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100 JAAR KPMG 1917 - 2017

IFRS 15 Revenue recognition – A (final) call to action

KPMG's 2016 Annual Report market watch

June 2017

IFRS 15 Revenue recognition - A (final) call to action

As of 1 January 2018, the new standard on revenue recognition (IFRS 15 – *Revenue from Contracts with Customers or* 'IFRS 15') becomes effective. This means that there are only 7 months left to prepare for the biggest change in IFRS since the implementation of IFRS itself (which was back in 2005 for The Netherlands). In 2016, our colleagues in the United States completed a survey revealing that 80 percent of the respondents were still assessing the impact of their new standard or had not commenced implementation.

We analysed the status of IFRS 15 implementation projects within The Netherlands using disclosures in the 2016 annual reports of the top 75 Dutch listed companies[1], showing similar results.

Originally, the initial application date of the standard was 1 January 2017. This date was postponed by one year as frontrunners such as telecommunications industry faced significant and time consuming challenges. Some companies have taken this relief as an opportunity to work on other topics, ultimately still ending up with a restrictive timeframe.

ESMA expectations

Apart from the formal transition options in IFRS 15 and generic disclosure requirements for forthcoming standards, the European Securities and Markets Authority ('ESMA') communicated expectations for disclosures regarding IFRS 15 in a public statement in 2016. For the 2016 annual reports, the ESMA expected:

- A description of how key concepts in IFRS 15 would be implemented (highlighting differences from current practice);
- The timeline for implementing IFRS 15 (including the expected transition method), and;
- Quantitative information on the impact of IFRS 15 to the extent known or reasonably estimable.

While the ESMA requirements for the 2016 annual reports appear to leave some room to avoid quantitative statements, the expectation for the 2017 annual report (or earlier in an interim report, when available) is full quantitative disclosure.

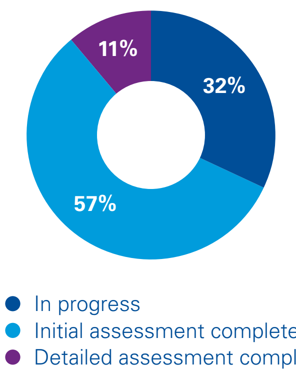
Observations

Studying the 2016 annual reports resulted in the following observations:

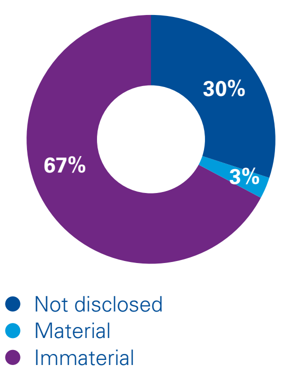
- Only 8 companies (11%) have completed a detailed assessment of the potential impact of IFRS 15. A further 41 companies (57%) indicated that they have completed an initial assessment, and most of these companies are planning to complete a detailed assessment in 2017. The remaining companies (32%) disclosed the status of the impact assessment as 'in-progress'. In summary, almost 90% of the companies have not yet completed the impact assessment, which is higher than the 80% *'stuck in the assessment phase'* according to the US survey. Given the limited disclosure it is unclear what efforts are required to complete the impact assessment.

- A total of 50 companies provide a qualitative statement on the expected impact, of which the vast majority (96%) expect an immaterial impact

Status of impact assessment



Expected impact



[1] Companies included in AEX, AMX and AScX-indices. At the time of the study three annual reports were not available, so in total 72 annual reports were investigated.

(or similar wording). The companies that indicate that IFRS 15 is expected to have a material impact on their financial statements all operate in the telecommunications industry. Most likely the majority of the companies that expect an immaterial impact have based their conclusions on the outcomes outcomes of the initial accounting gap assessment. Assessing the broader impact or finalizing a detailed assessment might be considered a merely documentation matter by these companies.

- In total, 60 companies (83%) have not yet disclosed their anticipated transition method to IFRS 15. Obviously, the quantitative impact would be an important factor in this consideration, not underestimating the new extensive disclosure requirements for comparative periods when opting for retrospective application! Considering the number of companies which disclosed a statement on the expected impact, there must be a number of companies that know the quantitative impact but have yet to decide on the transition method.

- For a significant number of companies (44%), the external auditor included a key audit matter related to revenue recognition in their auditor's report. For those companies, the auditor might put extra emphasis on the implementation process during upcoming interim reviews and financial statement audits.

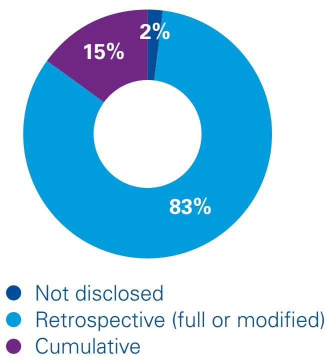
A (final) call to action: how to prepare for upcoming IFRS 15 challenges

Our research reveals that most Dutch listed companies are still in the assessment phase of determining the impact of the new standard. This is probably due to a variety of implementation challenges that companies may face when adopting IFRS 15.

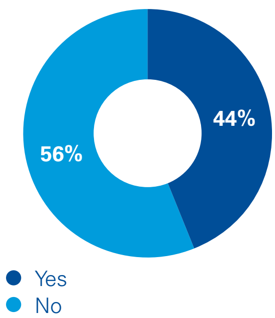
Implementation road map and involvement of the external auditor

In order to prepare high-quality and IFRS 15 compliant financial statements by 2018, a well-conceived comprehensive implementation plan is required. A successful transition process for implementing new accounting standards includes a four phase approach. See figure 1. Validation of the implementation plan with your external auditor is important. A mutual understanding of the implementation process will enable any issues or challenges to be identified and resolved upfront.

