

AASB 15

REVENUE FROM CONTRACTS

WITH CUSTOMERS

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AASB 15 REVENUE FROM CONTRACTS WITH CUSTOMERS

According to the IASB, the new revenue recognition standard removes inconsistencies and weaknesses from the standards and interpretations which it supersedes. IFRS 15 is also cited as providing a more robust framework for addressing revenue recognition issues and will improve comparability across companies, industries and capital markets. One of the objectives of AASB 15 is also to provide more useful information to the users of the financial statements by requiring more comprehensive disclosures to be made in the financial statements than previous standards required.

Some entities' revenue recognition practices have been in the headlines over recent years, mainly for all the wrong reasons. Revenue is often the headline figure in the financial

statements and essentially drives the pre-tax profit figure. In addition, as tax liabilities are primarily based upon the pre-tax profit figure reported in the financial statements, any manipulation in the revenue figure would effectively have a direct impact upon the level of tax payable or refundable from the tax authorities.

Over the years, accounting scandals have highlighted companies that have deliberately manipulated revenue to achieve a desired outcome; usually to achieve a desired level of profit or earnings per share figure. This act of revenue manipulation is regarded as fraudulent financial reporting and can carry heavy sanctions (including prison sentences) when individuals are found guilty of such accounting irregularities.

AASB 15 has been widely publicised in the professional press as a fundamental change in the way that entities in the scope of the standard will recognise and, thus, report revenue. It follows, therefore, that the implications of adopting AASB 15 will go well beyond simple accounting adjustments. For preparers of financial statements, there are new, rather than additional, judgements that are needed; however, AASB 15 does include more guidance within the standard as to how to apply its technical content. Other factors that reporting entities will need to consider are:

- How will technical staff deal with the new requirements – are additional training needs required?
- What are the costs involved in implementing the standard?
- Will entities' financial and accounting systems be able to deal with the new requirements?
- What will the impact be on sales targets and bonuses (particularly as retrospective application of the standard is required)?
- What is the impact of transition on the reporting entity's financial statements (see Chapter 4)
- Who will do the impact assessment and when will this be carried out?

The importance of the final bullet point in respect of an impact assessment cannot be over-emphasised. For some entities, the impact of AASB 15 may be fairly minimal, but for others the impact may be significant.

NetSuite has assembled the following guide based on a long history of leadership in providing revenue recognition issues and accounting solutions that aim to help organisations to comply with the requirements of accounting standards.

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WHY WAS AASB 15 ISSUED?

Revenue is considered to be one of the most important figures within a reporting entity's financial statements. It is the key driver of gross profit margins, pre-tax profit and tax liabilities/assets and can heavily influence the decision-making processes of the users of the financial statements.

The IASB, which is responsible for issuing, amending and withdrawing IFRSs, decided that existing standards and interpretations covering revenue recognition were in need of improvement. The IASB made this decision on the grounds that standards such as IAS 11 Construction Contracts and IAS 18 Revenue only provided limited guidance and therefore were difficult to apply where complex transactions were concerned. Furthermore, IAS 18 was viewed as only providing limited guidance on many important revenue topics (for example, accounting for multiple-element arrangements). In comparison, US GAAP included a broad range of revenue recognition concepts including numerous revenue recognition requirements for certain industries or transactions; the upshot of which often resulted in different accounting treatments for transactions that were, in substance, similar.

The IASB and FASB formed a collaboration which would result in an accounting

standard that would clarify the principles for recognising revenue and would also:

- Eradicate inconsistencies and weaknesses within existing standards that deal with revenue recognition.
- Provide entities with a more robust framework for dealing with revenue recognition issues.
- Improve comparability across entities, industries, jurisdictions and capital markets.
- Provide more useful information to users of the entity's financial statements.
- Simplify the financial statement preparation process by reducing the number of requirements which an entity must have regard to.

As mentioned in the introductory section, various accounting scandals have been well-publicised whereby revenue has been manipulated to achieve a desired outcome. While accounting standards may not necessarily eradicate all forms of fraudulent financial reporting, due to individuals deliberately departing from the requirements of such standards so as to achieve a desired outcome, compliance with AASB 15 aims to reduce such instances and provide more robust guidance where an entity's revenue recognition policies are concerned.

