IFRS 15 – A New Approach to Revenue Recognition

Revenue is the single largest item on the face of the income statement. It is also one of the most important indicators in measuring the performance of a business enterprise- a key determinant for benchmarking across the industry used by analysts and markets. Ensuring that businesses account and report revenues faithfully in their financial statements go a long way into lending credibility to the financial statements. A research study conducted by the Committee of Sponsoring Organisations of the Treadway Commission (COSO) in US has indicated that during the period from 1998 – 2007, 61 % of the frauds in the financial statements by public companies have been committed in terms of revenue recognition (overstatement, fictitious revenues, premature revenue recognition, etc.) out of 347 companies analysed. The importance of having proper accounting literature on measurement and disclosure of revenues can in no way be underemphasised. The previous requirements of IFRS and US GAAP were limited and needed improvement. IASB, on 28th May 2014, issued IFRS 15 – Revenues from contracts with customers. It was an outcome of years of deliberations by the standard setters towards providing a comprehensive guidance for the preparers. It was another step by the FASB and IASB towards convergence. The standard provides guidelines on the revenue recognition process. An attempt has been made in this article to go through the standard for understanding the basic framework.

Background

The International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) of the US in their efforts towards convergence first conceptualised the requirement for a joint standard on revenue recognition in 2002. The initial paper on this topic was issued by the Boards in 2008 titled "Preliminary views on revenue recognition in contracts with customers". Subsequent to this paper, an Exposure Draft on the topic "Revenue from Contracts with Customers" was issued in June 2010. Due to the importance of the topic and the far reaching implications it can have, the Boards received more than 1000 comment letters on the first exposure draft. After examination of the comments from the preparers and considering the feedback therein, the Boards significantly modified the ED and re-exposed it in June 2011. During the course of 2012 and 2013, the Boards examined the responses received on the revised ED and based on further deliberations issued the final standard in May 2014 as IFRS 15/ASU 2014-09, ASC 606 (USGAAP)– Revenues from Contracts with Customers. The new standard will be applicable for all annual periods beginning on or after 1st January 2017 for IFRS preparers and 15th December 2016 for all public companies in the US.

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The US GAAP contained exhaustive literature on revenue recognition, that was based on broad concepts and backed up by industry specific guidance and has resulted in different accounting for similar transactions across industries. On the other hand, IFRS had principles based guidance for revenues mainly based on IAS 18 *Revenues* and IAS 11 *Construction Contracts* and a few other interpretations, which was limited and failed to provide help in case of complex transactions. This, at times, made the IFRS preparers look towards US GAAP for guidance. This new standard among others aims to fulfill the gaps in both the accounting frameworks by removing the existing weaknesses, enhance comparability, improved disclosures and provide a more robust framework for addressing the issues.

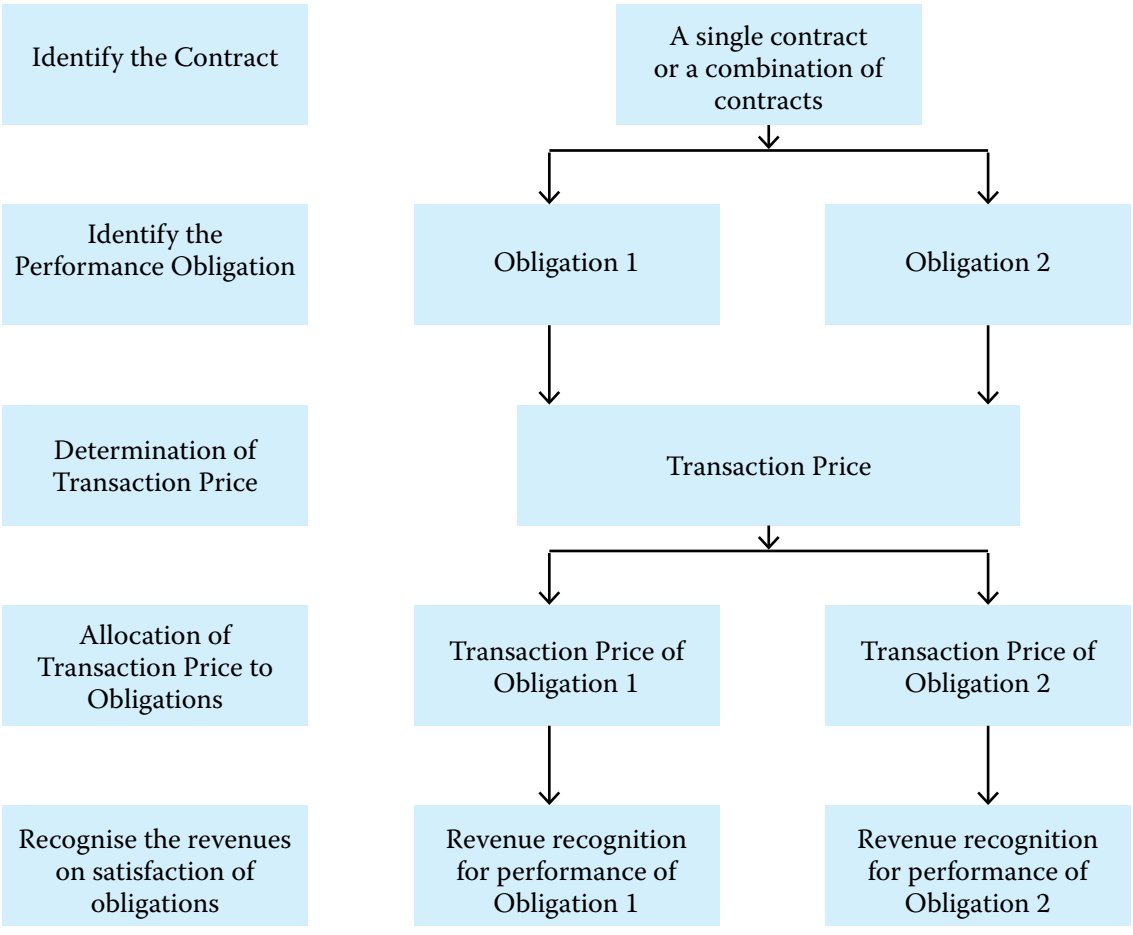
The core theme of the standard is that the entity has to recognise revenues in its financial statements to depict the transfer of goods and services to the customers at an amount that reflects the consideration to which the entity expects to be entitled in exchange for them.

