IFRS 15

Revenue from Contracts with Customers

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Introduction

Revenue is income from ‘ordinary activities’.

A **contract** has rights and obligations between two or more parties.

A **customer** receives a good or service.

ex

- Chris Limited (Chris) received and accepted an order for 'furniture' from a regular customer, Toffer Limited (Toffer), on 21 December 2016 for an agreed price of sh 50 m. However, due to the Christmas holidays, the goods were not despatched until 4 January 2017. Toffer received the goods on the same day, and paid for them on 23 January 2017. The goods are included in Chris's inventory at 31 December 2016 at their cost price of sh 40m.

- Requirement
- Explain how this transaction should be accounted for in Chris's financial statements for the year ended 31 December 2016.

Issue date

- Issued May 2014.
- Sets out the requirements for recognising revenue that apply to all contracts with customers except for contracts within the scope of;
    - leases,
    - insurance contracts and
    - financial instruments.
- Effective from 1 January 2017.
- Earlier application is permitted.

Scope exclusions

  - Leases, insurance, financial instruments, certain guarantee contracts and certain non-monetary exchanges
- Contracts with elements in multiple standards
  - Evaluate under other standards first

Convergence

- Joint project between IASB and FASB,
- Establishes a single, comprehensive framework for revenue recognition.
- to be applied consistently across transactions, industries and capital markets, and will improve comparability in the 'top line'

- The IASB and the FASB have formed **Transition Resource Group** a group of external stakeholders to identify and discuss issues that may arise

Supersedes

- IFRS 15 replaces the previous revenue Standards:
  - IAS 18 Revenue
  - IAS 11 Construction Contracts,

- the related Interpretations on revenue recognition:
  - 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.

Brief comparison

IAS 18 /11	*IFRS 15*
Separate models for: • Construction contracts • Goods • Services	**Single model for performance obligations:** • Satisfied over time • Satisfied at a point in time
Focus on risk and rewards	**Focus on control**
Limited guidance on: • Multiple element arrangements • Variable consideration • Licences	**More guidance:** Separating elements, allocating the transaction price, variable consideration, licences, options, repurchase arrangements **and so on….**

Quick forward

- For straightforward contract such as retail transactions, IFRS 15 will have little, if any, effect on the amount and timing of revenue recognition.
- For other contracts, such as long-term service contracts and multiple-element arrangements, IFRS 15 could result in some changes either to the amount or timing of the revenue recognised by a company.

Need for change

- Significant diversity in revenue recognition practices
- Limited guidance on many important topics, such as accounting for arrangements with multiple elements.
- Difficult for investors and analysts ('investors') to understand and compare a company's revenue.
- Difficult to apply to complex transactions due to lack of basis for conclusions.
- numerous industry and transaction specific requirements, which often resulted in economically similar transactions being accounted for differently.
- new types of transactions emerges.

Need for change

- Inadequate disclosure or information disclosed was often ‘boilerplate’ in nature or was presented in isolation and without explaining how the revenue recognised related to other information in the financial statements.

- IFRS 15 addresses those deficiencies by specifying a comprehensive and robust framework for the recognition, measurement and disclosure of revenue.

Overview of the framework

- Framework for determining when to recognise revenue and how much revenue to recognise.

- The core principles

“a company should recognise revenue to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services”

The framework five steps

1. Identify the contract(s) with the customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price
5. Recognise revenue when a performance obligation is satisfied

Order of application

Core principle
Revenue recognised to depict transfer of goods or services

Step 1 - Identify the contract with the customer

Step 2 - Identify the performance obligations in the contract

Step 3 - Determine the transaction price

Step 4 - Allocate the transaction price

Step 5 - Recognise revenue when (or as) a performance obligation is satisfied

Step 1

- Agreement between two or more parties that creates enforceable rights and obligations
- No contract unless customer committed, criteria include:
  - it is probable that the entity will collect the consideration to which it will be entitled
- Combine two or more contracts with the same customer when:
  - negotiated as a package with a single commercial objective;
  - amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- goods or services promised in the contracts are a single performance obligation (see step 2)

Step 2: Performance obligation

- Performance obligations are promises to transfer goods or services to a customer that are:
  - explicit,
  - implicit, or
- arise from customary business practices
- Identifying performance obligations is critical to measurement and timing of recognition

Step 3 transaction price

- Probability weighted or best estimate
- More specific guidance covering:
  - time value of money
  - constraint on variable consideration
  - non-cash consideration
- consideration payable to customers: reduction to transaction price unless for a distinct good or service.

Step 4: Allocation of price

- Allocate transaction price to separate performance obligations based on relative standalone selling price:
- Actual or estimated
- Residual ‘approach’ if selling price is highly variable or uncertain (change from current practice)
- Initial allocation and changes to variable consideration might be allocated to a single performance obligation if:
- Contingent payment relates only to satisfaction of that performance obligation, and
- Allocation is consistent with the amount the entity expects to be entitled to for that performance obligation

Step 5: Revenue recognition

- Guidance applies to each separate performance obligation
- First, evaluate if performance obligation satisfied ‘over time’
- recognise revenue based on the pattern of transfer to the customer

- If not point in time
- recognise revenue when control transfers

Transaction cost

- Incremental costs of obtaining a contract required to be capitalised if expected to be recovered (e.g. sales commissions)
- May be expensed if expected contract period less than 1 year
- Contract fulfilment costs
- Look to other guidance first (inventory, PPE)
- If out of scope of other standards, required to be capitalised if:
- Relate directly to a contract and
- Relate to future performance and
- Expected to be recovered
- Amortise capitalised costs as control transfers
- Impairment reversals required

Disclosures

- Both qualitative and quantitative information including;
- Disaggregated information
- Contract balances and a description of significant changes
- Amount of revenue related to remaining performance obligations and an explanation of when revenue is expected to be recognised
- Significant judgments and changes in judgments

