



IFRS 15 Revenue from **Contracts with Customers >>**

The 5-step Model under IFRS 15

IFRS 15 establishes the principles an entity applies when reporting information about the nature, amount, timing, and uncertainty of revenue and cash flows from a contract with a customer. Applying IFRS 15, an entity recognizes revenue to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In doing so, entities are required to apply the following 5-step model:



Step 01

**Identify the
Contract with
the Customer**



Step 02

**Identify the
performance
obligations**



Step 03

**Determine the
Transaction Price**



Step 04

**Allocate the
transaction price to
performance obligations**



Step 05

**Recognize
Revenue**

Our experience working with clients globally, particularly in the Kingdom of Saudi Arabia, indicates that companies are facing challenges applying each of the aforesaid 5-steps to their specific facts and circumstances. Therefore, we have sought to produce this publication to support in navigating the complexities stemming from the implementation of this standard and to avoid last-minute audit adjustments and/or negative comments stemming from regulator reviews.

Step 01

Identify the Contract with Customer

In order to apply the guidance under IFRS 15, there must be an 'enforceable' contract with the customer, clearly outlining the rights and responsibilities of each party to the contract. Ultimately, enforceability is a matter of law and contracts can be written, oral, or implied based on a company's customary business practices. Generally, this step is relatively straightforward. However, complications could arise about the following:

- **Onboarding new customers:** Upon selling to a new customer, entities should carefully evaluate the customer's ability and intent to pay. This could be facilitated by incorporating strong customer onboarding processes, such as Know Your Customer ("KYC") checks.
- **Master Service Agreement:** If the arrangement has been executed as a framework agreement, i.e., the specific scope of work and fees for each instance of work are agreed upon as part of a Statement of Works ("SOW") or Purchase Orders. These Purchase Orders, when considered collectively with the Master Service Agreement, constitute the customer contract.
- **Contract Combination:** Sometimes, multiple transactions are entered into at or near the same time to achieve an overall commercial objective. In such cases, the individual transactions may not make commercial sense on a standalone basis. In such a scenario, consideration must be given to whether the individual transactions should be combined and accounted for as a single customer contract.
- **Contract Duration:** IFRS 15 stipulates that the customer contract should be enforceable. Therefore, it is vital to consider termination clauses (i.e., whether any party can terminate for convenience or cause), the notice period, the termination penalty, etc., to identify the contract duration.

Step 02

Identify the Performance Obligations

This step requires the identification of 'promises' in the contract. Once the promises have been identified, consideration should be given to whether each promise represents a 'distinct' performance obligation or multiple promises should be combined and considered as a single performance obligation. In determining whether each promise is distinct, consideration should be given to whether:

- a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer and
- b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

The performance obligation essentially represents the 'unit of account' for the purposes of revenue recognition, and therefore, performance obligations must be identified appropriately. Due to the critical nature of this step, auditors and regulators often find this to be an area of interest.

- Identifying performance obligations presents practical challenges, especially with complex contractual arrangements. This step often requires significant judgment to apply the concept of distinct from determining whether to recognize single or multiple performance obligation. As a result, this is an area of concern for regulators in the Kingdom of Saudi Arabia and globally.
- Multi-party arrangements (e.g., re-sellers) often add to the complexity of this step. In such cases, entities should carefully analyze each party's rights and obligations to determine whether it is acting as an agent or principle with respect to each performance obligation. IFRS 15, as originally issued, included significantly more guidance to determine whether you are acting as principal or agent in a contract with a customer. However, since the assessment of the transfer of control for items purchased online is more complex than tangible assets, these changes clarify that the principal obtains control of the good or service prior to transferring it to the customer. It is interesting to note that the International Accounting Standards Board (IASB) has reframed guidance paragraph B34 from listing indicators to identify agency relationships to instead listing indicators of when an entity could be acting as principal. This is an important consideration as it will affect the amount of revenue that the entity will be entitled to recognize (i.e., gross v. net presentation).
- Challenges in IFRS 15 licensing guidance include determining whether a license provides a 'right to access' or a 'right to use' intellectual property, leading to inconsistent accounting for similar transactions (e.g., sales-based royalties vs. asset divestments). Preparers also face issues identifying licensing arrangements, defining performance obligations in mixed contracts, and handling license renewals.

