Implementing forthcoming Revenue Recognition requirements

To assist you to prepare for the implementation of forthcoming IFRS—Revenue Recognition, the IFRS Foundation will hold an intensive half-day session immediately before the IFRS conference, on the morning of 23 June 2014.

09:00  Registration and refreshments

09:30  Introduction
Philippe Danjou
Member
IASB

09:35  IFRS Revenue Recognition
Henry Rees
Technical Director
IASB

10:15  Advisor’s perspective
Tony de Bell
Partner
PwC Global ACS

10:45  How we are preparing to implement forthcoming IFRS on Revenue Recognition
Miklos Szabo
Financial Expert
SAP AG

11:25  Round-table Q&A
Chair: Philippe Danjou, Member, IASB

Panellists:
- Henry Rees
- Tony de Bell
- Miklos Szabo

11:55  Concluding comments
Philippe Danjou
Member
IASB

12:00  Close session
Special Interest Session

Implementing forthcoming Revenue Recognition requirements

PHILIPPE DANJOU
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HENRY REES
Technical Director
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PwC Global ACS

MIKLOS SZABO
Financial Expert
SAP AG
The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

International Financial Reporting Standards

IFRS 15 Revenue from Contracts with Customers
IFRS 15 at a glance

- A genuinely global Standard
  - Joint Standard with FASB
  - Replaces IAS 18, IAS 11 and related Interpretations

- Culmination of extensive due process
- Framework for revenue recognition
- Effective date 1/1/2017, early application permitted
- Revenue Transition Resource Group

Project objectives

<table>
<thead>
<tr>
<th>The Boards’ objectives</th>
<th>Why?</th>
</tr>
</thead>
</table>
| A single comprehensive framework for revenue recognition | • IFRS had limited and sometimes inconsistent guidance  
  • US GAAP had numerous transaction- and industry-specific requirements |
| Improve comparability across companies, industries & markets | • Inconsistencies and limitations in requirements often resulted in diverse revenue recognition practices |
| A comprehensive and cohesive set of disclosure requirements | • Inadequate disclosure requirements made it difficult for users to understand and compare reported revenues |
A framework for revenue recognition

A single, principle-based Standard

- Principles for the 5 steps of the model
- Guidance and Examples to support principles plus Basis
- Disclosures to provide insights into judgements

A more robust framework for addressing issues

Scope

✓ All contracts with customers, except
  × Lease contracts
  × Insurance contracts
  × Financial instruments
  × Non-monetary exchanges in the same line of business to facilitate sales to customers
### The 5-step model

1. **Recognise revenue to depict transfer of goods or services in an amount of consideration to which expected to be entitled**
2. **Identify the contract(s) with a customer**
3. **Identify the performance obligations in the contract**
4. **Determine the transaction price**
5. **Allocate the transaction price to the performance obligations**
6. **Recognise revenue when (as) a performance obligation is satisfied**

### Step 1: Identify the contract

**Existence of a contract**
- Must meet specified criteria to apply the model, including
  - Collection of consideration probable

**Combine contracts**
- Negotiated as a package
- Linked consideration
- Goods or services form one performance obligation

**Contract modifications**
- Separate contract if add distinct goods/services at standalone selling price
- Prospective if remaining goods/services distinct
- Otherwise, cumulative catch-up
Step 2: Identify the performance obligations

Promise to transfer a distinct good or service

- On its own
- Together with other readily available goods or services (including goods or services previously acquired from entity)

Customer can benefit from good or service

- No significant service of integrating the good or service
- Good or service does not significantly modify or customise another good or service in the contract
- Good or service is not highly dependent on or interrelated with other goods or services

Promised good or service is separable from other promises

Step 3: Determine the transaction price

Amount of consideration to which entity expects to be entitled in exchange for goods or services

Variable consideration
Estimate using:
- Expected value
- Most likely amount but 'Constrained' (next slide)

Significant financing
Adjust consideration if timing provides customer or entity with significant benefit of financing

Non-cash consideration
Measure at fair value unless cannot be reasonably estimated

Consideration payable to customer
Reduction of the TP unless in exchange for a distinct good or service
Step 3: Constraining variable consideration

Include estimate of variable consideration in the transaction price only to extent it is highly probable a significant reversal of revenue will not occur when uncertainty is resolved.

- Entity’s expectations of revenue reversal assessed using indicators, eg
  - Factors outside entity’s influence (market, 3rd-party actions)
  - Entity’s level of experience with similar types of contracts
  - Length of time before uncertainty resolved

Step 4: Allocate the transaction price

Allocate to each performance obligation the amount to which entity expects to be entitled in exchange for satisfying that performance obligation.

