

IFRS 15: THE 10 KEY POINTS FOR INDUSTRIAL ENTITIES WITH LONG-TERM CONTRACTS

The essentials from the Long-Term Contracts Club for the finance function

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EDITORIAL



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In September 2014, Mazars created in France the Long Term Contracts Club to enable stakeholders in project-driven industries to get together to discuss the practical impacts of the new IFRS 15 standard on their activities.

The 34 groups listed below regularly take part in the Club sessions.

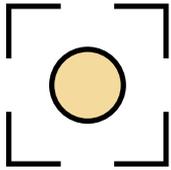


These sessions gave everyone an opportunity, with the aid of case studies, to analyse the new standard, to compare it with existing practices in their sector and to benchmark their practices against those of other stakeholders.

IFRS 15 will be applicable to periods beginning on or after 1 January 2018, with a requirement to present comparative information from 2017 at least. Endorsement by the European Union is expected during the second quarter of 2016. Early application will then be possible.

2016 is thus an important year in terms of transition!

The following pages will outline the 10 key points identified during sessions of the Long Term Contracts Club. Enjoy your reading!



THE ESSENTIALS

1 RECOGNITION OF REVENUE OVER TIME IS NO LONGER AUTOMATIC

Revenue will only be recognised over time if the exact conditions set out in the standard are met. Some contracts that are currently recognised over time may be recognised on completion, and vice-versa.

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2 A LIMITED CHOICE OF METHODS FOR MEASURING REVENUE RECOGNISED OVER TIME

Some approaches used today, such as the “technical milestones method”, will no longer be applicable without potentially significant changes. The cost-to-cost method is therefore likely to come into wider use.

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3 THE END OF MARGIN SMOOTHING

Whatever method is used to measure progress, IFRS 15 prohibits mechanical adjustments of the margin that would not reflect the reality of the costs incurred for performance realised to date. “Margin smoothing” will thus no longer be automatic.

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4 A POTENTIALLY DIFFERENT BREAKDOWN OF CONTRACTS, WITH A SEPARATE MARGIN FOR EACH DISTINCT GOOD OR SERVICE

Within each contract, the unit of account is now the performance obligation (PO). Breaking a contract down into performance obligations therefore is a crucial step for both the profile of revenue recognition and, of course, the margin.

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5 A CLEAR FRAMEWORK FOR ESTIMATING VARIABLE CONSIDERATION

All variable consideration in the contract (bonuses, penalties, price revision clauses, etc.) must be estimated in a consistent manner and taken into account only to the extent that it is highly probable as defined by the standard. This may therefore change the profile of revenue recognition.

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UPWARD OR DOWNWARD ADJUSTMENT OF REVENUE WHERE THERE IS A SIGNIFICANT FINANCING COMPONENT

This adjustment will be made if the contract includes provision for significant advance or deferred payments by comparison with the date at which an entity satisfies the performance obligation. Departing from current practice, the net cash position of the contract will no longer determine whether or not revenue is adjusted.

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A LEGAL APPROACH TO CONTRACTS AND CONTRACT MODIFICATIONS

IFRS 15 establishes precise conditions under which a contract can be said to exist, and for which revenue can therefore be recognised. This also applies to contract modifications.

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THE END OF DUE TO / DUE FROM

IFRS 15 removes the net approach to balances for a given contract. Instead the new presentation takes account of down payments received from the customer.

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DISCLOSURE ON THE BACKLOG, NOW DEFINED IN ACCOUNTING TERMS

IFRS 15 requires disclosure of unrecognised revenue and a quantitative or qualitative explanation of the expected realization of backlog.

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A RESTRICTIVE APPROACH TO CAPITALISING THE COSTS OF OBTAINING A CONTRACT

Only the incremental costs of obtaining a contract (those that would not have been incurred if the contract had not been obtained) that are recoverable are to be recognised as an asset.

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MAZARS' SPECIALISTS AT YOUR SIDE:
EXPERTS IN LONG-TERM CONTRACTS TO
SUPPORT YOUR TRANSITION TO IFRS 15

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RECOGNITION OF REVENUE OVER TIME IS NO LONGER AUTOMATIC

BEFORE IFRS 15...

