Possible Impacts of Application of the New Accounting Standard IFRS 15 Revenue from Contracts with Customers: A Case Study

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Abstract: The new accounting standard IFRS 15, issued in 2014 and effective from 2018, brings a consistent guidance of revenue recognition and reporting. The aim of the paper is to point out the possible implications of the application of the new International Financial Reporting Standard 15 to the entities accounting and to demonstrate on case study examples the possible accounting treatment. The case study is based on the practice of a prominent joint stock company operating in the Czech Republic, where existing customer contracts were analysed and areas with need of modification were identified. The results proved that the application of IFRS 15 brings changes into the current practice as to the amount and the time of the revenue recognition in the chosen company, where the most significant changes are related to the allocation of a transaction price, to the sales with the right of return and licences with the right to use. IFRS 15 provides a more systematic view of revenue recognition, and additionally, requires a higher degree of professional judgment.

Key words: Revenue · Contracts with Customers · Recognition · Reporting · Provision · Cost of Sales

Classification: M410

1 Introduction

International Financial Reporting Standards IFRS are currently required in over 125 jurisdictions and permitted in many more (IFRS Foundation, 2017b). Within the European Union, listed companies (those whose securities are traded on a regulated market) must prepare their consolidated and individual financial statements in accordance with IFRS instead of national accounting rules. (PWC, 2009). Research of Ipino & Parbonet (2016) shows that IFRS adoption came with the unintended consequence of certain firms substituting real earnings management for accrual-based earnings management.

In May 2014, the IASB published IFRS 15 Revenue from Contracts with Customers (Mazars, 2014; Deloitte, 2017). IFRS 15 was developed by the IASB in a joint project with the US Financial Accounting Standards Board FASB. This new standard establishes the principles that an entity applies when reporting information about the nature, amount, timing and uncertainty of revenue and cash flows from a contract with a customer. IFRS 15 is effective for annual reporting periods beginning on or after 1 January 2018, with earlier application permitted (IFRS Foundation, 2017, Deloitte, 2017). IFRS 15 replaces the current IFRS guidance set out in two relatively old standards - IAS 18 Revenue and IAS 11 Construction Contracts which are accompanied by a number of Interpretations (BDO, 2016). The aim of the new approach is to eliminate the current inconsistencies at revenue recognition and to increase the comparability of revenues reported by various accounting entities (Dvořáková, 2015). Applying IFRS 15, an entity recognises 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 in exchange for those goods or services (IFRS Foundation, 2017). IFRS 15 consists of a standard (including application guidance with clarifications on a number of topics such as licensing, a sale with a right of return, customer options for additional goods or services, etc.), illustrative examples and basis for conclusions (Mazars, 2014). To recognise revenue under IFRS 15, an entity applies the following five steps:

(a) identify the contract(s) with a customer.
(b) identify the performance obligations in the contract. Performance obligations are promises in a contract to transfer to a customer goods or services that are distinct.
(c) determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. If the consideration promised in a contract includes a variable amount, an entity must estimate the amount of consideration to which it expects to be entitled in exchange for transferring the promised goods or services to a customer.
(d) allocate the transaction price to each performance obligation on the basis of the relative stand-alone selling prices of each distinct good or service promised in the contract.

(e) recognise revenue when a performance obligation is satisfied by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For a performance obligation satisfied over time, an entity would select an appropriate measure of progress to determine how much revenue should be recognised as the performance obligation is satisfied (IFRS Foundation, 2017a).

Control of an asset is defined as the ability to direct the use of and obtain substantially all of the remaining benefits from the asset (Delloitte, 2017). According to Nielson (2016), an entity must assess whether revenue should be recognized over time or at a point in time. Tong (2014) names some examples which areas will be different according to the new IFRS, recognition of revenue on long-term contracts with customers, identification of separate performance obligations, product warranties, use of estimates, accounting for costs, etc. This can include assessing whether the customer controls an asset as it is created or enhanced. According to Procházka (2016), the new rules can lead to a significant change as to the moment and/or the amount of the recognized revenue.