Step 03

Determine the Transaction Price

The transaction price is the consideration to which the seller is entitled in exchange for the goods or services provided under the contract. The transaction price comprises not only fixed consideration but also any variable consideration such as bonuses, penalties, and fines (i.e., could positively or negatively impact transaction price). The transaction price should also be adjusted for the time value of money and any consideration payable to the customer. The transaction price should also capture the fair value of any non-cash consideration involved as part of the transaction. To determine the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be canceled, renewed, or modified.

The challenges in determining transaction prices stem from variable consideration and amounts payable to customers or their customers in multi-party transactions. Key issues include whether such payments should be classified as revenue or expenses and how to handle 'negative revenue' scenarios. This complexity impacts diverse industries, like food delivery, ride-hailing, and online platforms, where incentives and multi-party interactions are common, leading to inconsistencies in financial reporting practices.

Another consideration with reference to the transaction price relates to determining whether there is a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract. Consequently, entities should carefully review the customer contracts to determine if the timing of payments agreed to by the parties (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing. In such cases, the transaction price must be adjusted to reflect the time value of money, and the effect of the financing will be accounted for as a finance cost/ income, as applicable.

Lastly, if a contract contains a right to return, the transaction price should exclude the consideration related to products expected to be returned or anticipated amounts to be refunded. This is quite common for pharmaceutical and retail/ consumer goods companies. It is noted that sales returns exclude the right to return faulty goods, which are instead assessed under the guidance for warranty. If a sales return results in a refund of the consideration, a refund liability must also be recognized.

Step 04

Allocate the Transaction Price to the Performance Obligations

Once the transaction price has been determined, the entity must allocate the same to each performance obligation identified in the contract. This allocation should be based on the relative standalone selling price of each distinct good or service. When the standalone selling price is not directly observable, the entity must estimate it using the following approaches:

1. Adjusted market assessment approach – this approach requires the evaluation of the market in which the good or service is sold and using that market to estimate the price that the customers are willing to pay
2. Expected cost-plus margin approach – this approach involves the estimation of the cost involved in fulfilling the performance obligation and adding a suitable margin
3. Residual approach – this approach involves subtracting observable standalone prices from the total transaction price. However, it is worth noting that this approach is only applicable in limited circumstances.

Entities must establish a robust process with effective internal controls to estimate standalone selling prices accurately. The entity should carefully select an appropriate estimation method and allocate the transaction price at the contract's inception, utilizing available information. Importantly, once this allocation is made, it cannot be revised unless the contract is modified.



Step 05

Recognise Revenue

This is the final step of the 5-step model. Under this step, an entity recognizes revenue when (or as) the customer obtains control of that good or service. 'Control' refers to the ability to direct the use of and obtain substantially all of the remaining benefits. This includes preventing others from directing the use of and obtaining the benefits from the asset. The benefits related to the asset are the potential cash flows that may be obtained directly or indirectly.

Revenue is generally recognized at a point in time unless one of the following criteria is satisfied:

1. The customer simultaneously receives and consumes all the benefits provided by the entity as the entity performs
2. The entity's performance creates or enhances an asset that the customer controls as the asset is created or
3. 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 performance completed to date.

If any of the aforesaid criteria for overtime recognition are met, entities must choose a method that accurately reflects their performance in transferring control of the promised good or service. The standard provides two methods for measuring progress, i.e., the Output Method and the Input Method. Whilst both methods are allowed, in our experience, the application of output method is generally preferred. This is a critical step that significantly impacts the timing of revenue recognition for the entity. Consequently, entities would need to apply significant judgement to determine whether and when control is transferred and how to measure progress to date.

For infrastructure and real estate projects, determination of whether the revenue should be recognized over time or at a point in time would also be an area of judgment. The sale of standard apartments built and designed by the developer would be expected to result in recognition of revenue at a point in time as against customized / bespoke apartments designed by the customer where revenue may need to be recognized over time depending on the other criteria being met.

