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IFRS 15:
A critical disruption for businesses in 2018

Year 2018 is bound to witness a lot of critical disruptions in the financial reporting parlance. This is due to the mandatory adoption of IFRS 15 whose effective date is 1st January 2018 by companies.

The disruptions to be caused by this standard is pervasive as it will cut across almost all aspects of the business functions. In addition, a lot of companies are expected to be massively impacted. What differs across various sectors is the degree of complexities on issues to contend with and the efforts required for effective and efficient transition.

The ultimate adoption of this standard will represent a major mile stone in the convergence journey between International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) and it took about six years for both standard setting bodies to eventually agree on uniformity of existing revenue standards under US GAAP and IFRS.

The first FASB/IASB exposure draft on IFRS 15 was issued in December 2008, whereas the final standard was issued in May 2014.

Other critical standards that will cause disruptions in 2018 and beyond include: IFRS 9 on financial instruments and IFRS 16 on leases.

For instance, while companies in the IT and telecom space will be most impacted by IFRS 15 and IFRS 16, banks and others financial institutions have a lot of issues to contend with on IFRS 9.

This article particularly articulates the major highlights under IFRS 15, what changes should companies expect, the most critical impacts on different companies across each sector and what they need to do immediately to avoid any pleasant surprise that may ensue.

IFRS 15- Revenue from contracts with customers

This standard collapses all existing revenue standards into a single revenue reporting framework. Previous standards dealing with revenue include: IAS 18- Revenue, IAS 11- Construction contracts, SIC 31- Barter transactions involving advertising services, IFRIC 15- Agreements for the construction of real estate and IFRC 18 - Transfers of assets from customers.

Essentially, **IFRS 15 introduces a five-step model for revenue recognition**. These include:

- Identify the contract with customers
- Identify the performance obligations
- Determine the transaction price
- Allocation the transaction price to the performance obligations
- Recognise revenue as the entity satisfy the performance obligations

Specific topical issues addressed within the standard include but not limited to the following:

Contract modification: The is a change(s) in the scope or price (or both) of a contract that are approved by the parties to the contract. A contract modification may be treated as a separate performance obligation if: (i) it results in the creation of goods or services that are distinct and (ii) reflect their stand-alone selling price. Where the modification does not meet the above criteria, additional assessment is done to determine if the remaining goods or services are distinct from goods or services transferred on or before the date of the contract modification. If yes, there will be termination of existing contract and creation of a new contract. If no, it will form part of existing contract and treated as a single performance obligation.

Variable consideration: IFRS 15 provide more guidance on what amount should be recognized as revenue when there is likely to be a variation in the transaction price in a contract due to for example: discounts, rebates, price concessions, penalties, bonuses, incentive payments, refunds, money-back guarantees amongst others. The golden rule is to include variable consideration in transaction price only to the extent it is **'highly probable'** that a significant revenue reversal will not occur when uncertainty is subsequently resolved.

Rights of return: IFRS 15 requires that when an entity sells goods to customer under a right to return basis, it is expected to recognize revenue for the consideration to which it expects to be entitle. Therefore, for the goods the entity estimates are going to be returned, no revenue is recognized. Rather both liability and asset accounts should be set up to record the consideration the entity expects to refund and cost of sales for the right to recover products when a refund liability is settled.

Warranties: IFRS 15 have broadened the forms of warranty to include both assurance-type and service-type warranty. What distinguishes them is whether the warranty simply provides assurance that the product complies with agreed-upon specifications or whether it provides a service in addition to the assurance. While an assurance-type warranty is accounted for in accordance with the provision of IAS 37- *Provisions, Contingent Assets and Contingent* Liabilities, a service-type warranty represents a separate performance obligation and falls within the scope of IFRS 15.

Royalties/licenses: Entities are expected to assess if this forms a distinct service. If yes, it should be accounted for as a separate performance obligation in which case revenue can either be recognized over a period over or at a point in time. If no, account for the license and other promised goods or services as a single performance obligation.

Material right: These are contracts that provide customers with the option to acquire additional goods or services either for free or at a discount. IFRS 15 tend to expand the scope of coverage of items within this category. In addition to Customer Loyalty Programmes covered under IFRIC 13, IFRS 15 added items such as customer Award credits, sales incentives, contract renewal options amongst others. Provisions in the standard helps to distinguish between customer's option and marketing offers and how both should be treated. In essence, if an option provides a customer with favorable trade terms that they would not have enjoyed if they did not enter into the contract, it means that the customer is paying in advance for future goods or services. In such situation, a material right exists; and such option should be treated as a separate performance obligation.