The purpose of the paper is to contribute to a better understanding of the complicated issue of revenue reporting (recognition); and possibly to be an inspiration for solving the outlined issues. The aim of the paper is to point out the possible implications of the application of IFRS 15 Revenue from Contracts with Customers to the entities accounting, to demonstrate on illustrative examples the possible accounting treatment, to compare them with the current guidelines of IAS 18 and IAS 11 and to point out the possible influence on the informative potential of the financial statements.

2 Methods

The paper is based on a detailed analysis of the principles of revenue recognition according to the new standard IFRS 15 Revenue from Contracts with Customers (hereinafter referred to as IFRS 15). The purpose of the data analysis is the reduction, synthesis and summary of information in order to interpret the results so that the reasoning is supported by valid evidence (Hendl a Remr, 2017). The analysis is based both on the original issue of standards published by the International Accounting Standards Board IASB, respectively IFRS Foundation, and on other professional sources such as online discussions of experts. Principles identified on the basis of this analysis are subsequently compared to the previous treatment of revenues, according to IFRS - IAS 18 Revenue and IAS 11 Construction Contracts (hereinafter referred to as current IFRS guidelines). Another research method applied for the empirical research in order to gain data is an individual qualitative interview. The interview was conducted with the accounting methodologist of a significant international joint stock company operating in the Czech Republic. This company records its business transactions and reports its financial statements in accordance with IFRS. The two-hour interview took place in October 2017 with the physical participation of both parties and was audiotaped. In this guided interview the topics were specified beforehand and the interviewer determined their order. The topics focus on the specific consequences of applying IFRS 15 in the chosen company:

1. The influence of applying IFRS 15 on the existing practices in the chosen entity,
2. Specification of areas which would be affected by the transit to IFRS 15 in the chosen entity,
3. Execution of the significant general changes and of adjustments to the currently used accounting information system, which emerge from the obligation to implement the requirements of IFRS 15.

To realize a visual comparison, the method of case study was chosen. The scenario of the case study is based on the analysis of all existing customer contracts in the chosen company, and the following areas were identified for their need of modifications: Identification of contracts and their aggregation; Sale with installation; Received advance payments, Sales of “package” (with a discount); Sales with the right of return; The financial component of the transaction and The licence with the right to use (with an expiration date). These individual topics are compared to the current IFRS guidelines and IFRS 15 in particular, to highlight the differences in solutions. In the case of implications of a partial area on the financial statements of the entity, the transition consequences from the current IFRS guidelines to the IFRS 15 are stated and explained. The case study concludes with the assessment of suggested general changes and adjustments of the internal accounting system of the entity.

3 Research results

The issue of IFRS brings a more organised set of rules for revenue recognition on the international level, but at the same time, the companies will be required to exercise more professional judgement. The judgment will be based on a greater use of estimates to correctly define separately identifiable contracts and the allocation of the transaction price. Kubů (2015) has the same opinion, and the auditing company Ernst & Young (2014) adds that many companies will have to adjust their current accounting practices and accounting systems to comply with the new standard. According to Kubů (2015), the new standard will lead to the revenue reporting in a different time period than it is currently done and consequently, the companies will have to modify their contracts. Therefore, in Drábková’s (2014) opinion, it is im-
important for the users of the financial statements to have the opportunity to evaluate the risk of handling accounting and they should have the tools to evaluate this risk. The application of the five-step model for revenue recognition according to IFRS 15 has a greater or lesser impact on every company reporting under IFRS. The intensity and scope of this impact depends to a large extent on the scope of business of a given company and on the current settings of their accounting system. According to BDO (2016), for many entities, the timing and profile of revenue recognition will change. In some areas, the changes will be very significant and will require careful planning.

People responsible for accounting in every entity will have to learn the new principles of revenue reporting according to IFRS 15, to compare them with the current approach of revenue reporting according to IAS 18 and IAS 11 and on the basis of this revision, they will have to draw consequences for themselves. It is up to each accounting unit to assess in which accounting areas they will have to make changes and how significantly these changes will influence their financial statements. An entity will also have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances (Ernst & Young, 2014). According to Ernst & Young (2014), timely and quality preparation for the new requirements emerging from the new standard is a basic premise for a successful implementation.

