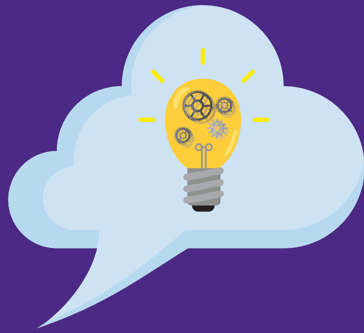
IFRS 15



Earnings surprises in store for investors?

28 April 2017

Matt Chapman
Senior Manager, Better Business Reporting
KPMG in the UK

Investors need to assess how the new revenue recognition standard will affect earnings

It's no secret that investors are struggling to get their heads around the impact that the new revenue standard will have on a company's track record, disclosures and potential for earnings surprises.

IFRS 15 promises much greater transparency over revenue mix – companies may need to publish new analyses of revenues by geography, market or type of customer, sales channel and/or contract type. But investor concern is rising as companies start to announce potential revenue and profit impacts.

So **what do investors need to look out for**, particularly those covering sectors where long-term contracts or contracts with bundled goods or services are common?

Timing of revenues

Revenues may get lumpier as certain contract activities will give rise to revenue and some will not.

IFRS 15 changes how and when companies recognise revenue. Some revenues may be pulled forward, and others pushed back. Applying the new 'five-step' model is complex, but some examples of the changes are as follows.

- **Separating out performance obligations:** Greater emphasis on separation than on identifying components at present, potentially creating fluctuations in margins.
- **Revenues pulled forward:** Day one products and services such as mobile handsets are no longer treated as 'freebies', as revenue now needs to be allocated to them.
- **Revenues pushed back:** Fees for mobilisation and activation will need to be deferred if they do not represent services delivered to the customer.
- **Long-term contracts:** Revenues from manufactured goods may historically have been recognised on delivery to the customer. Now, if the contract meets the 'over time' test, then the revenue would be recognised as the manufacturing happens – akin to current long-term contract accounting.

The impacts may average out for a business in a steady state, but this won't be the case on transition for a growing business.

Increased subjectivity

Increased management judgement is involved in identifying performance obligations and how consideration is allocated to each.

IFRS 15's emphasis on transfer of control means that invoicing does not drive revenue recognition. More accounting judgement is needed to determine the components of the contract, the time when goods and services have been transferred for each component, and the revenue to allocate – leading to fluctuations in margins.

With less linkage between revenues and billing schedules, we're already seeing much greater liaison between commercial teams and finance teams when new products are launched. Companies want to be sure that they can book the earnings they expect, when they expect them.

Transition surprises

There's a risk that transition adjustments could obscure underlying trends in companies' track records.

Companies can choose whether they will adjust their 2017 results when they adopt IFRS 15 in 2018. Transition adjustments may create surprises for investors, particularly when 2017 results are not restated.

- **Revenues that bypass the income statement:** Revenues and margin pulled forward wouldn't hit the income statement, but would instead be buried as an adjustment to retained earnings.
- **Revenues double-counted:** Revenues and margin pushed back would appear twice: once in the 2017 income statement, and again in the 2018 income statement.

Companies are required to explain their transition adjustments, but only in the year of transition. A clear understanding of how these adjustments affect the revenue track record will be key.

Anything else?

IFRS 15 primarily impacts the timing of revenue recognition, but in some cases the total amount of revenue recognised over the life of a contract may change. The most common circumstances are likely to include the following.

- Limitations on circumstances where revenue can be reported on a gross basis.
- Non-performance penalties (e.g. for failure to meet service level agreements) will generally need to be deducted from revenue rather than charged as an expense.
- Cash received more than a year in advance is seen as a loan – the related 'financing cost' is recorded as an interest expense, inflating revenues so that they exceed the cash received.

What should you do now?

If you haven't started already, I'd recommend opening up a dialogue with companies on how they'll be affected. They should be at an advanced stage with their transition assessments now. Looking forward, their IFRS 15 disclosures will be key to understanding underlying performance.

You can find more information on KPMG's Revenue page.

About the author

Matt runs KPMG's Better Business Reporting network, helping companies improve the investor relevance of their corporate reporting.

IFRS 15 – Earnings surprises in store?

Investor insights

The new revenue recognition standard goes live at the start of 2018. It brings greater transparency, but what do investors need to look out for?

Timing of revenues

Revenues may get lumpier – some revenues may be pulled forward and others pushed back

Examples of changes

— Greater emphasis on **separating performance obligations** could create fluctuations in margins

— **Mobilisation** and **activation fees** will need to be deferred if they do not represent services delivered to customers

— New criteria for **long-term contract** accounting could apply to different contract types – e.g. manufacturing

Increased subjectivity

Increased management judgement is involved in identifying performance obligations and allocating consideration

Things to think about

Emphasis on transfer of control means there is less scope for management to manage revenues through billing schedules

But, more **accounting judgement** is needed to determine…

— the components of the contract

— the timing for each component

— the revenue to allocate to each

Transition surprises

There's a risk that transition adjustments could obscure underlying trends in companies' track records

Things to look out for

Revenues that bypass the income statement: Some revenues pulled forward could be recorded as an adjustment to retained earnings

Revenues double-counted: Revenues pushed back could appear twice – once in the 2017 income statement and again in 2018