



# Revenue reckoning: a transformational new standard

The impact of the new IFRS standard  
extends far beyond the finance function

Entities reporting under IFRS will need to make more estimates and use more judgement than under the current revenue recognition standards.

## What you need to know

- ▶ The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have issued a comprehensive new revenue recognition standard that will supersede nearly all existing revenue requirements under IFRS and US GAAP.
- ▶ The effect on entities will vary, and some may face significant changes in revenue recognition. Entities should now be assessing how they will be affected so they can prepare an implementation plan for the new standard.
- ▶ The standard is effective for annual periods beginning on or after 1 January 2017, but early adoption is permitted under IFRS.

## Overview

In May 2014, the IASB and the FASB (collectively, the Boards) jointly issued a comprehensive new revenue recognition standard, IFRS 15 *Revenue from Contracts with Customers*. It will supersede nearly all existing revenue recognition requirements under IFRS and US GAAP.

The standard's core principle is that an entity will recognise revenue when it transfers goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This will require entities to use more judgement and make more estimates than under today's revenue standards.



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The standard will apply from 1 January 2017 (or for annual and interim periods beginning after 15 December 2016 for public entities reporting under US GAAP). Early adoption is permitted under IFRS, but not for public entities reporting under US GAAP.

IFRS 15 is likely to affect the measurement, recognition and disclosure of revenue, which is typically an entity's most important financial performance indicator. It is the indicator most closely scrutinised by investors and analysts. Gaining an understanding of the effects of the new standard, providing early communication to stakeholders and advanced planning will be critical for a successful implementation.

Entities that do not expect significant changes in the measurement and timing of revenue recognition will, at the very least, need to validate their assumption. Entities will need to identify necessary changes to policies, procedures, internal controls and systems to ensure that revenue transactions are appropriately evaluated through the lens of the new model. In addition, entities will need to plan for the significantly expanded disclosure requirements.

For entities that are going to experience a significant change in revenue recognition as a result of the new standard, the implementation effort required will be considerable. Early preparation will be crucial for a smooth transition.

### The new five-step model for revenue recognition

**Step 1:** Identify the contract(s) with customers

**Step 2:** Define the performance obligations in each contract

**Step 3:** Determine the transaction price

**Step 4:** Allocate the transaction price to the performance obligations in the contract

**Step 5:** Recognise revenue when (or as) the entity satisfies a performance obligation

## Not just an accounting change

With the new standard being applicable to virtually all entities, it is not surprising that changes to the accounting for revenue could affect multiple business functions, as illustrated below.



Because of the potential wide-ranging effects of the new standard, the implementation effort should include functions outside of the finance department, including IT, legal, sales, marketing, human resources, investor relations and senior management. A number of related workstreams should be considered in this effort, including:

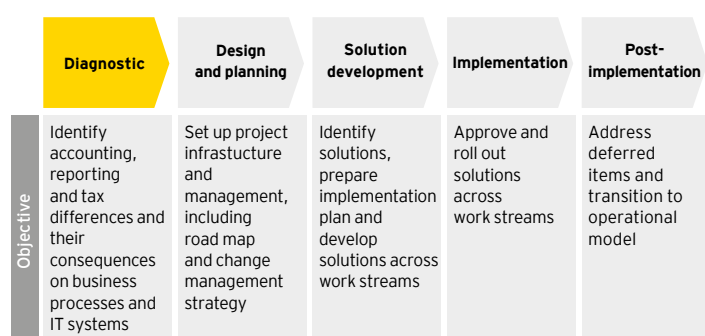
- ▶ Accounting and financial reporting
- ▶ Tax
- ▶ Business processes and systems
- ▶ Change management, communication and training

In addition, it will be critical to have strong project management in order to coordinate the roles of the various business functions and to keep the workstreams running smoothly and on schedule.

## Implementing accounting change

Adopting the new standard for the measurement and recognition of revenue may seem daunting. It is important to apply a comprehensive methodology for implementing the accounting change. Doing so will help you to adopt the standard in an organised and efficient manner that reduces risk and the possibility of costly errors and delays.

A five-phase model for implementing accounting change in entities is recommended:



In this publication, we focus on the diagnostic phase, or the starting point of the implementation process. The remaining four phases are also vital to a successful implementation; however, they are influenced significantly by an entity's specific facts and circumstances and, critically, the output from the diagnostic phase for implementing accounting change.

### Diagnostic phase

The diagnostic phase is perhaps the most critical of the five phases for implementing an accounting change because it will establish the foundation on which the remainder of the project is built. In this initial phase, an entity will need to determine the effect of the new standard on each of the entity's significant revenue streams.

