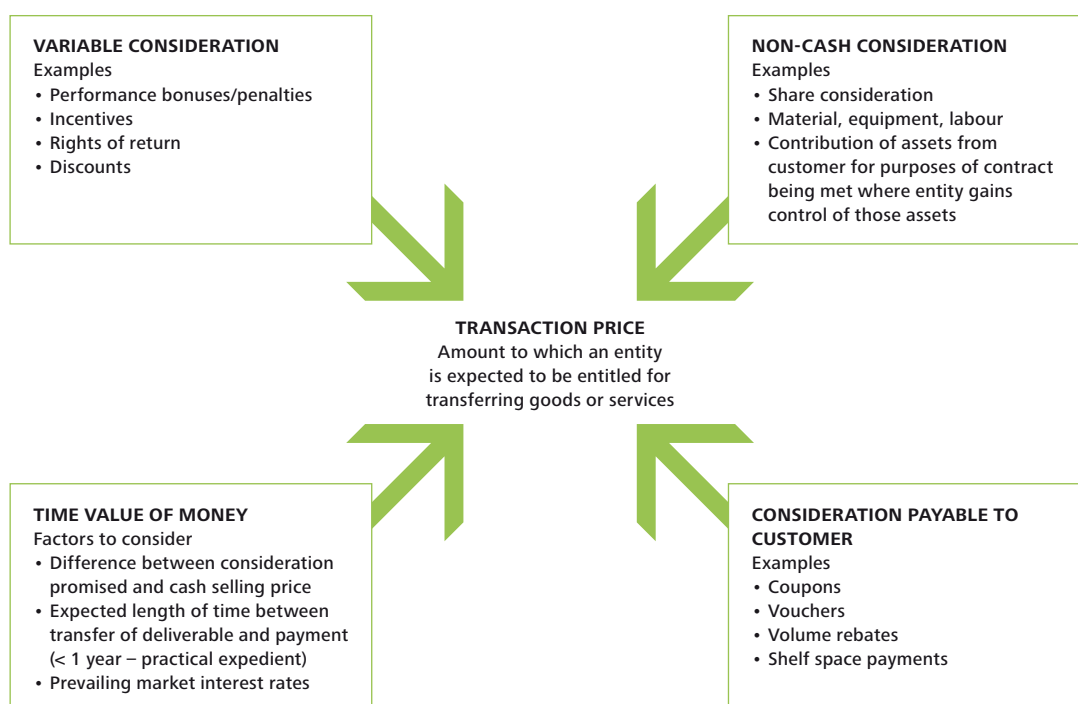
- the difference between the promised amount of consideration and the cash selling price of the promised goods or services; and
- the combined effect of the period between an entity fulfilling its performance obligations and customer payment, and the prevailing interest rate in the relevant market.

The discount rate used should be a rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception, taking into account credit characteristics. The significant financing component arising on a contract will be accounted for in accordance with IFRS 9 *Financial Instruments* (or, if IFRS 9 has not yet been adopted, IAS 39 *Financial Instruments: Recognition and Measurement*).

Why does it matter? Management's estimate of consideration will have consequences when applying Steps 4 and 5 of the revenue model. These are discussed in further detail below.

Step 3 requires careful consideration of multiple factors when determining the transaction price. The key considerations have been summarised below.

Step 3. Transaction price



Variable consideration

Entities providing industrial products and services may enter into contracts that contain significant variable elements, such as volume discounts, rebates or price concessions. The amount expected to be received under the contract may vary due to performance bonuses, penalties and discounts contained in these contracts. Amounts may also vary depending on renegotiations or disputes which may result in price concessions (recorded as an adjustment to revenue) or bad debt (recorded separately from revenue).

The new requirements in IFRS 15 in respect of variable consideration as noted above will need to be carefully considered in such scenarios that entities may encounter. This is particularly important when assessing the probability of a significant amount of revenue being reversed in the future which in turn determines how much consideration is included in the transaction price. This ultimately determines the amount of revenue that can be recognised (see Step 5 below). If potential penalties could result in a significant reduction of revenue, the transaction price would be based on that reduced amount until such time that it is highly probable that the penalties will not arise.

Significant financing component

Sales of industrial products and services may include significant financing components in that the timing of revenue recognition and cash flows do not correspond. Payments received in advance, as well as those in arrears, should be assessed to determine whether a significant financing component exists. This may change current practices for the recognition of interest as a separate element from revenue.

