Revenue recognition by applying IFRS15 in financial statements

Bachelor’s thesis
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Abstract
This Bachelor’s thesis discusses the revenue recognition principles set by the new IFRS15 standard effective from 1 January 2018 onwards. The shortages found in old IAS11 and 18 standards propelled the development of the more consistent IFRS15 standard which was co-created by the IASB and FASB. The structure of this study is organized as follows. First, a short introduction of the relevance of revenue is presented, followed by the definition of revenue. Second, the content and applicability of the preceded IAS11 and IAS18 standards are analyzed as they lay the foundation for the creation of the IFRS15. The third section focuses on the new IFRS15 standard by covering its contents via the Revenue Model. The fourth section aims to enhance understanding about the standard’s application by giving concrete examples through charts and real-life cases. The fifth and final section concludes the thesis with takeover insights.

The objective of the new IFRS15 is to simplify the revenue recognition principles in the IFRS world by emphasizing transparency and consistency in financial reporting. The lack of clarity found in former IAS standards is now replaced with more principle-based rules, accounting for more difficult transactions such as licenses and warranties. The five-step model for recognizing revenue is helpful as it offers a clear path to follow at contract inception. Step one requires to identify the contract with customer. In step two, performance obligations are identified. The transaction price for the contract is determined in step three. In step 4 the transaction price is allocated to each performance obligation proportionately. Finally, revenue is recognized in step 5. Each step needs to be covered to successfully apply the IFRS15 standard.

Studies conducted retrospectively found that the difficulty in complying with the requirements of the new standard varied depending on the industry and its characteristics. Especially, the identification of performance obligations and the allocation of transaction price turned out to be more challenging than expected. Although the new standard is much more applicable to complex cases such as costs of obtaining and fulfilling a contract, it still requires plenty of serious judgment in sectors like telecommunication and construction. The former standards allowed the entity to unrecognize transactions that were not considered income. The new IFRS15, however, doesn’t allow that. All revenue needs to be recognized in an amount that depicts the consideration determined at contract inception after the control of goods or services has been transferred to the customer. Having the ability to control the use of asset and obtain its benefits is the key indicator for the entity to determine whether the risks and rewards have been transferred to the customer. Further studies also showed that compliance with the standard was better in sectors where the standard’s effect on reporting was more substantial.

Keywords Revenue recognition, IFRS15, The Revenue Model
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1. Introduction

Revenue as a concept is one of the most fundamental elements in financial statements. Its nature does not only determine the correct way to recognize but it also acts as a crucial component for any business entity that wants to be profitable. Regardless of cost-structure, no company can be lucrative without sufficient revenue streams. Revenue acts as a basis for business operations, enabling an entity to acquire and maintain resources to deliver value to both customers and other stakeholders via products and services. Therefore, appropriate recognition of revenue is vital for an economic entity to display its financial position truthfully and transparently.

The International Financial Reporting Standards (IFRS) are set by the International Accounting Standards Board (IASB) to provide principles for accounting by enhancing transparency, accountability and efficiency when comparing and analysing financial statements of different companies. More than 140 jurisdictions have allowed the use of IFRS standards and for example all EU-listed companies are obliged to apply them (IFRS, 2020). The new IFRS15 standard (Revenue from contracts with customer) was effective on 1 January 2018 and therefore, fairly little research has been done on its effect on financial statements and financial reporting. This thesis focuses on the structure of the new IFRS15 standard, its preceding standards, the application of the new standard and the impact on reporting in real-life companies. The purpose of this thesis is to provide its readers with a detailed analysis of the current revenue recognition principles in the IFRS world through theory and real-life examples.

This study is organized as follows. Section two provides a short explanation for the definition of revenue and why revenue is such a vital metric in accounting. Section three acts as the main section as it focuses on the background and theory of the new IFRS15 standard but also covers the two replaced IAS-standards: IAS11 and IAS18. Section four aims to enhance understanding by covering the effects of the standard in real-life with illustrative examples. Section five concludes the thesis with takeaway points of the new standard.
2. The definition of revenue

Since revenue is the backbone of all economic operation, it’s only wise that we understand the definition as thoroughly as possible. According to IFRS15, “revenue is income arising in the course of an entity’s ordinary activities” (Flood, 2017). Furthermore, “income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases in liabilities that result in an increase in equity other than those relating to contributions from equity participants” (Flood, 2017). Inappropriate revenue recognition does not only falsify income statements, but it also creates misinformation for owners and investors who are trying to decide whether or not they should invest in a specific company. Plenty of widely used KPIs are derived from revenue and therefore it’s extremely important that the information serving as a foundation for calculations is accurate and timely. The International Financial Reporting Standards (IFRS) and especially the new IFRS15 standard (Revenue from contracts with customer) have harmonised the revenue recognition principles and now provide an easy-to-understand framework for companies to rely on.

