IFRS 15 Update Webinar (Transcript)

Hello, everyone. My name is Raghu, Raghu Karanamu. CFA, FRM. A few alphabets you can see at the end of my name, but just those alphabets are just for the purpose of showing how much is there for me to know rather than to tell you how much I know, because the more you learn, the more you realize how much you don't know and you have yet to master those areas.

Today we are going to talk about IFRS 15. This proposal came in about 2014 and since then, it became a sort of comprehensive landmark standard in terms of revenue from the contract in terms of customers. As for my background concern, I have been predominantly in the field of banking for the last almost close to 14 years, and been doing in terms of valuation as well as accounting standards from the point of view of valuation. To that extent, the perspectives that I'm going to glean are not as a one who's going to prepare the accounts, but as a person who's going to be the end user of the accounts. That's the whole point of it.

It means I look at it as much simplified viewpoint view as possible, number one. Number two, it also means because we will look at it from the end user point of view, as much possible, you can see all the problem areas that could arise in its implementation if there are any discrepancies in terms of conflicting views possible, for example, or if there are any conflicting views that could be used as a way to manipulate the standard, etc. Those are the areas also we would like to focus on.

However, considering the sparsity of time that we will have, not sure how much we can continue, but let's just jump right into it and see how we can understand the context of IFRS 15. We also understand what exactly is this proposal now, and what is the purpose of that proposal? What is the scope of this proposal? What are the different steps that are being proposed in terms of the 5-Step Model for revenue recognition, and we will briefly look at a very simplified illustration to understand this carefully, and also see those niggling areas that might pop up in the implementation or the understanding of the standard.

Context of IFRS 15

This will be predominantly a one-way talk in terms of getting an overview of this, sort of an extent that has very less scope for any of you to ask any questions. The context of IFRS 15 is basically this: to understand when and how can we recognize revenue. Once we understand this, we need to know, historically speaking, that is, before 2014, etc, before the change happened and the IFRS 15 came into the picture, we have multiple standards to address this question, when and how to recognize the revenue.

For example, we had IAS 18 to recognize revenue, we had IAS 11 recognize revenue exclusively from construction contracts. Or we had SIC 31, which is revenue, but for barter transactions involving advertising services. IFRIC 13, which is for customer loyalty programs, or IFRIC 15 for agreements for the construction of real estate. IFRIC 18 for transfer of assets from customers. These are all multiple standards, all of them vying for attention and each of us have to decide which standard is applicable in which context, and apply accordingly. There were occasions wherein there could be some potential conflicts from one standard said versus what the other standard was implying in some of the context. Therefore, now, what happened is, after that, the change happened in 2014, then, we have instead of all this multiple different standards, we have one standard which is called as IFRS 15, which is revenue from contracts from customers.

This is a really important point for us to understand, because this pretty much sums up everything that we know til now about the revenue recognition, and put it into one standard for most of us to understand from a simplification point of view. When is it applied from in terms of relevance? From 1 January 2018, this standard will be applied and this is not just relevant to IFRS, even as FASB is coming similarly and that means whatever we previously had all the different standards, they all give way to IFRS 15. This also means because IFRS and FASB both of them are not in the standard in their own similar way, then the convergence of IFRS and US GAAP is also happening more and more.

IFRS 15 Revenue from Contracts with Customers

Let's go a little deep into this. What does this mean in terms of scope? Scope wise, there is multiple points we need to understand when at one juncture, basically it applies to almost all the situations with customers, all the contracts with customers, except for the following. That becomes easy for us to understand, rather than list all the situations where it's applied.

Where it is **not** applicable:

- Leases
- Insurance
- All the other financial instruments which come under IAS 59, IFRS 9, 10, 11, 27, IAS 27, IAS 28, and also,
- All the non-monetary exchanges between entities within the same business, but these are not final sales, but these are to enable the final sale, so to facilitate sales. To some extent they will not be construed to be sales by themselves. Except for these, for rest, everything all the scenarios, IFRS 15 is applicable.

Complex Contracts

To understand this, there's also an exception in terms of understanding a complex contract. Even in that context, it doesn't mean IFRS 15 is not applied, but we need to know to which portion of the complex contract, IFRS 15 is applicable. For example, it means there could be a transaction, there could be a contract with the customer such that a portion of it, you can have IFRS 15 apply to that and the remaining portion some other standard apply to that.