Step 4. Allocate the transaction price to separate performance obligations

Summary of the requirements

Allocating the transaction price	After determining the transaction price at Step 3, Step 4 specifies how that transaction price is allocated between the different performance obligations identified in Step 2. Previously, IFRSs included very little in the way of requirements on this topic, whereas IFRS 15 is reasonably prescriptive. Accordingly, this could be an area of significant change for some entities, and entities will need to consider whether their existing systems are capable of allocating the transaction price in accordance with the Standard's requirements.
What method should be used to allocate the transaction price?	If there are multiple performance obligations identified in a single contract, the transaction price should be allocated to each separate performance obligation on the basis of relative stand-alone selling prices. The stand-alone selling price should be determined at contract inception and represents the price at which an entity would sell a promised good or service separately to a customer. Ideally, this will be an observable price at which an entity sells similar goods or services under similar circumstances and to similar customers.
Are any other methods available?	If the stand-alone selling price is not directly observable, the entity should estimate it. Estimation methods that may be used include an adjusted market assessment approach, an expected cost plus margin approach or a residual approach, but the last may only be used if certain conditions are met.
How should any discounts be allocated?	If the stand-alone selling prices are greater than the promised consideration in a contract with a customer, the customer is deemed to have received a discount. Unless the discount meets the criteria set out in the Standard to be allocated to only some of the performance obligations, the discount should be allocated proportionately to all the performance obligations in the contract. Variable consideration should also be allocated proportionately to all the performance obligations identified unless certain criteria are met.

Step 4. Inputs to allocate transaction price

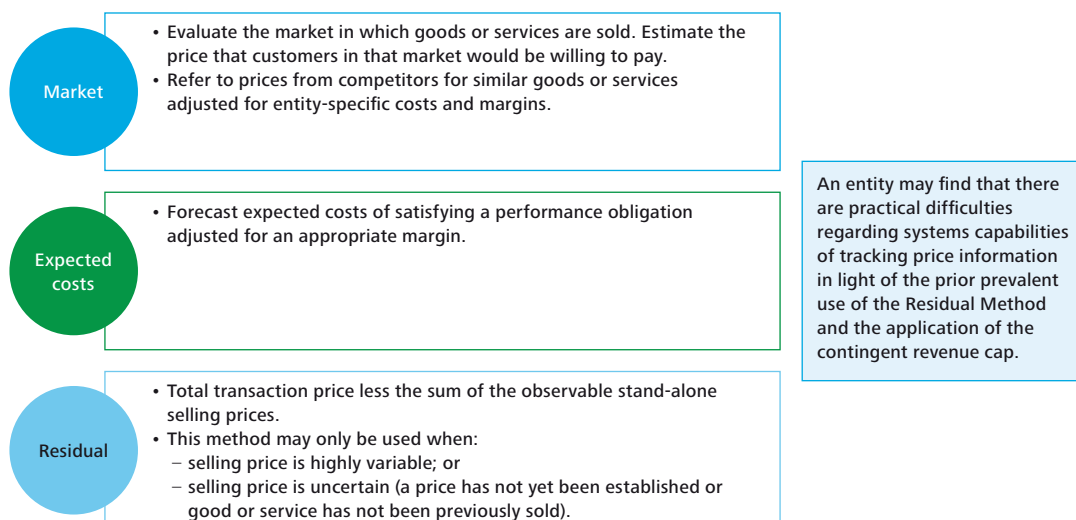
How to determine the stand-alone selling price?

Best evidence: observable price of a good or service when sold on a stand-alone basis

Not directly observable?



Must estimate! – maximise the use of observable inputs



Allocating the transaction price

As noted in Step 2 above, when there are two or more performance obligations within a contract, an entity will need to allocate the transaction price to the various performance obligations.

For example, an entity enters into a contract with a customer to sell the customer component parts and free servicing for a specified period. The entity has determined that the sale of the component parts and the free servicing are distinct goods and services and therefore has determined that there are two performance obligations. The price contained in the contract is CU1,000 and the entity expects to be entitled to this amount – CU1,000 is therefore determined to be the transaction price.

The stand-alone selling prices of these goods and services are directly observable and are CU300 for the sale of the components and CU900 for the servicing. The entity therefore allocates the total transaction price to the distinct goods and services as required by Step 4 based on their relative stand-alone selling prices. Therefore, the transaction price allocated to the sale of the components is CU250 ($1000 \times 300 / (300 + 900)$) and CU750 is allocated to the servicing ($1000 \times 900 / (300 + 900)$). The pattern in which the entity will recognise revenue will be determined by Step 5.