3. The background and theory of IFRS15

The accounting conducted in IFRS-adopted jurisdictions is more principle-based than the rules-based US GAAP (Generally Accepted Accounting Principles). With less rules, IFRS standards require more knowledge and interpretation to comply with. In the case of revenue recognition, the preceded International Accounting Standards (IAS) IAS11-Construction contracts and IAS18-Revenue didn’t provide with enough guidance for more complex transactions. There was a strong need and will for simplification and consistency regarding the revenue recognition principles. In 2002 it was decided that the new IFRS15 standard would be jointly developed by the IASB and their counterpart FASB in the US (Flood, 2017). The new standard replaced the former IAS11 and IAS18 standards as well as interpretations including IFRIC 13,15,18 and SIC-31 (Flood, 2017).
Flood (2017) provides with a list of goals of the new IFRS15 standard as presented by the IASB and FASB:

- remove inconsistencies and weaknesses in existing revenue requirements
- provide a more robust framework for addressing issues
- improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets
- provide more useful information to users of financial statements through improved disclosure requirements

3.1 IAS11- Construction contracts

The preceded IAS11 standard (Construction contracts), which was later superseded by the new IFRS15 standard, provides “requirements on the allocation of the contract revenue and contract cost to accounting periods in which construction work is performed” (IASPlus, 2020). The revenues and expenses of the contract are recognized by reference to the state of completion of the contract activity but only when the outcome of the contract can be estimated reliably. Otherwise, only to the extent of recoverable contract costs incurred (IASPlus, 2020). Originally effective on 1 January 1980, the standard was reissued in 1993 and later replaced by IFRS15 on 1 January 2018.

The IAS11 standard begins by providing an explanation for the definition of a construction contract. “A construction contract is a contract specifically negotiated for the construction of an asset or a group of interrelated assets” (IASPlus, 2020). Under IAS11, if a contract covers two or more assets, the construction of each asset should be accounted for separately if these requirements are met:

- separate proposals were submitted for each asset
- portions of the contract relating to each asset were negotiated separately
- costs and revenues of each asset can be measured

In addition, two or more contracts should be recognised as a single unit if they were negotiated together and the work is interrelated.
“If a contract gives the customer an option to order one or more additional assets, construction of each additional asset should be accounted for as a separate contract” (IASPlus, 2020). This only applies if either the additional asset differs significantly or the price of it is negotiated separately.

IAS11 requires that the revenue includes the initial contract value plus any revenue from alternations in the original contract and claims or incentive payments that are both expected to be collected and measured reliably (IASPlus, 2020). “Contract costs should include costs that relate directly to the specific contract, plus costs that are attributable to the contractor's general contracting activity to the extent that they can be reasonably allocated to the contract, plus such other costs that can be specifically charged to the customer under the terms of the contract” (IASPlus, 2020).

Based on the reliable estimation of the outcome of the construction contract, a so-called percentage of completion- method should be used to recognise the revenue and costs. This means the recognition is done in proportion to the stage of completion of contract activity. However, no profit should be recognised without a reliable estimate. In that case, “revenue should be recognised only to the extent that contract costs incurred are expected to be recoverable. Contract costs should be expensed as incurred” (IASPlus, 2020). The percentage of completion (POC) can be determined in several ways including the contract costs incurred to date in proportion to the estimated total contract costs, surveys of work performed, or completion of a physical proportion of the contract work (IASPlus, 2020). An expected loss should be recognised as an expense as soon as it’s probable.

3.2 IAS18- Revenue

IAS18, which is the second standard the new IFRS15 standard replaced, deals with revenue recognition from the sale of goods and services but it also determines the requirements for recognising interests, dividends and royalties (IASPlus, 2020).

According to the standard, “revenue is measured at the fair value of the consideration received or receivable and recognised when prescribed conditions are met” (IASPlus, 2020). IAS18 was initially issued in December 1982 and reissued again in 1993.
(IASPlus, 2020) defines revenue as “the gross inflow of economic benefits” which is the outcome of ordinary activities performed by an operating activity. “Revenue should be measured at the fair value of the consideration received or receivable” (IASPlus, 2020). An exchange for goods and services of similar nature, however, is not a transaction that creates revenue.

