by Fred Nieto



The Head of Investor Engagement at the International Accounting Standards Board, on the major impacts arising from IFRS 15 *Revenue from Contracts with Customers*, which takes effect next year

# Judgments and estimates in revenue recognition

Investors don't analyse investments in a vacuum. Comparing a company's financial performance with that of its peers is a critical step in making informed investment decisions. After all, it's difficult for an investor to argue that a company's financial performance was "good" without clarifying the basis for comparison.

Weaknesses in existing revenue recognition requirements have been responsible for diversity in companies' revenue accounting practices, according to various stakeholders including preparers, various national standard setters, auditors and investors. The diversity resulted, in part, from companies having to use judgment in the absence of clear principles or guidance. Consequently, the financial reporting outcome may not be comparable across companies. Investors may not be aware of this, and as a result may end up comparing apples to oranges – reminding us of a popular quote that's relevant to investment analysis: "*It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so*" – Mark Twain.

For this reason, we believe investors can look forward to a time when results are prepared under a single comprehensive standard – International Financial Reporting Standard (IFRS) 15 *Revenue from Contracts with Customers*. IFRS 15 is effective from 1 January 2018 with earlier application by companies permitted.

## Revenue recognition – previous standards

IFRS 15 replaces the previous revenue standards: International Accounting Standard (IAS) 18 *Revenue* and IAS 11 *Construction Contracts*, and the related Interpretations from the IFRS Interpretations Committee (IFRIC) and the Standard Interpretations Committee (SIC): IFRIC 13 *Customer Loyalty Programmes*, IFRIC 15 *Agreements for the Construction of Real Estate*, IFRIC 18 *Transfers of Assets from Customers* and SIC-31 *Revenue – Barter Transactions Involving Advertising Services.*

## Principles and guidance – a balancing act in support of comparability

The core principle of IFRS 15 is simple and intuitive. A company should recognize revenue when the promised goods or services are transferred to the customer and the revenue recognized should reflect any performance objectives built into contracts. To enable entities to apply that core principle, IFRS 15 provides a comprehensive and cohesive set of steps to follow and related application guidance for determining when and how much revenue to recognize.

We believe that the principles and the related application guidance in IFRS 15 provide company management with sufficient tools to exercise appropriate judgment enabling companies to reach consistent conclusions in recognizing revenue in economically similar situations. Reducing diversity in practices should ultimately benefit investors seeking to compare companies' reported revenues – within or across sectors, and within or across jurisdictions that use international financial reporting standards.

For example, a company may struggle to determine if it should recognize revenue for some goods or services at a point in time, or over time, because of a lack of clear and comprehensive guidance today.

A case in point is the sale of residential real estate unit in multi-unit developments. Currently, a company may have difficulties determining whether the construction of such assets is a service that is provided over time (and, hence, revenue is recognized over time) or a good that is transferred to the customer when construction is completed (and, hence, revenue is recognized at that point in time). IFRS 15 clarifies this by providing specific criteria which must be met for a company to be able to recognize revenue over time. If the criteria are not met, a company will recognize revenue at the point in time when the customer obtains control of the promised good or service.

## Disclosures – giving investors insight into management's judgments

To provide investors with a better understanding of the nature, amount, timing and uncertainty of revenue and cash flows from contracts with customers, IFRS 15 not only requires quantitative information about revenues (e.g. disaggregation of revenues into appropriate categories, for example, by type of good, service, geography, or market) but also qualitative information about the significant judgments and changes in judgments made in applying the revenue recognition requirements.

By not only requiring management to explain its decision to apply a certain accounting treatment, but also to discuss the reasons behind that decision. We believe the new disclosure requirements should provide investors with enhanced transparency into management's decision-making.

## Closing the loop

Through the combination of a single comprehensive revenue recognition framework and specific disclosure requirements, we believe that IFRS 15 will help investors better understand and compare a company's revenue – across reporting periods and with its peers. Find more details on IFRS 15 by going to the List of Standards page of *www.ifrs.org*.