

PNG Accounting Technical Update

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contracts with
customers***

IFRS 15 has now changed the rules for revenue accounting – are you still compliant?

IFRS 15 Revenue from contracts with customers

The new IFRS 15 ‘Revenue from contracts with customers’ standard became applicable for the 2018 year, so most companies should now be familiar with the new requirements and applying them in their day to day accounting. The standard has wide ranging application, since all companies derive some form of revenue; however, the reaction from many companies has been that they do not think the standard will have a significant impact on their current practice and they will wait until the 2018 year end to worry about any additional disclosure requirements.

Whilst this may indeed be the case for many companies with straightforward revenue streams, there are likely to be many entities with more complex revenue contracts that will see a significant impact on their current revenue recognition and measurement practices. For example, contracts with multiple elements, licensing arrangements, outsourcing contracts and contracts with milestone payments can be challenging to understand. It may be difficult to determine what the entity has committed to deliver, how much and when revenue should be recognised.

The earlier that companies can analyse their current revenues streams, identify the areas that are impacted, and make the necessary changes to their accounting policies and systems, the easier it will be to ensure compliance and minimise the impact on year end reporting.

This technical bulletin reinforces the main requirements of the new standard, identifies some of the key considerations and questions management and boards should be asking and highlights some of the main industries and types of transaction that will be impacted.

Overview of the main requirements

The core principle of IFRS 15 is that an entity recognises revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The new standard is based on the principle that revenue is recognised when control of a good or service transfers to a customer – so the notion of control replaces the existing notion of risks and rewards.

An entity recognises revenue in accordance with that core principle by applying the following five steps:

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract, and
5. Recognise revenue when (or as) the entity satisfies a performance obligation.

Certain criteria must be met for a contract to be accounted for using the above five-step model. An entity must assess, for example, whether it is “probable” it will collect the amounts it will be entitled to before the guidance in the revenue standard is applied.

A contract contains a promise (or promises) to transfer goods or services to a customer. A performance obligation is a promise (or a group of promises) that is distinct, in the context of the transaction. Identifying performance obligations can be straightforward, such as an electronics store’s promise to provide a television. But it can also be more complex, such as a contract to provide a new computer system with installation, set-up and training, a three-year software licence, a right to upgrades and

ongoing technical support. Entities must determine whether to account for performance obligations separately, or as a group.

The transaction price is the amount of consideration an entity expects to be entitled to from a customer in exchange for providing the goods or services. A number of factors should be considered to determine the transaction price, including whether there is variable consideration, a significant financing component, noncash consideration, or amounts payable to the customer.

The transaction price is allocated to the separate performance obligations in the contract based on the relative standalone selling prices. Determining the standalone selling prices can be challenging when goods or services are not sold on a standalone basis. IFRS 15 sets out several methods that can be used to estimate a standalone selling price when one is not directly observable. Allocating discounts and variable consideration must also be considered.

Revenue is recognised when (or as) the performance obligations are satisfied. The revenue standard provides guidance to help determine if a performance obligation is satisfied at a point in time or over time. Where a performance obligation is satisfied over time, the related revenue is also recognised over time.

IFRS 15 also provides guidance on accounting for licences of intellectual property, the principal versus agent assessment (gross versus net revenue presentation) and the accounting for contract costs. Incremental costs of obtaining a contract, such as sales commission, are capitalised if they are expected to be recovered. Incremental costs include only those costs that would not have been incurred if the contract had not been obtained. As a practical expedient, capitalisation is not required if the amortisation period of the asset would be less than one year.

The new standards also contains additional disclosure requirements that will result in an entity providing users of financial statements with comprehensive information about the nature, amount, timing and uncertainty of revenue and cash flows arising from the entity's contracts with customers.

The new revenue standard is applicable for most entities starting in 2018. The standard

permits entities to apply the guidance retrospectively using any combination of several optional practical expedients. However, we expect most entities to adopt the modified retrospective application under which the cumulative effect at the date of application (i.e. in most cases as at 1 January 2018) is recognised as an opening balance sheet adjustment in equity, with no restatement of comparatives.