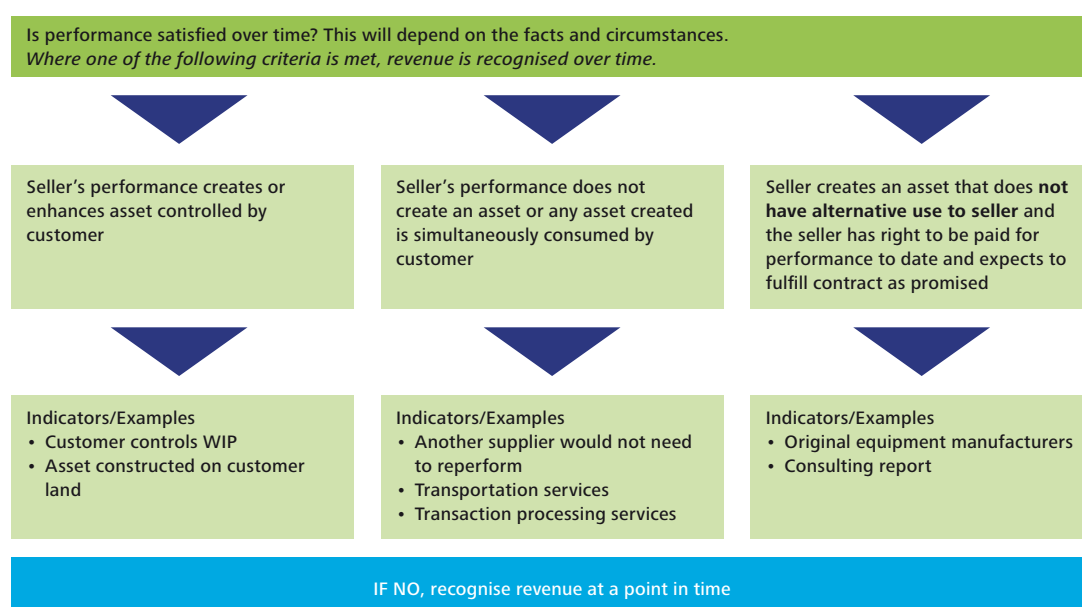
Step 5. Recognise revenue as the entity satisfies a performance obligation

Summary of the requirements

When should revenue be recognised?	The final step is to determine, for each performance obligation, when revenue should be recognised. This may be over time or at a point in time. Previously, IAS 18 required revenue for services to be recognised over time and revenue for goods to be recognised at a point in time, but it did not include guidance on how to determine whether a particular item supplied under a contract should be regarded as a good or a service for these purposes. IFRS 15 does not distinguish between goods and services but instead includes specific and detailed guidance on when to recognise revenue over time and when to recognise revenue at a point in time. Some entities may find that items for which they previously recognised revenue at a point in time now have revenue recognised over time, or vice versa.
What is control and how is it assessed?	An entity should recognise revenue as the performance obligations are satisfied. A performance obligation is satisfied when control of the underlying goods or services for that particular performance obligation is transferred to the customer. 'Control' is defined as 'the ability to direct the use of and obtain substantially all of the remaining benefits from the asset' underlying the good or service. Control can transfer, and hence revenue be recognised, over time (for example, servicing or service-type warranties), or at a point in time (for example, the transfer of component parts).
When is revenue recognised over time?	Control is deemed to have transferred over time if any one of the following is met: <ul style="list-style-type: none">• the customer simultaneously receives and consumes all of the benefits provided by the entity's performance as the entity performs. This means that if another entity were to take over providing the remaining performance obligation to a customer, it would not have to substantially reperform the work already completed by the initial provider. This criterion applies to service contracts where the customer consumes the benefits of the services as they are provided (for example, a service-type warranty);• the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced. Control refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. Therefore this criterion is satisfied if the terms of the contract transfer control of the asset to the customer as the asset is being built (i.e. control of work in progress). This asset may be tangible or intangible; or• 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, including a reasonable profit margin. This criterion may apply in situations where the indicators of control are not immediately apparent. Entities will assess whether an asset has an alternative use at contract inception. An asset with no alternative use to an entity is one where the entity is unable to readily direct the use of the asset, which may be partially or wholly completed, for another use. This limitation may be imposed contractually or practically. A contractual restriction is one where the terms of the contract would allow the customer to enforce its rights to the promised asset if the entity attempted to direct the asset for another use, whereas a practical restriction is one where the entity would incur significant economic losses to redirect the use of the asset, such as significant costs of rework or significant loss on sale of the asset.
When is revenue recognised at a point in time?	If a performance obligation does not meet the criteria to be satisfied over time, entities should consider the following indicators in evaluating the point in time at which control of the asset has been transferred to a customer: <ul style="list-style-type: none">• the entity has transferred title to the asset;• the entity has transferred physical possession of the asset;• the entity has a present right to payment for the asset;• the customer has accepted the asset; and• the customer has the significant risks and rewards of ownership of the asset.

