Revenue recognition
Measurement &
Disclosures

Revenue under IAS 18

- Revenue arising from;
  - Sale of goods
  - Rendering of services
  - Interest, royalties and dividends

IAS 18 Related issues

- IFRIC 18 Transfers of Assets from Customers
- IFRIC 15 Agreements for the Construction of Real Estate
- IFRIC 13 Customer Loyalty Programmes
- IFRIC 12 Service Concession Arrangements
- SIC 27 Evaluating the Substance of Transactions in the Legal Form of a Lease
- SIC 31 Revenue - Barter Transactions Involving Advertising Services

Different activities

- 'Bill and hold' sales
- Goods shipped subject to conditions
- Lay away – delivery occurs after final payment
- Sale and repurchase agreements
- Agency transactions
- Instalment sales
- Servicing fees
- Advertising commissions
- Financial service fees
- Membership fees
- License fees and royalties

Definition of revenue

- The gross inflow of economic benefits
- Arising in the course of the ordinary activities
- Inflows result in increases in equity, other than increases relating to contributions from equity participants.

Revenue Recognition Options

- **During production**
- **At completion of production**
- **Time of sale**
- **Over period receivables outstanding**
- **At the time cash is collected**

When recognized at time of sale, look at:

- **Uncollectible accounts expense (bad debts)**
- **Sales returns and allowances**
- **Warranty expenditures**
- **Also want to look at A/R Turnover**

Alternate forms of revenue recognition

- **Contractors**
  - Percentage of completion
  - Completed contract

- **Receipt of payment uncertain**
  - Installment method
  - Cost-recovery-first method

Revenue recognition

- Revenues are recognized to the extent that it is probable that economic benefits will flow to the entity and the amount of revenue can be measured reliably.
- Revenues are stated net of discounts, allowances and returns.

Sale of goods

- Recognised when all the following conditions have been satisfied:
  - the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
  - the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
  - the amount of revenue can be measured reliably;
  - it is probable that the economic benefits associated with the transaction will flow to the entity; and
  - the costs incurred or to be incurred in respect of the transaction can be measured reliably.

Transfer of risks and rewards

- Examine the circumstances of the individual transaction.
- In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer.
- Common for most retail sales.

Risk and reward not transferred

- The transfer of risks and rewards of ownership may occurs at a different time from the transfer of legal title or the passing of possession.
- If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised.

Insignificant risk

- If an entity retains only an insignificant risk of ownership, the transaction is a sale and revenue is recognised.
- For example, a seller may retain the legal title to the goods solely to protect the collectibility of the amount due.
- In such a case, if the entity has transferred the significant risks and rewards of ownership, the transaction is a sale and revenue is recognised.
- Another example of an entity retaining only an insignificant risk of ownership may be a retail sale when a refund is offered if the customer is not satisfied.
- Revenue in such cases is recognised at the time of sale provided the seller can reliably estimate future returns and recognises a liability for returns based on previous experience and other relevant factors.

Risk rewards not transferred

- Examples of situations in which the entity may retain the significant risks and rewards of ownership are:
  - when the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;
  - when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods;
  - when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity; and
  - when the buyer has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

Rendering of services

- When the outcome of a transaction involving the rendering of services can be estimated reliably,
- Revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period.
- The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:
  - the amount of revenue can be measured reliably;
  - it is probable that the economic benefits associated with the transaction will flow to the entity;
  - the stage of completion of the transaction at the end of the reporting period can be measured reliably; and
  - the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.6

Percentage of completion

- Revenue is recognised in the accounting periods in which the services are rendered.
- This provides useful information on the extent of service activity and performance during a period.
- IAS 11 also requires the recognition of revenue on this basis.
- Applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services spanning over a longer period.

Probable economic benefits

- Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity.
- Reliable estimates after it has agreed to the following with the other parties to the transaction:
  - each party's enforceable rights regarding the service to be provided and received by the parties;
  - the consideration to be exchanged; and
  - the manner and terms of settlement.

