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# PwC Alert

## Are you ready for MFRS 15 – Revenue from Contracts with Customers?



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## *Why change?*

The objective of MFRS 15 is to provide one comprehensive revenue recognition model for all contracts with customers to improve comparability within industries, across industries, and across capital markets.

## *The new framework for revenue recognition is here.*

On 2 September 2014, the Malaysian Accounting Standards Board issued MFRS 15 *Revenue from Contracts with Customers*. This standard is word for word that of IFRS 15 issued by the International Accounting Standards Board. Companies are required to apply MFRS 15 for annual periods beginning on or after 1 January 2017. Early adoption is permitted.

The new revenue standard will replace all existing revenue recognition guidance under IFRS, MFRS and FRS.

This standard will affect many companies, but those most significantly impacted are likely to be companies with a longer delivery cycle, complex contract terms, and goods and services that come as a package.

***Before diving into the financial reporting implications - which can be significant - consider the strategic ones. This means looking across the business, which could require input from business unit heads, operations, sales, legal, HR, finance, tax, and IT. This cross functional team can evaluate how revenue recognition affects each function and the business as a whole.***

Companies should start reviewing existing revenue arrangements, contract terms, and business practices, to identify where changes might occur:

- Will you have to rethink customer negotiations?
- What might compensation and benefit plans look like in the future?
- Should you rethink how you sell your products?
- What do you need to communicate to your investors, and when?
- Are there business opportunities resulting from increased flexibility?

# Preparing for the impending change

"While many companies can afford to wait until closer to the 2017 effective date, those who are significantly affected will need to start now to get the necessary systems changes up and running in time."

## Two adoption methods

**(1) Full retrospective method**

Companies can choose how they want to adopt the new standard. One way is by recasting prior period financial statements as if the guidance had always existed, which may require a lot of time and effort.

**(2) Simplified transition method**

Companies can instead choose to apply the new guidance prospectively and show the numbers in the year of adoption under both the new and old model. For example, this method requires presenting the 2017 financial statements under the new guidance, but including a footnote disclosure of all financial statement line items and the amounts they would have been under legacy guidance for 2017. This method offers a simpler alternative, but it isn't without its challenges.

## Manage the transition

Transition could be especially difficult for companies with multi-year contracts. Start record keeping soon if retrospective application is a consideration. Do a cost-benefit analysis: Do you have the resources at hand to do one method more effectively than the other? Is there a benefit to your business in having comparability between the before-and-after? What do your investors expect? What are your competitors doing?

## Plan for adoption

Your plan for adoption should include forming a cross-functional steering committee that oversees the entire process and takes into consideration the impact on your business as a whole.

Take inventory of arrangements that may be impacted and identify the gaps in your systems and controls before deciding on an implementation plan.

1 Develop — a plan to communicate to stakeholders

2 Consider — changes to strategies and contract terms

3 Identify — gaps in system and controls

4 Strategise — affected contract provisions

5 Form — a cross-functional steering committee

# The core principle: a new

The core principle of MFRS 15 is that revenue is recognised when the goods or services are transferred to the customer, at the transaction price. Revenue is recognised in accordance with that core principle by applying a 5-step model.

| Step 1 | Step 2 | Step 3 | Step 4 | Step 5 |
|---|---|---|---|---|
| *Identify the contract* | *Separate performance obligations* | *Determine transaction price* | *Allocate transaction price* | *Recognise revenue* |


**Step 1: Identify contract(s) with customer**

A contract creates enforceable rights and obligations. It may be written, oral, or implied by customary business practice. Combine contracts when they are entered into at or near the same time and are negotiated as a package, payment of one depends on the other, or goods/services promised are a single performance obligation. A contract modification is accounted for as a separate contract or continuation of the original contract prospectively or with cumulative catch-up, depending on facts and circumstances.

**Step 2: Identify separate performance obligations in the contract(s)**

Performance obligations are promises in a contract to transfer goods or services, including those a customer can resell or provide to its customer. Use the model's indicators to separate the performance obligations if they are capable of being distinct and if they are distinct based on the context of the contract (separately identifiable from other promises in the contract).

# 5-step model

### Step 3: Determine the transaction price

Transaction price is the amount of consideration an company is entitled to receive in exchange for transferring goods or services to customers. Determining the transaction price is straightforward when the contract price is fixed; it becomes more complex when it is not fixed. Discounts, rebates, refunds, credits, incentives, performance bonuses, and price concessions could cause the amount of consideration to be variable. In situations where there are variable considerations, transaction price is estimated based on the expected value or the most likely amount but is constrained up to the amount that is highly probable of no significant reversal in the future. The minimum amount that meet this criteria is included in the transaction price. Assess your experience with similar types of performance obligations in making this determination.

