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report

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Subject	Development of the 2017/18 Code of Practice on Local Authority Accounting in the United Kingdom – IFRS 15 *Revenue from Contracts with Customers*

To consider the approach to adoption of IFRS 15 in the Code of Practice on Local Authority Accounting in the United Kingdom

1 Introduction

1.1 This report outlines the issues that CIPFA/LASAAC will need to consider for the adoption of IFRS 15 *Revenue from Contracts with Customers* in the *Code of Practice on Local Authority Accounting in the United Kingdom* (the Code). It sets out the main requirements of the Standard in overview and seeks CIPFA/LASAAC's views on the approach to adoption in the Code.

2 Background

2.1 The objective of IFRS 15 *Revenue from Contracts with Customers* is to establish the principles an entity is required to apply to report useful information to the users of financial statements about the nature, amount, timing and uncertainty of revenues arising from contracts with customers.

2.2 The IASB issued IFRS 15 in May 2014. In September 2015 the IASB deferred the effective date of IFRS 15 by one year to 1 January 2018.

2.3 The development of IFRS 15 took place over a long period. The project was added to the IASB agenda in 2002. The project was also a joint project between the IASB and the FASB to develop a common revenue recognition standard for IFRS and US GAAP.

2.4 IFRS 15 replaces:

- IAS 11 *Construction Contracts*
- IAS 18 *Revenue*
- IFRIC 13 *Customer Loyalty Programmes*

- IFRIC 15 *Agreements for the Construction of Real Estate*
- IFRIC 18 *Transfers of Assets from Customers,* and
- SIC 21 *Revenue – Barter Transactions Involving Advertising Services*.

2.5 IFRS 15 applies to all contracts with customers (except those within the scope of IAS 17 *Leases*, IFRS 9 *Financial Instruments*, the Group Accounts Standards[1] and IFRS 4 *Insurance Contracts* and non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers).

2.6 The core principle in IFRS 15 is that entities should recognise revenue to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. To recognise revenue the standard sets out five steps:

- step 1- identify the contract(s) with the customer
- step 2 - identify the performance obligations in the contract
- step 3 - determine the transaction price
- step 4 - allocate the transaction price to performance obligations; and
- step 5 - recognise revenue when a performance obligation is satisfied.

2.7 As with IFRS 9 a Technical Working Group (TWG) has been established by HM Treasury with the relevant authorities and representatives from Government Departments[2].

3 Five Steps to Applying the Principles in the Standard

Step 1 - Identify the Contract with the Customer

3.1 A contract is an agreement between two or more parties that creates enforceable rights and obligations.

3.2 IFRS 15 applies to all contracts with customers except for those that are within the scope of other IFRS except those listed in paragraph 2.4 above.

3.3 An entity would apply IFRS 15 to each contract with a customer that has commercial substance and meets other specified criteria. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

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[1] IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IAS 27 *Separate Financial Statements* (2011) and IAS 28 *Investments in Associates and Joint Ventures* (2011)

[2] The comments relating to the Technical Working Groups may be found in the Annex to the HM Treasury Report to FRAB 19 November 2015 which is available by means of the attached link: ihttps://www.gov.uk/government/uploads/system/uploads/attachment_data/file/495312/FRAB_125__2_3__Annex_A_IFRS_9_and_15_FD_Consultation_october_2015_v1_3__....pdf

3.4 In order for a contract to be within the scope of IFRS 15, all of the following criteria must be met:

- the parties to the contract have approved the contract (in writing, orally or in accordance with other customary business practices) and are committed to perform their respective obligations

- the entity can identify each party's rights regarding the goods or services to be transferred

- the entity can identify the payment terms for the goods or services to be transferred

- the contract has commercial substance (ie the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract), and

- it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession.

3.5 In certain circumstances, IFRS 15 requires an entity to combine contracts and account for them as one contract. IFRS 15 also specifies how an entity would account for contract modifications.

3.6 IFRS 15 also provides criteria to recognise revenue where there are no contracts with customers but consideration is received. IFRS 15 requires:

a) there to be no further performance obligations to transfer goods or services, or

b) the contract is terminated.

Under both (a) and (b) above the consideration must be non-refundable.

Step 2 - Identify the Performance Obligations in the Contract

3.7 Performance obligations are promises in a contract to transfer to a customer goods or services that are distinct. In determining whether a good or service is distinct, an entity needs to consider if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer. An entity needs to consider whether the entity's promise to transfer the good or service is separately identifiable from other promises in the contract.

3.8 If a promised good or service is not distinct IFRS 15 requires an entity to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. Revenue is recognised by the entity based on the satisfaction of these individual performance obligations.

Step 3 - Determine the Transaction Price

3.9 The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both. The consideration may be in a form other than cash.

3.10 The transaction price is meant to reflect the amount to which the entity has rights under the present contract. Therefore transaction price does not include estimates of consideration resulting from future changed orders for additional goods and services.

3.11 Some or all of the estimated amount of variable consideration is included in the transaction price only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

3.12 Adjustments to the transaction price are also made for the effects of financing (if significant to the contract) and for any consideration payable to the customer. For contracts with a significant financing component an entity is required to adjust the promised amount of the consideration for the time value of money.