Delayed revenue recognition

- Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity.
- In some cases, this may not be probable until the consideration is received or until an uncertainty is removed.
- For example, it may be uncertain that a foreign governmental authority will grant permission to remit the consideration from a sale in a foreign country.
- When the permission is granted, the uncertainty is removed and revenue is recognised.

Bad debts

- Uncertainty may arise about the collectibility of an amount already included in revenue,
- The uncollectible amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense.
- Not as an adjustment of the amount of revenue originally recognised.

Multiple-element revenue arrangements

- • Limited guidance – IAS 18 para 13:
- Identify components of one transaction to reflect substance
- Combine two transactions if their commercial effect cannot be understood otherwise
- Key issues
  - Which is the applicable standard?
  - Can the arrangement be divided into separately identifiable components?
  - How should total consideration be allocated to the separately identifiable components?
  - How should revenue be recognised for an arrangement that is accounted for as a whole?

Specialised IT platform

- Work commenced 1 January 2011. At 31 December 2011, the hardware (which the IT company also sells separately) has been installed and the software is 50% completed.
- The IT company does not anticipate any problem with the software development, which should take another 6 months to complete.
- The customer has the right to return the hardware if the software does not work according to the customer's specifications.
- The contract as a whole is approximately 70% completed based on the costs incurred, which is a reliable measure of the services performed.
- Costs incurred to date and costs to complete can be measured reliably for the hardware and software separately and in total.
- The hardware and software account for 30% and 70% of the total consideration respectively.

Measurement of revenue

- Revenue arising on a transaction is usually determined by agreement between the entity and the buyer or user of the asset.
- Measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity.
- Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Measurement issues

- Fair value of consideration
  - Delayed payment (deferral, discounting, collection risk)
- Exchanges/barter transactions
  - Similar items - no revenue
  - Otherwise dissimilar - fair values
- Agent/principal relationship
  - Amounts collected on behalf of principal are not revenue
  - Revenue = commission

Consideration

- In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable.
- However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest-free credit to the buyer or accept a note receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods.

- When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest.
- The imputed rate of interest is the more clearly determinable of either:
  - the prevailing rate for a similar instrument of an issuer with a similar credit rating; or
  - a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.
- The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in accordance with paragraphs 29 and 30 and in accordance with IFRS 9.

Excluded from revenue

- Amounts collected on behalf of third parties
- such as sales taxes, goods and services taxes and value added taxes
- They are not economic benefits which flow to the entity and do not result in increases in equity.

Agency relationship

- Commonly consignment sales, real estate agents or appointed distributors.
- The gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity.
- The amounts collected on behalf of the principal are not revenue.
- Recognise the amount as liability due to principle
- Revenue is the amount of commission.

The principal recognise gross revenue

- Key indicators ***for principal*** (i.e. gross revenue reporting)
  - Responsible for fulfilling orders by customers *
  - Assumes general inventory risk *
  - Flexibility in establishing prices
  - Adds significant value
  - Discretion in choosing suppliers
  - Determines product or service specifications
  - Assumes physical inventory loss risk and credit risk
  - Margin earned is not fixed

Example of agents recognise commission income

- A beverage company is required to sell all its product through distributors
- Mobile operator distributes its token cards through dealers

Exchange for goods or services

- If goods or services are of a similar nature and value,
- the exchange is not regarded as a transaction which generates revenue.
- Example oil or milk where suppliers exchange or swap inventories in various locations to fulfil demand on a timely basis in a particular location.

Exchange of dissimilar goods

- When goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue.
- The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred.
- When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred.

Grants

- Grants are recognized in the income statement where there is reasonable assurance that these will be obtained and that all the conditions for their recognition will be met.
- Capital grants, in the amount pertaining to the year, are charged to the income statement on the basis of the useful life of the assets to which the grants relate. The proportion of the capital grant that relates to future financial years is entered under the item "Accrued liabilities".
- Operating grants are recognized according to the accrual method of accounting in the same period in which the associated costs are incurred, shown net of these grants.

