Revenue recognition: finally, a Standard approach for all

Patricia McConnell, a member of the IASB, provides her perspectives on the new accounting requirements for revenue recognition.

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On 28 May 2014, after extensive consultation and deliberations spanning several years, the IASB and the US Financial Accounting Standards Board (FASB) jointly issued converged accounting standards on the recognition of revenue from contracts with customers. The IASB's standard is known as IFRS 15 *Revenue from Contracts with Customers* (IFRS 15).

With revenue as the 'top line' metric that is crucial to many investment decisions, the issuance of IFRS 15 is a significant milestone in financial reporting. Not only will IFRS 15 lead to better alignment between a company's revenue and performance, but it will also provide a one-stop shop for revenue accounting for companies that use IFRS and US GAAP, regardless of which sectors or capital markets they operate in. This, in turn, will help investors in their analysis and comparison of these companies.

IFRS 15 is required to be applied to annual reporting periods beginning on or after 1 January 2017. Although 2017 is still a few reporting cycles away, there are two main reasons why investors should learn about the requirements before then:

- Companies can start applying IFRS 15 before 2017.
- In financial statements issued prior to adopting IFRS 15, companies are required to disclose information about the possible impact IFRS 15 will have on their results.

Investors should pay particular attention to a company's choice of transition method. While either transition method will provide investors with trend information, that information will differ depending on the transition method selected.

What will change?

Weaknesses and inconsistencies in existing revenue guidance often lead to different accounting for economically similar transactions. Existing IFRS has limited revenue guidance that is often difficult to apply to complex transactions and existing US GAAP has numerous sector- and transaction-specific requirements on revenue that produce inconsistent revenue recognition outcomes. In contrast, the new requirements specify a robust and comprehensive framework for recognising revenue that applies consistently to all contracts for goods or services[1]. The effect that those changes have on the amount and timing of revenue recognition will differ depending on the company, the transaction, the sector and the jurisdiction. In some cases, there will be no change to the amount and timing of revenue recognition. In other cases, there will be changes and those changes could be significant. For example:

- Revenue has not always been recognised for subsequent services such as extended warranties that are promised in addition to the good that is delivered to the customer.
- There has been uncertainty about whether, for some construction or production contracts, revenue should be recognised as the construction or production occurs or when construction or production is complete.
- For the sale of software, some practices have resulted in delaying revenue recognition when an item of software is sold with the promise of subsequent updates or additional functionality that is not sold separately.

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Sectors most likely to be affected

Because of the diversity in practice that exists today, the IASB cannot definitively explain the extent to which IFRS 15 might affect the amount and timing of revenue recognition after the Standard is implemented. As mentioned, the practical effect of IFRS 15 will depend on the company, the transaction, the sector and the jurisdiction. For that reason, investors should take the time to:

- understand IFRS 15;
- consider how it applies to the companies they follow, taking into account the types of contracts those companies enter into; and
- review companies' disclosures provided in financial statements prior to adopting IFRS 15 for information relevant to assessing the possible impact of IFRS 15 upon adoption.

In addition, as more companies begin to consider the effects of IFRS 15, the IASB investor education team will begin to develop more detailed and specific materials about the effects of the new Standard.

Described in further detail below, telecommunications and residential real estate developments are two of the sectors that are expected to be particularly affected by IFRS 15.

Telecommunications

When a contract provides a customer with both a mobile phone and network services, widespread existing practice is to recognise revenue on the sale of the phone only up to the amount of cash received from the customer at that time. Consequently, if the customer was provided

[1] Note that some contracts (eg lease contracts, insurance contracts and financial instruments) are within the scope of other accounting Standards.

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with a 'free' phone, no revenue would be recognised at that time even though the customer pays for the phone as part of the monthly payments under the contract.

In contrast, IFRS 15 recognises revenue from this transaction on a basis that provides a more faithful depiction of the company's performance. This is achieved by IFRS 15 requiring a company to allocate the transaction price—which would be the amount that the customer pays on entering into the contract and the monthly payments for the network services—to the mobile phone and the network services on the basis of the relative stand-alone selling prices of each item. Consequently, some revenue will be recognised when the handset transfers to the customer (even if the handset is marketed as 'free') and the remaining revenue will be recognised when the network services are provided. As a result, IFRS 15 ensures that, in accounting for these contracts, the amount and timing of revenue recognition will be the same regardless of payment terms (ignoring the time value of money).

For more detail about these effects see the June 2010 Investor Perspectives article by IASB member Stephen Cooper.

