IFRS 15, revenue from contracts with customers: a major project is completed

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This paper describes the development of the project to update the financial reporting of revenue from contracts with customers, which has now resulted in the issue of a new International Financial Reporting Standard (IFRS), and the views that ACCA has expressed during the various stages of this project.

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SUMMARY

The aims of the joint project carried out by the Financial Accounting Standards Board (FASB) in the US and the International Accounting Standards Board (IASB), were to establish common revenue reporting principles across industries, provide greater guidance on revenue recognition, improve the disclosures in financial statements, update international Standards, and simplify US Generally Accepted Accounting Practice. ACCA has been involved in the part of the consultation process led by the IASB, developing our views through the ACCA Global Forum for Corporate Reporting (and its predecessor, the ACCA Financial Reporting Committee).

The IASB and the FASB have sought to establish standard accounting practice for the types of contract where questions have arisen over the amount and timing of the revenue recognised. These uncertainties are due to factors such as the length of the contract, the number of separable components (distinct goods or services) in the contract, and the extent to which the contract product becomes tailored to the customer's specific requirements over time. In addition, there is a need to reflect the risk of not receiving payment ('credit risk').

On the international side, the IFRS that has now been issued (IFRS 15 – entitled: Revenue from Contracts with Customers) will replace International Accounting Standard (IAS) 11 Construction Contracts, and IAS 18 Revenue, along with four related Interpretations. The FASB will issue its own Standard for use in the US.

ACCA has mainly supported the project, both its technical content and its aim of achieving further progress towards the global convergence of Accounting Standards. ACCA agrees that IFRS 15 should represent further progress to greater convergence between jurisdictions, by tackling the previous areas of uncertainty that inevitably risked creating diversity in practice.

The content of the IASB's IFRS 15 is converged with the equivalent new US Standard issued by the FASB. In future, identical output from the two Boards may well be the exception. The IASB and the FASB have abandoned the principle of seeking to produce converged Standards in all cases, and although they still do not entirely disagree on all key accounting matters, their preparedness to 'agree to differ' is evident in recent developments in other accounting areas

BACKGROUND

The revenue recognition project has been under way for several years, allowing three opportunities for the IASB to seek views from interested parties, such as ACCA. The process has been one of evolution, without any fundamental changes in direction or any major retraction of the original proposals.

The scope of the project covers all contracts with customers other than, principally, those involving leases, insurance contracts or financial instruments. Some revenue-generating contracts are very straightforward (such as the sale of a pad of paper), while others are far more complex (such as the construction of a specialist building, taking several years). The revenue recognition project is of particular relevance to the latter.

Following the publication of a Discussion Paper (DP) in 2008, the IASB issued its first Exposure Draft (ED) of a revised Standard in June 2010. The 2010 ED generally did not differ from the earlier DP, but provided more guidance.

In November 2011, the IASB issued a revised ED. This contained a number of clarifications, such as about cases where work is performed over a period of time for a specific customer. In addition, as explained below, the 2011 ED changed how credit risk is recognised and presented.

The consultation period for the 2011 ED ended in mid-March 2012. The IASB and the FASB then deliberated the final content of the revised Standard IFRS 15, publication of which took place in May 2014.

SPECIFIC PROVISIONS IN THE EXPOSURE DRAFTS

The 2010 Exposure Draft

The 2010 ED set out a five-step process for revenue recognition:

- identify the contract
- identify the separate performance obligations in the contract
- determine the contract price
- allocate the contract price to the separate performance obligations, and
- recognise revenue when each performance obligation is satisfied (for example, on the acceptance of goods by the customer).

The key to the timing of the recognition of revenue is when control of the good or service passes to the customer. The more customer-specific the good or service is, the less likely it is that revenue will only be recognised on the transfer of the finished product to the customer. This is especially so for contracts that, owing to their customer-specific nature, give the customer the right to make changes and involve an unconditional obligation to pay. For example, specialised industrial buildings are very much tailored to the customer's needs almost from the outset, while general-purpose shops and offices are subject to very little (if any) modification before the new owner takes over.