Step 4 - Allocate the Transaction Price to Performance Obligations

3.13 Once the distinct (or separate) performance obligations are identified and the transaction price has been determined, the standard requires an entity to allocate the transaction price (a stand-alone selling price) to the performance obligations.

3.14 IFRS 15 indicates that the best evidence of a stand-alone selling price is an observable price from stand-alone sales of that good or service separately in similar circumstances and to similar customers. If a stand-alone selling price is not observable, the entity is required to estimate it. IFRS 15 provides examples of suitable methods for estimating the stand-alone selling price of a good or service (IFRS 15, paragraph 79).

3.15 The transaction price in a contract may include a discount or a variable amount of consideration that relates entirely to a specific part of the contract. The requirements of IFRS 15 specify when an entity should allocate the discount or variable consideration to a specific part of the contract rather than to all of the performance obligations in the contract.

Step 5 - Recognise Revenue when a Performance Obligation is Satisfied

3.16 An entity is required to recognise revenue when (or as) it satisfies a performance obligation by transferring a promised good or service (an asset) to a customer. A good or service is generally considered to be transferred when the customer obtains control (IFRS 15, paragraph 31).

3.17 Recognition of revenue on transfer of control is a different approach from that currently in IAS 18 which focuses on a transfer of risk and rewards. IFRS 15 states that "control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset".

3.18 At contract inception an entity is required to determine whether a performance obligation is satisfied at a point in time or over time.

3.19 Paragraph 35 of IFRS 15 specifies that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

- the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (this would be a recurring service, for example a cleaning service)
- the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced, or
- 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, for example building an asset that only the customer can use.

3.20 When an entity determines that one of the criteria above is met and therefore that a performance obligation is satisfied over time, IFRS 15 requires the entity to select a single revenue recognition method for the relevant performance obligation that best depicts the entity's performance in transferring the goods or services.

3.21 The Secretariat can see no need for adaptations or interpretations for the five step process to revenue recognition for contracts with customers for the local government context. Generally, where local authorities are recognising income from contracts with customers then they would do so in the same way as commercial entities.

CIPFA/LASAAC is invited to consider whether it agrees with the Secretariat's early analysis on the approach to revenue recognition.

4 Contract Costs

Costs to Obtain a Contract

4.1 IFRS 15 includes requirements for accounting for costs to obtain a contract. The incremental costs of a contract must be recognised as an asset if an entity expects to recover those costs. However, those incremental costs are limited to the costs an entity would not have incurred if the contract had not been successfully obtained.

Costs to Fulfil a Contract

4.2 For costs to fulfil a contract that are not within the scope of other Standards (for example, IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets)*, an entity recognises an asset for those costs only if the fulfilment costs meet the following criteria:

- they relate directly to a contract (or a specific anticipated contract)
- they generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and

- they are expected to be recovered.

4.3 The Secretariat does not see any specific need for adaptations or interpretations for the local government context for contract costs under IFRS 15.

CIPFA/LASAAC is invited to consider whether it agrees with the views of the Secretariat.

5 Disclosures

5.1 One of the IASB's main objectives during the Revenue project was to improve disclosure requirements to provide more useful information to investors. The disclosures under the new standard are more detailed than under IAS 18. The TWG has noted that the standard as a whole adds to the quantum and detail of disclosures required for revenue recognition. As with many recent new and amended standards, disclosure objectives have been introduced. IFRS 15 requires disclosures to help users understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. IFRS 15 requires an entity to disclose quantitative and/or qualitative information about:

- revenue recognised from contracts with customers, including the disaggregation of revenue into appropriate categories
- contract balances, including the opening and closing balances of receivables, contract assets and contract liabilities
- performance obligations, including when the entity typically satisfies its performance obligations and the amount of the transaction price that is allocated to the remaining performance obligations in a contract
- significant judgements, and changes in judgements, made in applying the requirements, and
- assets recognised from the costs to obtain or fulfil a contract with a customer.

5.2 The approach to disclosures in IFRS 15 will to increase the likelihood of more detail being added to local authority financial statements with a possibility that this might obscure the main messages. Local authority accounts preparers will need to use the concept of materiality judiciously to avoid this. The Secretariat will include relevant commentary on materiality in the Exposure Draft.

CIPFA/LASAAC's early views are sought on the approach to disclosures under IFRS 15.

6 Application for Local Authorities

6.1 The Invitation to Comment (ITC) on the 2016/17 Code also provided an overview of IFRS 15. The ITC outlined that for many contracts revenue recognition may not change. For other contracts, including long-term service contracts, there may be changes to the timing and amount of revenue recognised, depending on how local authorities previously accounted for these contracts. The ITC highlighted that possible areas where practice may change include:

- sales with incidental obligations (eg equipment sales with maintenance agreements)

- transfers of goods and services where there is no observable evidence of the stand-alone price of each of the goods and services

- licences of intellectual property

- situations where there is uncertainty about whether revenue should be recognised at a point in time or over time,

- estimates where consideration is variable, and

- situations where customers pay in advance or arrears and financing of the contract needs to be considered.