### Step 4: Allocate the transaction price

Transaction price should be allocated to distinct performance obligations based on relative standalone selling price. This may be the standalone selling price of a good or service when sold separately to a customer in similar circumstances and to similar customers. If a standalone selling price is not directly observable, estimate it by considering all information that is reasonably available, such as market conditions, specific factors, and class of customers.

### Step 5: Recognise revenue when the performance obligation is satisfied

Recognise revenue when the promised goods or services are transferred to the customer and the customer obtains control. This may be over time or at a point in time. The new standard provides indicators when control is transferred. Additionally, the new standard introduces a new concept and revenue is required to be recognised over time when:

i) the asset being created has no alternative use to the company; and
ii) the company has an enforceable right to payment for performance completed to date.

***Some of the significant changes that flow from applying the new 5-step model:***

**Transfer of control**

Revenue is recognised when a customer obtains control of a good or service. A customer obtains control when it has the ability to direct the use of and obtain the benefits from the good or service. Transfer of control is not the same as transfer of risks and rewards as it is considered today. Companies will also need to apply new guidance to determine whether revenue should be recognised over time or at point in time.

**Judgements and estimates**

Although more extensive guidance are provided, companies will need to exercise judgement when considering the terms of the contract and all relevant fact and circumstances in applying the principles and requirements of the new standard. In addition, the need to use estimates based on observable information or reasonably available information is more extensive.

**Variable consideration**

Companies may agree to provide goods or services for consideration that varies upon certain future events occurring or not occurring. An estimate of variable consideration is included in the transaction price if it is highly probable that the amount will not result in a significant revenue reversal if estimates change.

**Allocating bundled sales**

Any bundled goods or services that are distinct must be separately recognised, and any discounts or rebates must generally be allocated to the separate elements. Companies shall defer a portion of revenue related to unsatisfied performance obligations.

**Disclosures**

The new standard includes a cohesive set of disclosure requirements to provide information about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Extensive disclosures are required to provide greater insight into revenue that has been recognised, revenue that is expected to be recognised in the future from existing contracts, as well as the opening and closing balances of receivables, contract assets and contract liabilities. Quantitative and qualitative information will be provided about the significant judgments and changes in those judgments that management made to determine revenue that is recorded. The disclosure requirements are significantly greater and more onerous than the existing disclosure requirements.

# Food for thought

## Here are some questions for you to think about:

### Bundled offerings

**What proportion of your customer offerings are bundled products and services (e.g. equipment plus maintenance agreement, software plus updates, goods plus extended warranty)?**

The new standard requires revenue to be allocated based on each distinct performance obligation. At present, some companies do not allocate and recognise revenue among the different offerings separately. In the future, they will likely need to allocate and recognise revenue separately for each distinct performance obligation, which may result in a change in the timing of revenue recognition.

Where a large proportion of offers are bundled, companies are more likely to have to make changes to their systems and processes in order to capture the required information. They will also be more likely to see a change in their reported revenue on transition.

### Significant financing component

**Do you offer different pricing to customers based on the timing of their payment? Are payment terms significantly different from timing of when goods or services are transferred?**

In the new standard, the timing difference between payment and the transfer of goods or services may affect the transaction price. Companies that have contracts with a significant financing component may face operational challenges associated with measuring and tracking time value of money.

Determining when a significant financing component exists could require considerable judgment. In some situations, it might be difficult to determine if a significant financing element exists.

## Licences

### Do you have significant licence arrangements? Do those licence arrangements include other services?

Licensors may be greatly affected. Licences allow a customer to use a company's intellectual property ("IP"), such as its technology, media, patents, trademarks, or copyrights. The model for recording revenue on licences will first depend on whether the licence is distinct from other elements of the contract. This will require significant judgement. Revenue is recognised together with other elements if it is not distinct.

The type of licence will also depend on whether the IP is "dynamic" (over time recognition) or "static" (point in time recognition). A dynamic licence is one where the provider of the IP continues to undertake activities related to the IP, and the customer is exposed to the effects of that activity. For example, a licence to place a famous sports team brand on T-shirts might be dynamic, as the sales of T-shirts (and therefore the value of the licence) could be impacted depending on the team's performance. In contrast, a static licence provides the customer with the right to use IP that does not change after the licence transfers to the customer (e.g., purchasing a licence to download the content for a textbook).