More implementation guidelines

- Customer options
- Warranties
- Breakage
- Non-cash consideration
- Consideration payable to the customer
- Returns
- Repurchase options
- Principal or agent

- Interactive session

- Question and answers

IFRS 16

- IFRS 16 Leases published in January 2016
- replaces IAS 17 and related interpretations
- changes lessee accounting substantially
- little change for lessors
- Effective date 1 January 2019
- early application permitted (only with application of IFRS 15 Revenue from Contracts with Customers)

The need for change

Leases are an important and flexible source of financing—listed companies using IFRS Standards or US GAAP estimated to have huge lease commitments

Therefore, it is <u>difficult</u> for investors and others to:

- Get accurate picture of entity's lease assets and liabilities
- Compare companies that lease assets with those that buy
- Estimate the amount of off balance sheet obligations: often overestimated
- Over 85% of lease commitments do not appear on balance sheet today

The need for change

- Leases create assets and liabilities
- Most leases are not reported on the balance sheet
- Long-term liabilities of heaviest users of off balance sheet leases[1]
  Huge variation across and within industries

The need for change

- Why investors need better information?
- Many do not adjust reported numbers
- More sophisticated investors adjust using estimation techniques (eg multiples of rent expense)
- Uses incomplete information so difficult and inaccurate

What’s changed for

- lessors
- Substantially carry forward IAS 17 accounting requirement for s; some additional disclosure requirements

- lessees
- Former operating leases capitalised. All leases accounted for similarly to today’s finance leases Exemptions for short-term leases and leases of low-value assets

Definition of a lease

- Similar to previous definition, changed guidance on control
- Control = directing the use and obtaining the benefits from use
- Based on control of the use of an identified asset

- Separate services provided with leases
  - Separate using available information (including estimates)
  - Option to not separate components

Lessee accounting

- *Right-of-use model*
- A lease conveys the right to use an asset for a period of time in exchange for cash payments
- Lessee reports lease assets and liabilities on balance sheet, except for short-term and for low-value asset leases, at present value of future lease payments
- Discount rate: the rate implicit in the lease, or, if rate implicit not available, lessee's incremental borrowing rate
- Exclude variable payments and most optional payments
- Portfolio application, simplified reassessment

Lessee Accounting

- Increase in lease assets and financial liabilities—all leases reported on balance sheet (other than short-term leases and leases of low-value assets)

Included in lease liabilities:

- Fixed payments (including inflation-linked payments)
- Optional payments if lessee is reasonably certain to extend beyond non-cancellable period
- Expected amount of residual value guarantees

Lessee Accounting

- *Optional recognition exemptions*
- Short-term leases
  - Leases with lease term <12 months
- Low-value asset leases
  - Leased assets in order of magnitude

what’s excluded

- Leases of low-value assets
- Short-term leases

→ Not required to be included in lease liabilities

- Variable lease payments linked to sales or use
- Optional payments (not reasonably certain)

→ Excluded from lease liabilities

Initial measurement

Right of use asset

(at cost)

=

Lease liability

(present value of lease payments)

Subsequent measurement

- Right of Use (ROU) Asset
  - Balance sheet presentation separately as an asset
  - Depreciated over the life of the lease
  - Depreciation in profit and loss
  - Reassessed for impairment
- Liability
  - Balance sheet presentation separately as a liability
  - Interest expense (discount unwind) through profit and loss as interest

Presentation

Balance sheet

- ROU assets together with PPE or as own line item
- Lease liabilities in accordance with IAS 1

Income statement

- Depreciation of all leased assets
- Interest expense for all lease liabilities

Cash flow statement

- Principal within financing activities
- Interest within either operating or financing activities (IAS 7 option)

Disclosure

Quantitative disclosures	**Entity-specific information**
• Breakdown of lease costs • Total lease cash flows • Maturity analysis of undiscounted commitments • Information about ROU assets by major class of leased asset	• Additional information, if relevant • Extension and termination options • Variable lease payments • Residual value guarantees • Sale and leaseback

Subleases, Sale and leaseback

- Subleases—Intermediate lessor
  - Account for head lease and sublease as two separate contracts
  - Classify a sublease with reference to the ROU asset arising from the head lease
  - Should not offset lease assets and liabilities, or income and expenses, unless meets existing IFRS guidance for offsetting
- Sale and leaseback transactions
  - Sale must meet the requirements in IFRS 15
  - Seller/lessee recognises only gain related to rights transferred
  - Adjustment made for off market terms

Lessor Accounting

- In essence, no change to lessor accounting in IAS 17
  - Lessor accounting in IAS 17 is not broken
  - Concerns about cost and complexity
- IFRS 16: enhanced disclosures
  - Information about the residual value risk
  - Operating leases: separate disclosures for leased assets and assets used by a lessor for other than leasing

Effective date and transition

- IFRS 16 effective for annual periods beginning on or after 1 January 2019
- Early application permitted if IFRS 15 Revenue from Contracts with Customers applied
- If cumulative catch-up transition method <u>elected</u>:
  - No restatement of comparatives
  - No need to apply IFRS 16 to leases ending within 12 months
  - Simplified measurement option on transition

Effects of lessee accounting changes

IAS 17 issues	Benefits of IFRS 16
• A lack of information • Investors attempt to estimate • Companies provide lease-adjusted information	• Improved quality of financial reporting
• A lack of comparability • No level playing field	• Improved comparability

Key benefits of IFRS 16

- Greater transparency about financial leverage and capital employed
- More level playing field for all market participants
- Reduce the need to make adjustments and to provide 'non-GAAP' information
- Improve comparability between those who lease and those who borrow to buy

- Interactive session

- Question and answers