#### 1. Setting the scope

To identify significant and unique revenue streams, an entity will need to look at its product and service offerings while considering the revenue recognition standards and interpretations that it applies today. Entities should also consider whether additional factors such as geography, type of contract or sales channels could affect their determination of significant and unique revenue streams.

#### 2. Determining the impact

Once the scoping is complete, an entity should apply the new standard to representative contracts within each revenue stream, while considering the related effects on systems, processes,

income taxes and change management. Please refer to our publication *Applying IFRS: A closer look at the new revenue recognition standard* (June 2014, EYG No. AU2516) for sample procedures under each workstream.

### 3. Significant judgements and estimates

During the diagnostic phase, an entity should identify the key judgements and estimates that it will be required to make under the new standard. Since the new model uses broad principles, rather than specific guidelines, it will require entities to make more estimates and judgements than under today's standards. Examples of areas requiring significant judgement include:

#### 3.1 Identifying a contract with a customer

An entity will need to evaluate whether an arrangement meets the criteria to be accounted for as a contract under the IFRS 15 model. Significant judgement will also be needed to apply the requirements for contract modifications. For example, an entity will need to determine whether a modification creates a new contract with the customer or whether it is accounted for as part of the existing contract.

#### 3.2 Identifying separate performance obligations

Identifying separate performance obligations will be a particularly challenging aspect of the new standard. An entity will have to evaluate the facts and circumstances of an arrangement, using significant judgement to determine whether to account for the promised goods and services as one or more distinct performance obligations.

For example, a warranty that provides a service to a customer beyond the assurance of a standard product warranty will be considered a service-type warranty and accounted for as a separate performance obligation. Revenue allocated to a service-type warranty will be deferred and recognised when the warranty performance obligation is satisfied. The new standard will require greater judgement in both determining whether the warranty provides a service-type warranty and in establishing the timing of revenue recognition for such warranties.

#### 3.3 Variable consideration and the constraint

The new standard will require entities to select either the 'expected value' method or the 'most likely amount' method to estimate the variable consideration within the transaction price. An entity must select the method that it believes better predicts the amount of consideration to which it will be entitled. The selected method will have to be applied consistently throughout the contract.

Once an entity determines the estimated amount of variable consideration, the constraint on variable consideration must be applied to that estimate. The constraint is aimed at preventing

the over-recognition of revenue, i.e., ensuring that it is highly probable<sup>1</sup> that a significant reversal of cumulative revenue will not occur in future periods. Entities will have to use judgement to determine whether a significant revenue reversal is highly probable, while considering both the likelihood and the magnitude of a subsequent revenue reversal.

### 3.4 Allocating the transaction price

An entity will allocate the transaction price to the performance obligations based on their relative standalone selling prices. This will require an entity to estimate the standalone selling price if it is not otherwise observable.

Making this estimation will be particularly difficult when the price is not currently observable or when goods or services are offered as incentives for the customer to purchase more from the seller.

### 3.5 Timing of revenue recognition

Under the new standard, revenue will be recognised upon satisfaction of the performance obligations. The performance obligations are satisfied when an entity transfers control of a good or service to a customer. An entity must determine whether it will transfer control of a promised good or service over time or at a point in time. The new standard provides several indicators of transfer of control. Determining the timing of transfer of control of a good or service will require judgement, particularly when the transfer of goods and services occurs over a period of time.

## 4. Diagnostic phase outputs

The diagnostic phase provides valuable insights that will serve as the foundation for the remaining implementation phases. At the conclusion of the diagnostic phase, an entity should be able to answer the following questions about its significant revenue streams under the new standard and its implementation approach:

- ▶ Will the entity apply a full retrospective or modified retrospective transition method?
- ▶ Which significant performance metrics will be affected?
- ▶ Has the entity determined what changes are required to accounting systems and processes?
- ▶ Will the entity change the way it does business with customers?
- ▶ How will IFRS 15 affect the entity's accounting policies?
- ▶ What changes to internal controls are required?
- ▶ What impact will the new standard have on taxes?

## What can you do now?

For calendar year-end entities, the new standard will be effective as from 1 January 2017. Entities electing the full retrospective transition method will be required to restate financial results for comparative periods. Early planning and preparation are vital to a successful and seamless transition.

