

Revenue Recognition - New and Revised Proposal

1. Introduction

In our previous Financial INSIGHT: *Australian Financial Reporting Update* issued in September 2011, we discussed the ongoing deliberations regarding the exposure draft ED 2010/6 released in June 2010 ("the 2010 ED") on revenue recognition. On 14 November 2011, the International Accounting Standards Board ("IASB") and US Financial Accounting Standards Board ("FASB"), ("the Boards"), issued a revised ED/2011/6 *Revenue from Contracts with Customers* ("the revised ED").

The core principle of this revised proposed standard is the same as that of the 2010 ED - that is, an entity would recognise revenue from contracts with customers when it transfers promised goods or services to the customer. The amount of revenue recognised would be the amount of consideration promised by the customer in exchange for the transferred goods or services.

If adopted, the proposed standard will replace existing standards AASB 118 *Revenue* and AASB 111 *Construction Contracts* as well as Interpretation 15 *Agreements for the Construction of Real Estate* and Interpretation 18 *Transfers of Assets from Customers*.

This proposed standard applies to all entities that enter into contracts with customers, except leases, insurance contracts and financial instruments which are dealt with under other specific standards.

This Financial INSIGHT provides an overview of the key changes in the revised ED.

2. Key Changes to the Revenue Recognition proposals

The key changes in the revised ED compared to the 2010 ED, relate to certain aspects of the implementation of the five steps to achieve the core principle in recognising revenue which remain unchanged from the 2010 ED. There is also added guidance and clarifications in the following areas:

- Criteria for determining distinct goods or services;
- Determining the transaction price;
- Transfer of control;
- Constraint on revenue recognition; and
- Onerous performance obligations.

The key features of the revised ED are set out in the following five steps:

Step One: Identifying the Contract with a Customer

The first step in determining whether revenue is to be recognised is to identify whether a contract between the entity and the customer is in place. The revised ED lists some of the criteria to be applied in making this determination:

- The contract has commercial substance;

- The parties to the contract have approved the contract;
- The entity can identify each party's rights regarding the goods or services to be transferred; and
- The entity can identify the payment terms for the goods or services to be transferred.

Step Two: Identifying Separate Performance Obligations in the Contract

The 2010 ED proposed that goods or services should be accounted for as separate performance obligations if they were 'distinct'. It was originally proposed that a good or service is distinct if it is sold separately by the entity, or another entity, or it could be sold separately because the good or service has a distinct function and a distinct profit margin.

Concerns were raised that this could result in an entity identifying too many separate performance obligations. This is particularly the case for construction contracts as this would result in separate performance obligations being identified for each type of construction material and service, even though these goods and services are highly interrelated and ultimately construct a single asset for the customer.

As a result, the Boards further refined this by revising the criteria for identifying separate performance obligations by:

- Specifying that a bundle of highly interrelated goods or services should be accounted for as a single performance obligation;
- Requiring an entity to consider only whether it sells the good or service separately, rather than whether other entities do so; and
- Eliminating the 'distinct profit margin' criteria.

Step Three: Determining the Transaction Price

In the 2010 ED, it was proposed that the transaction price is the amount of consideration which an entity expects to receive in exchange for transferring promised goods or services to a customer. As a result, the entity would be required to consider the effect of the customer's credit risk when determining the transaction price.

This raised concerns among constituents that the amount of revenue recognised in accordance with the proposals may not reflect the amount invoiced to the customer or the amount of consideration received from the customer. As a result, the Boards decided that an entity would recognise revenue at the amount of consideration to which the entity expects to be 'entitled', excluding expectations of collectability. It was also decided that an entity would not consider the effects of customer credit risk when determining the transaction price but, instead, would account for those effects by applying the requirements in accordance with the financial instruments standards - that is, to present any impairment losses relating to contracts with customers as a separate line item adjacent to the revenue line. By doing this, it will enable users of the financial statements to compare easily the revenue to the customer credit risk.

Step Four: Allocating the Transaction Price to Separate Performance Obligations

The fourth step is to allocate the transaction price to each separate performance obligation on the basis of the relative stand-alone selling price of each distinct good or service. The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. If a stand-alone selling price is not observable, an entity would estimate it. The revised ED also specifies when an entity should allocate the discount or contingent consideration to one performance obligation rather than to all performance obligations in the contract.

Warranties

In the 2010 ED, it was proposed that an entity account for warranties on the basis of the nature of protection promised to the customer. However, the Boards revised this decision by proposing that the warranty should be accounted for as a separate performance obligation only if a customer could purchase the warranty separately from the entity or if the warranty provides a service in addition to the assurance that the entity's past performance was as specified in the contract. If the customer does not have the option to purchase a warranty separately, the entity will account for the warranty in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, unless the warranty, or even part of it, provides an additional service to the product.

