Welcome to the first edition of Tech Business, a new regular newsletter from PKF Littlejohn's Technology team, providing a round-up of the main developments in accounting and general market matters.

Unbundling the new IFRS 15 revenue recognition rules

The new revenue recognition International Financial Reporting Standard (IFRS 15 - Revenue from Contracts with Customers) comes into force from 1 January 2018. Whilst that might seem a long way off, businesses should not underestimate the amount of preparatory work that may need to be undertaken and ought to keep in mind that the 2017 financial statements may need to be restated or adjusted as the comparative period. In addition, there already exists a requirement for entities that adopt IFRS to consider and disclose the impact of yet to be implemented new accounting standards on future financial statements, and that applies to financial statements to 31 December 2016. So what should you start thinking about over the next few months?

What is IFRS 15 – a recap

IFRS 15 introduces a five step revenue recognition approach that requires businesses to:

- Identify the contract(s) with the customer
- Identify the separate performance obligations
- Determine the transaction price
- Allocate the transaction price to the performance obligations
- Recognise revenue when the performance obligations are satisfied

It's worth spending some time now working through the steps to make sure you're correctly recognising revenue when you should and that you're capturing the reasoning. The relevant documentation you'll need is not just for your own reporting requirements but also to help support the year-end audit.

Businesses with a single non-complex product (or service) with a transparent pricing structure should find working through these steps relatively straightforward. However, many businesses that provide bundled products and services (such as those, for example, incorporating deferred payment options, warranties, licences, 'software as a service' and incentive schemes) will need to unbundle the underlying product and service components, and may find certain elements of a contract being dealt with by different accounting standards.

The challenges of unbundling – what do you need to look out for?

When unbundling, it's important that the less obvious components are identified and accounted for appropriately. For example, if incentives such as deferred payment options are offered, then part of the customer contract may be regarded as a financing. Warranty and incentive schemes that lock-in customers or encourage repeat business also need to identified and evaluated.

Once unbundled, a value will need to be attributed to each of the performance obligations. Where there are observable prices for similar discrete products and services, this should not be too onerous. Where prices are less observable the task is harder and will undoubtedly require the exercise (and disclosure) of judgement.

It's worth noting that IFRS 15 recognises that in certain circumstances the delivery of the product and service are inextricably linked to such an extent that there is a single performance obligation – such as the delivery of a piece of software that needs to be integrated into existing operational applications before it can be used – but each case will need to be looked at on its own merits.

The need to look at each contract might appear daunting - and it may well be if each customer contract is bespoke. However, IFRS 15 takes a pragmatic view by allowing a portfolio approach to be adopted if you have a large number of similar customer agreements – for example, where standard licence, support and maintenance agreements are issued in respect of a standard product suite.

The comparative year – two options

You will need to apply the new standard not just in the year it comes into effect, but also for the comparative period. The good news is that businesses have two options. You can either opt to fully restate all of the comparative figures for open contracts for each prior period presented. Alternatively, you could leave the comparative figures unaltered but show the financial impact of the change under IFRS 15 as a current period adjustment to the opening brought forward retained earnings

Managing the impact – should you tell your stakeholders?

It's worth investing time as early as possible to quantify the likely financial impact of the new standard. Even where only additional disclosures arise from the adoption of IFRS 15, time will still need to be taken to ensure all of the underlying details are known and available for reporting. It is also important to start managing the expectations of key interested parties such as:

- Analysts and the investment community - if your revenue and earnings forecasts are going to change materially;
- Funding providers - where you have financial covenants linked to profitability; and/or
- Employees - where you have an employee incentivisation scheme also linked to profit.

Is there a tax implication?

A business's tax base will typically be affected in cases where amendments to revenue recognition policies alter the business's profit. In the first period of implementation, adjustments to prior period profits will also be brought into charge.

However, such changes may be overridden by existing legislation that prescribes specific treatment that is not affected by accounting practice (for example, in respect of leases) or by any legislative changes introduced by the Government in light of the changes to IFRS 15. As things stand, no such changes have been identified, but this will be monitored as we approach implementation.

IFRS 15 is coming, and now is the time to begin your preparations. While undertaking this exercise, check that your finance team and accounting systems will be able to capture and maintain this information on a regular basis to ease the interim and financial reporting obligations.

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 Technology team.

RHODRI WHITLOCK
Partner
E: rwhitlock@pkf-littlejohn.com
T: +44 (0)20 7516 2433

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

DOMINIC FIORE
Partner
E: dfiore@pkf-littlejohn.com
T: +44 (0)20 7516 2253

CATHERINE HEYES
Partner
E: cheyes@pkf-littlejohn.com
T: +44 (0)20 7516 2237

NICK MCCHESNEY
Partner
E: nmcchesney@pkf-littlejohn.com
T: +44 (0)20 7516 2262

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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