The standard prescribes five core principles which the entity has to apply for the purposes of determining the amount and timing of revenue recognition:

- Identify the contract(s) with a customer.
- Identify the performance obligations in the contract.
- Determine the transaction price.
- Allocate the transaction price to the performance obligations in the contract.
- Recognise revenue when (or as) the entity satisfies a performance obligation.

The diagram below presents the five step model of the new standard:

Five Step Model of Revenue Recognition



Identify the Contract

The standard shall be applied when there is a contract with the customer. There is no specification that the contracts must be in writing. Even oral agreements constitute a contract if it is based on the entity's business practice. The current IAS 18 is silent on oral contracts; this may result in some entities being able to record revenues early as the obligations are discharged rather than waiting for signed documentation. The rights of the parties to the deliverables should be identified and the contract should also have commercial substance, *i.e.* they should be transferring risks and cash flows are expected to occur. It is not required that the transaction price has to be specified in the contract, as long as the entity has the right to receive the payment and contract has some clauses based on which transaction price can be calculated, revenue can be accrued. It provides more guidance on evaluation of contracts for combining those which are entered and negotiated around the same time period and account them as a single contract for the purpose of accounting if certain criteria are met. Finally, it should be probable that the entity will collect the consideration to which it is entitled.

Let's analyse each of the above five points which the standard specifies with the help of the below example:

Example: On 1st February 2015, an ATM manufacturer enters into a transaction for installation and maintenance of ATMs for a banking company. The vendor will provide and install the machines in one month and provide AMC support for a period of 3 years from March 2015 to February 2018. Only the manufacturer can install the machine and no other vendor will do a standalone installation service, as after installation special software has to be loaded to make the machine work. On installation, the bank also enters into an agreement with the vendor in March 2015 to stock the machine with relevant cash at regular intervals on a daily basis so that the machine operates as per the standards set by the bank. The agreement consideration is set at ₹45 crore, for 100 ATMs to be installed and AMC for 3 years. The cost of each ATM is ₹20 lakh for the machine of given specifications which is also available from other manufacturers. The vendor also provides AMC for the ATMs independent of the sale contract at ₹50,000 per machine per month. As per the contract for cash supply, the bank enters into an agreement for an amount of ₹15 crore for a period of 3 years. There are numerous security agencies that load cash and ensure running of the ATM at ₹1 lakh per machine per month.

The new standard provides more detailed guidance on combination of contracts than the earlier IAS 18. It is possible that contracts which are not currently combined may be required to be combined in the future. Even separate contracts with related parties of the customers may need to be combined based on facts of the agreements.

Here, there are two contracts between the bank and the vendor:

1. Supply of Machines and AMC–entered in February 2015
2. Maintenance of cash for use by the bank's customers-entered in March 2015.

Though there are two contracts, they are entered around the same time. It appears that both are interconnected, as the purpose of setting up ATM would be to subsequently operate them for cash dispensing, the objective being running of the ATM, and it is reasonable to assume that they are negotiated as a single package to avail the benefits of big ticket deals, though for some reason they have been made into two agreements could be due to legal or tax considerations. Given these facts, the two contracts may be bundled and considered as a single contract for accounting. The new standard provides more detailed guidance on combination of contracts than the earlier IAS 18. It is possible that contracts which are not currently combined may be required to be combined in the future. Even separate contracts with related parties of the customers may need to be combined based on facts of the agreements.

