IFRS 15

Revenue from Contracts with Customers

by Robert Kirk

In this article, Robert Kirk looks at how the move to IFRS 15 and resultant change to the timing of revenue recognition this year impacted on Budget 2019.

IFRS 15 was published in May 2014 but only comes into effect for financial statements commencing on or after the 1st January 2018. It really only affects those entities applying international financial reporting standards (IFRS) and that, in reality, means listed companies in Ireland when they are preparing their consolidated financial statements. However, it may eventually be brought into local accounting via FRS 102 in three years' time when the next triennial review of that standard takes place.

Background

The standard replaces IAS 18 Revenue and IAS 11 Construction Contracts as well as a number of SIC and IFRIC documents. Largely the rationale for it was the need globally to find a standard that consistently reports revenue and requires more specific disclosure by companies as to how they explain their revenue recognition policies rather than the boiler plated disclosure which has been common to date. It was a joint project with the USA as they also were concerned with a lack of consistency of reporting amongst their myriad set of individual industry standards on how to report revenue.

The process of reporting revenue

The standard starts with the basic core principle that revenue should represent:

"the depiction of the transfer of promised goods or services to customers in an amount that reflects the consideration to which the vendor expects to be entitled in exchange for those goods or services."

In order to meet that core principle, the standard has introduced a five-stage approach to recognizing revenue. These five stages will be discussed in turn as follows:

Step 1 Identify the contract

This step should be relatively straightforward. A contract does not have to be written, it could be oral or even implied but both parties must clearly understand their rights and obligations under the contract and be able to identify the agreed payment terms. The vendor should also, before embarking on the contract, assess the customer's credit risk' to ensure they are likely to be paid.

Sometimes a number of separate legal contracts may be accounted as one if the substance of the arrangement is such that, in commercial reality, they are really one contract. This applies the doctrine of substance taking precedence over legal form.

Step 2 Identify separate performance obligations

This is really where the standard could result in a change in accounting policy for revenue recognition. The standard clearly requires reporting entities to separate those parts of a contract which require separate performance obligations. In making the decision as to whether or not that is necessary, IFRS 15 introduces the notion of the word DISTINCT.

If an entity is able to sell part of a contract separately or permit the user to be able control that part of the contract without a requirement to acquire the other parts then the obligation is distinct. The decision must be looked at in the context of the individual contract. For example, if a building contractor acts as the project manager in integrating all aspects of a contract to build an office block for a client, it treats this as one performance obligation despite the fact that if the client had organized the contract him/herself he/she could have employed separate obligations such as bricklayers, electricians, plumbers etc to carry out the work.

There has been great discussion in the accounting press about the software and telecommunications industries who could well be affected by this new requirement. Will the mobile phone operators have to split their performance obligations between selling phones and providing subsequent servicing or could they argue that no customer could use a phone unless they sign up for the full-service agreement and, in addition, the phone is not sold to other customers on its own? In that case there would be only one performance obligation.

Step 3 Determine the transaction price

Most companies applying IFRS 15 for the first time will not change the determination of the appropriate transaction price to apply. It should be the consideration that a vendor expects to be entitled to in exchange for the goods or services transferred. This will often be the amount specified in the contract i.e. the invoice price.

However, it can be complicated if the vendor offers the customer delayed payment as this then presupposes that the contract contains a financing component as well as a sale. The vendor will need to discount the payment back from the payment date to present value and record that as the sale. The discount thus created will be recorded as finance income over the period to the date of payment.

There are also situations where variable terms have been negotiated between the parties and this will require the vendor to use either the expected value model or the most likely outcome to record the appropriate revenue in the financial statements.

Step 4 Allocate the transaction price to the performance obligations

The fourth step is only an issue if a contract has had to be split into more than one performance obligation in Step 2. IFRS 15 then requires the transaction price agreed in Step 3 to be allocated to the various separately identified performance obligations. The process of allocation involves the reporting entity in determining the stand alone selling prices of the obligations either directly or by estimation and then affectively allocating the discount to the obligations on that basis.

Example

Three performance obligations are identified and the transaction price agreed in the contract is €1,200. There are three separate performance obligations identified and their stand alone selling prices are as follows:

A	€800
B	€400
C	€400

Effectively a discount of €400 has been offered by the vendor to the customer so the fair value of the consideration will result in the following allocation of the revenues – A €600, B€300 and C€300.

Step 5 Recognise revenue when the performance obligation is satisfied

Revenue can only be reported in the Statement of Financial Performance when control of goods or services are transferred to the customer. The IFRS assumes that control over services passes to the customer as the customer consumes the service and thus gains the benefit from that service even if momentarily.