IASB defines recognition as transferring an item that meets the requirements of revenue to the income statement. It should meet the following criteria (IASPlus, 2020):

- there’s a probability that any future economic benefit associated with the item of revenue will flow to the entity
- the amount of revenue can be measured reliably

IAS18 outlines the requirements for recognising specific categories of revenue. In the sale of goods, all of the following criteria has to be satisfied:

- the seller has transferred to the buyer the significant risks and rewards of ownership
- the seller refrains from having neither managerial nor effective control over the goods sold
- both the amount of revenue and costs to be incurred can be measured reliably
- it is probable that the economic benefits associated with the transaction will flow to the seller

In the case of services, “revenue should be recognised by reference to the stage of completion of the transaction at the balance sheet date” (IASPlus, 2020). This means the aforementioned POC-method will be applied if the criteria listed underneath are met. If not, the revenue must be recognised only to the extent of expenses recoverable.

- both the amount of revenue and costs can be measured reliably
- it is probable that the economic benefits will flow to the seller
- the stage of completion at the balance sheet date can be measured reliably
Finally, in the case of **interests, dividends and royalties**, their recognition should be done as follows (IASPlus, 2020)

- interests by using the effective interest method as set out in IAS 39
- royalties on an accrual basis in accordance with the substance of the relevant agreement
- dividends when the shareholder's right to receive payment is established

As the two separate standards show, there was a need for clarity and simplicity in terms of applying the old IAS 11 and 18 standards in the IFRS jurisdictions. The old standards were more industry and transaction-specific and didn’t provide guidance on transactions such as warranties or licenses. The new IFRS15 standard is designed to be more principle-based and it contains less requirements to comply with. However, it leaves more room for accounting professional’s interpretation and can, therefore, take longer to implement properly (Flood, 2017).

### 3.3 The new IFRS15 standard

On 1 January 2018 onwards, the new IFRS15 standard (Revenue from contracts with customer) replaced the former IAS11 & 18 standards as well as multiple different interpretations including IFRIC13 (Customer loyalty programs), IFRIC15 (Agreements for the construction of real estate), IFRIC18 (Transfers of assets from customers) and SIC-31 (Revenue- barter transactions involving advertising services) (PKF, 2019). The IFRS15 standard provides much needed clarity and consistency to recognize revenue from the multitude of different transactions independent of industry. The preparation of financial statements is less time-consuming and more efficient since revenue recognition principles are now found under a single standard.

As previously mentioned, the IFRS15 standard defines revenue as income arising from entity’s ordinary activities. The preceded IAS18 standard contained requirements on divided and interest income which are not included in the new IFRS15. However, non-financial assets such as plant and equipment are subject to the requirements of the IFRS15 although a few exceptions exist e.g. leases and insurance contracts. The basis for the standard is “that an entity should recognise revenue to depict the transfer
of promised goods or services to the customer in an amount that reflects the consideration to which the entity expects to be entitled” (PKF, 2019). It’s also vital to understand that the standard only applies to contracts with customers which are bound with a bilateral agreement (PKF, 2019).

To provide guidance on the fundamental principles of revenue recognition, the new IFRS15 standard introduces a **Revenue Model** containing five different steps to follow at contract inception. The sequence in which the steps are taken into consideration is not specifically determined so discretion in applying the model may be used. However, all steps need to be covered to correctly apply the IFRS15 standard (PKF, 2019).

**Chart 1. The Revenue Model**
Data is retrieved from PKF International Ltd. (2019) Wiley Interpretation and Application of IFRS Standards, 20th. chapter. The design is modified.

![The Revenue Model Diagram](chart)

**Step 1- Identify the contract with customer**

The first step in the revenue model is to ensure there’s a proper contract between two parties that creates “enforceable rights and obligations” (Flood, 2017). Enforceability means that the contract is a matter of law. The enforceability varies across industries, legal jurisdictions and companies. The unique characteristics of the transferred goods or services should also be taken into consideration. If the contract does not fall under
the scope of the standard e.g. leases, no contract should be made as IFRS15 does not apply then. Flood (2017) lists the following five criteria a contract must meet:

- The contract has approval & commitment of the parties
- Rights of the parties are identifiable
- Payment terms are identifiable
- The contract has commercial substance
- Collectibility of consideration is probable

The approval of the contract may be either oral, written or based on previous business practises. The focus is on the enforceability of the contract rather than in the form. The substance over form principle is clearly seen here. For a contract to exist, substantial commitment of both parties is required, and underperformance must be compensated. Furthermore, both parties must have a bilateral right to terminate the contract under specified circumstances outlined by the contract’s termination clause (Flood, 2017). Requirements about the rights of the parties and payment terms being identifiable are fairly self-evident as no revenue is recognised if a transfer of goods or services does not occur. Likewise, the payment terms act as a basis for the estimation of the transaction price.