Just to give an example, let's say there's a mortgage contract with a customer, and there's also an assistance services contract let’s say to sell some of their insurance, for example, or a maintenance contract, etc. In this context, for the mortgage by itself, we have the IFRS 9, which is applicable. The mortgage at fair value comes under IFRS 9, and the remaining value, which is assistance service contract, and everything else, comes under the attributed to the assistance services, comes under IFRS 15. This is an example of a complex contract wherein the customer will be able to understand this as one product from their point of view, but from accounting treatment point of view, we know those standards don't apply in this context.

IFRS 15 – Revenue recognition model comparison

Whenever a complex contracts are there, we need to be very careful which standard is applied to which portion of the contract. This also means just to give you a comparative picture, in the earliest standard, IAS 18, 11, etc., we had separate models for everything. Construction contracts, goods and services, etc. It was predominantly focused on risk and rewards. Therefore, it had very limited explanation or guidance on multiple element arrangements or variable considerations for revenue, or licenses, etc. They were there, but the scope was very limited, and the breadth of the explanation was also very, very less. However, enter IFRS 15. The same thing instead of having separate models, they have one single model for performance obligations.

This is a very important point. It is for all the performance obligations, it means obligations have to be ascertained and explained, and put into clear terms. This could happen either over a period of time, or at one point of time. It could either be, let's say spread over multiple periods, it could be years, or months, or quarters, etc. Or the revenue and the obligation can all happen right now at one point of time, for example. Therefore, the focus here is not necessarily only on risk and rewards, but the focus actually shifted to control. Because of focus is also on control, the element of definition is again in the hands of the two parties who have most knowledge of the situation, in this case the supplier and the customer.

Finally, there is much, much more elaborate guidance on various aspects which were not really touched upon completely or fully, and become separating all the elements, allocating the transaction price, variable consideration is given to importance, licenses, options, repurchase agreements, every single thing, as much as possible, within the gamut of this revenue recognition. Lot of importance is given and explanations are provided.

IFRS 15 Revenue from Contracts with Customers

To understand this, let us understand IFRS 15 in a more overview kind of level. It has five important steps and each step is very important for us to understand fully, just to know the five steps. The first step is to identify the contract with customer. This is an important point, because to identify the contract, we need to know whether it's an oral contract or a written contract, or any contract with modifications possible, let's say, in the future or during the course of the contract, or is it a fixed contract. Like this, we need to understand first what does the contract, that is now the basis for revenue recognition. This becomes the first step, and in fact, this also defines the concept of control as well.

Having understood this, then the second step comes when you identify the performance obligations in the contract, or what you call a (PO). What is PO? Basically, are there any performance benchmarks or standards or guarantees based on either time or stage of completion, etc.? How are they defined, and who is to agree that it is completed, etc.? Is any procedure established? Are they distinct, whether they're goods or services, etc. Are they distinctly available for us to identify? By far, this is the first seed for some sort of confusion because when you say distinct, that definition of the distinct is not provided in the standard. Therefore, there is some sort of confusion here. However, on the whole, the concept of understanding this actual rules and services that are provided, and what are the performance obligations or guarantees, milestones or benchmarks, at different stages of completion the contract, etc. They're already clearly explained.

The third step off of this is determining the transaction price, or what we call its consideration. The price, again, we need to understand is it fixed or is it variable? When is it paid, etc. After this the fourth step is to understand the allocation of the transaction price to the performance obligations in the contract. It means, is it a standalone selling prices? How is it actually going to be paid? These things we need to understand because there could be cases where you could have a kind of a compound selling price, wherein the product is not just one distinct product, it could have multiple distinct products and therefore, the price could be paid in compound but recognizing it, it could be for each aspect you need to allocate.

For example, the customer pays price for one unit as one contract, but the contract would have listed three different products or services under it. You need to allocate which product gets how much percentage of the share of the revenue allocated to it from the point of view of revenue recognition.

Finally comes the recognized revenue when, or as an entity satisfies the PO, or the performance obligations contract. It means, just because we have received the revenue, can we recognize the revenue? No. Unless we have certified with some sort of certification or some sort of understanding based on the contract, we have fulfilled the terms and contracts which were mentioned in step 2. Based on that, we recognize the revenue. Again, it could be over a period of time, or at that point of time.