Based on research, the case study characterizes the chosen company with the following illustrative situation: The accounting entity produces and sells equipment (goods generally), provides installation of equipment and provides the possibility to buy an additional service to ordinary warranty. It also sells licenses to use for the supplied technologies. It usually receives advanced payments before the delivery. It takes into account the previous sales when determining the price and it provides discount if there is a previous sale. In certain cases it negotiates a put-option, i.e. the possibility to return the goods after a certain time. To the proven customers it provides – according to their needs – a deferred payment for the delivery. The accounting entity assesses the implications of its various activities from the view point of impacts on accounting as following:

3.1 Identification of contracts and their combination

The accounting entity has to revise its contracts whose validity overlap into 2018 and longer. In the contrast to the more relaxed conception of the current IFRS guidelines, according to IFRS 15, the rights and obligations related to delivery (supply) and the payment conditions have to be clearly stated in the contract. The contract has to have a commercial character with a high probability that the customer pays the agreed amount. There must be a clear identification of particular obligations arising from the contracts, for example separation of the physical delivery of goods from the provided service. It is necessary to consider whether the contract should be disaggregated into individual parts.

If the conditions for combination are fulfilled by multiple contracts simultaneously, it is imperative that the contracts are aggregated. The combination concerns those contracts which were made with one customer in the same period of time and which serve one identical purpose.

3.2 Sales with installation

Concerning the sale of equipment with an installation service, it is, according to IFRS 15, necessary to consider whether the installation is a separate consideration, or whether it is a part of the total physical delivery. Both cases are possible. If the installation does not require significant adjustment of the physical space, and it is possible to negotiate it separately or it can be done by the customers themselves, the installation is considered to be a separate consideration.

If the installation demands an adjustment of the equipment on the site, the installation is considered to be a part of delivery and the revenue from the whole contract must be reported after a successful installation. In this case, there is no significant shift from the current IFRS guidelines and no modifications are needed in the chosen company.

3.3 Received advance payments

Under the current treatment of revenues, received advance payments for goods and services may be classified as “deferred revenues”. Under IFRS 15, received advance payments are reported as liabilities. The balance sheet is not changed in this case, because in both regulations, the payment is reported as liability. A more significant change concerns the actual time of the revenue recognition. Under IFRS 15, the revenue is recognized at the time the seller gains the right to receive such payment, not at the time the seller actually receives the payment.

However, it must be sufficiently guaranteed that the payment will be received and the whole contract is going to be fulfilled. New categories will occur in the balance sheet of the chosen company, titled “contract liabilities” (and on the other side receivables from long-term contracts “contract assets”).

3.4 Sales of “packages“ (including a discount)

According to IFRS 15, the transaction cost can include a variable amount. The variable amount is usually related to future events, and it can depend on the discounts and volume rebates, on royalties for a timely delivery or penalties for a late delivery, on the possible refunds, etc. It is important to approach the sale in context. The sale of a “package” can be understood as a sale of goods where the prices of provided goods (and services) depend on each other. This concept is illustrated on the following example.
The accounting entity made a contract to supply two tractors for the total price of 580 currency units (CU) and one seeding machine with a three-year additional service of this machine. The sale of the seeding machine was discounted by 200 CU because of the previous tractors sale. The stand-alone selling price of the seeding machine is 960 CU and 60 CU for the three-year service. The delivery of tractors takes place in December 20x0 and the delivery of the seeding machine in January 20x1. The calculation of amounts necessary for recording transactions is shown in Table 1.

### Table 1 Allocation of transaction price at sale of “package”

<table>
<thead>
<tr>
<th>Performance obligation</th>
<th>Stand-alone selling price in CU</th>
<th>Allocation of transaction price in CU</th>
<th>Time of revenue recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Tractor 2x</td>
<td>580</td>
<td>(1,400/1,600) x 5.8 = 507.5</td>
<td>December 20x0</td>
</tr>
<tr>
<td>2. Seeding machine</td>
<td>960</td>
<td>0.875 x 960 = 840</td>
<td>January 20x1</td>
</tr>
<tr>
<td>3. Service</td>
<td>60</td>
<td>0.875 x 60 = 52.5</td>
<td>Share on the total individual price, in 20x1, 20x2 and 20x3</td>
</tr>
<tr>
<td>Total</td>
<td>1,600</td>
<td>1,400</td>
<td>/</td>
</tr>
</tbody>
</table>

Source: Authors’ own processing according to IFRS Foundation (2017a)

Where: The stand-alone selling price is the price at which the entity would sell a promised good or service separately to a customer (Andrus, 2015).