Commercial substance means the transaction must serve a purpose in the entity’s business. A contract has commercial substance when the risk, timing or amount of future cash flows is changed (Flood, 2017). The last requirement stands for the probability of the consideration being collectible. In other words, cash is expected to flow into the entity as a result of a transaction. The last criterion is derived from the former IAS18 standard which required similar type of “flow of economic benefits to the seller” (Flood, 2017). The IASB emphasises the importance of credit risk in assessing the collectibility of considerations. A company should monitor customer’s credit risks and liquidity to determine the grounds for the contract’s validity. If customer’s ability to pay for its received rights is seen as unstable, IFRS15 should not be applied. Reassessment about the grounds for applying the IFRS15 standard should be conducted only if there are significant changes, for example, in the customer’s ability to pay.
The IFRS15 also introduces a new way of recognizing revenue from a portfolio of contracts. An entity may apply the standard to group of contracts if the contracts are of similar type and the effects of applying the standard to a group instead of individually don’t differ significantly from each other. The combination of contracts may sometimes be required if all the following criteria are met Flood (2017):

- The entity negotiates the contracts as a package with a single commercial objective
- The amount of consideration to be paid in the contract depends on the price or performance of the other contract.
- The goods or services promised in the contracts constitute a single performance obligation

Notable points from the former IAS11 and 18 have been taken into consideration when designing the new IFRS15 standard. The first step of the Revenue Model contains requirements on the collectibility of consideration, similar to the requirements of IAS18. Although refrased in IFRS15, the message remains the same: it must be probable that economic benefits associated with the transaction will flow to the seller. Furthermore, the requirements of combining the contracts for recognition are almost identical to the requirements of the IAS11 (Construction contracts). The driving force behind combining contracts is the unified commercial objective. To sum up the first step of the revenue model, it is of great importance to carefully determine who the customer really is and if the contract should be accounted for individually or as a group (Flood, 2017).

Step 2- Identify the performance obligations in the contract

The second step in the Revenue Model explains how performance obligations should be identified. In short, a performance obligation is a promise to deliver either distinct goods or services or a series of goods or services that have a similar pattern of transfer. Identifying performance obligations is critical in determining the unit of account to which allocate the transaction price (Flood, 2017). Flood (2017) lists the requirements to follow when applying the second step at contract inception:

- identify all promised goods or services or bundle of goods or services
• identify the contract's performance obligations

Understanding both the explicit and implicit promises of delivering goods or services in the contract is vital in identifying the performance obligations. Past business practices or policies might be implicit and create a false expectation for the customer about the transaction. A constructive performance obligation like a free phone case with a purchase of a new phone is also a valid performance obligation according to the IASB though it might not seem like it. However, as long as a good or a service is transferred to the customer, it is an obligation (Flood, 2017).

Flood (2017) lists examples of promised goods and services that are clear indications of possible obligations:

• sale of goods produced by an entity
• resale of goods purchased by an entity
• resale of rights to goods or services purchased by an entity
• a contractually agreed-upon task for a customer
• arranging for another party to transfer goods or services to a customer
• licenses
• warranties

Determining the distinctiveness of an obligation is not always easy and in the case of shipping and handling the promised goods or services, an entity must decide whether the shipping and handling is accounted for as a separate obligation or not.

A distinct promise is “both capable of being distinct in itself and also distinct from other promises in the contract” (Flood, 2017). In other words, the capability stands for customer being able to benefit from the good or service by using, consuming or selling it. Being distinct from other promises in the contract, on the other hand, is based on the idea of separate risks (Flood, 2017).

It’s also possible that a series of promises are all distinct, but they share the same single purpose. The following criteria determines if they have the same pattern of transfer:
• Each distinct good or service in the series that the entity promises to transfer consecutively represents a performance obligation satisfied over time if it were accounted for separately
• The entity uses the same method of progress to measure the transfer of each distinct good or service in the same series to the customer

The interrelatedness of work described in IAS11 is also present in the second step of the Revenue Model when an entity must decide whether the promised goods and services are distinct or similar. This is to make the IFRS15 standard as coverable as possible.