Step Five: Recognise Revenue when the Entity Satisfies each Performance Obligation

The final step is to recognise revenue when the entity satisfies a performance obligation. In the 2010 ED, it was proposed that revenue should be recognised when an entity transfers goods or services to a customer - that is to recognise revenue when the customer obtains control of that good or service.

The 2010 ED proposed indicators of control, however concerns were raised particularly regarding construction and other long term contracts where the result may have been that revenue recognition was delayed until completion of the contract. As a result of redeliberations, the revised ED refines the indicators to assess whether a customer has obtained control of a good or service.

In the revised ED, the notion of control to determine when a good or service is transferred to a customer is retained. In addition, the revised ED specifies the criteria to determine when the performance obligation may be satisfied at either a point of time (such as for promises to transfer goods to a customer) or when the performance obligation may be satisfied over time (such as for promises to transfer services to a customer).

Performance obligations satisfied at a point in time:

To determine the point in time when a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity needs to consider the requirements for control, as outlined in the revised ED, as well as indicators of the transfer of control, which may include:

- Whether the entity has a present right to payment for the asset;
- Whether the customer has legal title to the asset;
- Whether the entity has transferred physical possession of the asset;
- Whether the customer has significant risks and rewards of ownership of the asset; and
- Whether the customer has accepted the asset.

Guidance is provided in the revised ED with respect to each of these.

Performance obligations satisfied over time:

For an entity to transfer control of a good or service over time, and hence recognise revenue over time rather than at a point in time, at least one of the following two criteria needs to be met:

- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced (e.g. work in progress); or
- The entity's performance does not create an asset with an alternative use to the entity and at least one of the following criteria is met:
 - The customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs;
 - Another entity would not need to substantially re-perform the work the entity has completed to date if that other entity were to fulfil the remaining obligation to the customer; or
 - The entity has a right to payment for performance completed to date and it expects to fulfil the contract as promised.

For performance obligations satisfied over time, an entity would select an appropriate measure of progress to determine how much revenue should be recognised as the performance obligation is satisfied. Appropriate methods of measuring progress include input and output methods.

It should be noted that it will be necessary for entities currently applying stage of completion accounting to consider their underlying contracts in light of the proposed criteria to determine whether this remains appropriate, particularly given that there are differences between current requirements applied to construction contracts and those proposed in the revised ED.

Other Key Changes

Constraint on revenue recognition

In the 2010 ED, it proposes that an entity should recognise revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. The Boards have decided to use the term "reasonably assured" rather than "reasonably estimated" in the revised ED. As a result, when the consideration is variable, the cumulative amount of revenue recognised would be the amount of consideration to which the entity is "reasonably assured" to be entitled, based on the entity's experience with similar types of performance obligations.

Onerous performance obligations

The 2010 ED proposed that an entity should recognise a liability for an onerous performance obligation. A performance obligation is onerous when the costs that relate directly to satisfying the performance obligation exceed the transaction price allocated to it. In the revised ED, the Boards have decided to refine the application of the onerous test by:

- Limiting it to performance obligations satisfied over time when those performance obligations are expected to be satisfied over a period of time greater than one year.
- Clarifying that a performance obligation is onerous when the lowest cost of settling the performance obligation exceeds the transaction price allocated to that performance obligation.

Disclosures

In the revised ED, the Boards have decided to retain the disclosure requirements that were proposed in the 2010 ED. An entity will be required to disclose the qualitative and quantitative information about its contracts with customers and the significant judgements, and changes in judgements, made in accounting for those contracts. Disclosures include the disaggregation of revenue into categories, reconciliation of contract assets and liabilities and information about performance obligations, specifically where contract duration is greater than a year.

The revised ED emphasises that companies should not consider the proposed disclosures to be a checklist of minimum disclosure - an entity would only be required to disclose information that is material.

3. Effective Date

Although the Boards have not yet finalised the effective date for the new standard, they have determined that the standard would not be effective sooner than for annual reporting periods beginning on or after 1 January 2015. It is proposed that retrospective application will still be required; however some reliefs have been proposed in the revised ED for initial application.

4. What's Next?

The deadline for comments on the revised ED is on 13 March 2012. The Boards are planning to issue the final standard in the second half of 2012.

The proposals could potentially affect any entity that applies Australian Accounting Standards, IFRS or USGAAP in recognising revenue. It is expected, however that entities who currently recognise revenue on a percentage of completion basis, those who provide separate warranties to customers and contracts with multiple elements, such as those combining various goods and services will be most affected. All entities are advised to familiarise themselves with the proposals to determine if and how they will be affected as the changes to accounting may also result in the need for systems changes, the need to prepare comparative information on implementation, changes to performance indicators, such as gross margin and increased financial statements disclosures.

If you wish to discuss any of the issues raised in this publication contact your local RSM Bird Cameron advisor.



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