

# Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas.



## Revenue recognition - how will the changes impact your business?

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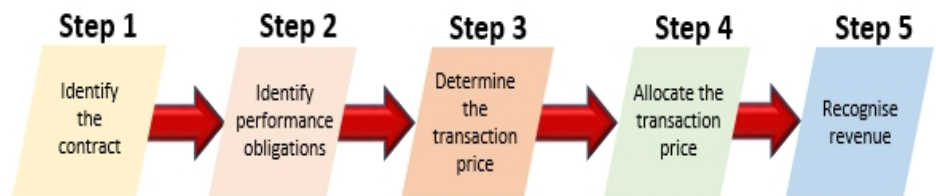
Revenue is a key financial statement metric for assessing past financial performance and future prospects. Changes have arrived to when and how much revenue a company will recognise. The IASB and FASB (the Boards) have published a new joint standard on revenue recognition, IFRS 15 *Revenue from Contracts with Customers*, which is effective for all entities reporting under IFRS and US GAAP from 1 January 2017. The new standard brings together the core principles for revenue recognition to be applied by all sectors in one place – there will no longer be specific industry guidance. The new standard will affect individual sectors and companies differently, depending on customary business practices and negotiated terms and conditions.

The most highly impacted sectors are likely to be:

- Aerospace and defence
- Construction
- Licensors (life and science media)
- Real estate
- Software
- Telecommunications

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Under IFRS 15, entities will apply a five-step model to determine how to recognise revenue:



Certain aspects of applying the new standard will require more judgment, consequently implementation and application are expected to be complex. Below we highlight these more judgemental aspects of the new revenue standard and discuss how they may impact certain sectors:

#### *Distinct good or service (within Step 2)*

For every contract with a customer, entities identify each promise to deliver a good or provide a service. A promise is a performance obligation if the promised good or service is distinct. A good or service is distinct from other goods and services in the contract, if:

- the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer; and
- the promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Examples of goods and services that are being assessed as to whether they can be accounted for as a single performance obligation and the questions entities are asking include:

- Licensors (life science) – in a contract for the licence of intellectual property (IP) and the provision of subsequent development services relating to the IP, can the development service be separated from the licence of the IP?
- Software – in a contract for a software license with post-delivery service support (e.g. upgrades, enhancements and maintenance), can post-delivery service support be separated?
- Telecommunications – in a contract for a mobile phone and data, does the mobile phone have utility without the data service?

As the amount and timing of revenue recognition are determined for each performance obligation – the identification of performance obligations will be crucial to when and how much revenue an entity recognises and could result in revenue being recognised differently under the new standard.

#### *Variable consideration (within Step 3)*

If the consideration promised in a contract includes a variable element such as discounts, rebates, refunds, rights of return, credit, price concessions, incentives, then the entity estimates the amount of consideration to which it expects to be entitled. The new standard introduces a revenue constraint. The constraint is that the variable amount of consideration is only included in the transaction price to the extent that it is *highly probable* that a significant reversal of the cumulative revenue amount will not occur when the uncertainty is resolved.



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The industries below often include significant variable elements in their contracts:

- Aerospace and defence – performance bonuses, penalties, subsequent downward price renegotiations, awards and incentive fees for successful outcome or completion by a specific date;
- Construction – contract variations and claims;
- Licensor (life science) – payments for successfully passing a research phase or meeting certain milestones, royalties;
- Licensors (media) – percentage of advertising revenue, royalties;
- Real estate / property management – performance bonuses, rental guarantees, profit sharing arrangements relating to the subsequent sale of real estate; and
- Software – price concessions offered such that the full contracted price is not collected.

An exception to the general requirements for variable consideration applies to sales- or usage-based royalties from the licensing of IP. Sales- or usage-based royalties from IP licences are recognised at the later of: the subsequent sale or usage, and the satisfaction or partial satisfaction of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.

Entities will need to consider whether there is some minimum amount of variable consideration that can be recognised even if the full amount of variable consideration cannot. As a result, some entities will recognise revenue earlier than currently allowed, as they will be able to recognise amounts before all contingencies are fully resolved, or because they earn sales- or usage-based royalties from non-IP licensing arrangements. Others will recognise revenue later due to the application of the revenue constraint.

## *Recognising Revenue (Step 5)*

An entity recognises revenue when (or as) it satisfies a performance obligation by transferring control of a good or service to a customer. If it cannot be demonstrated that a performance obligation is being satisfied over time, then an entity recognises revenue at the point in time when it has satisfied the performance obligation by transferring control of the completed good or service to a customer.

Below are some performance obligations that entities are assessing to determine the timing of revenue recognition:

- Aerospace and defence – government contracts usually require highly customised products that the government controls during the construction period (likely to be over time);
- Aerospace and defence / contract manufacturers – commercial aircraft engines that are of a standard design, where the engine remains the manufacturer's if the contract is cancelled (likely to be point in time);
- Construction – when built on the customers' site, customers will often control the assets as they are created or enhanced (likely to be over time);
- Licensors (life sciences) – right to distribute drugs (likely to be over time) compared to selling the IP relating to the drug (likely to be point in time);
- Real estate – where customers provide a deposit on an unbuilt home and land package and have no further payment obligations until completion but will forfeit the deposit if they do not buy at completion, control generally does not transfer until completion (likely to be point in time); and
- Software – licence to access the software including upgrades and maintenance (likely to be over time) compared to a license of IP where the licensed IP is not expected to change (likely to be point in time).



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Whether these contracts result in the transfer of goods or services over time will be a matter of judgment depending on the nature of the product, the contract terms and the entity's commitment to supporting the product. Small differences between otherwise similar contracts could have a fundamental impact on the timing of revenue recognition.

## *Other areas of implementation complexity*

Other judgmental areas that could result in implementation issues include:

- Contract modification – are changes in scope accounted for as part of the original contract or as a separate contract?
- Incremental costs to obtain a customer contract – should these be capitalised or expensed?
- Method for recognising revenue over time – should the output method (e.g. units produced) or the input method (e.g. costs incurred or labour hours) be used?
- Transition approach – should the retrospective or cumulative effect method be chosen?

Disclosures both on transition and ongoing will increase. In addition, judgments used in making the decisions of how revenue will be recognised, such as variable consideration, are also required to be disclosed.

## *Potential deferral of the standard's effective date*

These and many more implementation issues are being discussed, resulting in many stakeholders pushing for a delay of at least one year to the effective date. During the February 2015 meeting, the Boards indicated they will undertake outreach with stakeholders over whether to defer the effective date. The result of the outreach will be discussed by the Boards in the second quarter of 2015. After the February Board meeting, IASB member Patrick Finnegan stated, "It's pretty obvious there's going to have to be a deferral."<sup>1</sup>

Whilst a delay of the effective date of the new revenue standard to at least 1 January 2018 seems likely, entities should continue to assess the impacts of implementation for required changes to contracts, processes, systems and protocols. This is especially the case for those entities in the high impact sectors of aerospace and defence, construction, real estate, software and entities entering into licence arrangements.

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<sup>1</sup> Per [www.CFO.com](http://www.CFO.com) "IASB Member Sees Revenue Rule Delay As Inevitable" – 19 February 2015