IFRS INDUSTRY ISSUES

MEDIA

IFRS 15: REVENUE FROM CONTRACTS WITH CUSTOMERS

The headlines

The International Accounting Standards Board published IFRS 15 Revenue from Contracts with Customers in 2014, revised the effective date in 2015 and issued clarifications in 2016. IFRS 15 contains comprehensive guidance for accounting for revenue and will replace existing requirements which are currently set out in a number of Standards and Interpretations.

IFRS 15 contains significantly more prescriptive and precise requirements in comparison with existing IFRS. This means that 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, including for commercial effects.

For entities in the media sector, BDO's initial analysis of IFRS 15 indicates that the following areas may be of particular significance:

- Is revenue recognised at a point in time, or over a period of time?
- If revenue is recognised over time, how should progress towards completion be measured and recognised?
- Will a contract need to be 'unbundled' into two or more components? Alternatively, will two or more contracts need to be 'bundled' into a single overall obligation?
- How is it determined whether an entity is a principal or an agent?
- How should contracts which include variable amounts of consideration be dealt with?
- How should modifications to contracts be dealt with?
- Should costs associated with obtaining a contract be capitalised, or expensed immediately?
- What adjustments are required for the effects of the time value of money (a 'financing component')?

IFRS 15 also introduces significantly more disclosures about revenue recognition. It is possible that new and/or modified internal processes will be needed in order to obtain the necessary information.

IFRS 15 is applicable for annual periods beginning on or after 1 January 2018. Earlier application is permitted.

EFFECTIVE DATE

Annual periods beginning on or after 1 January 2018. Earlier application permitted.

ACCOUNTING IMPACT

Wide and potentially very significant effects on the timing and profile of revenue and profit recognition in comparison with current guidance. Significant enhancements to disclosure requirements.

ACTION REQUIRED

The potentially serious commercial implications of this standard, and the fact that it may affect current contracts and their revenue reporting, require most businesses to assess the impacts at an early stage.

At BDO, our accounting experts can carry out an independent impact assessment on the likely effects on your business. This could take the form of an initial short survey of your revenue generating activities, followed if necessary by a more detailed analysis.

If you would like to discuss this, please contact one of our industry sector specialists listed on the back of this leaflet.

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The clarifications

The clarifications made in 2016 relate to:

- Identifying the performance obligations in a contract
- Determining whether a party involved in a transaction is the principal or the agent
- Determining whether a licence provides the customer with a right to access or a right to use the entity's intellectual property ('IP').

They also introduced additional transitional provisions relating to completed contracts and modified contracts.

The commercial effects

The adoption of IFRS 15 may lead to significant changes in the pattern of revenue and profit recognition. Careful consideration and planning will be needed for a wide range of issues, including the effect on:

- Compliance with bank covenants
- Performance based compensation (including share-based payments)
- Internal budgeting processes
- Corporate tax obligations
- Market and investor communications, including compliance with regulatory requirements (which might arise from significant expected future changes to an entity's reported financial position or performance).

A review of the terms and conditions of existing contracts will be needed (in particular long term contracts which extend into periods covered by financial statements affected by the adoption of IFRS 15) as well as those which are to be entered into in future. In some cases, entities may wish to consider whether changes should be made to contracts.

It is also likely that sales departments and/or account management teams will need to liaise more closely with the accounting department in future, in order that the effects of any proposed contractual terms on the related financial statements can be understood in advance.

Is revenue recognised at a point in time, or over a period of time?

IFRS 15 contains specific, and more precise, guidance to be applied in determining whether revenue is recognised over time (often referred to as 'percentage of completion' under existing standards) or at a point in time. Entities in the media sector often recognise revenue at a point in time, and will need to give the new guidance careful consideration.

