FINANCIAL REPORTING WORKSHOP

New Developments on revenue recognition: IFRS 15, IPSAS 9 and IPSAS 23

Presentation by:

CPA Stephen Obock

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Agenda

1. IFRS 15- Revenue from Contracts with Customers
2. IPSAS 9 - Revenue from Exchange Transactions
3. IPSAS 23 - Revenue from Non-Exchange Transactions

Standards replaced

Single standard (IFRS 15) replaces:

- IAS 11 *Construction Contracts*
- IAS 18 *Revenue*
- IFRIC 13 *Customer Loyalty Programmes*
- IFRIC 15 *Agreements for the Construction of Real Estate*
- IFRIC 18 *Transfers of Assets from Customers*
- SIC-31 *Revenue – Barter Transactions Involving Advertising Services*

IFRS 15 applies to annual periods beginning on or after 1 January 2018

IFRS 15 – objectives of the new standard

Remove inconsistencies and weaknesses in existing requirements

Provide a more robust framework for addressing revenue issues

IASB / FASB Converged Standard

Provide more useful information through improved disclosure requirements

Simplify preparation of financial statements by reducing the number of requirements by having one revenue framework

The Five Step Model – Overview

1. Identify the contract with a customer
2. Identify the performance obligations
3. Determine the transaction price
4. Allocate the transaction price to performance obligations
5. Recognise revenue

Identify the Contract

A *contract* is an agreement between two or more parties that creates enforceable rights and obligations in exchange for consideration. Contracts can be written, oral or implied by an entity’s customary business practices.

Identify the Contract

Step 1

A contract exists if...

... collection of consideration is considered probable.

... *rights to goods or services* and *payment terms* can be identified.

... it has commercial substance.

... it is approved and the parties are committed to their obligations.

Identify Performance Obligations in the Contract

A performance obligation (PO) is a promise to deliver a good o
meets **both** the following criteria

Criterion 1: Can the customer benefit from the good or service either on its own or together with other resources that are readily available to the customer?

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Criterion 2: Is the promise to transfer the good or service separately identifiable from other promises in the contract?

Yes → **Distinct performance obligation**

No → **Not distinct – combine with other goods and services**

Performance Obligations

An entity enters into a contract to build a house for a customer

The contractor supplies the following as potential Performance Obligations:

- **Bricks**
- **Windows**
- **Fittings**
- **Construction service**

Performance Obligations

Identify the performance obligations

A. Bricks
B. Windows
C. Fittings
D. Construction services
E. Single performance obligation (i.e. all combined)
F. Bricks, Windows & Fittings combined

Performance Obligations

Identify the performance obligations

A. Bricks
B. Windows
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D. Construction services
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Performance Obligations

An entity enters into a contract to build a house for a customer

Potential Performance Obligations

Bricks	Windows	Fittings	Construction service

Q: Do the goods and services individually meet the criteria?

Criterion 1 – Benefit on its own ✓	Criterion 2 – Good or service separately identifiable ✗
Each material could be used with another readily available item.	Entity is providing a significant integration service.

Performance Obligations

- Customer contract for a sale of a machine and standard installation.
- Installation services are also offered by third party providers.

Potential Performance Obligations

Machine	Installation

Q: Does the sale of the machine meet the performance obligation criteria?

Performance Obligations

Does the sale of the machine meet the performance obligation criteria?

A. Yes
B. No

Performance Obligations

Does the sale of the machine meet the performance obligation criteria?

A. Yes

B. No

Determine the Transaction Price

Variable consideration and the constraint

Consideration payable to a customer

…reduction to the transaction price unless it's a payment for a distinct good or service.

Transaction Price (excludes credit risk)

Non-cash consideration

…measured at fair value unless it cannot be reliably measured.

Significant financing component

Variable Consideration

Variable consideration can be

- Discounts
- Returns
- Incentives
- Performance bonuses
- Many more...

Variable consideration is estimated using most appropriate method of either:

- Expected Value
- Most Likely Amount

Estimating Variable Consideration

Contract to build a jet for a customer. The transaction price includes:

- Fixed amount: CU100.
- Completion bonus: CU100 if completed two months prior to a specified date.
- Performance bonus: CU0 – CU100 depending on the number of flights in its first 12 months of service.