One of the key changes in IFRS 15 is the basis for the recognition of revenue. For goods, IAS 18 utilised the concept of the transfer of risks and rewards, whereas IFRS 15 utilises the concept of the transfer of control in all cases. Although applying the two different concepts will often not alter the timing of revenue recognition, it is nevertheless possible in some circumstances for entities to have a different pattern of revenue recognition based on a transfer of control as opposed to a transfer of risks and rewards, and this should be taken into careful consideration. It is possible that as a result of IFRS 15, revenue which was previously recognised over time will now be recognised at a point in time, or vice versa.

Step 5. Recognising revenue over time



Impact of shipping terms

Providers of industrial products and services may ship products under various terms to customers. The point at which risks and rewards pass, based on an assessment of shipping terms, may be different to the point at which control passes to the customer. For example some goods may be shipped on the basis that title passes to the customer at the point of shipment, but customers are still compensated for any loss or damage during shipping. Previously revenue may have been recognised at the point of final delivery on the basis that some risks and rewards are retained during shipping.

Under IFRS 15, entities need to assess whether control passes to the customer at the point of shipment or at the point of final delivery. If revenue is recognised at the point of shipment, then a distinct shipping and coverage service may also be identified (see Step 2 above).

Contract manufacturing

Entities in the industrial products and services industry sometimes manufacture products for a specific customer. It is not uncommon in these cases for customers to have control over the products during the manufacturing process. In these cases revenue may need to be recognised over time. Careful analysis should be given to contractual terms that provide customers with the right to cancel, curtail or significantly modify the contract and whether the seller is entitled to adequate compensation for work performed to date. These terms will significantly impact whether revenue is recognised over time or at a point in time.

Further areas of guidance

Contract modifications

Summary of the requirements

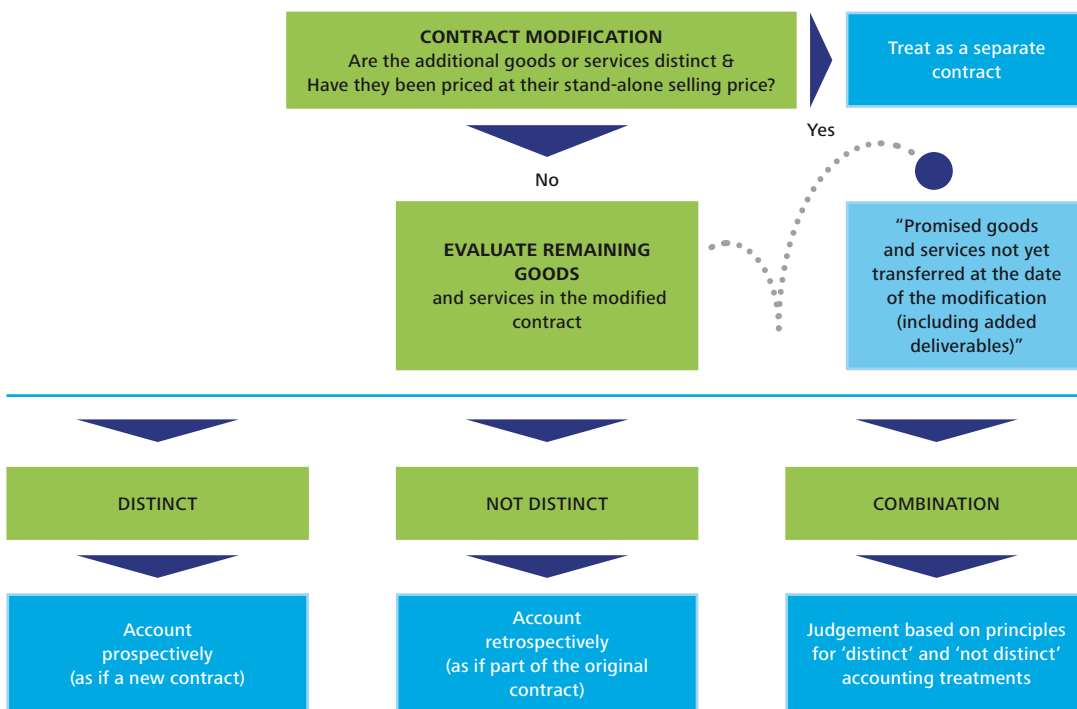
Should revenue be adjusted when a contract is modified?