Cost of sales

- The cost of sales represents the cost of buying or producing the products and goods that have been sold and includes the cost of raw materials, goods and direct and indirect production costs.
- The cost of sales also includes margins on construction contracts recognized by reference to the stage of completion (percentage of completion method).

- Revenue and expenses that relate to the same transaction or other event are recognised simultaneously;
- this process is commonly referred to as the matching of revenues and expenses.
- Expenses, including warranties and other costs to be incurred after the shipment of the goods can normally be measured reliably when the other conditions for the recognition of revenue have been satisfied.
- However, revenue cannot be recognised when the expenses cannot be measured reliably; in such circumstances, any consideration already received for the sale of the goods is recognised as a liability.

Interest and dividends income

- Interest time proportion basis to take into account effective yield on the asset;
- Dividends when shareholders' right to receive payment established interim dividend immediately declared while final divided when approved by shareholders;

- Royalties accruals basis as follows;

- Paid for the use of an entity's assets (such as trademarks, patents, software, music copyright, record masters and motion picture films) are normally recognised in accordance with the substance of the agreement.
- As a practical matter, this may be on a straight-line basis over the life of the agreement, for example, when a licensee has the right to use certain technology for a specified period of time.

Fees and royalties

- An assignment of rights for a fixed fee or non-refundable guarantee under a non-cancellable contract which permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform is, in substance, a sale.
- An example is a licensing agreement for the use of software when the licensor has no obligations subsequent to delivery.
- Another example is the granting of rights to exhibit a motion picture film in markets where the licensor has no control over the distributor and expects to receive no further revenues from the box office receipts. In such cases, revenue is recognised at the time of sale.

Contingent fees and royalties

- In some cases, whether or not a licence fee or royalty will be received is contingent on the occurrence of a future event.
- In such cases, revenue is recognised only when it is probable that the fee or royalty will be received, which is normally when the event has occurred.

New developments

- In Nov 2011 the IASB and FASB published for comment *Exposure Draft: Revenue from Contracts with Customers*, a revised draft standard that converges the revenue recognition standard for IFRSs and US GAAP.
- The goals of the exposure draft are to
  - improve financial reporting by creating a single revenue recognition standard,
  - clarify the principles for recognising revenue, and
  - create consistent principles that can be applied across various transactions, industries and capital markets.

November 2011: Exposure Draft Reissued

- Core principles unchanged but there are clarification and simplification in a number of areas:
- amending the principle for identifying separate performance obligations in a contract
- adding criteria to determine when a performance obligation is satisfied over time and, hence, when revenue is recognised over time
- simplifying the measurement of the transaction price
- aligning the accounting for product warranties more closely with existing requirements
- limiting the scope of the onerous test
- adding practical expedients for retrospective application of the proposals
- specifying the disclosures required for interim financial reports
- Comment letters on the revised exposure draft are due by 13 March 2012.

Potential Misstatements of Revenue

- Recording unearned revenue
  - Ethical environment created by top management
  - Effective billing process (tied to shipping function)
  - Effective controls for testing invoices, computer reconciliations

- Early (late) recognition of revenue
  - Ethical environment created by top management
  - Effective cutoff procedures in shipping department

Examples of issues in revenue recognition

- Cloud computing
- Shared mast
- Joint arrangement (aviation industry fuelling equipment)
- Multiple deliverables
- Royalty award schemes
- Sale with buy back conditions

Other examples

- Mobile phone services operator and handset dealer (Orange and Phone Express) arrangements
- Supermarket operating bank's credit card (Nakumatt and Barclays)
- Revenue sharing arrangement example
  - a company in Wilson airport or
  - car hire company

Other issues

- Special order production method (when we produce on contract customised goods)
- Instalment method (goods sold on extended credit where collectability is not virtually certain)