On the other hand, if parts of an item are delivered separately, but all are needed before the customer can use the item, control does not pass until the last delivery is made. Revenue would be recognised at that point, rather than on each delivery as if each were a separate performance obligation.

The 2011 ED and IFRS 15 have retained the five-step method of identifying revenue, and the above principles of control, when recognising revenue.

Clearer criteria were set out in 2011 for the recognition of revenue where goods or services are provided over time, based on the actual control or enjoyment by the customer during that period, or 'specificness' to the customer during that period. In addition, goods or services that were not distinct from each other could now be treated as one performance obligation, for ease (and logic) of accounting.

Under the 2011 ED, the figure disclosed for revenue in the financial statements would now be the actual contract amount. The amount for impairment, which reflects credit risk, would no longer be deducted from revenue, but would be disclosed as a separate figure adjacent to revenue.

The 2010 ED proposed that the treatment of warranties would depend on when the fault arose. As this is often difficult to establish (faults are not always detected as soon as they happen), the 2011 ED proposed a distinction between the following types of warranty:

- warranties covering defects up to the point of contract fulfilment, plus statutory warranties and rectification required by product liability law
- warranties bought separately, or which provide subsequent protection.

Only the latter category of warranties above would be treated as separate performance obligations. The former would be accounted for as a liability (previously, they were to be recognised by the deferral of part of the transaction price, and by including in inventory the amount of goods expected to be defective). Overall, these proposals for warranties are now closer to existing requirements.

The 2011 Exposure Draft

The following additional clarifications were included in the 2011 ED.

The principle for recognising variable revenue would now be that similar experience should enable management to make a prediction. Previously, a probability weighting was required, and the cost and complexity of this were criticised, as was the potential resulting 'theoretical' transaction price, which would probably never be achieved in reality

With respect to onerous commitments, a liability and corresponding expense should be recognised only for performance obligations expected to last over one year. A number of respondents (including ACCA) do prefer the onerous test to be applied to the contract as a whole (rather than its constituent performance obligations), for practical commercial reasons. Nonetheless, the IASB decided to offer a compromise by not now requiring the test and associated accounting for performance obligations that are short-term, making the point that, furthermore, this is consistent with IAS 11 Construction Contracts.

ACCA'S POSITION ON THE PROPOSALS

The 2010 Exposure Draft

ACCA supported the IASB's wider objective of creating a general set of principles for revenue recognition, and the central role given to the concept of control of revenue. ACCA also expressed the view that a robust set of principles in a wide-ranging Accounting Standard should not need further additional guidance (which might also appear to have a prescriptive nature), unless warranted by industry complexities.

Concerns were, however, expressed to the IASB that the focus on the transfer of assets to a customer might, in some cases, override accounting based on the economic substance of a contract (such as the customary practice at the entity, or when a contract is performed over time). In situations where the contract provisions result in control passing only at the end of the contract, it was considered that the required accounting treatment would be overly based on the contract's legal form. A noticeably different result could then arise from that achieved by current practices, such as the percentage of completion method for construction contracts.

There was also less agreement with the IASB on accounting for anticipated losses on individual performance obligations, when entities and existing standards tend to look to overall contract profitability. As set out below, ACCA has reiterated this view in its response to the 2011 ED.

ACCA agreed with the principle that variable consideration should be reflected through the use of an estimate, if one could be reasonably established, but not through the application of a probability weighting to individual transactions (as noted above, this latter proposal has since been removed).

ACCA also expressed reservations about the complexity (and hence, practicality) involved in the process of separating and combining contracts and performance obligations (or modifications thereto), which will often require estimation to be applied. This issue was partly addressed in the 2011 ED by the removal of the requirement to consider 'price interdependence' when deciding whether or not to combine contracts.

