NZ IFRS INDUSTRY ISSUES: RETAIL

NZ IFRS 15: Revenue from Contracts with Customers

The headlines

In July 2014, the New Zealand Accounting Standards Board published NZ IFRS 15 Revenue from Contracts with Customers. NZ IFRS 15 contains comprehensive guidance for accounting for revenue and will replace existing requirements which are currently set out in a number of Standards and Interpretations.

NZ IFRS 15 is fully converged with equivalent new US GAAP guidance, and contains significantly more prescriptive and precise requirements in comparison with existing NZ IFRS. This means that for many entities, the timing and profile of revenue recognition will change. In some areas, the changes will be very significant and will require careful planning, including for commercial effects.

For entities in the retail sector, BDO's initial analysis of NZ IFRS 15 indicates that the following areas may be of particular significance:

- Will a contract need to be 'unbundled' into two or more components? Alternatively, will two or more contracts need to be 'bundled' into a single overall obligation?
- How should contracts which include variable amounts of consideration (rights of return) be dealt with?
- How should payments made to customers be dealt with?
- How should licences granted by a franchisor be dealt with?
- Should costs associated with obtaining a contract be capitalised, or expensed immediately?
- What adjustments are required for the effects of the time value of money (a 'financing component')?
- What changes will be required to internal controls and processes?

NZ IFRS 15 also introduces significantly more disclosures about revenue recognition. It is possible that new and/or modified internal processes will be needed in order to obtain the necessary information.

NZ IFRS 15 is applicable for annual periods beginning on or after 1 January 2018. Earlier application is permitted.

The commercial effects

The adoption of NZ IFRS 15 may lead to significant changes in the pattern of revenue and profit recognition. Careful consideration and planning will be needed for a wide range of issues, including the effect on:

- Compliance with bank covenants
- Performance based compensation (including share-based payments)
- Internal budgeting processes
- Corporate tax obligations
- Market and investor communications, including compliance with regulatory requirements (which might arise from significant expected future changes to an entity's reported financial position or performance).

A review of the terms and conditions of existing contracts will be needed (in particular long term contracts which extend into periods covered by financial statements affected by the adoption of NZ IFRS 15) as well as those which are to be entered into in future. In some cases, entities may wish to consider whether changes should be made to contracts.

Effective Date

Annual periods beginning on or after 1 January 2018. Earlier application permitted.

Accounting Impact

Wide and potentially very significant effects on the timing and profile of revenue and profit recognition in comparison with current guidance. Significant enhancements to disclosure requirements

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Will a contract need to be 'unbundled' into two or more components? Alternatively, will two or more contracts need to be 'bundled' into a single overall obligation?

Previously, NZ IFRS had little specific guidance for 'unbundling' contracts into components. In contrast, NZ IFRS 15 contains detailed guidance and it is likely that many entities will need to amend their current accounting policies and approaches. This may have a significant effect on the profile of revenue and profit recognition.

Common examples of items that may need to be accounted for separately include:

- Discounts on future purchases
- Warranties
- Service contracts

Discounts on future purchases

Customers who purchase certain goods and services may be given a voucher which entitles the customers to a discount if they purchase particular items during a specified period in future. This includes customer loyalty schemes, under which points may be awarded which can be used for partial or complete payment for future goods and services. For these transactions, part of the purchase price for the original goods and services needs to be allocated to the voucher, and deferred to a future period. Revenue attributable to the voucher is then recognised either when the subsequent sale of goods and services takes place, or the voucher expires unexercised.

Warranties

Retails goods are frequently sold with a warranty (or guarantee) that they will operate satisfactorily for a specified period of time. The accounting treatment depends on:

- Whether customers have an option to purchase the warranty separately; and
- Whether the warranty is part of the overall package of goods sold to the customer and, if so, whether the warranty simply provides assurance that the goods are in compliance with the agreed upon specifications in the contract.

Agreed upon specifications often relate to an assurance that an item will function properly for a specified period, and may link to legal requirements in some jurisdictions.

If customers have an option to purchase a warranty separately from the goods themselves, this is accounted for separately. If the warranty is part of the overall package then, if it simply provides an assurance of compliance with agreed upon specifications, it is not accounted for separately. If it goes beyond compliance with agreed upon specifications, then it is accounted for separately regardless of whether it is identified as a separate component of the sales transaction.

Goods may also be sold with a warranty for a specified period (such as 12 months), with the customer being given the right to renew the warranty for a further 12 months at a discount from the standard selling price. In these cases, the consideration received for the first 12 month warranty may need to be split between the initial 12 month licence and the renewal right, with revenue relating to that renewal right being deferred and recognised in a future period.

Service contracts

Goods sold to customers may require periodic maintenance. In such cases, it is common for the goods to be sold together with maintenance covering a specified period of time. Revenue attributable to the contract is required to be allocated to each of the two components, with the amount allocated to the maintenance service being deferred and recognised as the maintenance services are provided.

NZ IFRS 15 also requires two or more contracts to be combined and accounted for as a single contract if one or more of the following conditions are met:

- The contracts are negotiated as a package with a single commercial objective;
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- The goods or services promised in the contracts (or some of them) are a single performance obligation.

The purpose of this guidance is to ensure that, for a particular good or service, regardless of the legal form of a contract (or contracts) with a customer, the accounting will be the same. Consequently, careful consideration will be required of the commercial objectives of, and item(s) covered by, one or more contract(s) with the same customer.