Identify the Performance Obligations

The entity must identify each promise in the contract to deliver the goods or service to the customer. Each promise is a performance obligation if the goods or service are distinct. Distinct means that the customer can benefit from the goods or service on their own or along with other goods/services available readily to the customer and the promise can be separately identifiable. The contract has to be analysed carefully to identify these

obligations and entities have to document reasons thereof where material. Problems in identification of the obligations can cause challenges for large contracts in industries like defence equipment or aerospace as the amounts will be significant.

A performance obligation is distinct only if the entity sells the goods separately or customer can use the goods as is or without significant effort in getting the benefit from the goods or services contained in the promise. A good indicator will be to check if there are other vendors who can provide services or goods which can be used along with the goods received as a part of this contract to get the desired benefits.

Taking our example of the ATM company contract, we can see that there are four tasks:

1. Sale of ATM machines
2. Installation of machines at the premises specified by the bank
3. AMC for 3 Years
4. Cash maintenance for running the ATMs

The first question that arises is which of these goods/services are distinct from each other so as to constitute performance obligations.

Sale of ATM machines can be considered as performance obligation, however we see that the bank cannot use the ATMs without installation and the installation cannot be done by any other vendor except for the manufacturer. Hence, both the supply and installation of the machine are to be bundled as a single obligation and cannot be considered distinct from each other. Once the installation is done, there are vendors in the market who can provide the AMC and also cash maintenance services. So, the bank can use these services from other vendors as well once the machines are installed. As these services are provided on standalone basis by other vendors, they can constitute separate performance obligations. Hence in the given contract, we have three performance obligations from four activities.

Identification of performance obligations appropriately is a key step as once they are identified, the transaction price has to be allocated to these obligations and revenue is recognised as they are satisfied (at a point in time or over a period of time).

Determine the Transaction Price

The transaction price constitutes the consideration which an entity expects to receive for transferring promised goods or services to the customer excluding amounts collected for third parties, like sales taxes, VAT, *etc.* The consideration may be variable or fixed as per the terms of the contract. In case of variable consideration, an estimate of the transaction price can be arrived based on either the sum of weighted probabilities or the most likely amount which best depicts the consideration which the entity will be entitled to. Variability can be a result of many factors such as rights to return, refunds, discounts, rebates or even contingencies like performance bonuses, *etc.* Fixed consideration can generally be inferred based on the contract terms.

Normally, the transaction price is easier to determine when the consideration is fixed. However, there may be cases where contract contains elements like non-cash considerations, financing elements, consideration payable by the vendor to the customer, *etc.* which will complicate the estimation process.

Example: Company A enters into a contract with Company B to develop software in 3 months' time for ₹10 lakh. As company B urgently needs the software it promises that it will pay ₹15 lakh if the software is developed in 1 month and ₹12 lakh if in 2 months and the agreed contract price if it is done in 3 months based on A's experience in similar contracts in the past.

This is a case of variable consideration wherein the company needs to identify the probabilities to arrive at the transaction price.

Transaction Price	1 Month	2 Months	3 Months
Probability	25%	40%	35%
Cumulative Prob	25%	65%	100%
Consideration	15 lakh	12 lakh	10 lakh
Weighted Trans Price	3.75 lakh	4.8 lakh	3.5 lakh

Using the probability weighted estimate, the transaction price will be ₹12.05 lakh (3.75+4.8+3.5).

If Company A uses the most likely outcome approach, the transaction price will be ₹12 lakh which is the consideration with 40% probability

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being the most likely determined by the company. However, this approach is better to apply when there are only two outcomes. In case of multiple outcomes, weighted method appears better and more scientific.

Under the earlier IAS 18, the entity would have taken an amount of ₹10 lakh being the assured price as the transaction value and defer the additional amounts based on early performance till the time uncertainty is resolved, in this case till the software is developed and then recognise the additional consideration based on which it gets. From the new method of determination of transaction price, it appears that entities will be able to record revenues based on variable consideration sooner based on facts on hand.

Coming to the example of the ATM manufacturer which is more based on the fixed consideration and has no variable elements in the contract, the transaction price is initially determined by adding the consideration mentioned in different contracts. The total transaction price comes as below (ignoring discounting):

Particulars	Amount(₹)
Supply, Installation & AMC of ATMs	45 crore
Cash Management	15 crore
Total Transaction Price	60 crore

Allocation of Transaction Price to Performance Obligations

The performance obligations that are determined have to be allotted transaction price so that the revenue recognition can be done by the entity as it satisfies those obligations. The exercise has to be done based on the stand alone selling prices of the performance obligations. This allocation can sometimes be complex as, those prices may not be available at all times as the entity or any other third party may not normally sell them separately in the market, in such cases this price has to be estimated. The standard prescribes three methods for calculation, including the cost plus margin method.