ACCA acknowledged that the proposal to reflect credit risk in the initial recognition of revenue has a similarity to existing requirements (principally, IFRS 9's expected loss model), while expressing concern that credit risk deductions from the revenue figure might make the financial statements less understandable (as mentioned above, the IASB no longer requires a deduction). At the time, ACCA preferred recognition of the credit risk element as deferred revenue, rather than releasing it to other income if subsequently reversed.

ACCA also supported adjustments for the time value of money, where contracts include a material financing component. For practical purposes, the 2011 ED only required an adjustment for the time value of money where there is a gap of more than one year between payment and the transfer of the goods or services, and there was then a further relaxation, as described below.

The 2011 Exposure Draft

In 2011, the IASB sought feedback on whether its proposed requirements were clear, and properly presented the economic substance of contracts with customers. Although respondents to the ED were not required to restrict their comments to these themes, the IASB was acknowledging that the main principles of revenue recognition were generally accepted, following the consultations that had accompanied the 2008 DP and the 2010 ED. ACCA's comments on the 2011 ED were generally more in agreement with the IASB than were those made on the 2010 proposals.

Application of the control criteria and the five steps described above will still not necessarily give an outcome identical to the current 'percentage of completion' method. ACCA has expressed concern that potentially, there will be a significant difference in the timing of revenue recognition across longer-term large-scale projects. Nonetheless, ACCA generally welcomed the inclusion of the control criteria, which bring a number of contracts closer to the percentage of completion method than would otherwise have been the case.

ACCA has also supported the following proposals.

ACCA supports the proposals for warranties, as set out above but notes that these were included in the guidance section of the ED (and also IFRS 15), which seems inappropriate when the proposals are worded as required accounting practice, and warranties will be an issue for many entities.

The disclosure of a credit risk figure (if material) adjacent to revenue, rather than as a deduction from revenue, is supported on the grounds of understandability for users of the financial statements. Should any material element of this figure relate to revenue recognised in previous periods, ACCA expressed the view that this fact should be made clear, and that the meaning of the credit risk figure would probably be clearer if it were presented below the revenue figure, rather than adjacent to it.

For variable consideration, the reliance on management prediction based on experience, rather than the calculation of a probability weighting is again supported by ACCA. The ED did provide guidance on the prediction process, which ACCA viewed as important for consistency between entities, as well as for the re-assessment of the process by an entity's external auditor.

ACCA was less in agreement with the proposal that only those performance obligations expected to last more than one year should be assessed for indications of being onerous. The 12 month cut-off may be appropriate for the construction industry, but it came across as more of an artificial compromise in a Financial Reporting Standard designed to encompass many industries, and consequently differing revenue streams.

ACCA still believed in a contract-based assessment for indicators of an onerous situation, on the grounds that one loss-making performance obligation in an overall profitable contract would not be as onerous as one that is the sole obligation in the contract, or one in a contract that was unprofitable overall. The Basis for Conclusions section in the 2011 ED did point out that the IASB regards assessment at the contract level as being unduly complex, although ACCA did not believe that a full justification was given for this view.

Finally, ACCA did not support the amount of disclosure that the proposed Standard would require in interim financial statements. Five potentially detailed disclosures would have been required, including a breakdown of revenue, and other information in tabular formats. This would probably be unduly lengthy compared with other disclosures, as the present version of IAS 34 envisages that interim financial statements will provide just a general update on the latest complete set of annual financial statements.

COMMENTS FROM ACCA TO THE IASB (INTERNATIONAL ACCOUNTING STANDARDS BOARD)

ACCA's responses to the 2009 DP
http://www.accaglobal.com/uk/en/technical-activities/technical-resources-search/2009/june/revenue-recognition.html

ACCA's responses to the 2010 ED
http://www.accaglobal.com/uk/en/technical-activities/technical-resources-search/2010/july/iasb-revenue-customer-contracts.html

ACCA's responses to the 2011 ED
http://www.accaglobal.com/uk/en/technical-activities/technical-resources-search/2012/march/contract-revenue.html

THE NEW INTERNATIONAL STANDARD, IFRS 15

Changes made in the light of responses to the 2011 Exposure Draft

In the light of the responses received to the 2011 ED, the IASB has made a number of changes to the proposals contained in it. These changes are reflected in IFRS 15, and address a number of the concerns expressed by ACCA, as above. The main amendments made by the IASB can be summarised as follows.