Example

Once we understand this, now let's understand this with an illustration because this looks a little fuzzy. Very simplified, oversimplified illustration but that does capture the full meaning of what we want to convey, is presented here. Let us take a small company, a telephone company. It has a bundle offer. Telephone company provides to us various services. It could be data service or could be voice service, or could be combination of these two, or how, nowadays, is becoming very popular. A telecom company basically its main product is with network service uses, access to the network basically data and voice. Now that, they come by and say, "Hey, I will give you a free phone," so that there is a more temptation for the customer to stick to a company or to stick to a network provider for a duration of time.

Taking such an example of this. Let's say there's a bundle offer in which the customer will get a free phone with the contractual obligation of 12 months of fixed rental plan for the usage of the network. It means during the 12 months, the telecom company is assured of the revenue. It means the customer cannot break the contract and go. If they do, there will be such clauses which will compensate the telecom or network provider accordingly. Assuming this is a very simple plain contract with the customer, who will take this contract, there's a telecom provider, who will offer this, says, "I give you a free handset plus 12 months of service." Assuming this service and the handset is, let's say, accepted by the customer, the customer will enter into this contract. In return for this, the customer agrees to pay, let us say, $200 for 12 months. Every month, the customer will pay $200 and therefore, the total obligation of the customer is 12 multiplied by $200 which is $2,400.

This is a very simple contract in which the telecom provider is giving free handset plus 12 months of service and the customer is paying 12 months, $200 each month. While it looks very simple, now we are given additional information for example, just to make life a little more interesting, let's say that if the handset were to be separately sold, let's say that would sell for $600. If the plan service was sold separately, that would account to, let's say, $160 separately per month. Without the handset, just the phone service itself. Now how will we account for this is what we're going to see under this IFRS 15 standard.

Assuming the standard did not exist under the old standard, IAS 18, for example, no revenue is recognized for the handset because it was given free. Therefore, it becomes marketing expense. It is a different thing but marketing expense looks huge because all the handsets that were given free of course from the point of view of the revenue recognition. However, the revenue for network services is recognized as $200 multiplied by 12, therefore $2,400. This under the IAS 18, but under the IFRS 15, now let's look at it in comparison.

First, the transaction price of the TP is $2,400. Again, the calculation is very simple and obvious to us. Now let's look at the 12 months, how does it look like from the point of view of revenue recognition? If you look at it only for the first one, just look at the standalone price itself. From the performance obligations point of view, you have handset, you have network service, your service is provided over the next 12 months time, and the total value is given to us based on what the handset value plus the network service. We have recognized that the handset standalone price is about $600. Therefore, the network service, which was based on the price that was given to us here as $160, the network service is $160 multiplied by 12 comes to $1,920. Therefore, the total value assuming the standalone price for each one of them of the element of the contract, is $2,520.

You might wonder at this juncture if this is the total value, $2,520, why is the telecom company providing this total transaction at a total transaction price of $2,400? It is possible because a telecom company is getting the benefit of a lock-in customer for the next one year, that willing to forgo this price. Or they might have an agreement with the handset supplier for the slightly discounted price, whatever may be the case. Understanding that $2,400 is a price that is set by the telecom provider, now let us see how do we allocate this transaction price? We are looking at $600 handset price for the transaction price relegated as $571.40. How do we arrive at this? $600 is the face value of the handset. On a total transaction value of $2,520. But because we are charging the customer only $2,400, we recognize the proportionate revenue of $600 multiplied by $2,400 divided by $2,520.

That gives us a proportionate revenue for $600 of handset worth to be recognized at $571.40. That brings us to the next step, which is what about the network service? The network service is now valued at $1,828.60 using the same logic. That is, the total transaction price is $2,400 vis-a-vis $2,520 which is the transaction value if standalone separating, $1,920.

When you take a proportionate based on this ratio, it works out to $1,828.60. That gives us the total transaction value to be $2,400. From the point of view of revenue recognition, you recognize the $571.40 when the handset is delivered, you recognize this revenue. Therefore, that revenue is recognized immediately, the moment the customer takes the delivery of the handset. Then, over the next 12 months, $152.40 per month will be recognized as revenue as in when the month goes in terms of [inaudible 00:22:45]. Every month that passes, we recognize $152.40 and at the end of the 12 months, we will have recognized a total revenue of $1,828.60 on behalf of this contract with the customer, and therefore, the total revenue is again, $2,400.

