Fast tracking IFRS 15 implementation for reduced compliance costs and robust risk mitigation

Abstract

The 2008 financial crisis, which exposed dubious financial reporting engaged in by several prominent listed companies, marked a turning point in the annals of corporate governance. The dramatic collapse of some leading securities firms, and its stunning ripple effects on financial markets, highlighted the vital need for robust risk management with regard to balance sheet reporting.

Subsequently, the International Accounting Standard Board (IASB) and the Financial Accounting Standards Board (FASB) undertook a joint review of key accounting norms, in order to ensure faithful representation of transactions in financial statements. This exercise culminated in the unveiling of a new accounting standard for revenue recognition under International Financial reporting Standards (IFRS) in May 2014.

Dubbed 'IFRS 15: Revenue from Contracts with Customers', the norm eliminates the transaction- and industry-specific revenue recognition guidance under existing Generally Accepted Accounting Principles (GAAP), and replaces it with a principle-based approach.

Key Contours

IFRS 15 is rooted in the principle that an entity will recognize revenue only after actual transfer of goods or services to its clients. The quantum of revenue being recognized should reflect the consideration to which the firm expects to be entitled in return for providing those goods or services, the standard stipulates. Set to come into effect worldwide from January 1, 2018, the norm includes five core obligations for companies, as far as commercial contracts are concerned:

- They will need to identify contracts with all of their individual customers, and analyze underlying dimensions like interdependency of such revenue streams, and nature of contract. For instance, a standalone contract will require a different accounting treatment as compared to a portfolio or package arrangement.
- The second requirement involves identifying performance obligations within each contract, with organizations expected to configure input and output models for revenue recognition, as well as licensing pacts.
- This has to be followed by determination of the transaction price, based on consideration of commissions and other variables, and extended warranty treatment.
- Firms must then allocate the transaction price to the concerned performance obligation.
- Finally, they must recognize revenue as and when the obligation is satisfied. The top line, which could be recognized upfront or phased out over a period of time, would entail usage-based royalty, amortization of direct costs, and robust accounting for barter transactions.

Ramifications for CMI Companies

IFRS 15 will have significant impact, along multiple dimensions, on companies across the communication, media and information services (CMI) industries that typically deal in bundled contracts.

Organizations will have to report contracts for distinct goods and services–print, online and television revenues for a diversified media group, for example–separately. Increased disaggregation of revenue will imply fundamental changes in reporting of core business metrics like revenues, profitability, free cash flow, receivables and payables. Accordingly, financial

ratios and key performance indicators (KPIs) will likely be redefined, triggering notable revisions in compensation and benefit structures, pre-qualification criteria, and bonding and surety capacity.

CMI firms now need to swiftly overhaul their underlying IT systems and business processes concerning 'order to cash', general ledger (GL), and reporting, apart from revamping metrics measurement tools. Simultaneously, they must update billing and other front-end systems, and institutionalize integrated data management and harmonization for information granularity, in order to ensure regulatory compliance. Substantial system modifications will also be imperative for capturing additional data around performance obligations, contract balances and disclosures mandated by IFRS 15.

Following the identification of distinct contracts and performance obligations under the new revenue recognition practice, firms will alter their business dealings with third parties like suppliers, customers and lenders. In conjunction, accounting and reporting policies will be updated, with market communication and internal controls being recalibrated.

Finally, IFRS 15 will necessitate a thorough review of product sizing and pricing strategies, given the inevitable spike in working capital requirements, and the transformation of the entire revenue recognition cycle.

Major Impact Areas

A prominent change in the manner media companies recognize revenue going forward will be around the accounting treatment of barter transactions, involving advertising pacts struck between such organizations.

Currently, sales are not recognized during a swap of similar goods or services, with revenue being recorded at fair value for dissimilar goods and services–adjusted for cash or equivalent received. However, IFRS 15 will require companies to record revenues at fair value or standalone selling price of the concerned offerings, as and when the performance obligation is satisfied by the customer. This change in rule will apply to both similar goods–advertising for advertising, for example–as well as dissimilar ones, including advertising for other non-cash consideration.

The second major impact area, in the CMI context, will be the way principal and agent contracts are structured. Once IFRS 15

comes into force, organizations must determine the nature of each performance obligation–principal or agent–and recognize the same separately on their books. In the event of an obligation being principal, revenue will be recorded at gross value. For entities characterized as agents, sales will be booked at net value. This accounting change will potentially result in increased revenue recognition on the balance sheets of telecom carriers and media firms.

The third vital aspect of revenue recognition that will be influenced under IFRS 15 is in relation to intellectual property (IP) licensing, and associated agreements around royalty revenue and franchising. Presently, companies recognize revenues upfront if they acquire rights to a given IP outright, and book the same over a period of time if the license is bought for a defined time frame. Under the new norm, firms will have to determine when they secure commercial rights for an IP such as film, music or photography, and accordingly recognize revenues either over time or at a point in time.

Compliance Challenges

Transitioning to the new accounting setup will not be easy for CMI organizations, both in terms of compliance costs and timelines. Such a migration would involve a wide range of activities, starting from assessment of opening balances and dual tracking for retrospective adoption, to system updates and orientation for key stakeholders.

Each individual contract, comprising multiple sub-line items, will have to be reviewed and restructured, prompting large-scale changes in associated contract systems, business support systems (BSS), and operations support systems (OSS).

Firms will need to reconfigure their revenue accounting engines, and ensure smooth, error-free integration of the same with GL for business continuity. Other notable emerging challenges pertain to mapping the new accounting norms to existing business rules, and implementing a comprehensive data management system for enhanced disclosure and reporting.

Recommendations

In order to effectively migrate to the new accounting environment, CMI firms should chart out and implement a broad-based roadmap for IFRS 15 compliance.

- To start with, they need to gauge the transition's likely impact on their accounting practices, such as as IP and licensing agreements, barter transactions, billing and contract systems, and tax implications. This exercise should also factor in the maturity of the organization's relevant business processes and data management systems.
- The second step would involve defining an implementation strategy, with regard to timing of revenue recognition, amortization principle, contract modification approach, and system and data requirements. This should pave the way for baselining of accounting principles for revenue recognition, revised capitalization and disclosure policies, and amended IT systems including billing.
- Finally, CMI entities should develop a portfolio methodology for multiple contracts, whereby reengineered workflows concerning revenue recognition will be automated, accompanied by end-to-end documentation.

Executing these best practices would help telecom operators and media and entertainment businesses institutionalize a standardized framework for all of their IFRS 15 reporting needs, and ensure pan-enterprise data consistency. Consequently, they will be able to reduce compliance costs, and mitigate risks effectively.

Conclusion

IFRS 15 will have cross-functional impact beyond accounting, dramatically reshaping sales, tax, audit, legal, investor relations, financial planning and analysis, human resources and IT. Therefore, companies across the CMI landscape must look at this as a strategic business imperative that could deliver tangible financial benefits, and urgently devise and implement a compliance roadmap.

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