Chapter 2

THE FIVE-STEP PROCESS TO RECOGNISING REVENUE

A notable feature of AASB 15 is the five-step model that is incorporated within the standard. On first glance, the model itself may seem fairly straightforward to apply; however, as is always the case with accounting standards, the devil is in the detail. There will be more professional judgement needed on the part of management where fair values for revenue recognition are concerned as well as splitting performance obligations and establishing collectability of revenue. Professional judgement will also apply to issues such as the determination of any

sales-related bonus schemes the entity has in place as well as any probable obligations contained within contracts with customers. While the standard tries, as far as possible, to be prescriptive, entity-specific issues will undoubtedly need to be taken into consideration, which is where professional judgement will also be needed.

The five-step process involves:



Step 1: Identifying a contract

The first step in the five-step model involves the identification of a contract with a customer. Contracts can, and often are, in different forms such as written contracts, verbal contracts or contracts that are implied. The key issue here is that the contract must be enforceable, have commercial substance and be approved by those that are a party to the contract.

The five-step model will apply once the terms of payment for the goods and/or services have been identified and it is probable (i.e. more likely than not) that the entity will receive the consideration in the contract. The rights of each party to the contract must be capable of identification. If a contract with a customer does not meet these criteria, the entity can reassess the contract (on a continuing basis) to see if the criteria can be subsequently met.

Step 2: Identifying the performance obligations

Step two requires an entity to identify the separate performance obligations within the contract. This is done at the inception of the contract and is often referred to as 'unbundling'. A key factor in identifying a separate performance obligation is distinguishing between a good and a service, or a bundle of goods and services. IFRS 15 says that a good or service is distinct if the customer can benefit from the good or service on its own, or together with other readily available resources and is separately identifiable from other elements of the contract.

Where a series of distinct goods or services are substantially the same with the same pattern of transfer, the standard requires them to be regarded as a single performance obligation.

Step 3: Establishing the transaction price

Step three requires the entity to establish the transaction price. The transaction price is the amount of consideration that an entity expects it will be entitled to in exchange for the promised goods or services. Transaction price does not include any amounts collected on behalf of third parties.

A key feature of AASB 15 is that the transaction price may include 'variable' or 'contingent' consideration. Where variable consideration is involved in a contract with a customer, AASB 15 requires the entity to estimate the amount of consideration to which it will become entitled. Consideration can be variable due to several reasons, such as volume rebates, discounts, refunds, credits, performance bonuses or penalties (variable consideration is included in the example at the end of this chapter). Consideration can also be contingent if it depends on the occurrence, or non-occurrence, of a future event. Management must use the approach that it expects will best predict the amount of consideration and should apply this approach consistently throughout the contract. If this principle is applied correctly, the correct amount of revenue should be recognised in the entity's financial statements.

Step 4: Allocating the transaction price to performance obligations

Step four requires the entity to allocate the transaction price to the separate performance obligations. The allocation itself is based on the relative standalone selling price of the good or service promised and is made at the start of the contract. The best evidence of a standalone selling price is the observable price of a good or service where the entity may sell that good or service separately. If observable prices are not available, an estimate should be made by management and this estimate should maximise the use of observable inputs. A typical example would be expected cost price plus profit margin.

In situations that the transaction price includes an element of variable consideration, management will need to establish whether such amounts relate to all or some of the performance obligations within the contract.

Step 5: Recognising revenue

The final step in the five-step model requires the entity to recognise revenue as each performance obligation is satisfied. Where AASB 15 is concerned, an entity will satisfy a performance obligation when it transfers control of a good or service to the customer. Satisfying performance obligations might not necessarily happen at one specific point in time; performance obligations could be satisfied over a period of time. AASB 15 requires that where an entity satisfies performance obligations over a period of time, it must recognise revenue over time by selecting an appropriate method for

measuring the progress towards completely satisfying performance obligations in respect of that performance obligation.