Transition method



Key audit matter on revenue recognition?



1. Assess

Determine the exact impact of IFRS 15 for your company by comparing current accounting policies to the new standard requirements. Given the potential diversity of revenue streams across the company, a thorough scoping is key.

Assess broader impact of new accounting standard on IT systems, processes, people and business.

2. Design

Draft new accounting policies and disclosures, select the preferred transition option and define requirements for systems and processes including new tooling.

3. Implement

Build and validate your solutions for IFRS 15 by performing system tests and output discussions with business analysts. Perform transition calculations and consider that all transition options require dual accounting for a certain period.

4. Sustain

After initial application of IFRS 15 it is important to evaluate and improve relevant processes.

Figure 1 - Implementation plan

10 things to consider

IFRS 15 will impact companies in many ways, depending on the way their business is organized. This adds complexity to the conversion process, and requires deep knowledge of both business and finance. Below are ten topics that provide more insight in the impact of IFRS 15:

1 **KPIs may be affected in unexpected ways** if the timing or pattern of revenue is impacted by the new standard. This holds even more for companies that can no longer apply over-time revenue recognition or work in progress balances that are impacted. What are the key accounting interpretations and judgements and why are they appropriate?

2 **Acceleration of revenue on transition** could crystallize cash tax payable, even though the related cash flows have not yet occurred.

3 **Sufficient resources** to deliver in the timeframe will need to be secured. Implementation of new accounting standards are normally driven by (group) accounting departments in addition to their normal day to day activities. Furthermore, IFRS 15 will also require in depth knowledge of the business itself for which training of staff (even beyond the finance function) will be necessary.

4 **Regulators** will be looking for an audit trail of the analysis performed and conclusions drawn. Documentation of this process is essential, as well as the validation of conclusions drawn by companies. Furthermore, specific disclosure requirements are provided by regulators like ESMA. Non-compliance could result in additional questions from the regulator.

5 **Complex new accounting rules will need to be embedded beyond the finance function** for example, bid or sales teams, IT, tax and investor relations teams. It is important to create momentum and bring all internal stakeholders onboard. For large companies with a decentralized structure and multiple operating companies, managing this process is challenging, especially when IFRS knowledge is organized centrally at group level.

6 **IT systems and processes** may require updating to fit new allocation methodologies, new account categories and tracing of products, revenue and costs to the end customer. Have all changes to existing systems and processes been identified, including data requirements and internal controls to ensure they are appropriate for use under the new standard?

7 **Investors** will require education on the change in revenue profile. How are changes in KPIs communicated to users?

8 **Transparency:** financial statements will need to disclose new judgements and potentially sensitive information – e.g. average customer lifespan. How will the IFRS disclosure requirements be met and how will those disclosures facilitate comparability? What level of assurance will you expect your auditors to provide on the adequacy of the transition disclosures?

9 **Pre-implementation disclosures** – both qualitative and quantitative – will be required in 2017 interims and finals.

10 **IFRS 9 and IFRS 16** are also on the horizon. Is your company ready for some of the biggest accounting changes in more than a decade?

The opportunities

- Contracts could be renegotiated to achieve **preferred accounting outcomes** and safeguard competitive advantage;
- **Product level profitability** and costing hidden by not disaggregating performance obligations could be revisited.
- Any existing or planned **systems transformation projects** could incorporate changes for IFRS 15 – and potentially IFRS 9 and 16.

Conclusion

IFRS 15 needs to be a key priority for the coming months – not only to avoid a potential crisis in the external financial reporting department, but also to safeguard potential opportunities in the implementation process. The results of the 2016 Annual Report market watch show that companies are potentially struggling with the implementation.

The most common challenge that companies are facing is to secure sufficient resources – both internal and external – to deliver by 2018. With regards to staffing, commercial managers must be integrated into the implementation team in order to facilitate the understanding of how contracts work in practice to get to the correct accounting treatment.

Prompt engagement with the external auditors is also important. They will need to validate the core judgements at an early stage. This will be even more important for companies that have to transform their systems and processes. Those companies would want to avoid any obstacles during the transition.

Disclosures and transparency to investors through timely communication are essential topics to be covered early in the transition process. Focus should be on the qualitative pre-implementation disclosures for the interim accounts and the fact that regulators have stated clearly that they are anticipating information on expected impacts. A statement that an implementation project is under way will not be acceptable. The breadth and specificity of your disclosures reflect the progress of your implementation project. Certain companies might make unsupported statements that there will be no impact, only to discover later that this is not the case.

The audit trail of the transition process that includes analysis and conclusions drawn, will be the key to prove to regulators that a conversion project has been undertaken. This is also important to companies that expect minimal financial impact from IFRS 15.

Overall, there is a (final) call to action. Complete the impact assessment of IFRS 15 as soon as possible and ensure that the broader impact is covered!

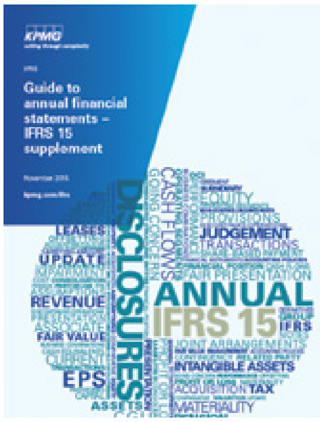
Sources

kpmg.com/ifrs
Are you good to go?
Transitiontoolkits
IFRS Blog

KPMG IFRS 15 publications

Revenue Issues In-depth

Revenue Transition options



Illustrative disclosures

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