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RICHTER

THE CFO SERIES

A GUIDE TO REVENUE RECOGNITION

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OUR EXPERTS

A GUIDE TO REVENUE RECOGNITION

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A GUIDE TO REVENUE RECOGNITION

INTRODUCTION

AMENDMENTS TO SECTION 3400: REVENUE RECOGNITION

WHY?

- Stakeholders need additional guidance on how to account for revenue.
- Too much diversity in practice
- Previously issued EICs were not formally incorporated into ASPE but expected to be followed.

WHAT?

Additional guidance on the following topics:

- Multiple-element arrangements;
- percentage of completion method;
- Reporting revenue gross or net;
- Bill and hold arrangements; and
- Upfront non-refundable fees/payments.

INTRODUCTION

AMENDMENTS TO SECTION 3400: REVENUE RECOGNITION

HOW?	WHEN?
• Familiarize yourself with the concepts • Identify situations at risk • Preliminary analysis • Communicate with your audit team.	• Fiscal years beginning on or after **January 1, 2022**.

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A GUIDE TO REVENUE RECOGNITION

MULTIPLE-ELEMENT ARRANGEMENTS

ADDITIONAL GUIDANCE TO BE PROVIDED ON

- Understanding the concept of “acts of performance” and whether or not they are significant.
- Determining how to allocate revenue to multiple elements.

MULTIPLE-ELEMENT ARRANGEMENTS

IDENTIFYING UNITS OF ACCOUNTS

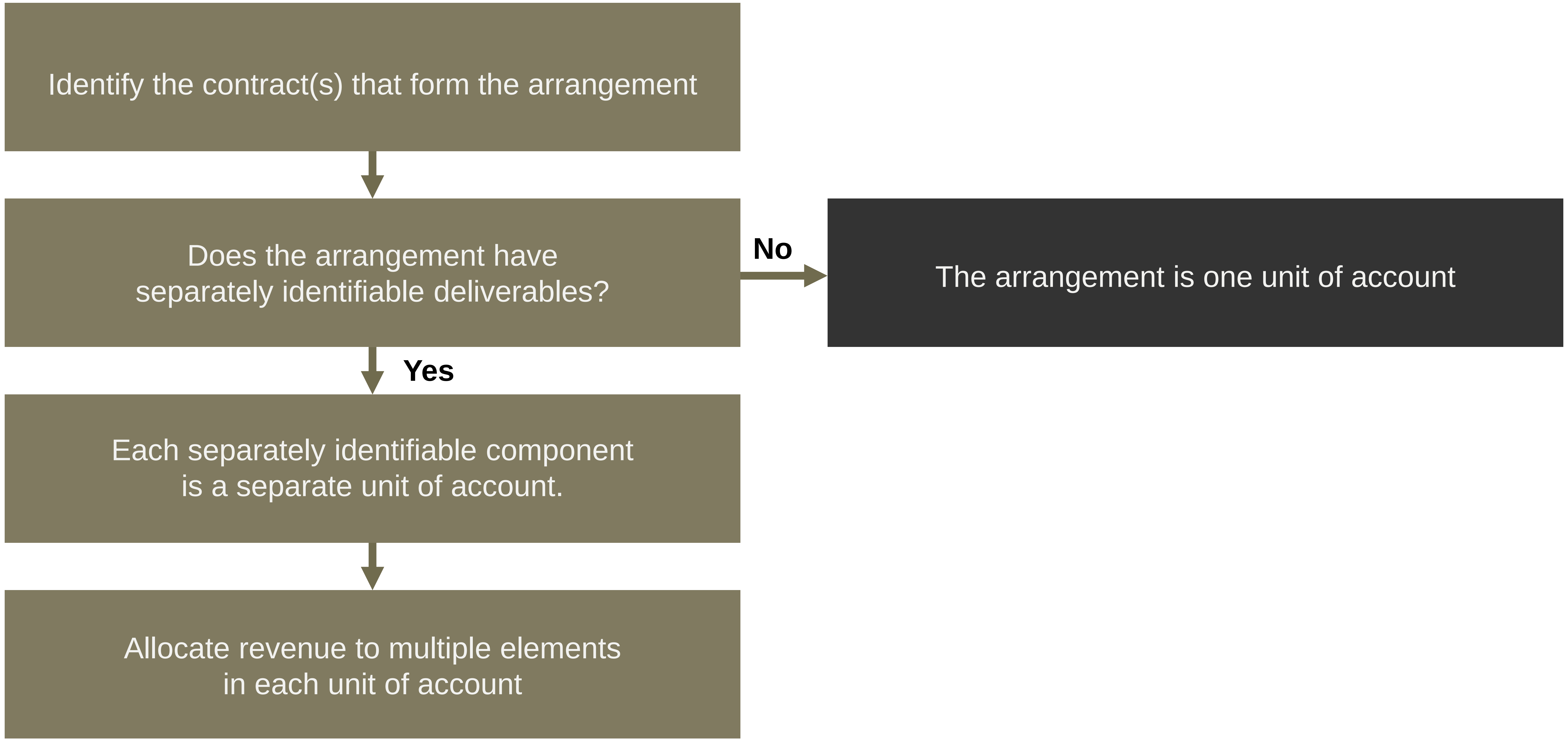
An enterprise evaluates all deliverables in the arrangement to determine whether they represent separate units of account. The deliverables should be considered a separate unit of account, if both the following criteria are met:

- If the arrangement includes a general right of return relative to the deliverable(s), delivery or performance of the remaining deliverable(s) is considered probable and substantially in the control of the vendor; and

- The deliverable(s) have value to the customer on a stand-alone basis.

MULTIPLE-ELEMENT ARRANGEMENTS

IDENTIFYING UNITS OF ACCOUNTS (CONT’D)



MULTIPLE-ELEMENT ARRANGEMENTS

PRODUCTS : MULTIPLE-ELEMENT ARRANGEMENTS – ALLOCATION OF SELLING PRICE BETWEEN COMPONENTS

Allocate based on relative stand-alone selling prices

Is observable price available?

Use observable price

Estimate price

Adjusted market assessment approach

Expected cost plus a margin approach

When the arrangement is finalized.

MULTIPLE-ELEMENT ARRANGEMENTS

IMPLICATION OF THE AMENDMENTS

There may be **additional costs** to applying these amendments as the information necessary to may not be readily available.

MULTIPLE-ELEMENT ARRANGEMENTS

EXAMPLE –

MACHINE INC. PURCHASES A SPECIALIZED PRINTING MACHINE FOR $30,000 AND SELLS IT TO CUSTOMERS IN THE PRINTING INDUSTRY FOR $50,000 ON THE FOLLOWING TERMS:

Type of Warranty	Amount	# of Years	Coverage
Standard	$1,000	1 year	Repair of defects
Extended	$15,000	5 years	Repair services

Machine Inc. offers three types of agreements	
Agreement #1	Sale of a specialized machine alone for $50,000
Agreement #2	Sale of the extended warranty alone for $15,000
Agreement #3	Sale of a specialized machine together with an extended warranty for $60,000 (discount of $5,000)

How would you account for the sale under each type of agreement?

MULTIPLE-ELEMENT ARRANGEMENTS

SOLUTION

Agreement #1 –
Sale of a specialized machine alone for $50,000

Account	Debit	Credit
Cash/Receivables	$50,000	
Sales		$50,000
Cost of Sales	$30,000	
Inventories		$30,000
Warranty Expense	$1,000	
Provision		$1,000

Agreement #2 –
Sale of the extended warranty alone for $15,000

Account	Debit	Credit
Cash/Receivables	$15,000	
Deferred Revenue		$15,000
*After One Year**		
Inventories		
Deferred Revenue	$3,000	
Revenue		$3,000

*Sale of the extended warranty alone for $15,000

MULTIPLE-ELEMENT ARRANGEMENTS

Agreement #3 –
Sale of a specialized machine together with an extended warranty for $60,000

Step #1: Identify separable components and allocate sales price to each unit of account:

Components	Sales Price Allocation
Sale of specialized machine	$60,000 x $50,000/$65,000 = $46,154
Sale of extended warranty	$60,000 x $15,000/$65,000 = $13,846

Step #2: Record the sale when the machine is delivered to the customer:

Account	Debit	Credit
Cash/Receivables	$46,154	
Sales		$46,154

The entries for costs of sales ($30,000) and the standard warranty ($1,000) are the same as Agreement #1

MULTIPLE-ELEMENT ARRANGEMENTS

Agreement #3 –
Sale of a specialized machine together with an extended warranty for $60,000