Example: Revenue recognition with variable consideration and change of contract terms

Scenario

On 1 July 2016, North PLC (North) was awarded a contract with a customer to construct an item of specialised medical machinery for \$1,200,000 with a bonus of \$750,000 should the machine be constructed and approved for use within two years. At the start of the contract (which the directors have concluded has a single performance obligation), North estimates the costs to be \$950,000 and due to the specialist nature of the machine to be constructed the directors have concluded that it is highly probable that a significant reversal of cumulative revenue recognised will occur. This is because many of the materials that will be needed to construct the machine have to be sourced from overseas suppliers and hence the receipt of such materials are outside the control of North, so there is a likelihood that the machine will not be completed within the two-year deadline.

The year-end of North is 30 June 2017 and on this date, the entity concluded that it had satisfied 70% of its performance obligations; this conclusion is based on the level of costs that it has incurred. Notwithstanding the fact that there were only 30% of the performance obligations to fulfil, the directors still regard the consideration as being variable as some problems were encountered with receipt

of materials over the last year, with a large proportion of the materials arriving later than anticipated.

Due to significant price increases by the main suppliers, the contractor and North agreed to a modification to the contract terms which increases the consideration by \$200,000 and costs by \$100,000. In addition, the deadline for completion of the project has been extended by a further six months. These contract modifications took place on 7 July 2017 and at that date, the directors changed their view where the variable consideration is concerned and concluded that the bonus will now be achieved and that the contract remains a single performance obligation.

Solution

Under AASB 15, North accounts for the promised bundle of goods and services as a single performance obligation. On 1 July 2016, the contract calculations are as follows:

Transaction price	\$1,200,000
Costs	\$950,000
<hr/>	
Profit in the contract	\$250,000 (20.8% margin)

The bonus element is excluded because at the inception of the contract, the directors have concluded that significant reversal of cumulative revenue recognised will occur, hence the bonus is ignored at this point in

time as at that time it is unlikely to be received due to circumstances beyond the entity's control.

At the year-end 30 June 2017, North has satisfied 70% of its performance obligations based on the level of costs incurred. Variable consideration is still constrained at the year-end. In the year-end financial statements, North will recognise the following under AASB 15:

Revenue (\$1,200,000 x 70%)	\$840,000
Costs (\$950,000 x 70%)	\$665,000
<hr/>	
Profit recognised at year-end	\$175,000 (20.8% margin)

On 7 July 2017, the consideration, costs involved and deadline for completion are all revised. The directors also conclude that as the deadline has been extended, it is now probable that the bonus will also be achieved (thus the variable consideration constraint is removed) and so the bonus can now be included within the transaction price. Therefore, the total potential consideration receivable post-modification is \$2,150,000 (\$1,400,000 plus the \$750,000 completion bonus). As North has also concluded that the contract still remains a single performance obligation, it accounts for the modification to the contract as if it were part of the original contract.

As North has satisfied 63.3% of its performance obligations (\$665,000 actual costs incurred compared to \$1,050,000 total expected costs post-modification), North must recognise an additional amount of revenue of \$520,950 ($(63.3\% \times \$2,150,000) - \$840,000$). As the modification to the contract took place AFTER the year-end, IAS 10 Events after the Reporting Period would regard this as a non-adjusting event so the additional revenue would not be reflected in the year-end financial statements, but would, instead, be recognised at the date the contract was subsequently modified as a cumulative catch-up adjustment.

Chapter 3

INDUSTRIES LIKELY TO BE AFFECTED BY AASB 15

It cannot be said that some industries will not be affected by AASB 15, because all entities reporting under IFRSs will be under the scope of the new revenue recognition standard. The IASB and FASB have identified some industries that are likely to be affected more than others, but the list is by no means exhaustive.



The telecoms industry is going to be hugely affected by AASB 15 because, certainly for mobile phone contracts, the handset is provided to a customer for free (in most cases) with a contract for services being agreed with a customer for a specified number of months, such as a 24-month contract.

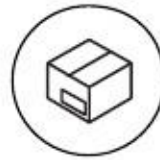
Many mobile phone companies treated the handset as an incentive cost to obtain a customer. This is not allowed under AASB 15 and the mobile phone company must allocate a total contract price between the sale of the handset and the sale of the plan. This changes the timing of revenue recognition because AASB 15 will require such revenue to be recognised earlier than. Modifications to existing

The challenge faced by the telecoms industry is that each bundled offer will need to be split into individual performance obligations and then have a transaction price allocated one-off adjustment (i.e. retrospectively) or as to those performance obligations.