Under the existing standards, revenue is **automatically** recognised over time if the transaction relates to the construction of a complex asset or the delivery of services.

Under IFRS 15, revenue will be recognised over time **if it can be shown:**

- > either that the customer **simultaneously receives and consumes the benefits of the entity's performance** as the entity performs; this criterion will apply, for example, to maintenance services which do not represent significant improvements to an asset;
- > or that the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced. This criterion will be relevant if a contract **transfers ownership to the customer as the asset is constructed**. This criterion will for instance apply if works are carried out **on the customer's asset** (for example, works to improve the asset);

> or that the entity's performance does not create an asset that the entity could use in any other way (e.g. by redirecting it to another customer), and that throughout the duration of the contract the entity has an enforceable right to payment for performance completed to-date should the customer terminate the contract for its convenience before its termination date. In practice, this right to be paid, evidenced by the contractual terms and/or the applicable legal framework, must cover the costs incurred up to the termination date, plus a reasonable margin. **This last criterion is likely to be relevant to many contracts for the construction of complex assets.**



Cédric Haaser,
Partner,
Long-term contracts expert

“ *Analyses should be carried out on each standard contract representative of the different business activities conducted by a group. They should involve the standards/accounting departments, legal departments and operational departments.*

These analyses will enable entities both to identify the expected impacts at the date of transition to IFRS 15 and to establish guidelines for the negotiation of advantageous contractual terms for future contracts. ”



A LIMITED CHOICE OF METHODS FOR MEASURING REVENUE RECOGNISED OVER TIME

BEFORE IFRS 15...

Existing IFRSs authorise several methods of **measuring the progress of a contract**.

Today entities essentially use two approaches: the technical milestones method, and the cost-to-cost method, which compares the costs incurred to date to the expected total costs at contract termination.

Theoretically, IFRS 15 authorises the use of many methods of revenue recognition, which the standard presents as two major categories:

- > methods based on the **direct measurement of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised in the contract** (for instance, methods based on the number of units produced or units delivered);
- > methods based on the entity's **inputs to date to satisfy a performance obligation relative to the total expected inputs necessary to satisfy that performance obligation** (for example the time elapsed as a proportion of the total estimated time).

This will be the case where these methods cause entities to carry significant work in progress on the balance sheet for which the entity has in reality transferred control to the customer through the transfer of control over time (see point 1, page 7).

Therefore, entities that currently use the technical milestones method should prepare to switch to a cost-to-cost method, with all the related consequences not only in accounting and financial terms but for information systems, internal audit, project management, etc.



Grégory Derouet,
Partner,
Long-term contracts expert

“ Differences in the way the progress of a contract will be measured will constitute a **major change for some groups**, calling for **appropriate communication** as soon as possible, both **internally and towards third parties**. ”



THE END OF MARGIN SMOOTHING

BEFORE IFRS 15...

Existing IFRSs allow **margin smoothing when revenue is recognised over time**, regardless of the method of measuring progress used. In practice, this is used to anticipate or defer certain costs through the balance sheet in order to obtain a constant margin in profit or loss over the duration of the contract, particularly when the technical milestones method is used. However, this smoothing of the margin is automatic when a cost-to-cost method is applied.

IFRS 15 addresses the recognition of both the revenue and the costs incurred in the course of a contract with a customer.

The standard does not directly address margin issues. It is nevertheless clear that **IFRS 15 does not aim to smooth the profit margin over the term of the contract.**

In practice, the actual costs incurred to date to build an asset or render a service should be recognised in profit or loss.

Therefore, even if a cost-to-cost method ought theoretically to smooth the margin over the duration of the contract, **adjustments will have to be made under some circumstances that could lead to “margin jumps”.** The objective of IFRS 15 is to ensure that the revenue accounted for reflects the entity’s actual performance at all times.

In this context, the standard clarifies that an entity cannot recognise revenue on the basis of **unexpected inefficiencies which were not reflected in the contract price.**

Generally speaking, the risks estimated at the start of long-term contracts cannot therefore be spread evenly over the duration of the contract regardless of when they actually occur.

