Are you Ready to Change How you Account for Revenue?

09 August 2017 by Aniela Gregan

NZ IFRS 15 Revenue from Contracts with Customers is the new accounting standard that will replace existing revenue standards and pronouncements in providing guidance on how to account for revenue. The new standard is effective for annual periods from 1 January 2018 and at a minimum one comparative (1 January 2017) period would need to be presented.

Where NZ IAS 18 gave you flexibility to do so, some companies mirrored the timing of their expenses with revenue recognition. If, "cash is king", surely revenue is the queen. I have something to tell you – there's been a royal divorce – forget about the timing of your receipts and how this relates to revenue recognition. The devil is in the detail with NZ IFRS 15.

The focus of NZ IFRS 15 is very much on the agreed performance obligations in a contract – "what does the customer expect to receive" and how we satisfy those performance obligations. Whether cash is received upfront, in a pattern that reflects the supplier's costs of production, or monthly through-out a contract does not impact how we recognise revenue.

To illustrate the complexities of NZ IFRS 15, in this article we will work through key considerations for steps 1-3 of the five step framework, using a retailer as an example. Keep in mind, the changes resulting from NZ IFRS 15 are more than financial reporting related. The standard is likely to impact:

- Changes to reported KPIs;
- Potential breach of banking covenants;
- Tax implications;
- Systems impacts
- Impact on compensation and bonus plans where targets are driven from revenue KPIs

NZ IFRS 15 five step framework

STEP 1: Identify the contract with a customer

This step appears simple but in reality is likely to be otherwise.

- A contract may be written, implied or oral.
- Contracts entered into either at or near the same time, with the same customer with the same commercial objective may be required to be accounted for as one single contract and, when identifying separate performance obligations, the pool of contracts will need to be assessed.
- A contract must be approved by the parties to the contract with identified payment terms, have commercial sub-stance and be probable that the entity is able to collect the consideration for which it is entitled.

When is a contract not a contract? – when NZ IFRS 15 applies. This is a key step not to overlook.

STEP 2: Identify the performance obligations in a contract.

At the inception of a contract, the entity should identify the distinct performance obligations set out within it. This is not reassessed unless a contract is subsequently modified. Hence it is important to get this right the first time. Performance obligations may be explicit in a contract or implied through customary business practice.

A good or service is distinct if both of the following criteria are met:

The customer can benefit from the good or services on its own or in conjunction with other readily available resources; and

The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Possible impacts for those in the retail industry:

- The standard distinguishes between **warranties** that provide assurance that a product will comply with basic quality requirements; and warranties that provide an additional

service. The former continues to be treated as a cost provision, the latter will be treated as a separate service or 'performance obligation' and the consideration provided in a contract will be allocated between the product and the service warranty. In the retail industry it is common to have a combination of both types of warranties. This may require some judgement to allocate the transaction price and may result in a different accounting treatment than at present.

- **Shipping of goods**. Some entities receive payment when goods are shipped, however, it is generally understood that if there was damage to the goods in transit to the customer, the entity would rectify any damages. Judgement should be applied in considering whether to recognise a separate element of the transaction price that relates to the safe delivery of products that have been ordered.

- **Royalties paid to franchisors for the licence of intellectual property.** NZ IFRS 15 includes a specific restriction from recognising the associated revenue from usage based royalties until the usage or onward sale has eventuated, even if past precedent is an accurate estimate of the royalty to be paid.

STEP 3: Determine the transaction price

The transaction price is the amount to which an entity expects to be entitled in exchange for the transfer of goods and services. Be aware of customary business practises an entity offers that may not be contractual but expected by customers, for example ongoing project management or a return liability outside of the warranty period. The transaction price needs to be allocated to these additional goods and services.

Variable consideration should only be recognised if it is highly probable that a significant future reversal will not result when the certainty is re-estimated.

Variable consideration can arise, for example, as a result of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items.

- **Accounting for volume rebates.** Deciding how rebates should be treated in accounts required discretion and NZ IAS 18 lacked any prescriptive guidance. In 2014, Tesco famously revealed it had overstated its profit forecast for the first half of the year by £250 million, and this disclosure wiped £2 billion off its stock market value. Suppliers may make payments to retailers to have their products dis-played more prominently or for targeted advertising. The standard explicitly addresses how to account for payments made to a customer. Judgement needs to be applied in considering whether the payment is made for a separate good or service or should be a deduction from revenue.

- **Accounting for non-refundable upfront payments (i.e. gift cards, gift certificates, coffee concession cards)**. In many cases, not all customers exercise their rights under these schemes – known as 'breakage'. Previously there was limited guidance on customer loyalty programmes with significant diversity in practice. Under NZ IFRS 15, if an entity expects to benefit from breakage, the expected breakage amount should be recognised as revenue in pro-portion to the pattern of rights exercised by the customer. i.e. compare what has been delivered to what the entity still needs to deliver overall. Alternatively, revenue should be recognised when the likelihood of the customer exercising those rights is remote.

- **Accounting for laybys and any significant financing components**. If a component of a contract involves financing which may be significant, it should be accounted for as a separate performance obligation and the consideration apportioned over the multiple obligations.

THE OPPORTUNITIES

Any planned systems changes or improvement could incorporate changes for NZ IFRS 15, NZ IFRS 9 and NZ IFRS 16.

Greater visibility of the company's operations where performance obligations are disaggregated and more transparent.

Contracts may be renegotiated to achieve particular accounting outcomes and safeguard competitive advantage.

Current accounting implications

"Management are currently assessing the impact of transitioning to NZ IFRS 15"

Sound familiar? As we step closer to the transition year, regulatory bodies have indicated their expectation that such statements are replaced with qualitative and quantitative disclosures.

"Directors and auditors should ensure that notes to the financial statements disclose the impact on future financial position and results of new requirements for recognising revenue, for valuing financial instruments, and accounting for leases. It is reasonable for the market to expect that quantitative information will be available and disclosed for the

reporting date that coincides with the start of the first comparative period that will be affected in a future financial report."

Asic media release 2016

The FMA have emphasised this message recently, acknowledging that those charged with governance should have this on the agenda and be considering more extensive disclosures in the year end accounts.

We would expect to see at a minimum a summary of the key focus areas of the transition review in the 31 March and 30 June 2017 financial statements for tier 1 entities.

Ready to dig a bit deeper about the new standard and its potential impact on your firm? Contact Aniela Tkacz for more information.

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