Principal Vs Agent: IFRS 15 provides more guidance on principal vs agent relationship by providing specific indicators to watch out for. An entity acts as a principal if: (i) It is primarily responsible for fulfilling the contract (ii) It has inventory risk (iii) It has latitude to establish price (iv)It is not exposed to credit risk (v) Its consideration is not in the form of commission. In such instance, it will control the goods or service before it is transferred to the customer. Otherwise, it is an agent. This determination of whether an entity is the principal or agent is key because while the principal will recognise revenue on gross basis, the agent will recognise revenue on net basis. Significant judgement will be required to determine who controls the goods or services before the transfer to the customer.

Bill-and-hold arrangements: This is an arrangement whereby the entity bills a customer for the sale of a product, but it retains physical possession until it is transferred to the customer at a later date. The treatment of Bill-and-hold arrangement under IFRS 15 is similar to that of IAS 18 with slight modification. For revenue to be recognized, control must have been transferred to the customer at the time of billing. To assess transfer of control, the criteria to consider include: (i) The reason for the bill-and-hold arrangement must be substantive (e.g., the customer has requested the arrangement), (ii)The product must be identified separately as belonging to the customer, (iii) The product currently must be ready for physical transfer to the customer, (iv) The entity cannot have the ability to use the product or to direct it to another customer. Also, the entity needs to determine if it is providing custodial services. If so, a portion of the transaction price should be allocated to each of the separate performance obligations.

The major industries impacted and critical issues to contend with include:

1. Telecoms entities

- Capitalization of subscriber acquisition costs
- Treatment of free goods and services or options for additional goods and services for discounted prices embedded in a product bundles.
- Treatment of extended payment terms in a contract.
- Divergence between billing and accounting due to timing of revenue recognition

2. Technology and software entities

- Whether or not renewal options represent a separate performance obligation.
- Judgement on assurance-type or service-type warranty in a contract and service offering
- Analysis of Integrated solutions is necessary to identify multiple performance obligations
- Migration from Vendor-specific objective evidence (VSOE) to residual method of revenue recognition when strict criteria are fulfilled
- Assessment of financing component in a contract
- Assessment of activities of the licensor after granting the license which significantly affect the granted IP might have consequences on the timing of revenue recognition
- Determination of best pattern of allocating transaction price over performance obligations that depicts the pattern of transfer of control over time.

3. Retail and consumer products

- Distinction between Cash incentives or incentives to provide free or discounted goods as a distinct PO as supposed to mere marketing incentives.
- Judgement on assurance-type or service-type warranty in a contract and service offering
- Professional judgment involved in estimation of returns and the accounting for loyalty programs, reseller agreements and licensing and franchising agreements.

4. Media and Entertainment

- Principal vs. Agent assessment
- Detailed analysis of licensing agreements to conclude whether one or multiple performance obligations exist.
- Thorough analysis of collaboration agreements to assess whether it falls within IFRS 15.
- Treatment of free goods and services or options for additional goods and services for discounted prices embedded in a product bundles.
- Estimation of variable consideration and treatment of Sales- or usage-based royalties.