Another cost-to-cost adjustment concerns “uninstalled materials”. This refers to the situation where certain components of the contract that are simultaneously significant, relatively generic and not distinct from the asset in which they will be integrated are procured from third parties, and the customer obtains control of these components before they are installed by the entity during the construction of the asset. In this instance, IFRS 15 requires these components to be excluded from the measurement of progress, and for revenue to be **recognised only for the costs they represent to the entity. The margin is recognised subsequently.** IFRS 15 does not clarify how the margin on these components should ultimately be accounted for.

A large, stylized white number '4' is centered in the upper half of the page. To its left, there are two vertical bars: a thin light blue bar and a thicker, medium blue bar. The background is a solid dark blue color.

4

A POTENTIALLY DIFFERENT
BREAKDOWN OF CONTRACTS,
WITH A SEPARATE MARGIN
FOR EACH DISTINCT GOOD OR
SERVICE

BEFORE IFRS 15...

When a contract contains a promise to sell a customer several goods or services (for example, a series of complex assets and maintenance services over several years) **current practices do not always take a consistent approach to breaking the contract down** in order to recognise revenue for each distinct good or service.

IFRS 15 contains concise guidance on how to identify what the standard calls "performance obligations".

Applying this guidance will call for the use of judgment and a consideration of all the relevant facts and circumstances.

The standard requires entities to **determine whether the goods or services promised to the customer are distinct on their own** (for example because they are also sold by the entity separately from the other goods and services) **and within the context of the contract** (for instance, if the good or service does not significantly modify another good or service promised in the contract).

As an illustration, a contract promising the construction of an asset followed by its maintenance should be broken down into two separate performance obligations.

As well as the goods and services promised in the contract, the question of how to identify performance obligations also applies to **warranties** (warranties that cover more than the simple statutory guarantee constitute performance obligations) and to **customer options for additional goods or services giving a material right to the customer** (in

which case the revenue relating to the option must be deferred).

The issues here are significant, because the identification of at least two performance obligations in a contract means entities must:

- > **allocate the revenue to each of the performance obligations identified** (using an approach set out in the standard based on the observable or estimated stand-alone selling price of each distinct good or service);
- > and therefore **recognise a separate margin for each separately recognised performance obligation;**
- > **determine the obligating event for recognition of revenue for each performance obligation separately** (in some cases revenue will be recognised over time and in others at completion, depending on the pace at which control of the underlying good or service is transferred to the customer).

Therefore, this is a structuring step in the application of IFRS 15.



5

A CLEAR FRAMEWORK FOR ESTIMATING VARIABLE CONSIDERATION

BEFORE IFRS 15...

IFRSs do not currently provide detailed instructions as to the treatment of the various forms of variable consideration, such as bonuses to be received, penalties to be paid, price indexation, etc.

Entities often take a **very prudent approach** to these aspects.

IFRS 15 is much more prescriptive and sets out a **two-step approach** which should be documented for each contract or portfolio of similar contracts:

- > first, **estimate** variable consideration **in a consistent manner** using either the expected value method or the most likely amount method (the choice will depend on the circumstances);
- > next, include the estimated amount of variable consideration in the transaction price **only to the extent that it is highly probable** (i.e. the entity must be able to demonstrate that a significant reversal in the amount of revenue already recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved).

Therefore, the more predictable the underlying parameters of variable consideration, the more this variable consideration can be included in revenue recognised over time.

Conversely, the more volatile or uncertain these parameters, the less likely it is that the revenue recognised may include the variable consideration.

The application of this constraint will require a quantitative and qualitative analysis which, once again, will call for the exercise of considerable judgment.



Sophie Delerm,
Senior Manager,
Long-term contracts expert

“ Price revision clauses and performance bonuses should in future be included in revenue **from inception**, though they must be measured in a **very prudent** manner. ”



UPWARD OR DOWNWARD
ADJUSTMENT OF THE
REVENUE WHERE THERE IS
A SIGNIFICANT FINANCING
COMPONENT

BEFORE IFRS 15...

Currently, a variety of approaches are taken to accounting for financing components in customer transactions. **Very few entities adjust the revenue to be recognised** when advance payments are made by the customer.

It is more common to adjust the revenue in the event of payment schedules that benefit the customer. This leads simultaneously to a reduction in the revenue recognised and to the recognition of financial income. In practice, the financing of the contract is nearly always assessed in consideration of the net cash position of a given contract (i.e. the difference between the cash received from the customer and the cash required to finance the performance of the contract or the subcontracting).