Q: How would the entity estimate variable consideration?

Fixed Amount	Completion Bonus	Performance Bonus
Not Variable	Most likely amount – only 2 possible outcomes	Expected value – wide range of possible outcomes

Constraint on Variable Consideration

Application

Transaction price – include the amount that is ‘highly probable’ and will not result in a significant revenue reversal.

Qualitative Assessment

- The risk of a reversal arising from an uncertain future event.
- The magnitude of the reversal if the uncertain event occurs.

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Significant Financing Component

Significant financing component

- Transaction price compared to cash selling price.
- Period between payment and delivery.
- Other reasons for payment terms.

Discount rate

- Rate that would be used in separate financing transaction between the entity and customer.

Practical Expedient

- No adjustment required if the period between performance and payment is 12 months or less.

Allocate the Transaction Price to Performance Obligations

Allocate based on relative stand-alone selling pric

Performance obligation 1	Performance obligation 2	Performance obligation 3

Determine stand-alone selling prices

Best evidence → **Observable price**

If not available → **Estimate price**

- **Adjusted market assessment approach**
- **Expected cost plus a margin approach**

Residual approach only if selling price is highly variable or uncertain

Fair value measurement

Recognise Revenue as Performance Obligations Satisfied

'Transfer of Control' principle

- Recognise revenue as and when **control** of the good or service is transferred to a customer
- **Control** may be transferred over time or at a point in time
- Assessed from customer's perspective and at the PO level

Recognise Revenue as Performance Obligations Satisfied

A performance obligation is <u>satisfied over time</u> if either:

1 Customer simultaneously receives and consumes the benefits as the entity performs.

Routine or recurring services.

2 The customer controls the asset as the entity creates or enhances it.

Asset built on customer's site.

3 The entity's performance does not create an asset for which the entity has an alternate use and there is a right to payment for performance to date.

Asset built to order.

Over Time or Point in Time?

- Entity agrees to build specialised equipment to integrate with the customer's existing plant
- Customer can cancel contract on 30 days notice
- If the contract is cancelled the entity has a right to payment that covers costs incurred
- Customer has agreed to make quarterly payments

Q: Is the PO satisfied over time or point in time?

Over Time or Point in Time?

Is the PO satisfied over time or point in time?

A. Over time
B. Point in time

Over Time or Point in Time?

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A. Over time
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Over Time or Point in Time?

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Point in time – ‘no alternate use and right to payment’ criteria’ is not met

No alternate use	Right to payment

- Payment needs to approximate selling price of goods and services transferred to date – i.e. payment amount should include a profit margin.

Measuring Performance Over Time

For each performance obligation an entity chooses the method that depicts performance.

Output method

- Surveys
- Milestones reached
- Units delivered

Input method

- Costs incurred
- Labour hours
- Machine hours

- Units delivered and similar methods not appropriate if work in progress is material.
- Adjustments required for wastage and uninstalled materials when cost method used.

IPSAS 9 - Revenue from Exchange Transactions

Key definitions

Exchange transactions are transactions in which one entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value (primarily in the form of cash, goods, services, or use of assets) to another entity in exchange.

Revenue should be measured at the fair value of the consideration received or receivable.

IPSAS 9 - Revenue from Exchange Transactions

Revenue from rendering of Services should be recognised when all the following conditions are satisfied:

a) The amount of revenue can be measured reliably;

b) It is probable that the economic benefits or service potential associated with the transaction will flow to the entity;

c) The stage of completion of the transaction at the reporting date can be measured reliably; and

d) The costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

IPSAS 9 - Revenue from Exchange Transactions

Revenue from the sale of goods should be recognized when all the following conditions have been satisfied:

a) The entity has transferred to the purchaser the significant risks and rewards of ownership of the goods;

b) The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;

c) The amount of revenue can be measured reliably;

d) It is probable that the economic benefits or service potential associated with the transaction will flow to the entity; and

e) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

IPSAS 23 - Revenue from Non-Exchange Transactions

- **Revenue**
  - Revenue is the gross inflow of economic benefits or service potential that results in an increase in net assets/equity, other than an inflow relating to contributions from the entity's owners.