There are three criteria, each of which would result in 'over time' recognition. These are:

- The customer simultaneously receives and consumes the benefits provided by the vendor's performance as the vendor performs
- The vendor's performance creates or enhances an asset (for example, work in progress) that is controlled by the customer as work progresses
- The vendor's performance creates an asset which does not have an alternative use to the vendor, and the vendor has an enforceable right to be paid for work completed to date.

In practice, the third criterion may be relevant, and the first part of this (no alternative use) will often be met because projects undertaken by, for example, television and film production companies or marketing agencies, are typically tailored to the requirements of a specific customer and would not be capable of being sold to another customer without significant modifications being made.

As a result, there may be significant focus on whether the vendor has, at all stages of the contract, an enforceable right to be paid for the work which has been completed to date. This will require careful analysis of the precise terms of each contract, including in particular the effect of any terms that permit the customer to cancel, curtail or significantly modify the existing contract. This analysis may also require consideration of the general (or common) law in each jurisdiction. The focus is on whether in all circumstances, other than the vendor's failure to fulfil its obligations under the contract, the customer will be required to pay for performance to date. This needs to be an amount that approximates the selling price of the goods or services that have been provided; compensation for loss of profit does not satisfy this condition. Alternatively, the vendor may have the legal right and practical ability to require completion of the contract and payment by its customer.

Entities involved in the production and transmission or display of advertisements will also need to give the new guidance careful consideration for longer campaigns and services which are in progress at a reporting date.

Films, television programmes and music are frequently sold in the form of rights (or licences) to broadcast them for specified periods in particular jurisdictions. IFRS 15 includes specific guidance about accounting for licence payments. To the extent that payments receivable for the licence of IP are dependent on future sales or usage, the licensor is prohibited from recognising revenue until the subsequent sale or usage has taken place. This is regardless of how likely it is that sales will take place, or how accurately the licensor is able to estimate future sales or usage values.

If revenue is recognised over time, how should progress towards completion be measured and recognised?

If revenue is recognised over time, the overall principle is that revenue is recognised to the extent that each of the vendor's performance obligations has been satisfied.

IFRS 15 permits either output or input methods to be used to calculate the amount of revenue to be recognised. An output method results in revenue being recognised on the basis of direct measurement of the value of goods or services transferred to date, while input methods result in revenue being recognised based on measures such as resources consumed, costs incurred or time records.

It is noted explicitly that when input methods are used, there may not be a direct relationship between the inputs being used, and the transfer of goods or services to a customer. Consequently, any inputs that do not relate directly to the vendor's performance in transferring those goods and services are excluded when measuring progress to date.

Certain contracts require administrative or other set-up activities to be carried out in order that an entity is in a position to carry out the services specified in a contract. These include, for example, costs incurred in transporting equipment to a site for large outside broadcast events. Under IFRS 15, these activities do not give rise to revenue. Instead, consideration is given to whether the costs incurred in setting up a contract meet the criteria to be capitalised as a contract asset.

Will a contract need to be 'unbundled' into two or more components? Alternatively, will two or more contracts need to be 'bundled' into a single overall obligation?

Previously, IFRS had little specific guidance for 'unbundling' contracts into components. In contrast, IFRS 15 contains detailed guidance and it is likely that many entities will need to amend their current accounting policies and approaches. This may have a significant effect on the pattern of revenue and profit recognition.

The lack of existing guidance in IFRSs has led some entities in the media sector to follow the requirements of US GAAP. Although IFRS 15 contains substantially more guidance than has existed in IFRS to date, it does not contain some of the most prescriptive aspects of current US GAAP, such as the need to obtain vendor specific objective evidence of selling prices when allocating sales consideration to multiple element arrangements. Consequently, and regardless of whether guidance in US GAAP is currently being followed, entities may see a significant change in the timing and profile of revenue recognition for those types of sales.

IFRS 15 also requires two or more contracts to be combined and accounted for a single contract if one or more of the following conditions are met:

- The contracts are negotiated as a package with a single commercial objective
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract
- The goods or services promised in the contracts (or some of them) are a single performance obligation.