How should contracts which include variable amounts of consideration (rights of return) be dealt with?

Contracts for the sale of goods frequently give the customer a right to return the goods and receive a refund, a credit that can be applied against another purchase, or another product in exchange.

These clauses give rise to what NZ IFRS 15 calls 'variable consideration'.

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This is significant, because when consideration is variable NZ IFRS 15 limits the amount that can be recognised.

To the extent that the vendor expects customers to exercise the right of return, revenue is not recognised for the related goods even though these may already have been transferred to the customer. Instead, a refund liability is recognised together with an asset for the right to recover the original asset (depending on whether the item recovered would have any value).

How should payments made to customers be dealt with?

Entities that supply goods to retailers frequently enter into arrangements under which payments are made to the retailers in return for goods being displayed or advertised prominently.

NZ IFRS 15 includes detailed guidance about accounting for payments to customers, and careful consideration will be needed of whether payments by suppliers to retailers are being made in exchange for a service that is provided by the retailer, or are instead a reduction in the sales price of goods supplied to the retailer.

How should licences granted by a franchisor be dealt with?

The contractual terms of licences granted by a franchisor to franchisees vary significantly, and can include amounts payable which depend on the franchisee's sales volume or revenues.

NZ IFRS 15 includes guidance about accounting for licence payments. To the extent that payments receivable are dependent on for example, future sales, the franchisor is prohibited from recognising revenue until those future sales have taken place. This is regardless of how likely it is that the sales will take place, or how accurately the franchisor is able to estimate future sales values.

Should costs associated with obtaining a contract be capitalised or expensed immediately?

In addition to the substantially more detailed guidance for revenue recognition, NZ IFRS 15 contains prescriptive criteria to be applied when determining whether costs associated with the acquisition of a contract should be recognised as an asset, or expensed as incurred. This extends to cover all contract acquisition costs, such as sales commissions, and is relevant in circumstances in which a sales contract includes sales which will be fulfilled in future periods.

NZ IFRS 15 is restrictive, in that it permits only incremental costs of obtaining a contract to be considered. Consequently, only those costs which would not have been incurred if the contract had not been obtained are eligible to be considered. An example is a sales commission which is only payable in the event that a customer completes a sale. In contrast, ongoing costs of running the business are not eligible to be considered because these costs would have been incurred regardless of whether a specific contract had been obtained. Although it might be argued that certain costs might be lower if an entity was not involved in obtaining sales contracts, NZ IFRS 15 does not permit contracts to be analysed on a portfolio basis. Instead, the focus is on whether costs attributable to each individual contract are incremental.

Once incremental costs have been identified, these are required to be recognised as an asset if there is an expectation that they will be recovered, typically through profits to be generated from the related contract. This asset is then amortised on a basis that is consistent with the transfer of the goods or services specified in the contract. It will be necessary for judgement to be applied in determining an appropriate amortisation period and profile.

What adjustments are required for the effects of the time value of money (a 'financing component')?

Contracts in the retail industry can involve cash receipts from customers which do not correspond to the timing of the recognition of revenue. If a financing component is significant, NZ IFRS 15 requires an adjustment to be made for the effect of implicit financing.

As a practical expedient, adjustments for a financing component are not required when there is a period of less than one year between the transfer of goods or services and the receipt of payment from a customer.

In a major change from existing practice, adjustments for a financing component are required for circumstances in which customers pay in advance, as well as in arrears. Payments in arrears will result in finance income and a reduction in revenue (because the vendor is providing finance to its customer), while payments in advance will result in a finance expense and an increase in (deferred) revenue (because the vendor is, in effect, borrowing funds from its customer).

The purpose of this approach is to reflect the 'cash selling price' of the underlying good or service at the point at which it is transferred to the customer. It also results in transactions which involve a significant financing component being split into two parts; one for the sale of the good or service and the other for the financing arrangement. However, the implications for the internal processes and systems that are needed in order to identify when a financing component is to be recognised, and to account for this, may be significant.

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What changes will be required to internal controls and processes?

The changes introduced by NZ IFRS 15 are significant and should not be underestimated. It is likely that changes to internal controls and processes will be needed, in order to analyse sales contracts in accordance with the new guidance and to ensure that the accounting is appropriate.

It is also likely that sales departments will need to liaise more closely with the accounting department in future, in order that the effects of any proposed contractual terms on the related financial statements can be understood in advance.

Disclosure requirements

Users of financial statements, and regulators, have criticised the existing disclosure requirements in NZ IFRS as being inadequate and lacking cohesion with other disclosures made in financial statements. This has made it difficult to understand an entity's revenues, as well as the judgements and estimates that have been made in determining their recognition and measurement.

In consequence, comprehensive disclosure requirements have been included in NZ IFRS 15. This means that, even if an entity concludes that the effect of the new standard on revenue recognition is not significant, changes to internal systems and processes may be required to enable the necessary information to be collected for disclosures.

In addition to the detailed guidance, an overall disclosure objective has been specified together with an explicit statement that immaterial information does not need to be disclosed and the disclosure requirements should not be used as a checklist. This is because some disclosures may be very relevant for certain entities or industries, but irrelevant for others. It is also intended to encourage entities to give careful consideration to the information that they will include in their financial statements in order to meet the disclosure objective. However, this again brings the need for careful planning, well in advance of adoption of the new requirements.

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