Contract modifications (also sometimes referred to as a change order, variation or amendment) of price, scope or both will have accounting consequences when they are 'approved' such that they create enforceable rights and obligations. Modifications should be treated as an adjustment to the original contract unless they merely add a further performance obligation that is both 'distinct' (as defined by the Standard – see Step 2 above) and priced based on an appropriately adjusted stand-alone selling price. If both these conditions are met, the modification is treated as a new, separate contract.

If the modification is treated as an adjustment to the original contract, the appropriate accounting depends on the remaining goods or services to be delivered under the contract.

- If the remaining goods or services are distinct, the modification is accounted for prospectively by allocating the remaining transaction price to the remaining performance obligations in the contract.
- If the remaining goods or services are not distinct, the modification is accounted for retrospectively, by updating both the transaction price and the measure of progress for the part-complete performance obligation.

Contract modification



The only scenario in which the original contract will be left unchanged and therefore the modification will be accounted for as a new, separate contract is when the incremental price charged for the added distinct goods or services is commensurate with the stand-alone price of those goods or services. All other changes to a contract should be treated as a modification of the original contract.

Cost of obtaining or fulfilling a contract

Summary of the requirements	
Types of cost which can be capitalised	When assessing whether contract costs are eligible for capitalisation it is important to distinguish between the costs of obtaining a contract and the costs of fulfilling it. Both of these categories of cost may be eligible for capitalisation in accordance with the Standard. However, the rules for each category are different and care must be taken to apply the correct guidance.
When should costs of obtaining a contract be capitalised?	<p>Costs of obtaining a contract should be recognised as an asset and subsequently amortised (see below) if they are incremental and are expected to be recovered. Costs of obtaining a contract are incremental only if they would not have been incurred if the contract had not been obtained (e.g. a sales commission).</p> <div style="border: 1px solid black; padding: 5px;"><p>Practical expedient Where the asset that would be recognised as a result of capitalising the cost of obtaining a contract would be amortised over one year or less, an entity may choose to expense those costs when incurred.</p></div> <p>Any costs incurred prior to obtaining a contract that do not relate to the fulfilment of the contract, and which would have been incurred regardless of whether the entity obtained the contract or not, should be recognised as an expense when incurred, unless they are explicitly chargeable to the customer regardless of whether the contract is obtained.</p>
When should costs of fulfilling a contract be capitalised?	<p>Where costs of fulfilling a contract are within the scope of another standard (e.g. inventories), they should be dealt with by that standard. Costs that are not within the scope of another standard should be capitalised as assets only if they meet all of the following criteria:</p> <ul style="list-style-type: none">• they relate directly to a specifically identifiable contract (whether this has already been obtained or is anticipated to be obtained);• they generate or enhance resources that will be used in satisfying the contract; and• they are expected to be recovered. <p>Examples of such costs are direct labour costs, direct materials costs, allocations of costs and any costs that are explicitly chargeable to the customer.</p> <p>Notwithstanding the guidance above, the Standard includes specific requirements that certain costs should be recognised as expenses when incurred. These include general and administrative costs (unless they are explicitly chargeable to the customer), costs of wastage and any costs that relate to fully or partly satisfied performance obligations or where the entity cannot distinguish whether the costs relate to unsatisfied, partly satisfied or wholly satisfied performance obligations.</p>
When are capitalised costs amortised?	IFRS 15 includes guidance on amortisation and impairment of assets arising from the capitalisation of both types of cost noted above. Amortisation should be charged on a basis consistent with the transfer to the customer of the goods or services to which the capitalised costs relate. Where the carrying value of such an asset exceeds the amount of consideration still to be received in relation to the related goods or services, less the residual cost of providing those goods or services, an impairment loss should be recognised.

Providers of industrial products and services may incur costs that are directly attributable to obtaining contracts with customers.

Treatment of these costs is currently varied, with some entities choosing to expense the costs and others choosing to capitalise the costs. When an entity incurs incremental costs that arise directly as a result of successfully obtaining a contract and certain criteria are met, IFRS 15 requires that these shall be recognised as an asset on the balance sheet (unless the practical expedient applies).