  - For Public Sector entities a major part of their revenue is received as taxation or other mandatory payments by citizens or companies, rather than being paid in exchange for good and services; and many public sector bodies also receive donations or grants.

- **Non-exchange transaction**
  - Revenue is the gross inflow of economic benefits or service potential that results in an increase in net assets/equity, other than an inflow relating to contributions from the entity's owners.

When assets received are not reported as non-exchange revenue

- **Contributions from owners**
  - These transactions are disclosed separately and are not part of revenue. These occur when a 'contributing' entity provides and designates funding or other assets as being a permanent contribution, establishing a financial interest in the net assets/equity of the receiving entity. (IPSAS 23 paragraph 37-38).

- **Advance receipts**
  - An entity may receive an asset in advance of the period for which it was intended. Such advance receipts relate generally to taxes or annual contributions received in the preceding year. These advance receipts are treated as a liability until the taxable or other event triggering recognition occurs for revenue to be recognised.

When assets received are not reported as non-exchange revenue (continued)

- **Assets with linked obligations**
  - The receipt of assets may give rise to a present obligation, in the form of a duty to act or perform in a certain way. In some cases this will indicate that the asset has been exchanged for acceptance of an obligation, and normal accounting for exchange transactions should be followed.
  - In other cases it is more helpful to treat the asset as being received as a non-exchange transaction, and to recognise a balancing liability in respect of the obligation.
  - For example, a grant may have been provided by an agency to improve and maintain a medical clinic. If there is a condition, the recipient has an obligation to spend the money in a specified manner, therefore a liability to incur such expenditure, or to return the money received.

Measurement

- Revenue from a non-exchange transaction is measured at the amount of the increase in net assets recognized by the entity.
- An asset acquired through a non-exchange transaction is measured at its fair value at the date of acquisition, together with a corresponding amount of revenue unless a liability is required to be recognized.
- The liability is measured as the best estimate of the amount required to settle the present obligation at the reporting date. It is the increase in net assets, if any, that is accounted for as revenue.

Application of the recognition and measurement principles

1. **Grants -** Grants are recognized at the receipt of grant or enforceable claim.
2. **Fines** - Fines are recognized in the period in which the fine is imposed.
3. **Bequests -** Bequests are recognized when the nature of the bequest is known and it has been established that the estate is sufficient to meet all claims. Bequests may contain stipulations as to how the money or assets are to be spent or utilized.
4. **Donations -** Receipt of gift of donation and transfer of legal title. For goods in-kind, receipt of the goods or binding agreement to receive them.
5. **Debt forgiveness -** Lenders may waive their right to collect a debt owed by a public sector entity, thus effectively cancelling the debt. In such a case the entity has an increase in net assets/equity and treats the amount forgiven as revenue from a non-exchange transaction.

Application of the recognition and measurement principles (continued)

Services in-kind

- Services in-kind are voluntary services provided to an entity by an individual or individuals. Such services may include free technical assistance from other governments or international organizations, voluntary work in schools and hospitals or community services performed by convicted offenders.

- The standard provides that entities may, but are not required to, recognize services in-kind as revenue and expenditure where the amount can be measured, is material and its inclusion enhances the presentation of the financial statements. Disclosure of the nature of significant in-kind services in all cases is encouraged.

Non-exchange revenue that is not classified as tax- Grants

- Grants represent a noteworthy type of revenue from non-exchange transactions.
- Grants are often provided with limitations on how money should be spent or assets utilized. The standard separates such 'stipulations' into conditions and restrictions.
- The distinction between conditions and restrictions may not always be clear cut and it is necessary to consider the substance of the stipulation and not merely its form. This might take into account the likelihood of enforcement, prior experience with the donor/grant-giver, and the extent of specification of detailed requirements.
- For transactions where the recipient entity considers that the donor/grant-giver has imposed conditions, they will set up a liability for the obligation generally to the value of the money received, which will be reduced as the conditions are satisfied. There is no such requirement for grants with restrictions and revenue is recognized immediately.


Ask
Answer
Who
Apply
Question
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Understand
Where
What
How
Questions
When
Answers
Query