- Relative stand-alone selling price basis
  - estimate selling prices if not observable
  - residual estimation techniques may be appropriate

- Discounts and contingent amounts allocated entirely to specific performance obligation if specified criteria met
Step 5: Recognise revenue when (as) a performance obligation is satisfied

Performance obligation is satisfied by transferring good or service

### Performance obligation satisfied over time if 1 of 3 criteria met (next slide)

Revenue is recognised by measuring progress towards complete satisfaction of the performance obligation
- Units produced or delivered may be a reasonable proxy in some cases
- Input methods may need to be adjusted (e.g. uninstalled materials)

### All other performance obligations satisfied at a point in time

Revenue is recognised at the point in time when the customer obtains control of the promised asset. Indicators of control include:
- Present right to payment
- Legal title
- Physical possession
- Risks and rewards of ownership
- Customer acceptance

Step 5: Criteria for POs satisfied over time (revenue over time)

The customer receives and consumes the benefits of the entity’s performance as the entity performs
- Routine or recurring services

The entity’s performance creates or enhances an asset (e.g. WIP) that the customer controls as the asset is created or enhanced
- Building an asset on a customer’s site

The entity’s performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date
- Building a specialised asset that only the customer can use
## Contract costs

<table>
<thead>
<tr>
<th>Costs of obtaining a contract</th>
<th>Costs of fulfilling a contract</th>
<th>Onerous contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognised as an asset if:</td>
<td>Recognised as an asset if:</td>
<td>Apply IAS 37</td>
</tr>
<tr>
<td>• Incremental</td>
<td>• Relate directly to a contract</td>
<td></td>
</tr>
<tr>
<td>• Expected to be recovered</td>
<td>• Relate to future performance</td>
<td></td>
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<tr>
<td><em>For example:</em> Selling commissions</td>
<td>• Expected to be recovered</td>
<td></td>
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<tr>
<td></td>
<td><em>For example:</em> Pre-contract or setup costs</td>
<td></td>
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</table>

### Application guidance

- Warranties
- Licences (next slide)
- Right of return
- Customer options for additional goods or services
- Breakage (customers’ unexercised rights)
- Principal versus agent
- Bill-and-hold arrangements
- Repurchase agreements
- Non-refundable upfront fees
- Customer acceptance
Application guidance: Licences

Step 2: Identify the performance obligation(s)

Is the licence distinct?

No

Account for bundle of goods and services

Yes

Apply criteria to determine whether nature of licence is to provide:

- a right to access the entity’s intellectual property as it exists throughout the licence period (i.e., a performance obligation satisfied over time); or
- a right to use the entity’s intellectual property as it exists at the point in time at which the licence is granted (i.e., a performance obligation satisfied at a point in time)

Sales- and usage-based royalties?

Comprehensive and cohesive disclosure requirements

Objective: To enable users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers

Revenue
Disaggregation of revenue (also required for Interims)
Amounts recognised relating to performance in previous periods

Contracts
Information about contract balances & changes
Information about performance obligations
Amounts allocated to remaining performance obligations

Judgements
Timing of and methods for recognising revenue
Determining the transaction price and amounts allocated to performance obligations
Transition, effective date and early application

- Effective date: annual reporting periods beginning on or after 1 January 2017
- Early application permitted

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<tbody>
<tr>
<td>Retrospective (with optional practical expedients)</td>
<td>Contracts under new standard</td>
<td>Contracts restated</td>
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<tr>
<td>Cumulative catch-up</td>
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<tr>
<td>Cumulative effect at date of application</td>
<td>Contracts not restated</td>
<td>Existing* and new contracts under new standard</td>
<td></td>
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<tr>
<td>Impact of IFRS 15 compared to IASs 11 &amp; 18</td>
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</table>

*contracts for which entity has not transferred all goods or services identified under IASs 11 & 18

Some key effects

<table>
<thead>
<tr>
<th>Sector</th>
<th>Accounting</th>
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</table>
| Construction / Aerospace & Defence | • Revenue may be recognised over time (eg percentage of completion) but ‘PO over time’ criteria must be met  
  • More discipline in cost-to-cost measures of performance  
  • Costs capitalised if result in resources to be used in fulfilling contract, not to normalise margin |
| Telcos                  | • Revenue recognised for ‘free’ handset, as well as for airtime contract                                                               |
| Products                | • Revenue recognition deferred for some sales incentives and incidental obligations  
  • Revenue deferred for some implicit product warranties                                                                 |