Residential real estate

Because of a lack of clear and comprehensive guidance, some companies that sell residential real estate in multi-unit developments have had difficulty with applying existing IFRS revenue requirements to the construction of real estate. In particular, those companies have had difficulty with determining whether the construction of such assets should be accounted for as a service (and, hence, revenue is recognised over time) or as the sale of a good that occurs when construction is complete (and, hence, revenue is recognised at that point in time). IFRS 15, however, specifies a clear and objective basis for assessing whether revenue should be recognised at a point in time or over time—consequently, companies in this sector are more likely to apply IFRS 15 early.

Disclosure requirements

Compared with existing guidance, the disclosure requirements in IFRS 15 have clearer objectives and provide more comprehensive information about a company's revenue.

One of the Board's main objectives during the Revenue project was to improve disclosure requirements to provide more useful information to investors. To help achieve this objective, the Board held many discussions with these stakeholders. In general, investors asked for better disclosures about revenue and how revenue relates to other information in the financial statements. In addition, because of the polarised views that preparers and investors held with regard to the level of disclosure that is appropriate, the Board held several workshops in which both parties discussed the proposed requirements together. These discussions proved helpful in informing the Board's redeliberations and ultimately, the final Standard.

Compared with existing guidance, the disclosure requirements in IFRS 15 have clearer objectives and will improve the disclosure of information about a company's revenue. This cohesive set of requirements will better explain the relationship between revenue and other line items in the financial statements by requiring:

- a disaggregation of revenue into meaningful categories (eg type of good or service, geographical regions);
- information about a company's rights to consideration and obligations to transfer goods or services (known in IFRS 15 as contract assets and contract liabilities, respectively) and when those rights and obligations convert to revenue, and, the reasons for changes in those balances during the period;
- quantitative or qualitative information about when remaining performance obligations (a metric similar to some 'backlog' disclosures) are typically satisfied and the amount of the transaction price that is allocated to remaining performance obligations in the contract; and
- more information about the estimates and judgements a company makes in determining the amount and timing of revenue recognition—for example judgements made about the timing of the satisfaction of performance obligations, or methods, inputs and/or assumptions used when determining the transaction price.

Transition guidance

To preserve trend information in the financial statements, the Board decided to require IFRS 15 to be applied retrospectively. This means that, as well as applying to any new contracts, IFRS 15 also applies to any 'open' existing contracts as if IFRS 15 had always applied to them.

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Companies can make the transition to IFRS 15 in one of two ways:

a) Retrospectively (with some practical expedients) with adjustments on transition made to the opening balances of the earliest comparative period presented. For companies that use this transition method, all contracts would have to be restated (if necessary).
b) Retrospectively with adjustments made to the appropriate opening balances of the current period (that is, the first period in which IFRS 15 is applied) upon transition. For companies that use this transition method, contracts that were determined to be complete using previous revenue guidance would not need to be restated. However, to preserve trend information, existing and new contracts would have to be presented under previous requirements in the footnotes in the year of initial application, and a company must disclose the effects of applying the new requirements on specific line items.

We believe that the development of a more comprehensive framework for recognising revenue in IFRS 15 will result in better information for you and your analyses going forward.

The following diagram illustrates how revenue information will be presented under each approach.

		PY2 (2015)	PY1 (2016)		CY (2017)	CY footnotes
Retrospective (with optional practical expedients)	Cumulative catch-up	Contracts under new standard				
Cumulative effect at date of application		Contracts **not** restated		Cumulative catch-up	Existing* and new contracts under new standard	Existing and new contracts presented under legacy IFRS/US GAAP

***contracts not completed in prior years as determined under legacy revenue guidance**

Conclusion

Before IFRS 15 was issued, inconsistencies and weaknesses in accounting for revenue often resulted in different accounting for similar transactions and a pattern of revenue recognition that did not always reflect a company's performance. This led to diversity in practice and made it difficult for investors to understand a company's revenue or compare revenue with that of other companies. Although the new requirements of IFRS 15 will result in changes for some revenue transactions in some companies, the changes are necessary to achieve consistent accounting for economically similar revenue transactions.

We believe that the development of a more comprehensive framework for recognising revenue in IFRS 15 will result in better information for you and your analyses in the future.

About the author

Patricia McConnell is a member of the IASB. The views expressed in this article are those of the author and do not necessarily reflect the views of the IASB or the IFRS Foundation. The IASB/IFRS Foundation encourages its members and staff to express their individual views. This article has been developed by the author as an individual. It has not been subjected to any due process of the IASB/IFRS Foundation. Official positions of the IASB/IFRS Foundation are determined only after extensive due process.

The Project Summary and Feedback Statement for IFRS 15 is another useful document to consult for a high level overview of the project and how the Board responded to the feedback.

If you would like to discuss this topic or other areas of accounting, please contact Barbara Davidson, Investor Liaison Principal, at bdavidson@ifrs.org or Fred Nieto, CFA, Investor Education, at fnieto@ifrs.org.