6.2 Most of the detailed responses received supported CIPFA/LASAAC's initial view that there was no substantial need to adapt or interpret IFRS 15 for local government circumstances. No respondents raised any particular application issues of the type mentioned in the ITC.

In the ITC CIPFA/LASAAC provided its early view that there is no substantial need to adapt IFRS 15 for local government circumstances. Does it have any further commentary or observations at this juncture?

7 Views from the Technical Working Group on IFRS 15

7.1 As with IFRS 9 a Technical Working Group (TWG) has been established by HM Treasury with the relevant authorities and representatives from Government Departments. The TWG identified the following, as relevant to local authorities[3]:

- Views from the private sector are still evolving regarding implementation of IFRS 15 and concerns and issues are still being identified with guidance being sought from the IASB. IASB issued a clarification to IFRS 15 exposure draft in July 2015, with consultation responses received in October 2015. The IASB are currently considering the outputs of that consultation.

- There was greater scope for judgement under IAS 18, whereas IFRS 15 is a significantly larger standard with detailed criteria and application guidance. As a result, the level of implementation required by entities is likely to be extensive.

- Accounts preparers should follow the output from IASB/FASB Joint Transition Resource Group for Revenue Recognition (TRG)[4] about potential implementation issues that could arise.

8 Recognition of Council Tax and Non-Domestic Rate Income

8.1 The Secretariat considers that Council Tax and Non-Domestic Rate income is not income that that should be recognised under IFRS 15. It is a non-exchange transaction and also there is no contract with a customer. Appendix A for completeness considers the criteria for recognition of a contract with a customer for council tax. A similar analysis is likely to be able to be provided for non-domestic rate income and income from district rates.

[3] See CL 08 03-15 as sent.
[4] http://www.ifrs.org/About-us/IASB/Advisory-bodies/Joint-Revenue-Transition-Resource-Group/Pages/Home.aspx

CIPFA/LASAAC is invited to consider whether it agrees with the Secretariat's analysis in relation to council tax, non-domestic rate income and district rates.

9 Transition

9.1 Generally the changes introduced by IFRS 15 are to be applied retrospectively, subject to some transitional reliefs under certain circumstances. There are two methods permitted by the Standard.

1. Retrospectively (with some practical expedients) with adjustments on transition made to the opening balances of the earliest comparative period presented. For entities that use this transition method, all contracts would need to be restated (if necessary).

2. Retrospectively with adjustments made to the appropriate opening balances of the current period on transition. For entities that use this transition method, contracts that were determined to be complete using previous revenue guidance would not need to be restated. Under this method quantification of adjustments is still necessary in order to determine the transition adjustments in the opening balances in reserves/other components of equity, as appropriate; the difference between the previous carrying amounts and the new carrying amounts is recorded in the opening balances of the annual period including the initial application date.

9.2 Additional disclosures are required with the second option, an entity must disclose the effects of applying the new requirements on specific line items.

9.3 As with the transitional approaches in IFRS 9 and per the HM Treasury report[5] on the adoption of both IFRS 9 and 15, the technical working groups agreed considerations of cost and effort should be regarded in considering the most suitable option for the public sector. The Secretariat concurs that on the basis of the resource implications for local authority accounts preparers the modified transitional approach could be applied.

CIPFA/LASAAC's early views are sought on two transitional approaches and whether it wishes to be prescriptive in its approach in the Code.

Recommendation

CIPFA/LASAAC is asked to consider the individual questions above and provide any other comments on the adoption of IFRS 15 in the Code.

[5] See FRAB 125 (2 and 3) at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/494991/FRAB_125_IFRS_9_and_IFRS_15_update.pdf

Appendix A

Does IFRS 15 apply to Council Tax?

IFRS 15 Requirement	Comment
Definition of a contract: An agreement between two or more parties that creates enforceable rights and obligations.	Council tax is levied on the council tax payers as a statutory duty. There is no agreement between two parties that creates enforceable rights and obligations. **The payment of council tax does not meet the definition of a contract**.
Criteria for a contract with a customer (all of the criteria must be met).	
i) the parties to the contract have approved the contract (in writing, orally or in accordance with other customary business practices) and are committed to perform their respective obligations;	There is no agreement or approved contract – the council tax liability for a council tax payer arises on residents in chargeable dwellings in local authority areas. **Doesn't meet criteria.**
ii) the entity can identify each party's rights regarding the goods or services to be transferred	Although the authority is statutorily required to provide a number of services, the level or requirements for those services are normally specified in statute or by the authority. **Doesn't meet criteria.**
iii) the entity can identify the payment terms for the goods or services to be transferred;	Payment terms are specified for the payment of council tax. However, these do not relate to the payment for services. **Doesn't meet criteria.**
iv) the contract has commercial substance (ie the risk, timing or amount of the entity's future ash flows is expected to change as a result of the contract); and	There are risks of timing and amount. However, these have economic rather than commercial substance and are not as a result of the contract. **Doesn't meet criteria.**
v) it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of	Although local authorities are required to provide services to council taxpayers this is not an exchange transaction. There may be issues of collectability but this is not related to the goods or services. **Doesn't meet criteria.**

consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession.	