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Some key effects continued

<table>
<thead>
<tr>
<th>Sector</th>
<th>Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Software</td>
<td>• Elimination of VSOE, so revenue can be recognised when license transferred</td>
</tr>
<tr>
<td></td>
<td>• Revenue recognition for software development only if ‘PO over time’ criteria met</td>
</tr>
<tr>
<td>Media/pharma</td>
<td>• Revenue may be recognised on transfer of licence, but will need to consider if licence is right to use or right to access</td>
</tr>
<tr>
<td></td>
<td>• Sales-based royalties recognised as sales occur</td>
</tr>
<tr>
<td>Asset management</td>
<td>• Contingent fees based on index recognised only if highly probable will not be reversed</td>
</tr>
</tbody>
</table>

What has changed since revised ED?

• Added collectability criterion for identifying a contract
• Clarified principles and added guidance for
  – Identifying performance obligations
  – Determining whether performance obligation satisfied over time
• Clarified objective for constraining variable consideration
• Withdrew presentation of impairments adjacent to revenue
• Removed onerous test from Revenue Standard
• Added guidance to determine nature of licence
• Simplified and clarified disclosure requirements
  – Reduced disclosures for Interims
• Added alternative transition method
Revenue Transition Resource Group

- New, limited life, joint group with FASB
- Public discussion to support transition to new Standard
- Inform IASB and FASB about application issues & help boards determine if/what action required
- Stakeholders can submit issues for consideration
- Will not issue authoritative guidance
- Members include preparers, auditors, users plus observers (including regulators)
  - Preparers drawn from a variety of regions and industries
  - Auditors mix of IFRS experts and US GAAP experts
IFRS 15 – Revenue from contracts with customers

June 2014

IFRS 15

Revenue from contracts with customers

- A new model
- A change in mindset?
  - Uncertainty about the price
  - Timing of recognition
  - Licences
  - Modifications
  - Time value
  - A portfolio
- Transition Resource Group
- Implications
**Revenue – the five step approach**

*Core principle*
Revenue recognised to depict transfer of goods or services

1. **Step 1** - Identify the contract with the customer
2. **Step 2** - Identify the separate performance obligations in the contract
3. **Step 3** - Determine the transaction price
4. **Step 4** - Allocate the transaction price
5. **Step 5** - Recognise revenue when (or as) a performance obligation is satisfied

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**A simple model, but what if...**

- ...the goods are specialised equipment that only can be used by one customer
- ...the sale of goods and services is combined with a licence
- ...consideration is all paid in advance
- ...price contingent on future revenues of customer

... IFRS 15 addresses customer options, breakage, warranties, contract combination, modifications, and the list goes on.

*A change in mindset?*
Change in mindset?

*Accounting might be similar for some but the model is not the same as today*

- Some aspects are different
- More guidance in complex areas
- Different judgments
- Disclosures – even if the accounting is the same
- Implementation developments?
- Broader implications?

Uncertainty about the price?

*Captures more than ‘contingent consideration’*

- Discounts
- Rebates
- Price concessions
- Refunds
- Penalties
- Performance bonuses
- Sales and usage-based royalties
- Incentives

Challenges

- Highly probable?
- A ‘minimum’?
- Interaction with cost of sales
- An exception
**Highly probable?**

*Judgments might vary*

For example....variable consideration may be based on...

- An equity market index
  - Performance fees for asset managers
- A commodities market
  - Provisional pricing in mining
- Consumer markets
  - Rebates by an electronics supplier

**Challenges**

- Different judgments from today?
- Recognising a minimum?
- Disclosures?

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**A minimum?**

*A minimum creates a ‘tipping point’*

For example....

- Sale of a patent
- Consideration is C1m plus royalty based on 1% of sales for 15 years

**Recognition profit?**

- Inception: no amount of the highly probable is highly probable of not reversing
  
  Revenue = C1m plus 1% when sales occur

- Year 6: Highly probable that sales will not be below C100m a year
  
  Revenue catch up = C10m - based on 1% * C100m years 6-15
Interaction with cost of sales

Impact on inventory

Same example....
• Sale of a patent to a customer
• Consideration is C1m plus royalty based on 1% of sales for 15 years

What if the patent was acquired in a business combination?
• Carrying value of C5m
• Inception: derecognise patent because control is lost
  Loss on sale = C4m
• Future years: Revenue but no cost of sales