Step #3: Record the rendering of services on the extended warranty

Account	Debit	Credit
Cash/Receivables	$13,846	
Deferred Revenue		$13,846
*After One Year**		
Deferred Revenue	$2,769	
Revenue		$2,769

*Recognized the warranty on a straight-line basis over 5 years ($13,846/5 = $2,769)

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PERCENTAGE OF COMPLETION

ADDITIONAL GUIDANCE TO BE PROVIDED ON:

- When to recognize revenue
- Determining the percentage of completion
- Determining when contracts should be combined or segmented
- Determining which costs to include or exclude
- How to account for contract costs
- How to account for expected contract losses.

PERCENTAGE OF COMPLETION

DETERMINING THE PERCENTAGE OF COMPLETION

TWO APPROACHES EXIST

THE USE OF EITHER TYPE OF MEASURE REQUIRES THE EXERCISE OF JUDGMENT AND THE CAREFUL TAILORING OF THE MEASURE TO THE CIRCUMSTANCES.

APPROACH #1

Input measures are used to measure degree of completion indirectly, based on an established or assumed relationship between a unit of input and productivity.

- Labour hours;
- Labour dollars;
- Machine hours; or
- Material quantities.

APPROACH #2

Output measures are used to measure results directly:

- Units produced; or
- Milestones.

PERCENTAGE OF COMPLETION

COMPUTATION OF INCOME EARNED FOR A PERIOD UNDER THE PERCENTAGE OF COMPLETION METHOD

AN ENTERPRISE IS TO USE THE SELECTED APPROACH ON A CONSISTENT BASIS FOR ALL CONTRACTS.

ALTERNATIVE A

Earned revenue, cost of earned revenue, and gross profit are determined as follows:

- Earned revenue to date may be computed by multiplying total estimated contract revenue by the percentage of completion. The excess of the amount over the earned revenue recognized in prior periods is the earned revenue that is recognized in the income statement for the current period.
- Cost of earned revenue to date is computed by multiplying total estimated contract cost by the percentage of completion on the contract. The excess of that amount over the cost of earned revenue recognized in prior periods is the cost of earned revenue that is recognized in the income statement for the current period. The difference between total cost incurred to date and cost of earned revenue recognized to date is reported on the balance sheet.
- Gross profit on a contract for a period is the excess of earned revenue over the cost of earned revenue.

PERCENTAGE OF COMPLETION

COMPUTATION OF INCOME EARNED FOR A PERIOD UNDER THE PERCENTAGE OF COMPLETION METHOD

AN ENTERPRISE IS TO USE THE SELECTED APPROACH ON A CONSISTENT BASIS FOR ALL CONTRACTS.

OTHER APPROACHES MAY ALSO BE APPROPRIATE

ALTERNATIVE B

Earned revenue, cost of earned revenue, and gross profit are determined as follows:

- Earned revenue is the amount of gross profit earned on a contract for a period plus the cost of earned revenue.
- Cost of earned revenue is the cost incurred during the period, excluding the costs incurred for subcontracted work that is still to be performed.
- Gross profit earned on a contract shall be computed by multiplying the total estimated gross profit on the contract by the percentage of completion (as determined by one of the acceptable methods of measuring extent of degree of completion). The excess of that amount over the amount of gross profit reported in prior periods is the earned gross profit that shall be recognized in the income statement for the current period.

PERCENTAGE OF COMPLETION

CONTRACT COSTS

COSTS THAT RELATE DIRECTLY TO THE SPECIFIC CONTRACT

- Site labour costs, including site supervision;
- Costs of materials used;
- amortization of plant and equipment used on the contract;
- Costs of moving plant, equipment and materials to and from the contract site;
- Costs of leasing plant and equipment;
- Costs of design and technical assistance that is directly related to the contract;
- Claims from third parties; and
- The estimated costs of rectification and guarantee work, including expected warranty costs.

COSTS THAT ARE ATTRIBUTABLE TO CONTRACT ACTIVITY IN GENERAL AND CAN BE ALLOCATED TO THE CONTRACT

- Insurance;
- Costs of design and technical assistance that are not directly related to a specific contract; and
- Overhead costs

COSTS THAT CANNOT BE ATTRIBUTED TO CONTRACT ACTIVITY OR CANNOT BE ALLOCATED TO A CONTRACT ARE EXCLUDED FROM THE COSTS OF A CONTRACT

- General administration costs for which reimbursement is not specified in the contract;
- Selling costs;
- Research and development costs for which reimbursement is not specified in the contract; and
- Amortization of idle plant and equipment that is not used in a particular contract.