## Contract profiles

### What is the volume of customer contracts you enter into, and how diverse are their terms and conditions? How often do the terms of those contracts change?

The greater the number, diversity and terms of contracts that a company handles, and the more often those change, the more work will be required to determine the impact of the new standard and the data that will need to be captured.

The standard presumes that contracts will be accounted for individually. However, as a practical expedient, a company may apply the new standard to a portfolio of contracts (or performance obligations) with similar characteristics if the company reasonably expects that the result of doing so would not differ materially from the result of accounting for each individual contract (or performance obligations).

Companies will need to assess whether and how they are able to apply the portfolio approach, or if they prefer to account for individual contracts.

If accounting for individual contracts is chosen, a company will need to assess how consistent the data granularity and quality is within their systems. A company will also need to assess whether it is practical and cost-effective to process all current contracts.

## Timing of revenue recognition

**Do you construct or manufacture assets that are unique to your customers? Have you considered when you transfer control of the goods and services to your customers?**

The new standard introduces a single revenue recognition model that focuses on the evaluation of transfer of control, without distinguishing between sales of goods and rendering of services. While the transfer of risks and rewards generally coincide with transfer of control, this may not always be the case.

Revenue is recognised when control of the goods or services are transferred to the customers. The standard provides guidance to ascertain whether control is transferred over time or at a point in time. A company should first assess whether the performance obligation is satisfied over time. If not, the goods or services transfer at a point in time. Arrangements where the performance obligations are satisfied over time are not limited to services arrangements. Complex assets or certain customised goods constructed for a customer could also transfer over time, depending on the terms of the arrangement.

Besides the key terms of the contracts, companies will also need to carefully assess the nature of the promised goods or services, as well as the governing laws and legal environment to determine when and how control is transferred to the customers.

## Impact on commercial arrangements

**How many and which contracts or commercial arrangements are linked to revenue/profit or use ratios based on revenue/ profit?**

The timing and amount of revenue recognised is likely to change under the new standard. There may also be changes to the assets and liabilities that will be recognised for contracts with customers, which have the potential to change balance sheet ratios.

Such changes may impact arrangements such as performance hurdles in employee share arrangements, debt covenants, business combinations with contingent consideration, or other contractual triggers linked to revenue. Companies will need to identify and renegotiate such agreements.

## System integration

**How integrated – and how complex – are your systems for sales, billing, customer management and accounting?**

Where systems are heavily integrated, the changes required to capture the information needed to recognise revenue are likely to trigger dependencies in other systems. If companies have complex systems with lots of inter-connections, or legacy systems for different lines of products, services, etc., then it is likely to take some time to devise a process and system that enables them to comply with the new standard.

Companies may also want to consider changes to the design or price of customer contracts, or the manner in which sales personnel gather or accumulate data on customer contracts.

**Are your systems capable of capturing the information you will need to report under the new standard -- for example, if you are required to unbundle elements of a customer contract or measure progress to completion in a different way?**

For many companies, major system changes will not be required. However, for others, revenue data on customer contracts will need to be captured in a completely different way. In these cases, system changes may need to be made. The timeline for implementing such changes can be significant – including design and testing.

# The impact to you beyond accounting

***The new rules on revenue recognition have the potential to trigger changes across your business.***

**The systems impact: billings ≠ revenue**

Most systems are set up to draw revenue numbers directly from the billings system. Under the new standard, information from the contracts that lie behind the billings will need to be analysed in order to determine the separable elements of the contracts and the revenue to be recognised from those elements.

Interfaces between customer relationship management, sales and distribution and the general ledger may be impacted, and previously automated processes may now require intervention.

You need to determine the extent of the impact on your business now. For many companies the impact will be manageable closer to transition date, but those with large numbers of customer contracts, diverse or constantly changing contract terms, or complex systems should act now.

**Systems:** Likely to be the most significantly impacted, and take the longest lead time to change. Your systems may need to capture and analyse new information in a more disaggregated way (see box).

Other than time that is needed, most systems need cost to upgrade and hence need to consider impact on capital expenditure.

**Controls and processes:** The standard requires you to make more estimates, judgements, and disclosures, calling for new controls and processes.