The purpose of this guidance is to ensure that, for a particular good or service, regardless of the legal form of a contract (or contracts) with a customer, the accounting will be the same. Consequently, careful consideration will be required of the commercial objectives of, and item(s) covered by, one or more contract(s) with the same customer.

How is it determined whether an entity is a principal or an agent?

Advertising and media sales often involve a vendor engaging external suppliers to supply content. A key question is whether the vendor should account as a principal (and record gross amounts for revenue and costs) or as an agent (in which case the amount recorded is the net fee or commission amount retained).

IFRS 15 includes detailed guidance to be followed in determining whether a vendor is acting as a principal by selling specified goods or services to its customer, or is instead acting as an agent by arranging for another party (or parties) to provide those goods or services.

The starting point is that if the vendor controls the goods and services to be provided to its customer, then the vendor is a principal. However, it is also noted that this may not be the case if, for example, the vendor obtains legal title of the goods or services only momentarily before they are transferred to a customer.

Other indicators that a vendor is acting as principal include:

- The vendor is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service (e.g. meeting customer specifications).
- The vendor has inventory risk before the specified good or service has been transferred to a customer, or after transfer of control to the customer (e.g. the customer has a right of return).
- The vendor has discretion in establishing price for the specified good or service. However, an agent can have discretion in establishing prices in some cases such as flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.

Although many entities in the media sector have previously considered whether they act as a principal or as an agent, the more prescriptive guidance in IFRS 15 may lead to changes in approach.

How should contracts which include variable amounts of consideration be dealt with?

Contracts often contain clauses which can give rise to variations in the amount of consideration receivable by the vendor. For example, a bonus payment might be receivable if a production or advertisement has been completed before a specified date, with penalties being deducted from the sales price if completion is late.

These clauses give rise to what IFRS 15 calls ‘variable consideration’. This is significant, because when consideration is variable IFRS 15 places a limit on the amount that can be recognised. This limit means that revenue is only recognised when it is highly probable that there will not be a significant reversal in the cumulative amount of revenue recognised to date (for example, because the criteria that were expected to be met for a bonus payment are not, in fact, satisfied). This may result in later recognition of revenue and profit in comparison with current accounting.

In assessing the amount of variable consideration which should be recognised, IFRS 15 permits two approaches. One, which applies to circumstances in which a large number of similar contracts exists, is to look at the expected value over the portfolio. The other, which would generally be applied when there are only two possible outcomes (for example, a bonus payment will or will not be received), is the most likely outcome – subject to the constraint over recognition.

How should modifications to contracts be dealt with?

It is common for the scope and/or price of contracts to be modified. IFRS currently has limited guidance for the accounting consequences of these changes. In contrast, IFRS 15 has detailed guidance to be applied in determining whether contract modifications result in changes to the existing contract or a new contract, and whether there is either an adjustment to the amount of revenue recognised to date (resulting in a ‘true up’ in the income statement) or to revenue to be recognised in future. These new requirements may result in significant changes to the pattern of revenue recognition.

Should costs associated with obtaining a contract be capitalised, or expensed immediately?

In addition to the substantially more detailed guidance for revenue recognition, IFRS 15 contains prescriptive criteria to be applied when determining whether costs associated with the acquisition of a contract should be recognised as an asset, or expensed as incurred. This extends to cover all contract acquisition costs, such as bid (or pitch) costs incurred prior to the award of a contract.

IFRS 15 is restrictive, in that it permits only incremental costs of obtaining a contract to be considered. Consequently, only those costs which would not have been incurred if the contract had not been obtained are eligible to be considered. An example is a sales commission which is only payable in the event that a customer completes a sale. In contrast, ongoing costs of running the business are not eligible to be considered because these costs would have been incurred regardless of whether a specific contract had been obtained. Although it might be argued that certain costs might be lower if an entity was not involved in obtaining sales contracts, IFRS 15 does not permit contracts to be analysed on a portfolio basis. Instead, the focus is on whether costs attributable to each individual contract are incremental.