Construction companies

Construction companies may be significantly affected because allowed quite a lot of room for judgement to be applied where the devising of revenue recognition policies and practices were concerned. AASB 15 is far more prescriptive in its requirements and the application of the rules in AASB 15 may give rise to significant changes in the profile of revenue and costs that are recognised in a construction entity's statement of profit or loss.



Manufacturing companies

There are a huge number of items that can be manufactured and thus, several variations of the types of contracts manufacturing entities will enter into. It is likely that manufacturing companies that produce specific goods which involve a lengthy period of production will be largely affected by AASB 15. This is because AASB 15 requires the consideration of whether revenue should be recognised over a period of time, or at a point in time hence the manufacturing entity will have to measure the progress of completion. A further example of how a manufacturing company may be affected is the consideration of whether contracts should be split into more performance obligations. The importance of impact assessments in this area cannot be over-emphasised and such assessments should be done as early as possible before transition to AASB 15 so there are no unpleasant surprises after transition.



Software companies

Some software companies offer ongoing support for their product, hence there will be a performance obligation for the software itself, plus a performance obligation for any ongoing support. The support element may cover a set period of time (e.g. two years) or be over a calendar year. Contracts will need to be scrutinised to ensure that revenue in respect of each performance obligation is recognised at the appropriate time and at an appropriate amount.

APPLICATION OF AASB 15

There are some options available to entities under the scope of the standard where the transition to AASB 15 is concerned. A company can apply AASB 15 to all its contracts and hence retrospectively adjust each comparative period when the entity does not early adopt AASB 15. Alternatively, an entity can recognise the cumulative effect of applying AASB 15 at the date of initial application and make no adjustments to comparative Information. The following example illustrates the impact of each method:

Example: Retrospective method and cumulative effect method

South PLC has a contract with a customer which would have required \$300 worth of revenue to be recognised in years 2015, 2016, 2017 and 2018. Under AASB 15, the revenue for these years is calculated as 2015: \$900, 2016: \$100, 2017: \$100 and 2018: \$100.

The table below shows the impact of both the retrospective method and the cumulative effect method:

	Comparative years		Current year	Total
	2016	2017	2018	
Current revenue recognition policy				
Revenue	300	300	300	900
AASB 15: Retrospective method				
Revenue	100	100	100	300
Adjustment to opening reserves (equity)	600*	-	-	600
AASB 15: Cumulative effect method				
Revenue	300	300	100	700
Adjustment to reserves (equity)	-	-	200**	200

*This figure is calculated as the amount of revenue that would be recognised under AASB 15 in 2015 (i.e. \$900) less the actual amount of revenue recognised under current GAAP of \$300.

**This figure is calculated as the amount of revenue that would be recognised in 2015, 2016 and 2017 under AASB 15 of \$1,100 (i.e. \$900 + \$100 + \$100) less the amount that has actually been recognised of \$900 (i.e. \$300 + \$300 + \$300).

CONCLUSION

AASB 15 is going to have a considerable impact on some entities' processes. This impact is not simply confined to financial reporting, but to a company's sales process in general. Assessments of the impact of AASB 15 are strongly advised, particularly if the business is in an industry that has been flagged as being most affected by AASB 15. Systems will need to be looked at to ensure that they can comply with the requirements of AASB 15 and where they cannot cope with the new standard, changes will have to be made (which may prove costly in some situations).

Auditors will also need a sound grip of the technical requirements of AASB 15, together with how it has impacted an entity's sales processes and financial reporting as these will give rise to additional risk areas that need to be considered.

Entities that are affected by AASB 15 are encouraged to:

- **Work with their auditors** at an early stage in the transition process to identify potential problems.
- **Review areas** such as sales targets that are linked with bonuses as revenue may be accelerated or delayed under AASB 15 than what was the case under previous standards.
- **Perform an 'end-to-end' review of financial systems** to ensure that it can cope with the reporting requirements of AASB 15.
- **Understand the issues faced by other entities** that have already implemented IFRS 15 to see if they may affect your entity.



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