IFRS 15 is mandatory for accounting periods commencing on or after 1 January 2018. This means that where significant changes are required to policies, the results for 2017 financial periods (including opening reserves and net assets) are also likely to be impacted.

The fundamental premise of the new standard is that revenue should be split along the lines of performance obligations inherent in the provision of a service or product, which may result in revenue recognition commencing at more than just one trigger point, often over differing periods of time.

At haysmacintyre we have assisted our clients in preparing for the introduction of IFRS 15 by working with them to create an implementation report, which uses the 'five step approach' to reassess the nature of the products and services they provide, determine how revenue is recognised currently and should be recognised under IFRS 15, and then advise on the key changes to be made.

Our approach recognises that entities need to have confidence when implementing changes to their revenue recognition policies and that this is achieved by regular, clear and concise contact with their advisers.

This case study breaks down the 'five step approach' as outlined by IFRS 15, while also providing an illustration of how it works for real-world example of 15 Software Plc* (15 Software), a software group focused on the mining and resources sector. We completed our in-house IFRS 15 questionnaire with 15 Software by meeting with them to understand the nature of their business, we walked them through the 'five step approach' and provided an initial assessment of the likely outcomes of the new revenue recognition standard.

We then prepared a detailed report assessing both current and prospective revenue recognition policies and highlighted how the two differ.

In the case of 15 Software, we identified a material difference in approach to their existing revenue recognition policy and what is permissible under IFRS 15.

Having identified this area and outlined how 15 Software should account for their revenue under the new standard, 15 Software have quantified the effect in financial terms.

We advised on the options available for implementation and how the changes should be presented both in the 2017 and 2018 financial statements.

* Company name and some details amended to preserve confidentiality
‘The five step approach’ with 15 Software Plc

Core Principle
An entity should recognise revenue to reflect the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services.

A contract is an agreement between two or more parties that creates enforceable rights and obligations. It must meet five criteria:
- The contract is approved by both parties
- The contract identifies each party’s rights
- The contract identifies payment terms
- The contract has commercial substance
- It is probable that consideration will be paid.

Other key contract features are as follows:
- It may be written, verbal, or implied by customary business practice
- It may be necessary to combine two or more contracts entered into at or near the same time with the same customer and account for them as a single contract
- As a practical expedient, an entity may apply the standard to a portfolio of contracts with similar characteristics.

IFRS 15 also provides guidance on contract modifications.

A contract may contain one or more performance obligations ie promises to deliver goods or services and they should be assessed at contract inception. A contract may contain one or more performance obligations ie promises to transfer what are known as ‘distinct’ goods or services to a customer and it is often necessary to break individual contracts down into a series of ‘distinct’ goods and services.

Goods and services are ‘distinct’ if:
- the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer ie the goods or services are capable of being distinct
- the entity’s promise to transfer the goods or services to the customer is separately identifiable from other promises in the contract ie the goods or services are distinct in the context of the contract.

Identify the contract(s) with the customer

Identify the performance obligations in the contract

Determine the transaction price

Allocate the transaction price

Recognise revenue or as a performance obligation is satisfied

Identify the performance obligations in the contract

A good/service (or bundle) that is distinct

A series of distinct goods or services that are substantially the same and have the same pattern of transfer
The transaction price is defined as the amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services. An entity must consider the terms of the contract and its customary business practices to determine the transaction price. In many cases it will simply be the price specified by the contract, excluding any amounts collected on behalf of third parties such as sales taxes. While the transaction price will usually be easy to determine when it is a fixed amount at the time of sale, it will be more complicated in other cases, for example when the amount could vary in the future based on contract terms or if consideration is in forms other than cash.

The transaction price is adjusted for the time value of money when a contract contains a significant financing component but is not adjusted for collectability.

When a contract contains more than one performance obligation, it will be necessary to allocate the transaction price to each of these. This is usually done in proportion to the stand-alone selling price of the goods or services underlying each performance obligation. If a stand-alone selling price is not directly observable, it should be estimated by considering all information that is reasonably available. IFRS 15 specifies that an entity should allocate a discount to all promised goods or services in the contract unless the entity has observable evidence that the discount relates to one or more, but not all, performance obligations in the contract.

IFRS 15 also contains guidance on whether variable consideration should be allocated to the entire contract or to specific parts thereof.

Performance obligations are settled by transferring the goods or services to the customer. This occurs when the customer obtains control of the goods or services i.e when the customer has the ability to direct the use of an obtain the benefits from the goods or services.

At the inception of the contract an entity will need to determine whether control is transferred – and revenue recognised:
- over time or
- at a point in time.
‘Over time or at a point in time?’

An entity recognises revenue over time if one or more of the following criteria is met:

- The customer simultaneously receives and consumes the benefits of the entity’s performance as the entity performs
- The entity’s performance creates or enhances an asset that the customer controls as the asset is created or enhanced
- The entity’s performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for the performance completed to date.

Conversely, revenue is recognised at the point in time when control is transferred to the customer:

- The entity has a present right to payment for the asset
- The customer has legal title to the asset
- The entity has transferred physical possession of the asset
- The customer has the significant risks and rewards of ownership of the asset
- The customer has accepted the asset.