Key considerations and questions

When reviewing their existing revenue streams and contracts, there are a number of key considerations and questions that management should be aware of:

- Are there multiple parties involved in the transaction? This can make it more difficult to identify who the customer is and the substance of the relationship between the parties. An entity needs to assess whether it is a principal or just an agent in an arrangement with multiple parties.
- Are there multiple contracts with the same customer (or related parties) which should be combined and accounted for as a single contract? Contracts should be combined if they achieve a single commercial objective and are negotiated as a package, or where the price or performance of one contract influences the amount of consideration to be paid under the other contract, or where the goods or services in the separate contracts represent a single performance obligation.
- If there are contract modifications that create new or change existing enforceable rights and obligations, should these be accounted for as a separate contract or as an adjustment to the original contract? A modification should be accounted for as a separate contract where it adds on one or more distinct performance obligations and the price increases by an amount that reflects the stand-alone selling price. Otherwise a modification is accounted for as an adjustment to the original contract, either prospectively or through a cumulative catch-up adjustment depending upon whether the remaining goods or services in the contract are distinct.

- Are there multiple promises in a contract? For instance to both supply and deliver or install. If so, you need to determine whether those goods or services are distinct from each other within the context of the contract. A good or service is distinct if the customer can benefit from the good or service either on its own or together with other readily available resources, and the good or service is separately identifiable from other promises in the contract. The standard provides indicators rather than criteria to determine when a good or service is distinct, which allows management to apply judgment to determine the separate performance obligations that best reflect the economic substance of a transaction.
 - Is there any element of variable consideration? Variable consideration is included in the transaction price to the extent that it is highly probable that a change in the estimate of the variable consideration would not result in a significant reversal of the cumulative revenue recognised.

Variable or contingent includes (but is not limited to) discounts, refunds, rebates, credits, incentives, performance bonuses and royalties. An entity's practices, policies or statements may result in variable consideration, for example, if they indicate the entity will provide price concessions. Variable consideration should then be estimated using the more predictive of the following approaches: the expected value or the most likely amount. This is not a free choice – an entity should use whichever approach it expects will best predict the amount of consideration to which it will be entitled based on the terms of the contract and taking account all reasonably available information.
 - Is there a significant financing component? If the time period between transfer of goods and services and payment is more than one year, there is a presumption that the transaction has a financing component that will impact the amount of revenue recognised. The difference will be recorded as interest income (deferred payment) or interest expense (advance payment).
 - Is there any consideration payable to the customer? Consideration paid (or expected to be paid) to a customer, or to a customer's customer, reduces the transaction price unless the payment is made in exchange for a distinct good or service that the customer transfers to an entity. For example, a manufacturer sells goods to a retailer, but the retailer then charges the manufacturer a 'slotting fee' to display the goods in a preferential space. This fee should be deducted from revenue rather than shown as an operating expense.
 - When is control over the goods or service transferred to the customer? The timing of revenue recognition could change for some transactions compared to previous guidance, which was more focused on transfer of risks and rewards. This is now only one indicator of transfer of control, and additional indicators now need to be considered. For example, an entity that transfers control of a good to a customer but retains some economic risks might need to record revenue when the good transfers, whilst under previous guidance revenue recognition might have been delayed until all the economic risks also transferred.
 - Revenue should be recognised over time when any of the following criteria are met:
 - The customer concurrently receives and consumes the benefits provided by the entity's performance as the entity performs (for example a transportation service).
 - The entity's performance creates or enhances a customer-controlled asset.
 - The entity's performance does not create an asset with an alternative use and the entity has a right to performance completed to date.
- If none of these criteria are met, the entity recognises revenue at the point in time when control of the good or service passes to the customer. Management judgment is required in assessing whether an asset has an alternative use or whether there is a right of payment for work completed to date.

- The following indicators should be considered when determining at what point in time control has passed:
 - The entity has a present right to payment
 - The entity has transferred legal title to the asset
 - The entity has transferred physical possession of the asset
 - The entity has transferred the significant risks and rewards of ownership to the customer
 - The customer has accepted the asset.