The contract contains three performance obligations: delivery of tractors, a seeding machine and services. The price at a discount must be allocated amongst all of these performance obligations, i.e. to the tractors and the service as well. The allocated price of the two tractors is 507.5 CU, 840 CU for the seeding machine and 52.5 CU for the service. The revenue from the sale of tractors will be recognized in December 20x0, the revenue from the sale of the seeding machine in January 20x1 and the revenue from services gradually during the years 20x0, 20x1 and 20x2. If the services are provided evenly each year, then the same amount each year is recognized; if not, then the amount recognized each year would be adequate to costs (expenses) incurred.

According to the current IFRS guidelines, the discount is allocated only between the seeding machine and the service, and the revenue from the sale of tractors is recognized in full. The new solution for a discount treatment influences the amount of revenue recognized each year, reported in the income statement.

### 3.5 Sales with the right of return

IFRS 15 brings a new solution for situations where there is a probability of the return of sold goods to the original seller after some time. This situation can be explained on the following example.

Case study accounting entity (company X) sells goods to company Y at a price of 100 CU. Previously recognized inventories cost is 80 CU. The contract includes a put option that allows the company Y to return the goods back after one year at a price of 70 CU. According to company X’s experience, company Y exercises the put option on 20% of goods in average. The accounting treatment at the moment of the sale is shown in Table 2.

### Table 2 Sale of assets with the right of return – first recognition

<table>
<thead>
<tr>
<th>Transaction No.</th>
<th>Account</th>
<th>Amount in CU</th>
<th>Account</th>
<th>Amount in CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Dr: Cost of sales</td>
<td>80</td>
<td>Cr: Inventories</td>
<td>80</td>
</tr>
<tr>
<td>2</td>
<td>Dr: Cash</td>
<td>100</td>
<td>Cr: Sales Revenue</td>
<td>100</td>
</tr>
<tr>
<td>3</td>
<td>Dr: Sales Revenue</td>
<td>14</td>
<td>Cr: Provision for Refunds</td>
<td>14</td>
</tr>
<tr>
<td>4</td>
<td>Dr: Other Assets</td>
<td>14</td>
<td>Cr: Cost of Sales</td>
<td>14</td>
</tr>
</tbody>
</table>

Source: Own processing according to IFRS Foundation (2017a)

where:

Dr   debit site (of an account)   Cr   credit site (of an account)

The cost of sales (Transaction 1) and the revenue from the sale (Transaction 2) are recorded as usual. Because of the high probability that company Y will return 20% of the goods after a year, company X cannot recognise the revenue in full and has to reduce the revenue by the estimated amount of the assumed return, by creating a provision for refunds (Transaction 3). The cost of sales must be adjusted by the same amount and at the same time an estimated asset is recorded – the account “Other assets” is used (Transaction 4). This is a completely new approach based on IFRS 15. The provision in this case does not increase the expenses, as it is suggested in the current IFRS guidelines (IAS 18 and IAS 11) and as it can be expected according to IAS 37 Provisions, Contingent Liabilities, Contingent Assets. The example continues: After a year, company Y returns 50% of goods. The accounting treatment is shown in Table 3.

The returned goods are received into the store and the provision for refunds is cancelled (Transaction 1 and 2).
Table 3 Sale of assets with the right of return (continued) – goods returned

<table>
<thead>
<tr>
<th>Transaction No.</th>
<th>Account</th>
<th>Amount in CU</th>
<th>Account</th>
<th>Amount in CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Dr: Inventories</td>
<td>35</td>
<td>Cr: Cash</td>
<td>35</td>
</tr>
<tr>
<td>2</td>
<td>Dr: Provision for Refunds</td>
<td>14</td>
<td>Cr: Other Assets</td>
<td>14</td>
</tr>
</tbody>
</table>

Source: Own processing according to IFRS Foundation (2017a)

Due to the above stated principle, new accounting entries are necessary if the company Y does not return any goods. The provision for refunds as well as estimated asset has to be cancelled, as it is shown in Table 4.