If an entity recognises an asset as a result of obtaining a contract, the entity will be required to determine the appropriate pattern of amortisation and assess for impairment. A change in treatment of these costs may result in a change in the profile of profit recognition.

Additional considerations

IFRS 15 provides detailed guidance in specific areas that may or may not be relevant to entities, depending on their industry and standard practices. Some of the areas for which existing practice may change are listed below.

- **Warranties:** Where a warranty is granted, the nature of the warranty will determine the accounting impact. The new Standard distinguishes between a warranty providing assurance that a product meets agreed-upon specifications (accounted for as a cost provision) and a warranty providing an additional service (for which revenue will be deferred). Consideration of factors such as whether the warranty is required by law, the length of the warranty coverage period, and the nature of the tasks the entity promises to perform will be necessary to determine which type of warranty exists. Where the customer can choose whether or not to purchase the warranty, or the warranty provides the customer with an additional service, it will be accounted for as a separate performance obligation. A warranty that merely provides assurance that the item supplied meets the agreed-upon specifications will not be accounted for as a separate performance obligation. In the industrial products sector, it is common for warranties to include both elements. For example a warranty may both assure the quality of the product and provide a free maintenance plan for two years. Where a warranty contains both elements, judgement will be needed in order to determine how to allocate the transaction price in a reasonable manner, and this may result in warranties being accounted for differently than at present.
- **Customer options for additional goods or services:** An option for customers to purchase additional goods or services at a discount will be accounted for separately if it provides a material right to the customers.
- **Customers' unexercised rights:** Entities sometimes receive non-refundable payments in respect of future goods or services, for example, commitments to purchase at least a specified quantity of an item. Customers do not always exercise all their contractual rights in these scenarios. Such unexercised rights are often referred to as 'breakage'. Entities should recognise the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer. Otherwise, the entity should recognise any breakage amount as revenue when the likelihood of the customer exercising its remaining rights becomes remote.
- **Non-refundable upfront fees:** An entity that charges a non-refundable upfront fee will not recognise that amount as revenue at the outset unless the fee relates to a separate performance obligation that has been fulfilled at the outset.
- **Repurchase agreements:** Where an entity sells a good to a customer and the entity has either a right or an obligation to repurchase the asset, this will affect the accounting treatment. If the entity is required to repurchase the good, or has the option to repurchase, the arrangement will either be accounted for as a financing arrangement or as a lease. Similarly, if the customer can choose whether to sell the item back to the entity, and at the outset would have a significant economic incentive to do so, the arrangement will either be accounted for as a financing arrangement or as a lease. If the customer can choose whether to sell the item back to the entity, but at the outset would not have a significant economic incentive to do so, the arrangement should be accounted for as a sale with a right of return.
- **Onerous contracts:** IFRS 15 does not contain any guidance on onerous contracts with customers. Prior to IFRS 15, guidance on loss-making contracts could be found in IAS 11. IAS 37 has been amended by IFRS 15 such that it now includes those contracts within its scope. IAS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from the failure to fulfil it.

Disclosures

IFRS 15 requires an increased level of disclosures about revenue recognition in comparison to previous Standards, which have been criticised for lacking adequate disclosure requirements. Under IFRS 15, the disclosure requirements are driven by the objective of providing users of the financial statements with information that will help them to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. As such, entities should not approach the disclosure requirements on a 'checklist' basis but should consider how to provide qualitative and quantitative disclosures around their contracts with customers, making clear any significant judgements made in applying IFRS 15 to contracts, and any assets recognised in relation to the cost of obtaining or fulfilling a contract. Updates or changes to the systems and processes of entities may be required to ensure that they are able to comply with the disclosure requirements.



The key disclosures required include the following.

- Contracts with customers
 - A disaggregation of revenue for the period into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. Information must also be provided to demonstrate the relationship between the disaggregated revenue information and any segment revenue disclosures.
 - Information about the entity's contract assets and contract liabilities. This includes opening and closing balances of balance sheet items relating to contracts with customers. Entities will also be required to disclose the amount of revenue recognised in the current year that relates to the satisfaction of performance obligations in previous reporting periods. In relation to its performance obligations, entities will explain how the future pattern of satisfaction of these will impact on the contract asset and contract liability balance.
 - Information about the entity's remaining performance obligations. Entities will be required to disclose the total transaction price allocated to the remaining performance obligations at the end of each reporting period (unless the remaining performance obligation will be satisfied in less than a year). Other disclosures required include information about when the entity typically satisfies its performance obligations, the significant payment terms, the nature of the goods or services that the entity has promised to transfer and information about obligations relating to warranties, refunds and returns.
- Significant judgements
 - Information about entities' judgements, and any changes in judgements, in relation to the timing of, and the transaction price allocated to, the satisfaction of performance obligations. Entities will be required to disclose how they have made these judgements and why these are a faithful depiction of the transfer of goods or services.
- Assets recognised in relation to the costs of obtaining or fulfilling a contract
 - The closing balance of any assets recognised in relation to costs incurred to obtain or fulfil a contract, in addition to any judgements exercised in determining the amount to be capitalised.
 - Amortisation information for the amount recognised in profit or loss in the current period and the method of amortisation.