PERCENTAGE OF COMPLETION

EXPECTED LOSSES

WHEN IT IS PROBABLE THAT TOTAL CONTRACT COSTS WILL EXCEED TOTAL CONTRACT REVENUE, THE ENTIRE EXPECTED LOSS IS RECOGNIZED AS AN EXPENSE IMMEDIATELY.

The amount of such a loss is determined irrespective of:

- Whether work has commenced on the contract;
- The degree of completion of the contract; or
- The amount of profits expected to arise on other contracts which are not treated as a single contract in accordance with **paragraph 3400.A3**.

PERCENTAGE OF COMPLETION

NEW DISCLOSURE FOR PERCENTAGE OF COMPLETION

THE AASB HAS DEVELOPED THE GUIDANCE BASED ON INDICATIONS IN IAS 11.

Additional requirement to address disclosure needs surrounding percentage of completion.

Additional information requested on understanding the contracts and the risks associated with them.

%

Provide better understanding of how the percentage of completion was determined and to distinguish between inventory WIP and unbilled revenue.

PERCENTAGE OF COMPLETION

IMPLICATION OF THE AMENDMENTS

There may be additional costs to applying these amendments which may include:

- Obtaining and tracking the information necessary, depending on the measure used to determine the degree of completion; and
- Retaining experts, such as engineers or architects.

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REPORTING REVENUES GROSS OR NET

ADDITIONAL GUIDANCE TO BE PROVIDED ON:

THE AASB HAS DEVELOPED THE GUIDANCE BASED ON INDICATIONS IN OLD EIC-141.

- Understanding which enterprise bears the risk; and
- When to perform the assessment to determine whether revenue should be reported gross or net.

REPORTING REVENUES GROSS OR NET

USE YOUR JUDGMENT TO DETERMINE THE MOST IMPORTANT CRITERIA AND CONCLUDE

INDICATORS OF GROSS REVENUE REPORTING	INDICATORS OF NET REVENUE REPORTING
• The enterprise is the primary obligor in the arrangement. • The enterprise has general inventory risk. • The enterprise has latitude in establishing price. • The enterprise has credit risk.	• The supplier (not the enterprise) is the primary obligor in the arrangement. • The amount the enterprise earns is fixed. • The supplier (and not the enterprise) has credit risk.

REPORTING REVENUES GROSS OR NET

EXAMPLE –
BREW CO. BUYS COFFEE PODS FROM A MAJOR COFFEE MANUFACTURER AND SELLS TO MAJOR RETAILERS UNDER THE FOLLOWING ARRANGEMENT:

- Brew Co. does not own the inventory. They pay inventory only when it will be sold. If the goods are damaged, the goods will be returned directly to Brew Co. and the manufacturer will check the return goods and Brew Co. will be credited.
- The customers issue a purchase invoice in the name of Brew Co. Brew Co. directly invoices the customers. The customers pay Brew Co. Then, the manufacturer will invoice Brew Co. for the inventory sold at PAF (Pricing Approval Form) price and will remit to Brew Co. a 14.0% commission calculated on the PAF.
- Brew Co. does not have title to the goods
- Brew Co. does not participate in the design of the product.
- Brew Co. bears the credit risk.
- The manufacturer does have the ability to conduct business independently.
- Brew Co. negotiates the prices paid by the customers jointly with the manufacturer. Therefore, the responsibility to establish prices lies with Brew Co. and the manufacturer. However, the prices are always approved by the manufacturer.

Should Brew Co. report revenue on a gross or net basis?

REPORTING REVENUES GROSS OR NET

SOLUTION – AN AGENCY RELATIONSHIP EXISTS AND RECORDING REVENUE NET IS APPROPRIATE

INDICATORS OF GROSS REVENUE REPORTING	INDICATORS OF NET REVENUE REPORTING
• The enterprise is the primary obligor in the arrangement. • The enterprise has general inventory risk. • The enterprise has latitude in establishing price. • The enterprise has credit risk.	• The supplier (not the enterprise) is the primary obligor in the arrangement. • The amount the enterprise earns is fixed. • The supplier (and not the enterprise) has credit risk.

