

# Are customer contracts still enforceable?

22 March 2022



Brian O'Donovan  
Partner, IFRG  
KPMG International

**Uncertainty about whether the rights and obligations in customer contracts remain enforceable may affect the timing and amount of revenue to be recognised.**

## What's the issue?

The impacts of economic uncertainty may call into question the ability of companies, and their customers, to abide by the stated terms of their contracts. This may affect the timing and amount of revenue to be recognised – or whether revenue should be recognised at all.

For example, companies may need to consider the following.

- Customers may struggle to meet their contractual obligations. Does this mean that companies should stop recognising revenue for existing contracts and not recognise revenue for new contracts?
- Rights to payment for performance to date may not be enforceable – e.g. due to force majeure or similar clauses being invoked. Does this affect whether revenue can be recognised over time?
- Companies and their customers may seek to change the terms of existing contracts to respond to the impacts of the COVID-19 outbreak on their business. How should companies account for these contract modifications?

Determining whether rights and obligations are enforceable may require significant judgement and regular reassessment as circumstances change.

## Getting into more detail

### Contract existence

Under IFRS 15 *Revenue from Contracts with Customers*, companies account for a contract with a customer only when the agreement creates enforceable rights and obligations under the law. That is, a company recognises revenue if, and only if, the contract passes the contract existence test in Step 1 of the **five-step model for revenue recognition**.

When entering into new contracts, companies need to consider carefully whether these Step 1 criteria are met. For example:

- Are both parties committed to performing their respective obligations?
- Is it probable that consideration will be collected?
- Does the contract allow each party to terminate a wholly unperformed contract without compensating the other party? [IFRS 15.9–12, Insights 4.2.30]

If a new contract with a customer does not meet all of the contract existence criteria, then a company does not recognise revenue.

In addition, companies may need to reassess whether the contract existence criteria continue to be met for existing contracts – i.e. if there is a significant change

in facts and circumstances. If an existing contract with a customer no longer meets these criteria, then a company stops recognising revenue for that contract. [IFRS 15.13]

### **Revenue recognition over time**

Some companies recognise revenue over time under paragraph 35(c) of IFRS 15 – i.e. the company's performance does not create an asset with an alternative use and it has an enforceable right to payment for performance to date.

This is common in sectors such as real estate, construction, engineering, aerospace and defence. However, this approach is not a choice – it is available under paragraph 35(c) only when the company has an enforceable right to payment.

During times of economic uncertainty, companies should consider carefully whether this right to payment continues to be enforceable. For example, if courts cease to uphold rights to payment, or force majeure or similar clauses are being invoked, then these rights may no longer be enforceable. Significant judgement may be required in making this assessment. [IFRS 15.35–37, Insights 4.2.220]

If this criterion for recognising revenue over time is no longer met, and the other over-time criteria in paragraph 35 are not met, then companies recognise revenue at a point in time. For example, a construction company that spends two years building an apartment block would recognise revenue no earlier than when it completes construction. [IFRS 15.32]

### **Contract modifications**

Companies and their customers may seek to modify existing contracts to respond to the impacts of events resulting in economic uncertainty. Under IFRS 15, a contract modification is a change in the scope or price of a contract, or both. This may be described as a change order, a variation or an amendment.

Companies account for contract modifications when they are approved and when they create or change the enforceable rights and obligations of the parties to the contract. Companies may need to exercise judgement to assess when contract modifications are approved, particularly when contracts are modified frequently or there is continuing uncertainty about how a contract will be completed. [IFRS 15.18]

Accounting for contract modifications can be complex. There are different approaches for different circumstances, depending on factors such as how the modification is priced and whether the current contract is being accounted for over time. Companies need to apply the specific requirements in IFRS 15. [IFRS 15.20–21, Insights 4.2.290]

### **Disclosures**

In annual financial statements, companies are required to disclose judgements made, and changes in those judgements that significantly affect the amount and timing of revenue recognised. For example, companies may need to provide or update disclosures about when the contract existence criteria are met or whether revenue is recognised over time under paragraph 35(c). [IFRS 15.123]

In interim financial statements, IFRS 15 requires companies to include information about disaggregated revenue. However, companies need to consider whether to provide other disclosures for revenue to meet the requirements in IAS 34 *Interim Financial Reporting* – e.g. if there is a change in a company's accounting policies for revenue.

## Actions for management

- Consider whether contracts meet Step 1 of the IFRS 15 model – e.g. do contracts meet the existence criteria?
- When revenue is being recognised over time under paragraph 35(c), determine whether rights to payment for performance to date remain enforceable.
- Assess whether existing contracts have been modified and account for these modifications when they are approved.
- Disclose significant judgements and changes in judgements made in applying IFRS 15.

References to 'Insights' mean our publication **Insights into IFRS®**

Publication name: *Are customer contracts still enforceable?*

Publication date: March 2022

© 2022 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization. KPMG International Standards Group is part of KPMG IFRG Limited.

KPMG refers to the global organization or to one or more of the member firms of KPMG International Limited ("KPMG International"), each of which is a separate legal entity. KPMG International Limited is a private English company limited by guarantee and does not provide services to clients. For more detail about our structure please visit <https://home.kpmg/xx/en/home/misc/governance.html>

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

*This publication contains copyright © material and trademarks of the IFRS® Foundation. All rights reserved. Reproduced by KPMG IFRG Limited with the permission of the IFRS Foundation. Reproduction and use rights are strictly limited. For more information about the IFRS Foundation and rights to use its material please visit [www.ifrs.org](http://www.ifrs.org).*

**Disclaimer:** To the extent permitted by applicable law the Board and the IFRS Foundation expressly disclaims all liability howsoever arising from this publication or any translation thereof whether in contract, tort or otherwise (including, but not limited to, liability for any negligent act or omission) to any person in respect of any claims or losses of any nature including direct, indirect, incidental or consequential loss, punitive damages, penalties or costs.

Information contained in this publication does not constitute advice and should not be substituted for the services of an appropriately qualified professional.

*'IFRS®', 'IAS®', 'IFRIC®' and 'IASB®' are registered Trade Marks of the IFRS Foundation and are used by KPMG IFRG Limited under licence subject to the terms and conditions contained therein. Please contact the IFRS Foundation for details of countries where its Trade Marks are in use and/or have been registered.*