Step 3- Determine the transaction price

Step 3 is critical in the revenue recognition process as it determines the ultimate amount of revenue to be recognized. The terms of the contract as well as customary business practices influence the transaction price setting. The goal, therefore, is to predict the revenue to which the entity is entitled at the end of the accounting period (Flood, 2017).

Determining the transaction price can be difficult as the amounts in the contract can be either fixed, variable or both. The following effects of transaction price setting should be taken into consideration:

• Significant financing component
• Variable consideration
• Constraining elements
• Noncash consideration
• Payable to the customer

Significant financing component is the time difference between the payment and the transfer of goods or services. However, the IFRS15 standard doesn’t require the amount of consideration to be adjusted if there’s only one year or less between the payment and the transfer. The agreed-upon payment terms could provide significant financing benefit if the entity delivers the goods to the customer before the customer
pays its consideration. When determining if a significant financing component exists, the entity should take into account all the following (Flood, 2017):

- The difference between the amount of promised consideration and the cash selling price upon transfer of the goods or services.
- The combined effects of both
  - the expected length of time between the transfer of goods or services and when the customer pays
  - the prevailing interest rates in the relevant market,

It’s also possible that there’s no significant financing component although a time difference exists. This could be due to e.g. the variability of sales-based royalties or a retention of payment if obligations are not completed. However, if significant financing component is found, a discount rate that reflects the inflation and credit risk of the financing party should be used (Flood, 2017).

Variability in the consideration is fairly common as it’s the result of both explicit and implicit contract terms. As a result, the overall entitlement to the consideration and its amount could vary. Variability in consideration could be the result of price adjustments e.g. price concessions, volume discounts or sales incentives.

If variability in consideration exists, an entity must determine its effect on the transaction price. The method to estimate the consideration, its measurement and if the consideration should be constrained, has to be determined (Flood, 2017).

There are two methods to choose from and the same method should be applied for similar contracts: either the expected value method or the most-likely amount method. The expected value method is “the sum of probability weighted amounts within a range of possible consideration amounts”. It’s best suited for a large number of contracts with similar characteristics. The most-likely amount method, on the contrary, “identifies the single most likely amount in the range of possible consideration amounts” (Flood, 2017). This is better for situations where only one or two possible outcomes exist. As revenue is such a vital metric, the entity should “apply a constraint focused on the probability of a significant reversal of cumulative revenue recognized” (Flood, 2017). The idea of applying the constraint is to avoid overstating the revenue recognized.
In the case of noncash consideration promised by the customer, fair value-method should be used to measure them. If the fair value cannot be estimated, the consideration should be measured “by reference to the standalone selling price of goods or services”. The variability of the noncash consideration should also be taken into account as the consideration might vary as a result of occurring future event (Flood, 2017).

Contracts with customer may also include considerations payable to the customer. These might be among others slotting fees for retailers, cooperative advertising agreements or coupons and rebates. If the consideration payable to the customer doesn’t relate to distinct goods or services, it should be subtracted from the transaction price (Flood, 2017).

**Step 4- Allocate the transaction price**

In the step 4 of the Revenue Model, the focus is on allocating the transaction price to each performance obligation identified in step two. This is done in proportion to the standalone selling price with few exceptions. The allocation should be done in an amount that reflects the amount of consideration the entity is expected to be entitled to (Flood, 2017).

The first part of the allocation is to determine the standalone selling price, which is the price at which a good or service would be sold separately to a customer. In the second part of the process, transaction price is allocated to each performance obligation proportionately. The standalone selling price is always decided at contract inception and cannot be updated (Flood, 2017). The standalone selling price can be observed from past business practices or estimated by using a method that reliably estimates price of goods or services as if they were sold separately. IFRS15 describes three possible methods to choose from:

- Adjusted market assessment approach
- Expected cost plus a margin approach
- Residual approach
In the adjusted market assessment- approach the focus is on the prevailing market conditions. The entity must look at the characteristics of the market in the form of trends, competitors’ prices, overall demand and demographic segments. The expected costs plus a margin- approach focuses on the costs of satisfying a performance obligation and what would be a reasonable margin for the good or service sold. Both direct and indirect costs must be included when evaluating the expected costs. The residual approach is restricted to situations where the standalone selling price is uncertain or highly variable. In these situations, the price of the goods or services is not determined yet or the same goods and services are sold at different amounts to different customers. In short, the sum of observable standalone selling prices of other goods or services in the contract is subtracted from the total transaction price. The term “residual” refers to that deduction (Flood, 2017).