Entities should consider the following actions now:

- ▶ Understand the magnitude of the changes to your entity from both a financial statement and business perspective
- ▶ Establish a project management team and project plan for adoption of the standard
- ▶ Determine the transition method to use in implementing the standard
- ▶ Determine training requirements for individuals responsible for the key judgements and estimates
- ▶ Identify key revenue streams, common transactions and potential implementation issues
- ▶ Establish a process for gathering needed data
- ▶ Understand how others in your sector are implementing the standard
- ▶ Monitor implementation issues being discussed by the IASB/FASB Joint Transition Resource Group for Revenue Recognition and other implementation groups

For a more complete technical discussion about IFRS 15 and its requirements, refer to the following publications available through EY's IFRS website, [www.ey.com/IFRS](http://www.ey.com/IFRS):

- ▶ IFRS Developments Issue 85: *Joint Transition Resource Group for Revenue Recognition debates implementation issues* (July 2014, EYG No. AU2535)
- ▶ *Applying IFRS: A closer look at the new revenue recognition standard* (June 2014, EYG No. AU2516)
- ▶ IFRS Developments Issue 80: *IASB and FASB issue new revenue recognition standard – IFRS 15* (May 2014, EYG No. AU2427)

<sup>1</sup> The FASB standard uses "probable," which has the same meaning as "highly probable" in IFRS.

## How EY may be able to help

EY can bring its multidisciplinary team of accounting, tax, systems and IT professionals to entities to assist in assessing the implications of the new revenue recognition standard.

The issues and steps that should be considered when adopting to the new standard, with an indication of how EY can assist entities, from the initial diagnostic through to adoption, are listed below:

Issues and steps	How EY may be able to help
Gain a general understanding of the new standard	<ul style="list-style-type: none"> <li>▶ Design and deliver training sessions for the entity's personnel</li> <li>▶ Share insights and views of the IASB, FASB and IASB/FASB Joint Transition Resource Group for Revenue Recognition and AICPA implementation groups</li> </ul>
Perform a preliminary diagnostic of the impact the new standard will have on the entity's financial statements	<p>Advise and provide input into:</p> <ul style="list-style-type: none"> <li>▶ Gathering necessary information needed to perform the diagnostic</li> <li>▶ Summarising customer contracts</li> <li>▶ Interpreting IFRS 15 and its application to customer contracts (including, identification of performance obligations, total transaction price, timing of revenue recognition and other relevant key contractual terms)</li> <li>▶ Developing a consistent methodology around judgemental areas, such as variable consideration, contract costs, warranties and the timing of revenue recognition that best depicts the transfer of goods and services</li> <li>▶ Calculating the new standard's impact on the income statement</li> <li>▶ Assessing the impact on performance and key financial ratios, such as gross margin</li> <li>▶ Identifying shortfalls or gaps in the information necessary to adopt the standard, especially relating to the additional disclosure requirements</li> <li>▶ Developing a process for monitoring performance obligations, estimates of variable consideration, measures of progress and costs incurred, and the impact to the financial statements</li> </ul>
Benchmark the entity against peers and others in its industry	<ul style="list-style-type: none"> <li>▶ Provide observations of how others are approaching the new standard, problems they encountered and solutions that have been developed</li> <li>▶ Assist in the evaluation of peers, competitors and industry disclosures and the expected impact of the new standard on their financial reporting</li> </ul>
Assess processes for data collection, internal controls, IT systems	<ul style="list-style-type: none"> <li>▶ Provide observations and insights on leading practices in how entities design their business processes, IT systems and internal controls in response to the new requirements</li> </ul>
Assess tax positions relating to the new standard	<ul style="list-style-type: none"> <li>▶ Advise on analysing tax positions arising from adopting the new standard, reducing tax exposure and determining tax effects of the new revenue recognition model</li> </ul>
Plan for the ultimate adoption of the new standard	<ul style="list-style-type: none"> <li>▶ Advise on project management and planning, including timeline, tasks and resource allocation</li> </ul>
Update accounting manuals and accounting policies	<ul style="list-style-type: none"> <li>▶ Read and provide input into accounting manuals and policies selected by management, and advise on drafting policies reflecting the requirements in the new standard</li> </ul>
Communicate the effect of adoption to stakeholders – analysts, regulators, and shareholders	<ul style="list-style-type: none"> <li>▶ Advise on developing a communication plan</li> <li>▶ Advise on drafting communications</li> <li>▶ Provide an analysis of the information that will be available under the new standard</li> </ul>



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**About EY's International Financial Reporting Standards Group**

A global set of accounting standards provides the global economy with one measure to assess and compare the performance of companies. For companies applying or transitioning to International Financial Reporting Standards (IFRS), authoritative and timely guidance is essential as the standards continue to change. The impact stretches beyond accounting and reporting, to key business decisions you make. We have developed extensive global resources – people and knowledge – to support our clients applying IFRS and to help our client teams. Because we understand that you need a tailored service as much as consistent methodologies, we work to give you the benefit of our deep subject matter knowledge, our broad sector experience and the latest insights from our work worldwide.

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