IFRS 15 **requires the revenue to be adjusted** wherever there is a significant financing component, whether the entity is financed by its customer (in the case of advance payments) or finances its customer (where payments are deferred).

The presence of a significant financing component must be identified at contract inception by comparing the expected **revenue recognition profile** over the duration of the contract with the **profile of payments to be received** from the customer, which differs from the current practice.

However, in some cases the timing of the customer's payments and the delivery of a service differ significantly for **reasons obviously other than the provision of finance to either the customer or the entity** in the contract. In these instances the revenue is not adjusted.



Edouard Fossat,
Partner,
IFRS expert

“ *The concept of a significant financing component may cause many entities to adjust their revenue, and in particular to **recognise more revenue in the event of advance payments by customers.** Financial expenses are recognised in parallel to take account of the finance obtained by the entity.* ”



A LEGAL APPROACH TO CONTRACTS AND CONTRACT MODIFICATIONS

BEFORE IFRS 15...

Existing IFRSs **give no definition of a contract with a customer.**

Provisions on contract amendments and contract claims state that the probability that the customer will accept the changes/claim is an essential condition for revenue recognition.

IFRS 15 provides **a legal definition of a contract**, which it says is “an agreement between two or more parties that creates enforceable rights and obligations”.

This concept of “**enforceable rights and obligations**” must be considered in the light of the contractual terms and local jurisdictions.

IFRS 15 also states that revenue from a contract with a customer can only be accounted for **if five conditions are met**.

In particular, the parties to the contract must have approved it and they must be committed to perform their respective obligations.

The entity must also expect to be able to collect the consideration to which it is entitled in exchange for the goods or services that will be transferred to the customer (the “collectability” of the revenue). The same logic applies to contract modifications (claims, variation orders, etc.) and enables entities to **identify when to take account of the changes in the scope of the contract or in its price**, with due consideration of the guidance on estimating variable consideration (see point 5, page 15).



Claire Dusser,
Senior Manager,
IFRS expert

“ *Whether or not amendments and claims are included in revenue will in future depend on an exclusively legal approach, **often more restrictive than existing practice.*** ”



THE END OF DUE
TO / DUE FROM

BEFORE IFRS 15...

Existing IFRSs call for a net amount to be presented for each construction contract corresponding either to what is due from the customer (asset) or what is due to the customer (liability). This amount includes costs incurred to date, plus recognised profits, less the sum of recognised losses and progress billings. It therefore **does not include down payments received from the customer**. Some entities present due to / due from directly on the balance sheet on separate lines. Others provide this information in the notes to the financial statements.

IFRS 15 requires the disclosure of what the standard calls “**contract assets**” and “**contract liabilities**”. These concepts apply to all contracts with customers, regardless of the lines of business/industry. Presentation on separate lines will depend on the materiality of these aggregates in the light of other balance sheet items.

Contract assets and liabilities differ from due from/due to because they must reflect the **relationship between the entity’s performance to date in comparison with the payments made by the customer at the same date**.

In practice, a contract asset will generally correspond to an invoice to be issued. A contract liability is recorded by an entity to account for net customer down payments where the performance obligation has not been satisfied, or has only partly been satisfied in a proportion that is less than the proportion of the total consideration represented by the down payments.

Contract assets should be presented **separately from receivables**, which will normally correspond to the revenue invoiced for services rendered.

The costs of obtaining and fulfilling a contract which have been capitalised will also be presented separately. Liabilities recognised for onerous contracts (i.e. when a loss at completion is identified for a given contract) will also be presented separately on the balance sheet.

IFRS 15 therefore removes the net balance sheet representation for a given contract (even if the existing standard takes no account of customer down payments). Quantitative and qualitative disclosures will be required in the notes to explain the changes in the contract asset and the contract liability balances during the reporting period.



Johanna Darmon,
Partner,
Long-term contracts expert

“ Entities that have been accustomed to the due to / due from approach will have to **change the way they report on Working Capital components**. ”



DISCLOSURE ON THE
BACKLOG, NOW DEFINED
IN ACCOUNTING TERMS

BEFORE IFRS 15...