IFRS 15 vs IAS 18: a practical example (15 Software Plc)

15 Software is a technology group that provides bespoke software integration solutions for the mining and resources industry.

Their products include an underground map data repository, specialist extraction costing software and equipment maintenance logs.

Given the complex nature of the industry, 15 Software tailors its product to specific client needs while retaining the intellectual property, meaning it licenses software to clients as part of a multi-year agreement. A typical contract will run for an initial three year period at a value of £75k per annum.

Working in conjunction with 15 Software, we worked through the five step approach and identified two distinct performance obligations:

- Tailoring and integration of bespoke software systems into existing client operations
- Ongoing support and updates for the initial agreement period.

Revenue under IAS 18 (existing treatment)

IAS 18 states that 15 Software should apply the recognition criteria to the separately identifiable components of a single transaction (here: tailoring, installation and ongoing support).

However, IAS 18 does not give any guidance on how to identify these components and how to allocate selling price and as a result, different practices have been applied across industries, including by 15 Software.

In common with many entities in the technology and telecommunications sector, 15 Software recognised its income on a wholly pro-rata (ie monthly) basis (they treated the cost of tailoring and installation as the cost of acquiring the customer).

The existing revenue treatment over a three year period for a £75k agreement is show below:

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<tr>
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<tbody>
<tr>
<td>Revenue</td>
<td>£25K</td>
<td>£25K</td>
<td>£25K</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>£25K</td>
<td>£50K</td>
<td>£25K</td>
</tr>
</tbody>
</table>

Revenue under IFRS 15 (required treatment)

As described above there are two different performance obligations which should be recognised separately. Tailoring and integration should be recognised on delivery of the software package. This is because risk, reward and control only transfers on delivery: 15 Software has no right to revenue prior to software installation and confirmation the software is useable.

Ongoing support and updates to software packages fall within the remit of software as a service and as such should be recognised over time.

Allocating the transaction price

The difficulty for 15 Software came in allocating a transaction price to each obligation. As installation and maintenance are sold as one license package, there is no simply identifiable standalone selling price for either element within a single transaction.

However, 15 Software also offers a standalone maintenance package, either through license extensions for pre-existing customers, or to those who were previously with competitors. 15 Software therefore utilised the residual approach to valuing its performance obligations. This approach works by considering the value of an individual maintenance package (£10k per annum for three years) and deducing that the residual £45k of a £75k agreement would therefore be related to the installation and tailoring service.
As a result, under IFRS 15 Software should recognise £55k in Year 1 (being £45k integration and £10k maintenance) and £10k in each of Years 2 and 3.

Revenue and Retained Earnings under IAS 18 and IFRS 15

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<tr>
<td>Revenue</td>
<td>£25k</td>
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<td>£25k</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>£25k</td>
<td>£50k</td>
<td>£75k</td>
</tr>
<tr>
<td>Revenue (IFRS 15)</td>
<td>£55k</td>
<td>£10k</td>
<td>£10k</td>
</tr>
<tr>
<td>Retained earnings (IFRS 15)</td>
<td>£55k</td>
<td>£65k</td>
<td>£75k</td>
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<tr>
<td>Transitional increase in</td>
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<td>£55k</td>
<td>N/A</td>
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<tr>
<td>opening reserves</td>
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</table>

Methods of adoption

The above table outlines the adjustments that would arise under the retrospective approach to IFRS 15 adoption. This is where a full transitional adjustment would be made in a set of IFRS 15 compliant financial statements, including to prior year comparative results and opening equity.

An alternative to this method is the cumulative approach which allows entities to commence accounting for revenue under IFRS 15 from the transition reporting date (ie post 1 January 2018) only. No comparative restatement is required.

While the retrospective approach requires greater time commitment in terms of assessing revenue from historic periods, our experience has been that it provides greater consistency in financial statements and consequently provides enhanced understandability to stakeholders and users of the financial statements.
About haysmacintyre

haysmacintyre is an award winning firm of chartered accountants and tax advisers based in central London, comprising 33 partners and over 240 staff.

Our corporate finance specialism has seen significant growth over the past five years as a result of our strong commitment to communication, relationships and our sector driven focus.

Our partner-led approach allows us to add value to various processes such as private sales or acting as reporting accountants for IPOs.

Our key services include:

- Transaction support
- Vendor and acquisition due diligence
- Management buy-ins and buy-outs
- Share valuations
- Financial and Black Scholes modelling
- Exit strategies
- Financial promotions approval.

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haysmacintyre is a member of MSI Global Alliance (MSI), which we co-founded over 20 years ago, with the aim that it would support our clients’ international business operations and growth plans. Now MSI is the seventh largest alliance in the world, involving over 250 medium sized legal and accounting firms based across more than 100 countries.

Being part of MSI allows us to offer our clients expert guidance and support internationally through working with our alliance colleagues.

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A list of partners’ names is available for inspection at 10 Queen Street Place, London EC4R 1AG.

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