The actual allocation is done at the fair value of each performance obligation. This fair value is usually indicated by the standalone selling price of goods or services. The allocation is done in proportion to the standalone price.

If a bundle of goods or services is sold at discount, the discount is allocated in proportion to the relative standalone selling prices. In case there’s variability in transaction prices, an exception to the proportional allocation- principle can be applied. The exception may include single performance obligation, a combination of obligations or distinct goods and services having variability (Flood, 2017).

**Step 5- Recognize revenue**

The last step of the Revenue Model determines the point in time in which revenue is recognized. An entity must recognize revenue when it has satisfied the performance obligations by transferring the promised goods or services to the customer and the customer has obtained the control of them (Flood, 2017). The fifth step is a major part of the Revenue Model as it simplifies the revenue recognition principles previously set by IAS11 and 18. The key point in revenue recognition according to IFRS15 is the timing of transferring the control. This new control-based model is more consistent and easier to apply than the preceding IAS-standards that emphasized the transfer of risks and rewards (Flood, 2017).
Revenue is recognized over time or point in time. Having the ability to “direct the use of the asset and obtain all of the remaining benefits of the asset” indicates the total control of the asset (Flood, 2017). To direct generally means using the asset in company’s operation and determining the users of the asset. The benefits of the asset are the potential cash flows e.g. in the form of providing services, producing goods and selling the asset obtained (Flood, 2017).

There are certain criteria to meet if performance obligations are satisfied over time. Obligation is satisfied over time if the consumer simultaneously receives and consumes the benefits while the entity performs. A recurring service like a subscription-based video streaming is a good example. Obligation is also satisfied over time if a customer controls an asset while the entity is creating it. The third possible criterion is the entity’s non-alternative use of asset and it’s right to receive the payment upon performance completed to date. Certain practical limitations or restrictions in the contract might restrict the use of asset for alternative purposes but the entity’s right to receive a payment still remains (Flood, 2017).

This implies that the entity must carefully assess the terms of the contract when determining the method of recognition.

If revenue is not recognized over time, it’s recognized point in time. Determining the timepoint in which the customer has received the control of the asset might be challenging. The customer has the right to direct and obtain the benefits of the asset when:

- Customer has a present obligation to pay
- The legal title has been transferred
- Customer has the physical possession
- Risks and rewards of the ownership have been transferred
- Customer has accepted the asset

These examples only serve as indicators to guide the entity in determining the point in time of transfer. All of them are fairly self-evident although customer accepting the asset generally means the entity has satisfied the obligations according to the contract and no adjustments have to be made (Flood, 2017).
When measuring the progress towards the satisfaction of a performance obligation, only a single method should be used consistently and applied to a single obligation. The measuring must be done at the end of each reporting period. The nature of transaction and its contents are indicative in deciding the best method for measuring progress. Output methods include the “value to the customer of the goods or services transferred, the results of the efforts expended and the direct measurement of value to the customer relative to the goods or services provided” (Flood, 2017). Measures could be contract milestones reached, time elapsed, units produced, units delivered etc. In the case of input methods, they measure inputs “relative to total inputs expected to be used” (Flood, 2017). These can include resources consumed, expended labour hours, costs incurred and so on. A cost-to-cost method is commonly used as an input method (Flood, 2017). The IFRS15 standard doesn’t include all possible methods to measure progress of satisfying obligations. Discretion should be used in determining the best method to faithfully depict the progress towards completed satisfaction.

The new IFRS15 standard also provides guidance on contract costs such as costs of obtaining a contract and costs of fulfilling a contract. This type of guidance was a missing element in the previous IAS11 and 18 standards and is now presented in its shortness in IFRS15. In short, obtaining a contract means that “an entity capitalises incremental costs to obtain a contract with a customer e.g. sales commissions if it expects to recover those costs” (KPMG, 2019). Fulfillment costs are recognized if they’re not within the scope of another standard and meet the following criteria:

- They relate directly to an existing contract or specific anticipated contract
- They generate or enhance resources of the entity that will be used to satisfy performance obligations in the future
- They are expected to be recovered

KPMG (2019) further explains the revenue recognition principles in the case of warranties and licenses. These more complex transaction issues were missing from the old IAS 18 standard and the IFRS15 provides much needed guidance on their interpretation. First, a warranty is a performance obligation if it’s distinct. The customer must have the option to purchase a product or a service with or without the warranty. Warranty is always assuring but it can also provide a service. If it only covers the product compliance, it is neither a performance obligation nor under the scope of
IFRS15. Determining the warranty’s nature is critical in allocating the transaction price correctly.

