BUSINESSTIMES
News for AIM-listed companies and their advisers

Welcome to the second edition of the PKF Capital Markets Newsletter. This month our focus is on IFRS 15 and some of the thoughts and actions both advisers and entities need to be considering ahead of schedule to avoid any nasty surprises. We also introduce our three-month calendar that highlights upcoming reporting deadlines.

IFRS 15 – Times they are a changin'

The article on IFRS 15 in last month's edition of the 'Business Times' prompted considerable debate and so, we've agreed to look at some key issues below that will affect how revenue is recognised and reported. Focus needs to be given to this standard to ensure that stakeholder's expectations are managed and any changes to the current requirements are appropriately communicated.

IFRS 15 centres on the following 5 step approach:

1. **Identify contract(s) with the customer** – This may sound simple in isolation but under the new standard different contracts with the same customer may need to be combined and looked at together.
2. **Identify the separate performance obligations in the contract** – These obligations need to be distinct in the context of the contract and therefore a detailed understanding and analysis of each contract is required. To highlight the complexity of this, consider a software company – Fox Limited - that enters into a contract with Alpha Limited which contains the following elements:
   - A licence for the use of a piece of Fox Limited's base software;
   - Detailed customisation of the basic software to meet Alpha Limited's specific needs; and
   - A four year helpline and support service.

How many performance obligations does this include? The reality is that this needs to be calculated and revenue recognised separately for each obligation; depending on the contract, the first two elements may well represent one performance obligation, and revenue would be recognised on a combined basis and the third element would represent a separate performance obligation with its own revenue recognition policy.

3. **Determine the transaction price** – This would seem to be quite simple as the standard states that the transaction price is the consideration that the entity expects to be entitled to in exchange for the promised goods or services. However, the variable consideration in relation to the time value of money needs to be considered in certain situations, which adds complexity to the matter.
4. **Allocate the transaction price to the separate performance obligations in the contract** – This requires the transaction to be split into the component performance obligations identified in step 2 which, if not properly scoped, could lead to difficulties.
5. **Recognise revenue when (or as) a performance obligation is satisfied** – This is arguably the most complex of the steps and the most likely to cause revenue to be recognised differently than before. The key is that revenue should be recognised as control is passed, either over time or at a point in time. Some key factors to consider are:
   - Entity has a present right to demand payment for the asset;
   - Customer has legal title to the asset;
   - Entity has transferred physical possession;
   - Customer has the significant risks and rewards of ownership; and
   - Customer has accepted the asset.

If this seems relatively straightforward on paper, consider the following example:

Example A *– Finlay Limited enters into a contract with Beck Limited to manufacture a customised component. This is designed to meet the specific needs of Beck Limited and will have no use to any other entity. Manufacture will take two years. When should revenue be recognised?*

In this example, control is only gained at the end of manufacture when Beck Limited takes title to the asset and revenue should only be recognised at the end of the two years. Whether or not cash has moved between Finlay and Beck Limited during this time in *respect of progress payments or the like is irrelevant. Obviously such cases will have a big impact on primary statements, forecasting and what companies need to tell the market and how to manage stakeholder expectations.*

As you will be aware, there are cases where performance obligations are satisfied over time. Provided certain requirements are met then, in certain cases, entities can recognise revenue by measuring progress towards satisfying the overall performance obligation. The following example allows for consideration of this:

Example B *– Three years ago, Calico Limited supplied a large IT system to Tiger Limited. It has now entered into a contract to conduct an upgrade which will take a full year. The contract calls for 60% of the contract price to be paid on signing, with the remainder payable on satisfactory completion of the contract. How should revenue be recognised on this contract?*

The performance obligation in this instance is the completion of a satisfactory upgrade with which Tiger Limited is happy. As such revenue can only be recognised at the date of complete of the upgrade (i.e. after the year of works). The timing of cash flows is irrelevant to the recognition of revenue and the example serves to highlight the disjoint that can arise between cash flows and revenue recognition.

To conclude, cash flows are irrelevant to revenue recognition and, as the examples indicate, there could be, in certain cases, a significant difference between when cash is received and when revenue is recognised. Certain types of businesses (e.g. construction, manufacturing, software) could see radical changes in the timing of the accounting for revenues, with the smooth revenues currently seen being consigned to the past. Inevitably this will affect how business report. These changes will lead to companies needing to carefully manage stakeholder expectations. All advisers need to be having upfront, early discussions with their clients to identify any potential revenue recognition changes as well as thinking about how such changes will affect the various reports required under current regulations.

Reporting dates

Each month we will be publish a three-month 'Look Ahead' for users to identify the key reporting deadlines that are on the horizon.

In the news

PKF Littlejohn has been ranked **fourth** among auditors for AIM-listed Basic Materials companies, according to the new edition of the Advisers Rankings Guide. This reflects both our in-depth understanding of the extractive industries sector, and our hands-on experience in helping listed clients create value for their shareholders. **Get in touch** to find out how we can help your business fulfill its potential.

Events

We are in the process of organising a series of focussed events for NEDs and companies to discuss current hot topics and share experiences and knowledge gained. If you have any specific topic you wish to cover, please let us know as we want these events to be as relevant and helpful as possible.

Hot topics

Brexit Planning – Regardless of your views on Brexit, change is afoot. To help you prepare for life outside the EU, our Brexit team has prepared a Brexit planning tool for your use. **Read more.**

Hard Brexit – A look at some of the potential implications of a Hard Brexit and the potential tariffs that may affect the UK as it heads down the unknown path of leaving the EU. **Read more.**

Making Tax Digital – The plan remains to make tax digital by 2018 and this article looks at some of the changes made by HMRC following the recent consultation process. **Read more.**

Key priorities for the profession – The ACCA has published a paper detailing what they believe to be the three key priorities for the accounting profession in 2017. **Read more.**

We hope you've found this issue useful. If anyone within your business would like to receive future issues, please send their details to Ruby Crowley (rcrowley@pkf-littlejohn.com).

Our specialist team is here to help. If you would like advice on any of the issues discussed in this newsletter, please contact one of our Capital Markets team.

JOSEPH ARCHER
Partner
E: jarcher@pkf-littlejohn.com

T: +44 (0)20 7516 2495

DOMINIC ROBERTS
Partner
E: dominicroberts@pkf-littlejohn.com
T: +44 (0)20 7516 2219

MARK LING
Partner
E: mling@pkf-littlejohn.com

T: +44 (0)20 7516 2208

PKF

PKF Littlejohn LLP
1 Westferry Circus
Canary Wharf
London E14 4HD
Tel: +44 (0)20 7516 2200

pkf-littlejohn.com

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