These indicators are of equal weighting and they do not all need to be satisfied before revenue is recognised at a point in time. Judgment is required in considering all the indicators to determine at what point control has passed.

Who will be impacted?

All entities should be considering the impact of the new revenue standard on their revenue streams and sales contracts; however, there are certain industry sectors and transactions where the impact is likely to be most significant:

Retail and consumer industry

1. Point of revenue recognition for FOB and CIF shipping terms – revenue will be recognized when control over the goods is transferred. For FOB contracts, this is generally at point of dispatch whilst for CIF contracts it will generally be at point of delivery, but contract terms need to be analysed to determine when legal rights transfer, when the right to receive payment is established, and any rights to redirect and sell the goods during transit, as these could bring forward or defer the general revenue recognition point. Shipping and insurance arrangements could also create additional performance obligations requiring partial deferral of revenue.
2. Rights of return for goods – revenue should not be recognised for goods that are expected to be returned and a liability should be established for the estimated expected refunds to customers, together with an asset and adjustment to COGS for the expected recovery of goods.

3. Sell-through / consignment stock arrangements – an analysis of the contractual terms with distributors will be necessary to determine when control over the goods passes in order to recognise revenue, based on a range of indicators rather than just risk and rewards.
4. Customer incentives, including coupons, rebates, free products and services, co-operative advertising, product placement and slotting fees – these can create additional performance obligations or create variability in the consideration price, both of which impact the timing and amount of revenue recognition.
5. Loyalty programs – these can create a separate performance obligation requiring deferral of a part of the consideration where it creates a material right to provide an additional good or service that is not available to a customer not in the loyalty program.
6. Gift cards for subsequent redemption – these are accounted for as a pre-paid liability and de-recognised when the performance obligation is fulfilled. The guidance for variable consideration is followed in accounting for breakage (customer's right that are never exercised).
7. Licenses and franchise arrangements – there is more detailed guidance than under IAS 18 in accounting for licenses over intellectual property and franchise arrangements, in particular whether the right to use a license transfers at a point in time or over time.
8. Warranties – product warranties that are not sold separately and provide for defects at point of sale are accounted for similar to IAS 18 as a cost accrual. Extended warranties are likely to give rise to additional performance obligations requiring deferral of part of the revenue. Warranties that are separately priced may impact allocation of the consideration.
9. Amounts collected on behalf of third parties – there is more detailed guidance on distinguishing principal v agent arrangements.
10. Bill-and-hold arrangements – the control model is applied to determine when revenue should be recognised. In certain circumstances a customer may have control to direct the use of an

asset, or obtain the remaining benefits from the product, even though physical possession is still with the seller.

Manufacturing and industrial products

1. Identifying the contract with the customer - contracts entered into by IP and manufacturing companies may be complex with multiple elements. These need to be analysed to determine whether individual contracts need to be considered on a combined basis as a single commercial transaction, or whether there are multiple performance obligations that need to be accounted for separately.
2. Entities that sell goods to a distributor, but promise additional goods or services to an end customer, will need to allocate an element of the consideration to those additional performance obligations even if they are provided by a third party.
3. Contract modifications - these will generally be treated as a modification of the existing contract and accounted for prospectively, unless the change represents a distinct performance obligation and the price reflects the stand alone selling price.
4. Determining transfer of control - entities that currently use construction-type accounting on a stage of completion basis may now need to recognise revenue at a point in time.
5. Measuring progress for performance satisfied over time - management should use that methodology, based on either inputs or outputs, that best depicts the transfer of control of goods and services to the customer. Certain contract manufacturers who are manufacturing products to specified customer demands may be required to recognise revenue based on production rather than delivery, depending on the contract terms.
6. Entities will need to consider their experience with customers to determine the extent to which expected volume discounts and other incentives or claims are highly probable and what level of rebate should be deferred.
7. Advanced payments or deferred payments should be taken into account in measuring revenue where the time period between payment and performance is more than 12 months.