The backlog is nowadays an important indicator for entities with long-term contracts.

However this indicator **is not standardised** and the information provided may **differ widely** from one entity to another.

IFRS 15 effectively provides a **definition of backlog** (though it never uses the term) and requires entities to disclose in the notes to the financial statements:

> the **amount of the transaction price** allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period. This assumes the identification of contracts as defined by the standard (see point 7, page 19) and that the contract price has been estimated in accordance with IFRS 15 (see points 5 and 6, pages 15 and 17);

> a quantitative or qualitative explanation of **when the entity expects to recognise as revenue its backlog**. Very few entities currently provide this information.

Therefore, this represents a major development concerning a key performance indicator that is widely followed by investors.



Carole Masson,
Partner,
IFRS expert

“ Our benchmarking of entities’ financial communication regarding backlog shows a **diversity of practices** which should be **harmonised** by the requirements of IFRS 15. ”



10

A RESTRICTIVE APPROACH TO CAPITALISING THE COSTS OF OBTAINING A CONTRACT

BEFORE IFRS 15...

Before obtaining a contract with a customer, an entity generally incurs costs which may **sometimes be significant** (i.e. legal costs, sales commissions, demonstration costs, pre-design, etc.). Under the existing standards, these costs can be recognised as assets under certain conditions.

IFRS 15 establishes a **restrictive definition** of the costs that shall be recognised as an asset when obtaining a contract. **Only the costs that would not have been incurred if the contract had not been obtained** (typically, a sales commission) shall be recognised as an asset, provided it is probable that they will be recovered.

Existing practices will therefore probably change. However, it should also be possible to recognise as an asset costs relating to an anticipated contract if they correspond to the beginning of performance of a specific contract that has not yet been approved but whose signature is highly probable.



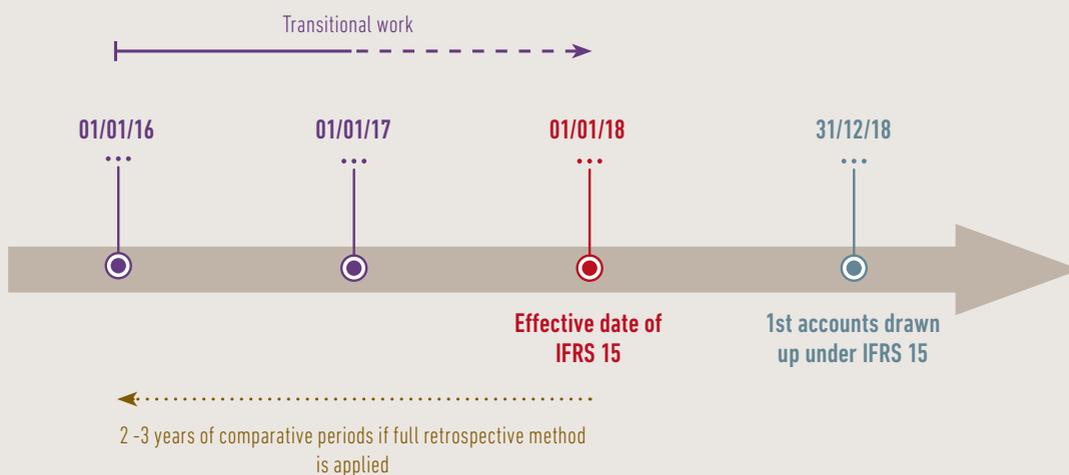
TRANSITION TO IFRS 15: OUR CUSTOMISED SERVICES

As we have seen in this study, the impact of the new revenue recognition standard on financial statements is only the **top of the iceberg**.

The IFRS 15 Task Force, made up of industry experts, consultants and members of the Financial Reporting Technical Support team, is **standing ready and can provide all the expertise you need** to support your transition to IFRS 15.

The key stages in transition are as follows:

- > **Map** the different revenue flows;
- > **Identify** the main differences between existing IFRSs and IFRS 15 on representative contract for your activities;
- > **Measure** the impacts of the adjustments identified;
- > **Adapt** information systems, internal audit procedures, accounting manuals, etc.;
- > **Roll out** IFRS 15 throughout the Group;
- > **Prepare** financial information for the transition and for regular reporting periods.



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