As for licenses, KPMG (2019) lists examples of intellectual property- licenses including software, patents, trademarks, films, music and franchises. It’s extremely important to distinguish whether the arrangement is a license or a service. The license has to be distinct according to the step 2 of the Revenue Model. Only then can it be a performance obligation and under the scope of the IFRS15.

It goes without saying that serious judgment and analysis is required to comply with all the five steps of the Revenue Model. Each step in the model has its own complexities and the simplicity of compliance with the standard varies across industries. However, IFRS15 seems to have successfully filled the gaps of information missing from the previous standards as the upcoming sections show.

4. The impact of IFRS15 in real life

The impact of the new IFRS15 standard on industries varied but was significant especially in telecommunication, automotive, real estate and contract manufacturing. Steps 2 (identify the performance obligations) and 4 (allocate the transaction price) were the ones causing most judgment. As an example, some telecommunication companies used to treat a handset separately from the monthly subscription as a sales incentive and only account for the monthly subscription as revenue. In IFRS15 this is no longer possible as the transaction price needs to be allocated to each performance obligation in the bundle (Deloitte, 2017).
Table 1. Allocating the transaction price in proportion to the standalone selling prices

The example provided by IASPlus (2018) illustrates how the revenue for each contract is recognized by allocating the transaction price in proportion to the standalone selling prices of the handset. The standalone selling price for the old handset is 250 and 500 for the new.

By dividing the standalone selling price of the old handset (250) by the sum of the standalone price and the total transaction price (1210) and multiplying it by the transaction price (960), the revenue on the handset for customer A is 198.

As the table suggests, proportioning the transaction price to the standalone selling prices give different percentages for the handset depending on the customer. Therefore, the portfolio approach could not be applied as significant material differences are not allowed. Applying the portfolio approach would present the recognized revenue untruthfully.

A Finnish telecommunication company Elisa presented the effects of applying the IFRS15 in their annual report release on 31 January 2019. Contracts open as of 1 January 2018 were under the scope of IFRS15 and the effects of applying the standard were 7.5 million euros as the opening balance of cumulated profits was adjusted. The
current receivables increased by 10.3 million euros in the opening balance sheet. The biggest difference for Elisa was that the sales incentives, price concessions and opening fees related to obtaining and fulfilling the fixed-term contracts with customers were taken into account in the new IFRS15. The combined effect of those was the aforementioned 7.5 million euros. The impact on annual revenue of 2018 was minimal (Elisa, 2019).

As for construction industries, the preceded IFRIC15 interpretation (Agreements for the construction of real estate) didn’t allow for revenue recognition before the completion of construction activity and handover of real estate units to the customer. IFRIC15 obliged the entity to determine whether the transaction is a good or service. Transaction of a good was to be recognized as revenue only after the risks and rewards had transferred to the customer (PWC, 2017). The new IFRS15, however, provides with the option to recognize revenue over time, based on the level of work completed each year (Deloitte, 2017). BDO (2018) demonstrates revenue recognition done over time in ship construction by using the input method. Customer A orders a ship from Company C for 2 million euros. The cost of constructing the ship is estimated at 1.5 million euros. The contract is efficient 1 January 2017 onwards. The design of the ship is specifically designed for Customer A and its construction is completed on 31 December 2017.

However, the financial year ended on 30 June 2017 and 50% of the costs of building the ship had been incurred. As the ship is designed specifically for the customer with no alternative use, the revenue is recognized over time according to the IFRS15.