8. Contract costs - incremental costs of obtaining a contract should be recognised as an asset if the costs are expected to be recovered, unless the duration of the contract is less than 12 months. Direct costs incurred to fulfil a contract are first assessed to see if they are within the scope of another standard, otherwise they are only capitalised if they relate directly to a contract, generate or enhance resources that relate to a future performance obligation and are expected to be recovered.
9. Principal v agent - the new standard contains more detailed guidance in determining whether a party is acting as a principal (gross revenue basis) or an agent (net commission basis) in a particular contractual arrangement.
10. Warranties (see above).

Transport and logistics

1. Transportation revenue - transport or freight services are generally provided over a period of time ranging from a day to multiple years. Transportation services will likely meet the criteria for recognition over time as the customer simultaneously receives and consumes the benefit of the service as the entity performs, as another entity would not need to substantially reperform the entities performance (i.e. distance travelled) to date. Therefore revenue should be recognised over the period from when transport of the goods begins through to delivery.
2. Freight fulfilment costs - these are generally expensed as incurred unless they (a) meet the requirements for capitalisation under another standard or (b) relate directly to a sales contract, generate or enhance resources of the entity that will be used in satisfying performance obligations in the future and are expected to be recovered.
3. Frequent flyer programs - credits received under a frequent flyer program are treated as separate performance obligations where they provide a material right that the customer would not receive without buying the initial product or service. The transaction price needs to be allocated between the initial transaction and the awards credit, and revenue from the rewards credit is only recognised when the customer redeems the awards.

4. Change fees - IFRS 16 requires management to assess whether the change fee should be accounted for as a separate contract or as a modification of the existing contract
5. Variable consideration - transportation contracts often contain volume discounts, performance bonuses or contract variations for delays, and these should be taken account of in determining the revenue than an entity expects to receive as it provides a service.

Asset management

1. Upfront fees received by an asset manager - the asset manager needs to determine whether any up-front fees for product distribution are a separate performance obligation from other services performed under the management agreement, or whether they are a supporting activity and form part of the overall asset management service. This will determine whether any up-front fees can be recognised when the distribution service is completed or should be deferred and recognised over time.
2. Upfront costs incurred for sales commission or placement fees - any incremental costs of obtaining a new contract should be deferred and then amortised on a systematic basis.
3. Variable consideration, including management and performance fees - Management fees are usually based on a fixed percentage of funds under management and will be derived over time based on the fund value. Any variability is generally only dependant on the value of the fund which is confirmed each reporting period. Return-based performance fees will involve a higher degree of estimation and should only be recognised to the extent that the highly-probable threshold is met. Management also need to consider whether there is a minimum amount of the variable consideration that should be included in the transaction price, even if the entire estimate of variable consideration is not included due to the constraint.

Banking

1. Interest income and credit facility fees are within the scope of IFRS 9 Financial Instruments rather than IFRS 15. However non-credit related fees such as

annual credit card fees, inter-change fees, card loyalty schemes, commission and cheque and savings account fees will fall under IFRS 15.

2. Banks also commonly engage in asset management activities and earn fees from brokerage, underwriting, advisory, syndication and other management services (see above).

Insurance

1. Insurance contracts are outside the scope of IFRS 15 and are covered by IFRS 4 and the new IFRS 17 standard from 2021; however, IFRS 15 will still have some impact on the insurance industry and particularly intermediaries.
2. Consideration for placement services by insurance intermediaries should be recognised at the point in time at which the intermediary has completed its obligations. Where the only service is placement, the commission would typically be recognised at the point in time when the terms of the insurance contract have been agreed between the underwriter and the insured and the insurer has a present right to payment from the insured. Where placement services are combined with other services such as claims handling, the consideration will need to be allocated between the separate performance obligations. Claims handling services are typically performed over time. The period over which the claims handling revenue is recognised will depend on the terms of the contract and may extend beyond the initial policy term.
3. Contract costs, such as commission and fees paid to intermediaries, will need to be distinguished between costs to obtain a contract and costs to fulfil a contract. The incremental costs of obtaining a contract should be recognised and amortised if those costs are recoverable, unless the contract term is one year or less.
4. The selling of unit linked investment contracts and other investment type contracts by life insurance companies are not insurance contracts and therefore these fall under the provisions of IFRS 15. In a unit linked investment contract the insured customer is acquiring a financial instrument plus an asset management

service. Typically there may be upfront fees deducted from the initial investment together with ongoing periodic fees, both fixed and variable based on asset value, together with surrender fees on early termination of the policy. Insurance entities will need to determine if the current amortisation method for deferred upfront fees is consistent with the pattern of transfer to the customer of services.