- There are now broader indicators for identifying a performance obligation, which should offer a reporting entity a greater opportunity for recognising revenue in accordance with the underlying economic substance of the contract.
- There is greater clarity on when transfers of goods or services made over a period of time count as a single performance obligation. A similar clarification is also provided in respect of the sale of licences.
- Impairment losses will no longer be presented adjacent to the revenue figure in the profit or loss account. They will instead be disclosed in the notes to the financial statements.
- Variable consideration will be recognised at the amount whose receipt is 'highly probable' rather than 'reasonably assured'. The former term is considered more precise for the purposes of avoiding an overstatement of revenue, or the premature recognition of revenue.
- The sales consideration will now only be adjusted for the effects of the time value of money when the seller or customer is receiving a significant benefit from the financing element included within the consideration.
- The proposed additional disclosure requirements in interim financial statements have now been greatly reduced.
- The requirement to test for onerous performance obligations is removed. This change recognises that entities usually assess profitability at the level of the contract, thereby taking all the contract's performance obligations into account.

Other points on IFRS 15

IFRS 15 was issued on 28 May 2014. To give preparers time to adopt it, it will be effective for accounting periods starting on or after 1 January 2017. As is common with IFRSs, earlier application of the Standard is permitted.

The IASB hopes that IFRS 15 will cover a wider range of revenue-generating contracts with customers than its previous Standards on revenue recognition, and will provide additional guidance as well as disclosures that are more relevant than before.

The convergence process between the IASB and the FASB has resulted in a Standard which is longer than the IASB Standards and Interpretations that it replaces, but is shorter than the US Generally Accepted Accounting Practice (GAAP), which it supersedes. This appears to be a promising start: IFRS 15 is intended to address concerns that the IASB's previous requirements lacked detail (resulting in the diversity in practice of preparers). On the other hand, US GAAP on revenue recognition had grown to the extent that it was widely viewed as unduly complex.

CONCLUDING THOUGHTS

Any major proposal on revenue recognition will have a noticeable impact on one of the most examined and discussed areas of the financial statements. Overall, ACCA is encouraged by the extent to which views have been sought and are reflected in the changes made between the 2010 and 2011 EDs, and thereafter. As a result, it does appear that the IASB and FASB's consultation process has resulted in a mainly appropriate and more up-to-date Financial Reporting Standard.

Shortly after the issue of IFRS 15, the IASB and the FASB announced the formation of a Transition Resource Group (TRG), which will work with them to consider issues raised concerning the implementation of the Standard. The regular TRG meetings scheduled for 2014 and 2015 should provide an opportunity for practical difficulties to be resolved in good time before the implementation date of IFRS 15, and with still some time before the earlier period, during 2016, when comparative information will be established.

The ACCA Global Forum for Corporate Reporting believes that IFRS 15 is likely to affect certain industries more than others, although the Standard's actual impact will only become fully apparent as it is implemented. Consequently, the Forum welcomes the input of the TRG to assist in identifying issues ahead of the first routine Post-implementation Review (PiR) of IFRS 15.

The IASB now undertakes a PiR once each new or revised IFRS has been in operation for two years. The PiR provides a formal mechanism for interested parties such as ACCA to submit comments based on members' experiences, so that the IASB can be made aware of how a Standard has been working in practice, and receive any suggestions for improvements. Where appropriate, ACCA could also raise issues sooner with the TRG or the IASB, before the start of the formal PiR process.

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