This aside, where revenue is recognized over time, measuring the progress is also critical, and the method chosen should reflect the pattern of transfer of control to the customer. This is an area of focus for regulators across the sectors specifically given that measuring progress goes beyond accounting and requires deep business knowledge. Finally, where the entity is acting as an agent and only facilitating the transaction, revenue would be recognized at a point in time since there is no continuing obligation once the transaction has been consummated.

Other matters

- **Applying IFRS 15 with other Standards:**

Entities face challenges in relation to the interaction between IFRS 15 and other standards, particularly with IFRS 16 Leases, regarding the separation of performance obligations and handling sale and leaseback transactions. For IFRS 3 Business Combinations, there is debate over whether to recognize contract assets and liabilities at fair value or transaction price at acquisition. IFRS 10 Consolidated Financial Statements, poses questions about whether transactions involving equity interests in single-asset subsidiaries should be accounted for under IFRS 15 or IFRS 10. IFRS 16 Leases, also raises issues about determining if an arrangement constitutes a lease, assessing control transfer in sale/ and leaseback/, and defining the unit of account for renewals. To resolve these matters, SOCPA issued a letter to IFRS Foundation on 26 October 2023, noting that ambiguity can lead to inconsistencies in revenue recognition, affecting the comparability of financial statements across entities. To address these scenarios IASB should include illustrative examples within the respective standards or produce a separate guidance document that details various scenarios to explain the interaction between IFRS 15 and other standards.

- **Nonrefundable upfront fees:**

In certain cases, the fee may represent a material right for the customer, entitling them to additional goods or services in the future. For example, a health club may charge an upfront fee when signing up a customer as a member, granting them the right to renew their contract at discounted rates compared to non-members. In such scenarios, the non-refundable fee is recognized over a period longer than the initial contract term (i.e., customer retention period). Entities must apply judgment to determine the appropriate recognition period, considering factors such as the term of the option granted or historical customer behavior in availing of additional goods or services.

- **Disclosure requirements:**

The IASB and SOCPA aimed to enhance disclosure requirements, but concerns have arisen regarding certain disclosures perceived as costly and of limited relevance, particularly those related to contract assets, liabilities, and remaining performance obligations. Additional concerns include the high cost of providing these disclosures, which may outweigh their usefulness, and instances where entities fail to provide the required information. The lack of guidance in relation to the minimum level of disclosure under IFRS 15 has created inconsistency in practice. We recommend that entities conduct a benchmarking exercise to understand what and how many disclosures are being provided by their peer companies and establish a disclosure baseline.

- **Capital Market Authority (CMA) Observations:**

In March 2023, CMA working team had published prominent observations based their assessment and analysis of financial statements of listed entities in the Kingdom of Saudi Arabia for the years 2020 and 2021. In their publication, the CMA working team identified deficiencies related to recognition policies of revenues, whereby accounting policies for important performance obligations were sometimes unclear or not disclosed, including about the methods used to recognize revenue and how they provide a faithful depiction of the transfer of goods or services. Also, a lack of company specific disclosures was observed stemming from companies providing boilerplate disclosures. Furthermore, it was noted that some companies had recognized all of their revenue at a given point in time, despite selling products that have no alternative use (i.e., customized goods), and hence did not properly assess their right to payment as required by IFRS 15.

A TEAM THAT YOU CAN TRUST TO DELIVER



Jamil Khatri

Co-Founder & CEO

jamilkhatri@uniquus.com



Sandip Khetan

Co-Founder, Global Head of ARC

sandip.khetan@uniquus.com



Dinesh Jangid

Regional Managing Partner

dj@uniquus.com



Saad Alkhathlan

Managing Partner,
Kingdom of Saudi Arabia

saadalkhathlan@uniquus.com



Rayan Al Karawi

Advisor, ARC

rayan@uniquus.com



Zaid Khatri

Associate Partner, ARC

zaidkhatri@uniquus.com