An exception

For licences of intellectual property with a sales or usage based royalty, revenue recognised only when sales/usage occurs

• ‘highly probable’ constraint does not apply
• not meant to be applied by analogy

Challenges
• What is a licence?
• What is a sales based or usage based royalty?
• What is intellectual property?
**Timing**

*Not the same as ‘good’ or ‘service’*

- Consider each distinct performance obligation
- Evaluate over time first – then point in time
- Alternative use based on contract terms and practical issues
- Right to payment

**Challenges**

- Different judgments from today?
- Over time might be broader than today for some
- Right to payment is key

---

**Alternative use and right to payment**

*Contract terms may create ‘no alternative use’ but must have both.......*

**No alternative use**

- Entity is unable *contractually* or practically to readily direct for another use during the creation/enhancement
- e.g., cannot contractually sell to another customer

**Right to payment for performance to date**

- Compensation for performance completed to date is an amount that approximates the selling price
- e.g., recovery of the costs plus a reasonable profit margin
‘Over time’?

For example....

Consumer goods
\( e.g. \) sale of furniture
- Most likely has alternative use
- Contractual restrictions might not be substantive

Specialised products
\( e.g. \) customised machinery
- Practical restrictions - too specialised to be used by others
- Need to assess right to payment

Contractual restrictions
\( e.g. \) apartment blocks
- Focus on right to payment
- Right could be achieved through contract or law

Licences

Right to use
- Right to use IP as it exists at a point in time
- Revenue recognised at a point in time

Right to access
- Right to access to IP as it exists throughout the licence
- Revenue recognised over time

Licensor performs activities that significantly affect the IP

Rights expose customer to effects of those activities

Activities are not a separate good / service

Different judgments?
**Modifications**

- Modification accounted for when it creates or changes enforceable rights and obligations
- Accounting depends on whether distinct goods or services added

<table>
<thead>
<tr>
<th>Distinct goods/services added at price that reflects stand-alone selling price</th>
<th>New separate contract: prospective adjustment only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remaining goods or services distinct from existing contract, but not at stand-alone selling price</td>
<td>Treated as new contract: Prospective but ‘carry forward’ of existing position (e.g. contract liabilities)</td>
</tr>
<tr>
<td>Goods / services not distinct from existing contract</td>
<td>Continuation of contract: Cumulative catch up</td>
</tr>
<tr>
<td>If combination of above</td>
<td>Apply ‘principles’ above</td>
</tr>
</tbody>
</table>

**Allocation**

**Relative stand-alone selling price**

Residual approach only permitted in limited circumstances

- Step 1 - Determine standalone selling price:
  - Actual or estimated
  - Residual ‘approach’ if selling price is highly variable or uncertain (*change from current practice*)
- Step 2 – Allocate on relative basis
  - Observable evidence required to allocate a discount to specific performance obligations

**Different judgments?**
**Time value of money**

**What is a significant financing component?**

**Challenges**
- Why has payment been deferred?
  - what are ‘reasons other than the provision of finance’?
- Affects prepayments as well as deferrals?
  - a change in practice?
- Multiple performance obligations, both point in time and over time?
  - complexity

**Different model?**

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**Portfolios?**

Model applies to individual ‘contract’, but portfolio approach if the entity reasonably expects that applying to portfolio would not differ materially

**Potential challenges**
- What if different customers have different payment terms?
  - point in time or over time?
  - time value of money
- Complex packages with frequent changes to pricing?
  - allocation of transaction price?
  - contract modifications?

**Different judgments?**
**Revenue Transition Group**

- Impact on authoritative guidance?
- Due process:
  - Agenda?
  - Status of conclusions?
  - Interaction with the Boards and Interpretations Committee?
- Form and content of output
- Need for guidance?

**Implications**

*Change in mindset?*

- New or different guidance
- Different models or judgments
- Not more difficult – just different
- Impact on industry based models
- Analysis and thinking will develop
- Even if accounting is the same...judgments and disclosures
Any questions?
Implementing IFRS 15
“Revenue from Contracts with Customers”
– Preparer’s Perspective –
Miklos Szabo – Finance Expert, SAP
London – June 23, 2014

SAP’s Financial Reporting and Revenue Recognition History

- Going Public in Germany
- Going Public in the U.S.
- IFRS Mandatory in EU

German GAAP

US GAAP

IFRS

SAP introduces industry specific US GAAP revenue recognition guidance (SOP 97-2) and adjusts certain business models to achieve a more favourable revenue recognition