No distinction is made between goods and services initially and all revenues therefore must be tested first to see whether or not they pass the criteria to be reported over time. Only if that fails are they recorded at a point in time.

It is likely, however, that both service income and income from construction contracts will still be recognized over time and entities will have freedom to choose the most appropriate method of spreading the income over the life of the contract. Both output and input methods will be acceptable as long as the chosen method is applied consistently.

Goods invariably will fail the criteria for over time recognition and therefore will be reported at a point in time. The new standard does stress the need for control to have passed but in most situations that also means that the risks and rewards have also passed. IFRS 15 does list a number of indicators that would suggest this has occurred such as the delivery of goods, the passing of legal title to the goods, physical possession and payment received for the goods. There are, however, situations where none of those would apply e.g. reservation of title does not prevent recognition of revenue as the substance of the agreement would suggest that a sale has taken place, physical possession ignores the fact that goods can often be returned.

IFRS 15 in Practice

A number of Irish listed companies have tried to evaluate the impact of IFRS 15 in their last financial statements as the impact of new standards must be identified in the years prior to implementation.

Ryanair Plc have identified the need to record their ancillary revenue at the date of flight rather than the date of booking. The impact was recorded in their February 2018 Annual Report as follows:

"Companies will probably adopt the simpler of the two transition options i.e. to recognise the change as a cumulative catch up"

Ryanair Group Plc Extract from Annual Report for the year ended 31st March 2018

IFRS 15: Revenue from Contracts with Customers

IFRS 15 is effective for periods beginning on or after January 1, 2018. The standard establishes a five-step model to determine when to recognise revenue and at what amount. Revenue is recognised when the good or service has been transferred to the customer and at the amount to which the entity expects to be entitled.

Ryanair has reviewed the impact of applying IFRS 15 on all of its revenue streams. For the majority of our revenue, the manner in which we currently recognise revenue is consistent with the requirements of IFRS 15. For certain ancillary revenue streams however, the recognition of revenue will be deferred under IFRS 15 to the flight date where it is currently recognised on the date of booking.

This change in the timing of revenue recognition will mean that an increased amount of revenue will be recognised in the second half of the year under IFRS 15.

Ryanair will apply the standard using the cumulative effect method. On adoption of the standard, the adjustment to retained earnings at April 1, 2018 was a reduction of €274.5 million. There will be a corresponding increase in deferred revenue within liabilities.

Ryanair Plc has chosen to adopt the optional transitional approach to implementation offered by IFRS 15 by recording a cumulative adjustment at the 1st April 2018 rather than the normal change of accounting policy of full retrospection. It is likely that most companies will adopt that method as it is less costly and less time consuming.

The Kerry Group in their December 2017 Annual Report disclose a minimal change to their accounting policy on revenue which will also be applied cumulatively.

Kerry Group Plc Extract from the Annual Report for the year ended 31st December 2017

IFRS 15 Revenue from Contracts with Customers

IFRS 15 was issued to establish a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. The core principle of IFRS 15 is that an entity should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Under IFRS 15, an entity recognizes revenue when (or as) a performance obligation is satisfied i.e. when 'control' of the goods or services underlying the particular performance obligation is transferred to the customer.

The Group has assessed the potential impact on its consolidated financial statements resulting from the application of IFRS 15. Findings from our review of IFRS 15 are that the impact of this new standard on the Group's results is unlikely to be material. Kerry do not supply services and generally legal title of goods sold is transferred on shipment.

In general, there is one performance obligation in each of our sale contracts. In certain parts of the Group's business, the performance does not create an asset with an alternative use to the Group and the Group has an enforceable right to payment (cost plus a margin) for performance completed to date. In these circumstances, revenue should be recorded over time rather than at a point in time as is our current policy.

Based on analysis conducted to date of its contractual and trading relationships, the Group currently estimates that the impact of IFRS 15 is not material and no material impact on profits in future periods is expected. In line with the transition guidance in IFRS 15 the Group will not restate the 2017 prior period on adoption.

Conclusion

The move to IFRS 15 and resultant change to the timing of revenue recognition this year impacted on Budget 2019. The Minister for Finance found in October that he had an unexpected additional €1bn in corporation tax revenue, as listed companies tax resident in Ireland applied IFRS 15 for the first time which impacted the timing of corporation tax payments.

Robert Kirk

Robert Kirk CPA is Professor of Financial Reporting at the University of Ulster. Robert is also author of the CPA Ireland Skillnet publication, A New Era for Irish and UK GAAP – A Quick Reference Guide to FRS 102