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FINANCIAL REPORTING FACULTY

MODIFICATIONS TO REVENUE RECOGNITION UNDER IFRS 15

GUIDE

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During the COVID-19 pandemic many entities have had to adapt the way they do business which may have implications for revenue recognition. In this short guide we consider the accounting implications of modifying a contract when applying IFRS 15 *Revenue from Contracts with Customers*.

IFRS 15 is broadly principles-based but there are also some detailed rules to consider when applying the standard. When circumstances change, the way an entity delivers goods and services to its customers may also change and some contract terms may be renegotiated. There may also be questions over the consideration expected to be received, or the ability of the entity to deliver on its performance obligations. Below we consider some of the accounting requirements which may be particularly relevant at this time.

Reminder of the five-step approach to revenue recognition

It is important not to lose sight of the basic five-step approach to revenue recognition set out in IFRS 15 as this may be pertinent when accounting for contract modifications and other changes in circumstances (considered further below).

The five key steps are as follows:

1. Identify the contract(s) with the customer. .
2. Identify the separate performance obligations.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations.
5. Recognise revenue when (or as) a performance obligation is satisfied.

Contract modifications

IFRS 15 sets out a rule-based approach on how to account for contract modifications. When a contract has been modified, you will need to consider the following to determine the appropriate accounting treatment.

Question 1 – Has the modification to the contract been approved?

Yes – go to question 2.

No – continue with the previous accounting.

Question 2 – Does the modification only add distinct products/ services, with a corresponding increase in the transaction price that reflects their standalone selling price?

Yes – treat the modification as a new, separate contract. The accounting for the original contract is unaffected.

No – go to question 3.

Question 3 – Are all remaining goods and services distinct?

Yes – treat the modification as the termination of the existing contract and the creation of a new contract. The amount of consideration allocated to the 'new' contract will be the amount of any consideration under the 'old' contract not yet recognised, as adjusted for the change in consideration arising as a result of the modification. The effect is that the changes to revenue will be accounted for prospectively. (In particular, revenue up to the point of modification is recognised on the basis of the old contract. No adjustments are made to that cumulative revenue as a consequence of the modification itself, even if some balances are waived. Instead, all remaining goods and services are accounted for as a brand new contract, applying the five step model.)

No – go to question 4.

Question 4 – Are any of the remaining goods and services distinct?

Yes – go to question 5.

No – the goods and services that are not distinct form part of a single performance obligation that is partially satisfied. The modification will be treated as part of the existing contract and there will a be a catch-up adjustment for cumulative revenue recognised; this will be calculated by comparing the amount of cumulative revenue that would have been recognised had the new contract terms at the beginning of the contract to the cumulative revenue recognised to date. (In other words, the contract accounting is reworked as if the modified contract had always been in place as at contract inception, and there is a true-up to the amount of cumulative revenue recognised on this basis.)

Question 5 – What is the appropriate accounting if some, but not all, of the remaining goods and services are distinct?

If some but not all of the remaining goods and/or services are distinct, IFRS 15 requires accounting that is consistent with the objectives described in the answers to questions 3 and 4 above, but is not prescriptive as to precisely how this should be achieved.

Note that establishing whether remaining goods and services are distinct is not the same as establishing separately identifiable performance obligations. This distinction is particularly important when considering performance obligations that are a series of distinct goods or services combined into a single performance obligation in accordance with the 'series guidance' in IFRS 15:22(b).

For example, under the terms of the contract the entity provides the customer with telecom services for two years. Although the obligation is performed daily over 730 days, it is a series delivered over time and represents a single performance obligation. If the contract was modified part way through the remaining telecom service would be viewed as distinct and would, therefore, give rise to the termination of the existing contract and the creation of a new one.

Other factors that may need to be considered

In addition to identifying whether promised goods and/or services are distinct, there may be other factors to take into account when determining the appropriate accounting treatment.

Price concessions

If a price concession is granted, it will be important to establish whether this represents variable consideration that was part of the original contract or, conversely, represents (part of) a modification to which the modification guidance described above should be applied. Where, at contract inception, there was an expectation that such a concession might be granted (for example, because it is quite common for the entity to grant such concessions), this will typically have been regarded as variable consideration in the original contract, and the price concession should simply be accounted for as a change in estimate of that variable consideration. Conversely, where a price concession is negotiated in the context of an increase to the goods or services to be supplied, and would not be granted absent that increase, it is more likely that this should be accounted for as a contract modification.