SAP establishes IFRS accounting policies „as close as possible to US GAAP“ => SAP’s IFRS revenue recognition policies heavily US GAAP influenced


Consolidated Financial Statements
SAP is a “Revenue Recognition-Driven” Company

Most arrangements are multi-element arrangements

Delivery not always easy to determine for software

Highly variable software pricing due to low direct cost

High number of large deals with individualised contracts

The New Standard:
A Change in Mind-set ... Rather than only an Accounting Change

SAP is under a very tight revenue recognition regime ... this may change

Example 1

**Under SAP’s Current Policies**
- Allocation of transaction fee to individual performance obligations based on Vendor Specific Objective Evidence of Fair Value (VSOE)
- Frequent pricing changes over time may be a significant issue

Low pricing flexibility

**Under IFRS 15**
- Allocation of transaction price to individual performance obligations based on Estimated Standalone Sales Prices (ESP)
- Frequent pricing changes over time are less of an issue

High pricing flexibility
The New Standard: A Change in Mind-set ... Rather than only an Accounting Change

SAP is under a very tight revenue recognition regime ... this may change

Example 2

<table>
<thead>
<tr>
<th>Under SAP’s Current Policies</th>
<th>Under IFRS 15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strict residual method due to lacking VSOE for software: Allocate amounts equaling VSOE to all elements other than software and residual to software</td>
<td>Full allocation of a discount to the triggering performance obligation may be appropriate even under residual approach</td>
</tr>
<tr>
<td>All discounts run against software revenue</td>
<td>Discounts triggered by a specific performance obligation may not affect “the residual”</td>
</tr>
</tbody>
</table>

Example 3

<table>
<thead>
<tr>
<th>Under SAP’s Current Policies</th>
<th>Under IFRS 15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocation of transaction fee to individual performance obligations based on VSOE High pricing consistency required to establish VSOE</td>
<td>Allocation of transaction fee to individual performance obligations based on Estimated Standalone Sales Prices (ESP) ESP deemed determinable even if pricing consistency is low</td>
</tr>
<tr>
<td>Strong incentive to focus on pricing consistency and to limit discounting on services</td>
<td>Weaker incentive to focus on pricing consistency because discounting of non-software deliverables has less of an impact</td>
</tr>
</tbody>
</table>
The New Standard: A Change in Mind-set ... Rather than only an Accounting Change

SAP uses revenue recognition to steer the business ... this may need to change

Example 4

<table>
<thead>
<tr>
<th>Under SAP's Current Policies</th>
<th>Under IFRS 15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Due to lacking VSOE for software all revenue of a transaction is deferred if a future functionality is committed to the customer in a multi-element arrangement</td>
<td>Only amounts equal to the ESP of the future functionality are deferred if a future functionality qualifying as a separate performance obligation is committed to the customer in a multi-element arrangement</td>
</tr>
<tr>
<td>Strong incentive to refrain from committing future functionalities</td>
<td>Weaker incentive to refrain from committing future functionalities</td>
</tr>
</tbody>
</table>

How We Prepare What is Coming

Aim
- Understand the proposals and their potential impact on SAP
- Actively participate in IASB Due Process to achieve a feasible outcome

Efforts
- Discuss proposals internally
- Discuss proposals with industry peers
- Discuss proposals with external auditor
- Comment on Discussion Papers and EDs (both alone and with industry peers)
- Liaise with IASB staff, IASB board members and national standard setter
How We Prepare What is Coming

Aim
- Understand the final standard and its impact on SAP
- Create awareness in the company
- Develop implementation strategy

Efforts
- Discuss final guidance internally and with industry peers to identify (a) required changes and (b) possible changes to business models, go-to-market models, accounting, internal controls, IT-systems, compensation models, finance processes etc.
- Align views on new proposals with external auditor
- Hold trainings for management and all internal stakeholders (accountants, other finance functions, sales force etc.)
- Decide on implementation strategy ("Minimize Differences" vs. "Use the Opportunity") and transition approach

How We Prepare What is Coming

Aim
- Implement new guidance
- Optimise processes regarding efficiency & effectiveness

Efforts
- Re-write revenue recognition guideline and amend accounting guideline
- Hold trainings across the organisation
- Re-design/adjust processes and IT systems and rollout the changes
- Adjust business models, go-to-market models, contracts, internal controls, compensation models, etc.
- Determine high level pro forma financial impact on prior periods
- Start executing and recording transactions under new guidance
- Prepare new disclosures
Thank you

Contact information:

Miklos Szabo
Finance Expert
Corporate Financial Reporting
SAP