5. Ongoing fees for asset management services are recognised over time as the performance obligations are satisfied, taking into account any variable consideration to the extent it meets the highly probable recognition criteria. Surrender penalties can either be taken into consideration in determining the fair value of the underlying financial instrument or accounted for separately under IFRS 15. Upfront fees may also contain a significant financing component that should be separated and recognised as a loan.

Resources sector

1. It is not always clear whether a vendor/customer relationship exists, which is vital for revenue to be generated. Transactions arising from arrangements where the parties are participating in an activity together, and share the risks and benefits of that activity, are excluded from the scope of IFRS 15.
2. Often a projects development is funded by entering into forward sales for future production. Such contracts require careful analysis to determine the correct accounting.
3. Product exchanges between different resource companies to facilitate sales to customers other than parties to the exchange are likely to be scope out of the revenue standard as non-monetary exchanges, even if the products are dissimilar.
4. The principle v agent distinction is important where the resource company may be engaging in other services in addition to selling the resource product, for example arranging transportation.
5. Delivery arrangements – Under both CIF and FOB arrangements, contractual terms usually mean that title and risk, and therefore control, pass at the ships

rail on loading, although under IFRS 15 the point of revenue recognition could change depending upon the terms of trade. The difference between shipping terms affects which party is responsible for freight costs. Under IFRS 15, with a CIF contract, freight services are likely to be a distinct performance obligation when risk and title pass on loading. However, if the contract terms specify that risk and title only transfer on unloading at destination, then shipping is not a separate performance obligation and revenue is only recognised when the product is unloaded, regardless of whether or not any advance payments were made.

6. Provisional pricing is common in the resources sector as final assay results may only be known after delivery and further processing. IFRS 15 requires initial recognition of the expected consideration at the time control of the goods is transferred, requiring an estimate to be made of final quantities and price outcomes. Any embedded derivatives in the provisional pricing contract may also need to be separated. These both require judgment.
7. Commodity sales contracts may be long term in nature and include both price variation clauses and volume options. Only the minimum amount of volume under a take-or-pay contracts would be treated as a sales contract, with any option to take up additional volume being a separate contract when exercised. Mining entities will need to assess whether these contracts represent financial instruments or contain embedded derivatives that should be accounted for under IFRS 9.
8. In the oil and gas sector, where joint ventures are common, physical shipments of product by tanker may not be in proportion to ownership interests, giving rise to overlift and underlift. Under current IAS 18 practise such transactions are accounted for as a sale from the underlifter to the overlifter. Under IFRS 15, the arrangements will need to be analysed to determine whether other parties in collaborative arrangements meet the definition of a customer or whether the transaction falls outside the scope of IFRS 15 as a non-monetary exchange between entities in the same line of business.

For further help on IFRS 15 implementation, other IFRS technical issues, accounting advice or training needs please contact our Accounting Technical Support Team or your Assurance Partner:

Stephen Beach, Partner
stephen.beach@pg.pwc.com
+675 7100 9535

Jonathan Seeto, Territory Senior Partner
jonathan.seeto@pg.pwc.com
+675 305 3223 / +675 7100 9520

Kanthan Rajadurai, Principal
kanthan.rajadurai@pg.pwc.com
+675 305 3236 / +675 7100 9531

Christopher Hansor, Assurance Leader
christopher.hansor@pg.pwc.com
+675 305 3206 / +675 7199 6333

Cynthia Muoti, Manager
cynthia.muoti@pg.pwc.com
+675 305 3282 / +675 7968 1480

Jonathan Grasso, Partner
jonathan.a.grasso@pg.pwc.com
+675 305 3260 / +675 7072 7461

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