Keep in mind very carefully, this gets a little complicated only because the revenue recognition is separate from the billing, because the billing when you're delivering the handset to the customer, you're billing $0 because for the customer, it is considered to be "free." Therefore, because the billing cycle and the billing values are different compared to the revenue recognition, to the extent it becomes a little complex, and again from the cash flow point of view, you can see how the cash flow assessed the accounting, the revenue recognition, and therefore the profit, again will be slightly different.

From the point of view of billing, the network services every month, they bill the client $200 per month as agreed to the customer. Revenue recognition, however, is different as we have just seen. This is how we recognize the revenue for the contracts with the customer under IFRS 15. This is a very important point for us to understand here, because if you can see here, this makes it more easy for us to understand, number one, and at the same time, it also gives compared to IAS 18 wherein the complete handset value was recognized as a marketing expense, this gives more intuitive awareness in terms of the revenue recognition. However, does this mean this proposal is final? No. This is still being discussed quite a lot. There are many more issues wherein we need to go for deeper level of understanding and deeper level of clarifications required, and the IFRS rule is open for discussion and comments and additions until October 2015, that is basically the next month, after which they will try to finalize the standard.

What this also means is, quite a few guidelines have been provided to us by the IFRS board in terms of understanding this, and what are those? A simple glance is given here. There are five areas where some sort of discussion and deliberation is required. Those five areas are here, that is, first one, identifying the performance obligations, second, principle versus agent considerations, third, licensing, fourth, collectability, and fifth one, measuring non-cash considerations. Therefore, to make this point very, very clear for all of us, there are very important points which we need to understand. What are those points? Are given to us very clearly here. That is, with reference to IFRS 15, the first point, the board gives a clarification as below.

This is the first one, that is, they mention to us very clearly that when you see performance obligation, goods or service or a bundle of goods and services, that is distinct. When they say distinct, this is where a lot of importance is given for us to understand this point very clearly because there is a doubt about this. Each distinct rule of service in the service that the entity promises to transfer to the customer would meet the criteria as below. This is where we need to understand what the criteria to be. Just look at the criteria for us to understand once. Here, it is this. An entity is a principle entity that controls a specified good, so the control is defining the notion of what is principle, versus what is agent. Having understood what is principle and agent, then we need the board define what is distinct and what is non-distinct. Are they all completely clumped into one?

This is the way in which, as you can see, the notion of conflict or lack of complete clarity is what making the proposal still under discussion stage and I hope with this, you are clear about five important points. One, to understand what is the relevance of the context of IFRS 15 versus all the old standards that we will use til now. We saw multiple standards.

Second, what is the scope of this IFRS 15 vis-a-vis the other standards, what it excludes, which situations it excludes, and wherein For example, I say compound or complex contract, or contract under IFRS, leases, for example, or the IFRS 9 etc. What it excludes, we have seen, I hope that is clear.

Third, what are the five different steps that are there under IFRS 15 which when we follow, we arrive at revenue recognition, under the standard. The fourth, we also saw a whole demonstration of the telecom operator on how under IAS 18, revenue would have been recognized, let's say, as $2,400 flat revenue, versus under IFRS 15, the revenue recognized and allocated proportionately to the distinct rules and services. In this case, the distinct rules was the handset for which we allocated the revenue, and the distinct service is also recognized which is the phone contract service. This is where the distinct definition is very, very important for us and we saw a little bit of clarification also from the IFRS board explanation.

Finally, having seen the illustration, we now understand, there are quite a few areas where more explanation is needed, more awareness is required. Do understand that this is not a comprehensive overview of the IFRS 15. This is just an introductory overview to ensure that once you understand this introduction, you'll be more intrigued and therefore you will be able to go and study the standard on your own and possibly attend a training wherein you will be able to learn this at much greater detail.

Contemplate in terms of how the standard can help you understand better the concept of revenue recognition and benefit from the insights that you have. If you have any more questions on this, please contact us and we will be glad to help you to understand this better. Have a good day.