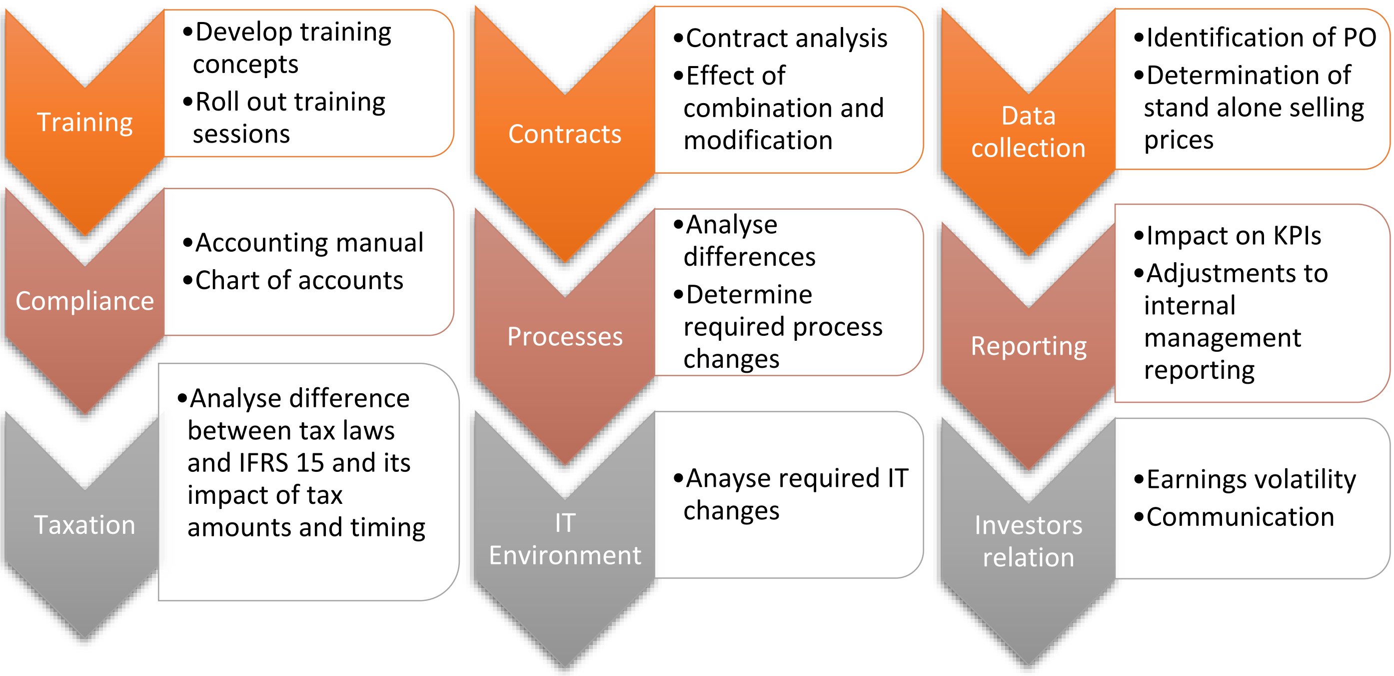
5. Real Estate, Power and Utility Entities

- Judgement evaluating contracts with fixed and stepped pricing and accounting for contract modifications
- Difficulties of leasing or development activities that are simultaneously received and consumed by the real estate owner
- Determination of the variable consideration considering a variety of factors.
- Rate-regulated entities will assess if their contracts fall within scope of IFRS 15

What must companies do in readiness for IFRS 15 adoption?

No doubt, all companies will be impacted by IFRS 15 in one way or the other. What differs across industries is the level of impacts it will have on them, complexities of accounting and process issues to contend with as well as efforts required to comply with the requirements of the new standard.

Generally, companies must consider the following in readiness for IFRS 15 whose mandatory adoption year is just around the corner.



Conclusion

As the saying goes that failing to plan is planning to fail. Given the enormous disruption to be caused by this paradigm shift in revenue recognition, companies are advised to adopt a project approach in their transition agenda to IFRS 15. The critical success factors to consider include:

- Early gathering of data for contract analysis.
- Create an enterprise wide awareness among all the stakeholder in the business.
- Develop a transition method that is scalable, robust and tailored to suite the business size and complexities of their companies.
- Develop a robust governance framework for effective implementation.

Our IFRS 15 solution suites

To support our current and prospective clients with the transition process to IFRS 15, Pedabo have developed a methodology that is robust, scalable and tailored to clients' specific needs. Specifically, we will assist in carrying out the following activities as part of the transition process:

- Contract analysis
- GAP and Impact analysis
- Identify data gaps
- Develop new revenue recognition model
- System re-design and customization
- Accounting policies and reporting updates
- Training during implementation
- Post implementation couching and supports

Ajibade Fashina
afashina@pedabo.com

Idris Adelabu
iadelabu@pedabo.com

Peter Asemah
pasemah@pedabo.com

Peter Ogbegbor
pogbegbor@pedabo.com

Samuel Bamidele
sbamidele@pedabo.com

Lagos Office:
67, Norman Williams Street
South West, Ikoyi
Lagos, Nigeria
Tel: 01-2919041
0808 820 8747
info@pedabo.com
www.pedabo.com

Abuja Office:
4th Floor, Grand Square
Mohammed Buhari Road
Central Business District,
Abuja
Tel: 09-8707692