Input method works the best in determining the percentage of completion accurately as the following table shows.
Table 2. Determining the percentage of completion by using the incurred costs


<table>
<thead>
<tr>
<th>Type</th>
<th>Budgeted $</th>
<th>Incurred $</th>
<th>Percentage completed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs</td>
<td>1,500,000</td>
<td>750,000</td>
<td>50% = ($750,000/$1,500,000)</td>
</tr>
<tr>
<td>Revenue</td>
<td>2,000,000</td>
<td>1,000,000</td>
<td>50% = (2,000,000 x 50%)</td>
</tr>
</tbody>
</table>

The second real-life example is from a Finnish construction company YIT. They present their accounting principles according to the IFR15 in their annual report of 2018. Many of their contracts contain variability in consideration due to performance incentives and additional fees characteristic for construction industry. This variability in transaction price is taken into consideration at contract inception and does, therefore, comply with the requirements of IFRS15. YIT updates the estimated transaction price at the end of each reporting period. They also mention the costs of fulfilling a contract being expenses related to the construction site where the site and the construction service constitute a single performance obligation. The costs of fulfilling are presented as inventory in the balance sheet. Depending on the business area, revenue is recognized either over time or point in time when the control of the asset has been transferred to the customer (YIT, 2019).

The previous real-life examples showed how little the impact of IFRS15 has been on annual turnover of various companies. Though the impact on accounting principles has varied depending on the industry, the actual monetary changes have been fairly small. Most scientific studies conducted about IFRS15 have discussed the standard’s impact on financial reporting and how revenue is recognized.

Boujelben and Fakhfakh (2019) studied the compliance with IFRS15 disclosure requirements in EU-listed companies. Their research focused on the same industries
I’ve discussed about in this thesis: construction and telecommunication. They also point out that the IFRS15 had a large impact on these specific industries as both fixed contracts and variability in consideration is common. Boujelben and Fakhfakh analyzed 22 annual reports of 2018 from listed groups in the EU and found substantial non-compliance with the disclosure requirements. They also discuss an article written by Trabelsi (2018) which showed that an early adoption of IFRS15 had a positive impact on earnings and stockholder’s equity in real estate companies in Dubai.

Boujelben and Fakhfakh discovered that all the 22 companies they analyzed adopted the IFRS15 at the beginning of 2018 and not earlier. This was due to the technical complexities in the adoption process. There were two transition options two choose from: the full retrospective method and the simplified method. “The full retrospective method consists of applying the IFRS 15 requirements to each prior reporting period presented in accordance with previous standards to adjust the comparative data” (Boujelben and Fakhfakh, 2019). The more simplified approach, on the other hand, gave the option to “recognize the cumulative effect of the IFRS 15 as an adjustment to the opening balance in equity” (Boujelben and Fakhfakh, 2019). Half of the sampled companies adopted the simplified method. Though all 22 companies reported their revenue from contracts with customers separately from other sources of revenue, information about impairment losses relating to contract assets was minimal. Non-compliance was also found in disclosing of contract balances (assets & liabilities), disaggregating the revenue and in determining the unsatisfied performance obligations.

Compliance with the disclosure requirements was better in telecom sector which Boujelben and Fakhfakh concluded might be the result of the complexity of multiple contracts that require more detailed disclosure. The more adjustments the new standard required, the better was the disclosure. Further enhancement is, therefore, required to improve the quality and quantity of disclosing.
5. Conclusion

This thesis has studied the revenue recognition principles set by the new IFRS15 standard and its effect on reporting in financial statements. Effective on 1 January 2018, the IFRS15 was co-developed by the IASB and FASB to bring consistency and transparency to the analysis of financial statements. Although certain elements were missing from the new standard including financial instruments and leases, the new IFRS15 covers areas left in darkness by the preceding IAS11 and 18 standards. Guidance on recognizing the costs of obtaining and fulfilling a contract as well as guidance on licenses and warranties was provided by the new standard. These more complex transactions are now covered by a single standard in addition to more detailed disclosure requirements.

The new IFRS15 introduced a five-step model to follow in order to appropriately recognize the revenue. The purpose of this model is to provide a framework that is easy to understand and adopt. The principle-based approach is clearly seen in the new standard as it’s less prescriptive but it requires more interpretation and judgment. Boujelben and Fakhfakh (2019) showed in their study how the overall compliance with the standard varied according to the standard’s impact on industry. Although the IFRS15 was designed to be less industry- and transaction-specific, adopting and implementing the standard turned out to be more difficult for some industries than other. Telecommunication and construction were industries that faced the most challenges and changes as these industries are characterized by the diversity of contracts and variability in consideration.

Compliance with the standard is something that needs to be substantially improved for the standard to be meaningful. Fairly little research has been carried out about the effects of the standard on different industries and that’s definitely something worth considering in the accounting world. To help in implementing the new IFRS15 standard accordingly, an IFRIC interpretation or two might be worth issuing by the IASB. This would also help in developing the standard even further.
References