Additional goods/ services for free

If, as a result of negotiations between the entity and a customer, the customer is provided with additional goods and/or services for free, it seems likely that this will be seen as a modification. Consequently, part of the transaction price will be allocated to these ‘free’ goods and/or services, and typically recognised as revenue when they are supplied.

Conversely, if the seller decides unilaterally to provide additional goods or services, without any negotiation with the customer, it seems quite possible that these free goods or services may not form part of the contract from an IFRS 15 perspective. If they are not part of a revenue contract, no revenue will be recognised when goods or services are provided for free.

Care needs to be taken to determine whether an obligation has been created to provide further goods and services for free.

Extension of payment terms

As noted below, IFRS 15 has a collectability threshold before the standard can be applied. Therefore, if there is an extension to payment terms because there are doubts about the recoverability of consideration due, this may have implications for the amount of revenue recognised.

If the collectability threshold is still met, but the extension to payment terms is significant, it may be that the contract now includes a significant financing component and some of the consideration should be recognised as interest receivable instead of revenue. (The implications if the collectability threshold is no longer met are discussed further below.)

Further considerations in the application of the five-step approach

Even when a contract has not been modified, there may still be changes to the timing and amounts of revenue recognised as a result of the pandemic.

Doubts over full recoverability of consideration receivable

IFRS 15 includes a ‘collectability threshold’ which requires that it must be probable (ie, more likely than not) that an entity will collect in full the consideration to which it is ultimately entitled from the customer before it can apply the standard to the contract. If it is no longer probable that the consideration will be received in full, IFRS 15 typically prevents any further revenue being recognised until certain conditions are met.

Changes in estimates of variable consideration

IFRS 15 requires variable consideration to be estimated and may restrict the amount that can be recognised as revenue when there is a degree of uncertainty; this restriction is generally referred to as the ‘variable consideration constraint’. As a result of the pandemic the estimate of variable consideration may have changed; in addition, if there is an increased level of uncertainty, this is likely to lead to greater restrictions on the amount of revenue that can be recognised.

IFRS 15 includes guidance on how to determine whether variable consideration relates to a specific performance obligation or to the contract as a whole. This judgement can have a significant impact on when revenue is recognised. For example, in circumstances in which it is appropriate to allocate penalties for late delivery to each individual delivery, an expectation of future late deliveries will typically not affect revenue recognised to date. Conversely, in circumstances in which it is appropriate to allocate such late delivery penalties to the contract as a whole, expectations of future late deliveries will affect the amount of revenue recognised for deliveries already made. Accordingly, an entity will need to refer to the guidance in IFRS 15 as to whether penalties and other types of variable consideration should be allocated to individual deliveries or to the contract as a whole.

Costs attributable to inefficiencies

As a result of the pandemic some entities may be incurring additional costs, for example because of interruptions to the supply chain. When assessing the appropriate impact of such costs, it is important to assess whether they should be regarded as attributable to significant inefficiencies in the entity's performance. It should not simply be assumed that any costs not initially envisaged will represent inefficiencies. For example, many entities will face increased costs in order to comply with safety requirements, such a social distancing, but these are typically not inefficiencies – they simply mean that a contract may be less profitable than was originally expected.

Nevertheless, some costs may be attributable to significant inefficiencies in the entity's performance. Such costs should be:

- expensed to profit or loss when they are incurred.
- excluded from the measurement of progress when recognising revenue over time.

Disclosures

IFRS 15 has extensive disclosure requirements but in current times there is an even greater need to tell a clear story and explain associated uncertainties. Below are some of the specific disclosures that might need to be enhanced, but please note that this is not a comprehensive list.

- Revenue recognised in the current period in relation to performance obligations satisfied in previous periods. Typically, this is the effect of releasing variable consideration that has previously been constrained and the amount may be negative for some entities.
- Changes to typical timing of payment / payment terms, and impact on contract assets and liabilities.
- Explanation of significant changes to contract assets and liabilities, including quantitative information on key impacts.
- Significant judgements, and changes in judgements, relating to:
  - assessing when control is transferred to customer;
  - estimating variable consideration;
  - constraining estimates of variable consideration;
  - measuring obligations for returns, refunds and similar obligations.

Related resources:

- Online guide: Contract modifications under IFRS 9 Financial Instruments (coming soon)
- Webinar recording: Contract modifications under IFRS
- Financial Reporting Coronavirus hub – guidance for preparers of financial statements on the coronavirus outbreak, including advice on disclosure of risks and treatment of events after the reporting period.
- ICAEW coronavirus hub – bringing together all resources related to COVID-19 including information on tax, help for business and much more.

For more guidance on the requirements of IFRS and UK GAAP visit icaew.com/financialreporting

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