IFRS 15 also amends IAS 34 *Interim Financial Reporting* to require disaggregated revenue information to be disclosed in interim financial statements.

Transition

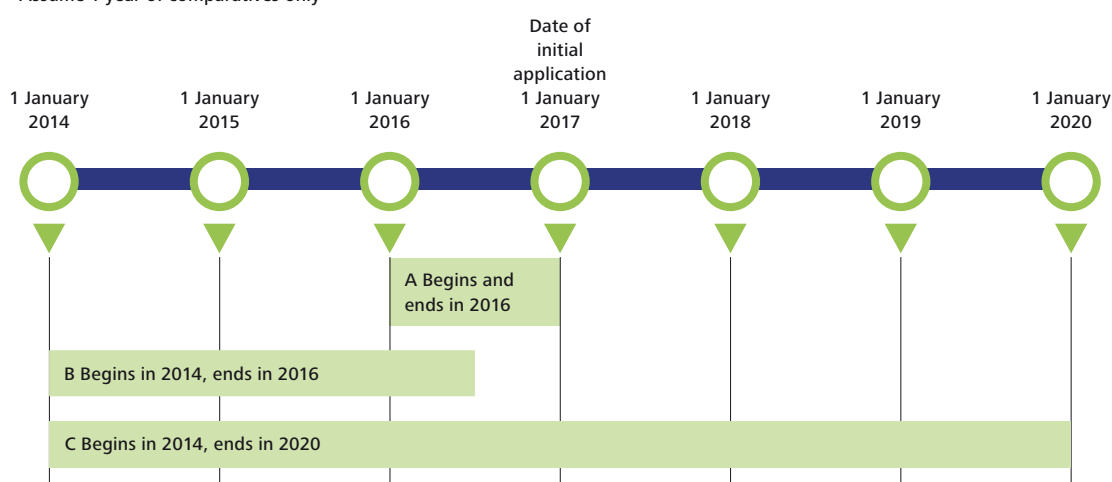
Entities have two options for transitioning to IFRS 15. Both options are fairly detailed but helpful in providing some relief on initial application of IFRS 15. Both of these options make reference to the date of initial application – which is the start of the reporting period in which an entity first applies the Standard. For example, entities applying the Standard for the first time in financial statements for the year ending 31 December 2017 will have a date of initial application of 1 January 2017.

Transition timeline

Example

Assume December 31 Y/E

Assume 1 year of comparatives only



Method 1 Full retrospective approach

Contract A Begins and ends in same annual reporting period and completed before the date of initial application – Practical expedient available

Contract B Adjust opening balance of each affected component of equity for the earliest prior period presented (1 January 2016)

Contract C Adjust opening balance of each affected component of equity for the earliest prior period presented (1 January 2016)

Method 2 Simplified transitional approach

Contract A Contract completed before the date of initial application – Do not apply IFRS 15

Contract B Contract completed before the date of initial application – Do not apply IFRS 15

Contract C Adjust opening balance of each affected component of equity at date of initial application. Disclose information per paragraph 134.2

Method 1

Full retrospective approach

Entities can apply the Standard retrospectively to all comparative periods presented. Under this option, prior year comparatives are restated, with a resulting adjustment to the opening balance of equity in the earliest comparative period. Where this option is chosen, the Standard provides a number of optional practical expedients. These include the following.