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Looking at our example of ATM Vendor, the value attributable to each of the performance obligations is determined as:

Performance Obligations	No's	Stand Alone Price/ ATM	₹ lakh	%	Transaction Price (lakh)
ATM & Installation	100	20 lakh	2,000	27	1,620
AMC support	100	18 (0.5 lakh * 12M* 3Yrs)	1,800	24	1.440
Cash Operations	100	36(1 lakh * 12M* 3Yrs)	3,600	49	2,940
Total			**7,400**	**100**	**6,000**

The total contract value is ₹60 crore (₹45 crore Supply & AMC + ₹15 crore Cash Operations); this is the total consideration which the vendor reasonably expects to receive. This is broken down based on the stand alone prices. (ATM Installation and AMC support values are based on what the vendor normally sells in the market individually and cash operations are based on prices in the market offered by security agencies for the job). The consideration is allocated in the same ratio as the standalone prices of each obligation as they bear to the total of all the individual standalone prices, normally referred to as the relative standalone price basis.

The current IAS 18 is silent as to the method of allocation of the contract value in case of multiple deliverables, though there is some mention of this in IFRIC 13-'Customer Loyalty Programmes', which mentions allocation using fair value method and residual method. The revised standard prescribes the methodology for allocation, which is in line with the current US GAAP guidance on multiple deliverables codified in ASC 605-25.

In cases where stand-alone prices are not available due to the specialised nature of the goods or services, either of the methods like the cost plus margin or adjusted market approach can be used. The former can be calculated based on the cost

information available with the entity and the profit margin it anticipates. The latter is more based on information available from the market price trends and the customer behavioural patterns. The price arrived in both of these cases cannot be significantly different as this may indicate excess allocation of transaction price to an obligation. The final method prescribed by the standard is "the residual method" which will be the balance amount attributable to an obligation if we have arrived at the prices of other obligations. This can be used only based on satisfaction of conditions laid in the standard.

Recognise Revenue on Satisfaction of Performance Obligations

As per the standard, revenue is to be recognised when the entity transfers the promised goods/ services to the customer. It mentions that transfer is done when the customer obtains control over the goods or service. Transfer mechanism happens in two ways as below:

1. Over time-normally associated with services.
2. At a point in time-normally associated with goods or one time service.

Obligations are satisfied over time: If the customer receives and consumes the benefit of the goods/ services or an asset is created gradually which is controlled by the customer or the entity has the right to performance till date. Revenue in this case is recognised over the time either based on input or output measures.

Considering the same example of ATM manufacturing company, the obligations of AMC and cash operations are continuously carried by the vendor and consumed by the company over a period of 3 years and hence they are satisfied "over time". The revenue for these obligations has to be accrued evenly over the contract term. As there will be no output measures in this case, the input measure will be time period and the transaction price is straight-lined over the period of 36 months. The measure will change in case the transaction price is a function of the number of service calls attended or amount of cash loaded.

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Obligations are satisfied at a point in time: This is residuary; if an obligation is not satisfied over time, then it is done at a point in time. Normally in case of goods when the customer has title to the goods and physical possession is transferred to the customer thus, taking the risks and rewards associated therewith, the vendor gets right to payment for the obligation satisfied.

In the case of ATM vendor in the example above, this point in time will be when the vendor has delivered the machines and installed them at the premises specified by the bank in running condition. Based on the terms of the contract, the vendor will have a right as and when each ATM is installed up and starts running.

Disclosures

IFRS 15 has enhanced the disclosure requirements in respect of revenues. Both qualitative and quantitative disclosures have been added broadly as below:

1. Disaggregation of revenues as to the nature, timing and uncertainty associated.
2. Details on the balances on contract assets, liabilities and receivables, both the opening and closing amounts with explanation of significant changes.
3. Mode of satisfying the performance obligations, obligations on returns, refunds, warranties, *etc*. Transaction price allocated to remaining performance obligations at the end of the period.
4. Significant judgements made on timing, variable consideration, costs capitalised in respect of contracts and methods of satisfaction, *etc.*

Conclusion

The new standard which comes in after five years from the initial concept paper, supersedes all the existing revenue related literature contained in IAS 18- Revenue, IAS 11- Construction Contracts, 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. IFRS 15 also enhances the disclosure requirements previously uncalled for. While permitting early adoption, it goes a long way in providing in-depth guidance on matters which were silent under the earlier IAS 18; it is a step towards convergence with US GAAP. ■