**Compensation and bonus plans:** Revenue recognition can trigger payments like bonuses or commission. You will need to consider how timing changes for revenue recognition may affect these and other internal arrangements.

**Tax:** The timing of cash tax payments could be affected if, for example, you recognise revenue sooner than in the past.

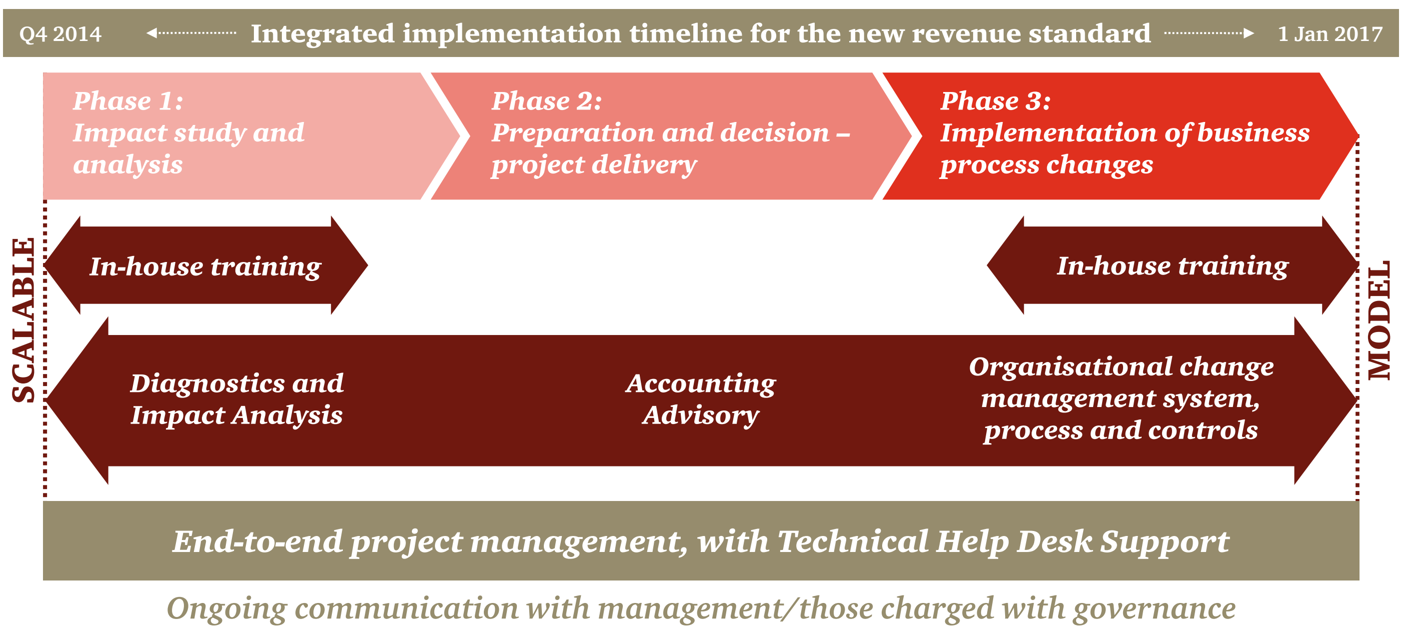
**Investor relations:** Stakeholders may want to understand how revenue recognition will change and how the new standard affects your company's financial picture.

**Contracts:** Existing terms could take on new meaning under the new standard, so you may need to re-negotiate debt covenants or earn-out arrangements to maintain the original intent. You may also want to rethink how you structure customer agreements in the future, for example if you want to achieve recognition over time rather than at a point in time.

# How we can help

**Our ‘one firm’ solution**

PwC is already working with a number of large companies around the world to manage their transition to the new standard. We have developed an approach that draws on our expertise in accounting, systems implementation and transaction structuring to deliver an end-to-end integrated solution.