Once incremental costs have been identified, these are recognised as an asset if there is an expectation that they will be recovered, typically through profits to be generated from the related contract. This asset is then amortised on a basis that is consistent with the transfer of the goods or services specified in the contract. It will be necessary for judgement to be applied in determining an appropriate amortisation period and profile.

What adjustments are required for the effects of the time value of money (a ‘financing component’)?

Contracts in the media sector can involve cash receipts from customers which do not correspond to the timing of the recognition of revenue. If a financing component is significant, IFRS 15 requires an adjustment to be made for the effect of implicit financing.

As a practical expedient, adjustments for a financing component are not required when there is a period of less than one year between the transfer of goods or services and the receipt of payment from a customer.

In a major change from existing practice, adjustments for a financing component are required for circumstances in which customers pay in advance, as well as in arrears. Payments in arrears will result in finance income and a reduction in revenue (because the vendor is providing finance to its customer), while payments in advance will result in a finance expense and an increase in (deferred) revenue (because the vendor is, in effect, borrowing funds from its customer).

The purpose of this approach is to reflect the ‘cash selling price’ of the underlying good or service at the point at which it is transferred to the customer. It also results in transactions which involve a significant financing component being split into two parts; one for the sale of the good or service and the other for the financing arrangement. However, the implications for the internal processes and systems that are needed in order to identify when a financing component is to be recognised, and to account for this, may be significant.

Disclosure requirements

Users of financial statements, and regulators, have criticised the existing disclosure requirements in IFRS as being inadequate and lacking cohesion with other disclosures made in financial statements. This has made it difficult to understand an entity's revenues, as well as the judgements and estimates that have been made in determining their recognition and measurement.

In consequence, comprehensive disclosure requirements have been included in IFRS 15. This means that, even if an entity concludes that the effect of the new standard on revenue recognition is not significant, changes to internal systems and processes may be required to enable the necessary information to be collected for disclosures.

In addition to the detailed guidance, an overall disclosure objective has been specified together with an explicit statement that immaterial information does not need to be disclosed and the disclosure requirements should not be used as a checklist. This is because some disclosures may be very relevant for certain entities or industries, but irrelevant for others. It is also intended to encourage entities to give careful consideration to the information that they will include in their financial statements in order to meet the disclosure objective. However, this again brings the need for careful planning, well in advance of adoption of the new requirements.

For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below.

LONDON (NATIONAL CONTACT)	BIRMINGHAM	BRISTOL	EAST ANGLIA
Andrew Viner	Graham Elsworth	Neil Dimes	Gary Hanson
+44 (0)207 893 2373	+44 (0)121 352 6212	+44 (0)117 930 1501	+44 (0)122 353 5050
andrew.viner@bdo.co.uk	graham.elsworth@bdo.co.uk	neil.dimes@bdo.co.uk	gary.hanson@bdo.co.uk
EAST MIDLANDS	GATWICK	GUILDFORD	NORTH WEST
Rick Wilson	John Everingham	Nick Poulter	Julien Rye
+44 (0)115 962 9208	+44 (0)129 359 1089	+44 (0)148 340 8086	+44 (0)161 817 7505
rick.wilson@bdo.co.uk	john.everingham@bdo.co.uk	nick.poulter@bdo.co.uk	julien.rye@bdo.co.uk
READING	SCOTLAND	SOUTHAMPTON	YORKSHIRE
Simon Brooker	Mark McCluskey	Jane Mulholland	Dan Brookes
+44 (0)118 925 4488	+44 (0)141 249 5230	+44 (0)238 088 1982	+44 (0)113 204 1244
simon.brooker@bdo.co.uk	neil.mcgill@bdo.co.uk	jane.l.mulholland@bdo.co.uk	dan.brookes@bdo.co.uk