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BILL AND HOLD ARRANGEMENTS

ADDITIONAL GUIDANCE TO BE PROVIDED ON:

THE AASB HAS DEVELOPED THE GUIDANCE BASED ON INDICATIONS IN OLD EIC-141.

- Determining whether revenue should be recognized or deferred when there is a bill and hold arrangement with a customer; and
- Understanding whether significant risks and rewards of ownership have been transferred to the buyer.

BILL AND HOLD ARRANGEMENTS

ALL OF THE FOLLOWING CRITERIA ARE REQUIRED TO BE MET TO RECOGNIZE REVENUE WHEN DELIVERY HAS NOT OCCURRED:

a) The risks of ownership must have passed to the buyer;
b) The customer must have made a fixed commitment to purchase the goods;
c) The buyer must request that the transaction be on a bill and hold basis, and the buyer must have a substantial business purpose for ordering the goods on a bill and hold basis;
d) There must be a schedule for delivery of the goods that is reasonable and consistent with the buyer's business purpose;
e) The seller must not have retained any specific performance obligations such that the earning process is not complete;
f) The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders; and
g) The product must be complete and ready for shipment.

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A GUIDE TO REVENUE RECOGNITION

UPFRONT NON-REFUNDABLE FEES/PAYMENTS

ADDITIONAL GUIDANCE TO BE PROVIDED ON:

Determining when to recognize revenue in respect of these fees/payments.

UPFRONT NON-REFUNDABLE FEES/PAYMENTS

General Rules

- **Even though** upfront fees may be **non-refundable**, the revenues are earned over time as the goods are delivered or services are rendered. Revenues must be **deferred**.
- Then, recognized in a systematic manner over the periods during which they are earned.

Licenses

- Upfront payments related to a temporary license are recognized as revenues over the term of the license.
- Upfront payments related to a perpetual license are recognized as revenues when they are received or are receivable.

UPFRONT NON-REFUNDABLE FEES/PAYMENTS

EXAMPLE –

Cloud Co. enters into a contract with a customer for a license of its software and a non-cancellable one-year subscription to access the licensed application (the cloud services).
The contract amount for the software license is an upfront, non-refundable fee of $1 million. The fee for the cloud services is $500,000 for one year. The customer has the right to renew the cloud services each year for $500,000.

How would recognize the non-refundable fee of 1 million?

UPFRONT NON-REFUNDABLE FEES/PAYMENTS

SOLUTION –

Cloud Co. enters into a contract with a customer for a license of its software and a non-cancellable one-year subscription to access the licensed application (the cloud services). The contract amount for the software license is an upfront, non-refundable fee of $1 million. The fee for the cloud services is $500,000 for one year. The customer has the right to renew the cloud services each year for $500,000.

Assume that Cloud Co. determines the software license and cloud services are a single unit of account. There are no other promised goods and services in the contract. Therefore, the upfront fee is not associated with the transfer of any other good or service to the customer. However, Cloud Co. determines there is an implied performance obligation. That is, the right to renew the cloud services each year for $500,000 is a material right to the customer because that renewal rate is significantly below the rate the customer paid for the first year of service ($1.5 million in total).

Based on its experience, Cloud Co. determines that its average customer relationship is three years. As a result, Cloud Co. determines that the performance obligations in the contract include the right to a discounted annual contract renewal and that the customer is likely to exercise twice.

Cloud Co. should recognize the non-refundable fee of $1 million systematically over the period the licensing fees are expected to be earned.

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EFFECTIVE DATE AND TRANSITION

EFFECTIVE FOR PERIODS BEGINNING ON OR AFTER JANUARY 1, 2022

Proposals are to be applied retrospectively with transitional relief:

- An enterprise is not be required to make retrospective adjustments for long-term contracts accounted for using the percentage of completion method that are completed during the fiscal year in which the amendments are first applied or during the immediately preceding fiscal year; and
- An enterprise is not be required to make retrospective adjustments for multiple-element arrangements when all deliverables have been delivered during the fiscal year in which the amendments are first applied or during the immediately preceding fiscal year.

CONCLUSION AND DISCUSSION

QUESTIONS AND COMMENTS

NEXT WEBINAR

Richter's CFO Series will be back in 2022!

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THANK YOU!