Described below are some ways in which we can help you as you plan for adoption. All these services can be customised to suit your needs.

| Service | What we will do |
|---|---|
| **In-house training and technical help-desk** | • Provide you with training for your accounting, IT, legal and compliance teams on specific areas and implementation issues you may face<br>• Provide on-going implementation and technical support to finance team and other cross functional teams on ad-hoc questions through transition phase |
| **Diagnostics** | • Perform diagnostic review of your existing arrangements / accounting policies to assess business issues and financial reporting implications and provide proposed practical solutions and recommendations<br>• Perform diagnostic that includes understanding the financial and cross-functional impact; analyse your business models and contracts underlying your revenue recognition; analyse your IT landscape and an overview of risks and gaps. This will help you understand the breadth and depth of the impact (e.g. accounting, reporting, sales contracts, controls and process, systems, remuneration, taxes and investor relations) so you can plan for implementation |
| **Impact analysis** | • Work closely with your finance team to model the impact of adoption under different revenue recognition scenarios to your earnings, business model, compensation plans, debt covenants and any other impact areas identified by you<br>• Perform a detailed analysis of differences in accounting policies, data gaps and IT systems landscape including required interfaces to be deployed / upgraded based on business requirement and functional design specifications<br>• Based on the impact analysis, develop and execute a cross-functional communication strategy both internally and externally to your investors, audit committee, board of directors and other stakeholders on a timely basis |
| **Accounting advisory** | • Undertake a detailed analysis of your specific revenue contract considering your business model while also being mindful of your objectives and propose possible solutions for you<br>• Active participation on the implementation of the proposed solutions, for example, participation in discussions with your lawyers for possible changes to contracts, internal meetings with other cross-functional teams to coordinate implementation, etc |
| **Systems, process and control** | • Collaborate with your finance and IT teams on updating revenue recognition process, contract reviews, system change, books and records through the transition period<br>• Support you to determine a sustainable software solution that is able to support compliance with the complex accounting requirements for revenue recognition |
| **Full Scale Implementation** | • A combination of all of the above to assist with your full scale implementation of the standard (from implementation in-house education, initial diagnostic phase, impact analysis, to embedding changes in your financial reporting tool) utilising PwC developed and tested implementation tools and methodologies<br>• Support you in project managing, gathering data, testing IT concept, configuring IT systems and testing the results |

# Appendix: Implementation plan

Here is an example of some of the key areas and activities you may wish to consider in your implementation plan:

| Key stages | Overall objectives | Key activities | Done? |
|---|---|---|---|
| **1. Inception and baseline** | Inventorise and quantify existing business transactions that carry an implication to the MFRS 15 | • Understand existing contractual arrangements<br>• Understand existing incentive plans and bonuses<br>• Identify separate performance obligations and incremental costs through the contracts review | |
| **2. Information gaps and impact study** | Identify information gaps for MFRS 15 compliance and to conduct a business and financial impact study | Assess Information Gaps<br>• Agree approach to determine transaction price<br>• Identify information required to meet MFRS 15 requirements<br>• Assess the availability of information through existing system or manual sources<br>• Explore options to address the information gaps (e.g. IT enhancement)<br><br>Conduct Impact Study<br>• Conduct high level financial impact study to simulate the financial impact of MFRS 15 on Company performance<br>• Conduct a business impact study based on the options available, taking into consideration existing process and IT infrastructure<br>• Develop decision paper for adopting “Contract” or “Portfolio” approach. The decision paper shall contain a cost benefit analysis and project risk assessment (e.g. project complexity and ability to deliver on time) | |

Here is an example of some of the key areas and activities you may wish to consider in your implementation plan: (cont'd)

| Key stages | Overall objectives | Key activities | Done? |
|---|---|---|---|
| **3. Solution design** | Design the detailed solutions and implementation roadmap | • Work with respective business divisions to develop a solution blueprint that clearly defines:<br>– the IT enhancements initiatives;<br>– refinement of incentive plans;<br>– fine tuning of existing contract templates and processes, if applicable<br>• Develop implementation plans and roadmap<br>• Seek endorsement and commitments from all business partners | |
| **4. Solutions rollout** | Develop all changes required on the systems, policies, processes and templates. Train the relevant stakeholders and roll out to the operations | • Construct IT enhancements and develop tracking database<br>• Complete system testing and user training<br>• Update Policies & Procedures to incorporate new processes and controls to capture information to meet MFRS 15 requirements<br>• Update relevant templates and forms jointly with the business owners (e.g. contract template, incentive calculation, tax computation, budget and management report, etc.)<br>• Streamline and refine existing incentive plans and bundling packages, if applicable<br>• Conduct rollout training and final rollout to the operations | |
| **5. Revenue reporting and post implementation optimisation** | Assess impact of new revenue reporting and optimise the approach | • Determine transaction prices<br>• Determine standalone transaction prices<br>• Allocate the transaction price to separate performance obligations<br>• Simulate financial closing with MFRS 15 requirements to assess the financial impact to company performance<br>• Update company budget or targets | |

# *Let's talk*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