- For completed contracts, entities are not required to restate contracts that begin and end within the same annual reporting period. For example, if an entity first applying the Standard for a 31 December 2017 year end entered into and completed a contract in 2016, that contract will not need to be restated (that is, the interim periods in 2016 are not required to be restated).
- For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods. For example, for an entity first applying the Standard for a 31 December 2017 year end, if a contract was completed prior to 31 December 2016, rather than estimate variable consideration at earlier dates, the entity may base earlier revenue figures on the consideration (including any variable consideration) that was ultimately payable.
- For all periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to remaining performance obligations and an explanation of when the entity expects to recognise that amount as revenue. For example, for an entity first applying the Standard for a 31 December 2017 year end, if a contract is entered into on 1 January 2016 and is incomplete at 31 December 2016, the entity will not be required to provide disclosures on the contract's remaining performance obligations as at 31 December 2016.

Any practical expedients used should be used consistently for all prior periods presented and disclosure should be given with regards to which expedients have been used. To the extent possible, a qualitative assessment of the estimated effect of applying each of those expedients should be provided.

Method 2

Modified approach

Under the modified approach, entities can apply the Standard only from the date of initial application. If they choose this option, they will need to adjust the opening balance of equity at the date of initial application (i.e. 1 January 2017) but they are not required to adjust prior year comparatives. This means that they do not need to consider contracts that have completed prior to the date of initial application. Broadly, the figures reported from the date of initial application will be the same as if the Standard had always been applied, but figures for comparative periods will remain on the previous basis.

If this option is used, disclosure is required of the amount by which each financial statement line item is affected in the current period as a result of applying the guidance and an explanation of the significant changes between the reported results under IFRS 15 and the previous revenue guidance followed.

Transition Resource Group

IFRS 15 is the first comprehensive principles-based Standard on revenue. The previous guidance under IFRSs was fairly limited, and the previous guidance under US GAAP was rules-driven, with specific guidance available for different industries. The IASB and FASB are aware that, whilst they have put a lot of time and thought into the development of the Standard, issues will arise as entities begin to implement the Standard in practice. As a result, they have formed a joint "Transition Resource Group", which is intended to help the Boards resolve any diversity in practice and address implementation issues as they arise. Therefore, the Boards may issue additional revenue guidance or interpretations before the Standard's effective date in 2017.

Final thoughts and broader issues

The transition to IFRS 15 will affect all businesses, to varying degrees. Nevertheless, with an effective transition date of periods starting on 1 January 2017, this provides businesses with an opportunity to consider carefully the new requirements and resolve any potential accounting issues in advance. In addition to those potential accounting issues, IFRS 15 will have a wider effect on the business. The following list highlights aspects of the business that may be affected by the transition to IFRS 15, although it is not intended to be exhaustive.

- **Systems and processes** – as noted previously, in order to gather the information required for reporting under IFRS 15, an entity may require re-designs or modifications to its IT systems and to its processes (e.g. internal controls) more generally.
- **Training for employees** – entities should provide training to those employees affected by the changes. This will include accountants, internal auditors and those responsible for drawing up customer contracts.
- **Bank covenants** – changes in the revenue recognition accounting methods may change the amount, timing and presentation of revenue, with a consequent impact on profits and net assets. This may impact the financial results used in the calculation of an entity's bank covenants. As such, entities should seek early discussions with lenders, to establish whether renegotiation of covenants will be necessary.
- **KPIs** – where they are based on a reported revenue or profit figure, they may be impacted by the changes. As such, an entity may want to begin evaluating the impact of the Standard on key financial ratios and performance indicators that may be significantly impacted by the changes with a view to determining whether its KPI targets should be adjusted. Where there are changes, an entity will also need to consider how to explain these to investors.
- **Compensation and bonus plans** – bonuses paid to employees are sometimes dependent on revenue or profit figures achieved. Changes in the recognition of revenue as a result of IFRS 15 may have an impact on the ability of employees to achieve these targets, or on the timing of achievement of these targets.
- **Ability to pay dividends** – in certain jurisdictions, the ability to pay dividends to shareholders is impacted by recognised profits, which in turn are affected by the timing of revenue recognition. Where this is the case, entities will need to determine whether the changes will significantly affect the timing of revenue and profit recognition and, where appropriate, communicate this to stakeholders and update business plans.
- **Tax** – the profile of tax cash payments, and the recognition of deferred tax, could be impacted due to differences in the timing of recognition of revenue under IFRS 15.
- **Stakeholders** – users of the financial statements such as the Board of Directors, audit committee, analysts, investors, creditors and shareholders will require an explanation of the changes in IFRS 15 in order to understand how the financial statements have been impacted.

More information on the new Standard, as well as other UK accounting, reporting and corporate governance news and publications can be found at www.ukaccountingplus.co.uk

Contacts

If you would like further, more detailed information on the new Standard please contact your local Deloitte partner.

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