Table 4 Sale of assets with the right of return – no goods returned

<table>
<thead>
<tr>
<th>Transaction No.</th>
<th>Account</th>
<th>Amount in CU</th>
<th>Account</th>
<th>Amount in CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Dr: Provision for Refunds</td>
<td>14</td>
<td>Cr: Sales Revenue</td>
<td>14</td>
</tr>
<tr>
<td>2</td>
<td>Dr: Cost of Sales</td>
<td>14</td>
<td>Cr: Other Assets</td>
<td>14</td>
</tr>
</tbody>
</table>

Source: Own processing according to IFRS Foundation (2017a)

Since the creation of provision reduces the revenue directly, cancellation will increase the revenue. The structure of the income statement will be influenced in comparison to current IFRS guidelines where provisions are created by increasing the expenses. Depending on the materiality of the amount, this new treatment may have an influence on some partial indicators of a potential financial analysis.

3.6 The financial component of the transaction

It is a basic principle of IFRS, that deferred payments (payables, respectively receivables) are reported at their current value. On the basis of the effective interest rate, financial revenue and financial expense is recognized from the transaction. IFRS 15 brings simplification: in the case of deferred payment which does not exceed one year it is not necessary to recognise the financial component of transaction. Particularly in the case of low interest rates, this change is relevant and will not influence the reliability of the financial statements.

3.7 Licence with the right to use (with an expiration date)

According to current IFRS guidelines, revenue from licences with an expiration date is currently deferred. If the subject provides a licence at the value of for example 300 CU for three years, every year, 100 CU will be recognized as revenue. The application of IFRS 15 changes this rule; revenue will be recognized immediately at the point in time when the control over the intellectual property is handed over (for example handing over of the documentation). This is a fundamental change, which has an impact on revenue recognition over a period of time. Naturally, it therefore depends on the materiality of the amount.

3.8 Assessment of the changes needed in the accounting system

Each change related to the accounting treatment of the above mentioned situations has to be incorporated into the accounting system of the company. Even if the changes are frequently concerning the principle of the amount of revenue recognition over a period of time, there will be no need for a fundamental change and general readjustment of the company’s accounting system for the illustrative topics discussed in this paper.

It is necessary for the entities to disclose the possible impacts of the application of IFRS 15 in the notes to their financial statements for 2017. If entities have analysed the impacts of the new standard since the date it has been issued, i.e. from 2014, it is possible that they have gradually changed their accounting system already to implement the new requirements and at the same time made sure to avoid conflict with current IFRS guidelines. In that case the changes will not be too substantial. It will always be necessary to assess the situation of each company individually. Procházka (2016) states that in some instances such as allocation of discounts in case of the change of the total transaction price, the new solution according to IFRS 15 will probably result in significant modification of the company’s information system. Certain industries, such as real estate and telecommunications, may experience the most significant of the changes, given the changes required by this new standard, nearly all companies will be impacted to some degree (Yeaton, 2015). According to Tong (2014), for long-term service contracts and multiple-element arrangements, IFRS 15 could result in some changes either to the amount or timing of the revenue recognised by an entity. Procházka (2016) states that the new rules can lead to a significant change as to the moment and/or the amount of the recognized revenue.

4 Conclusions

The results of the case study proved the necessity to revise all the existing contracts whose validities overlap into 2018 and to compile an overview of the expected impacts. The most significant changes in the chosen company are related to the allocation of the transaction price considering discount in the case of Sales of “package”, to the accounting treatment of Sales with the right of return, and to the Licences with the right to use. Less significant changes are to be found in the area of Sales with installation, Received advance payments and The financial component of the transaction. The results are in line with findings of Tong (2014) and Procházka (2016). The changes in the accounting treatment will depend on the accurate identification of the combined or separate components of the contracts, on the particular contract specifications and on the materiality of the amounts. Companies have to inform the users of their financial statements...
for the year 2017 about the possible changes related to the application of IFRS 15. IFRS 15 brings a simplified orientation within the wide range of issues of revenue recognition on one hand, but on the other hand, the new standard requires a higher degree of professional judgment.

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