APPLYING AASB 15 IN PRACTICE

Introduction

In May 2014, the AASB issued AASB 15: *Revenue from Contracts with Customers*. The new standard is applicable for periods beginning on or after 1 January 2018, and replaces AASB 111 *Construction Contracts* and AASB 118 *Revenue* and related interpretations.

The new standard was the result of the standard setters' objective of harmonizing IFRS and US GAAP requirements for revenue recognition into a single principles-based standard, and also reflected the need to replace the existing standards, which were over 20 years old, and contained little practical guidance. It sets out a comprehensive five-step approach to recognition of revenue:

- Identify the contract(s) with a customer
- Identify the performance obligations in the contract
- Determine the transaction price
- Allocate the transaction price to the performance obligations in the contract
- Recognise revenue when (or as) the entity satisfies a performance obligation

Impact

The impacts of the new standard were immediately clear in the construction industry. Construction contracts typically involve long-term and complex contracts, which were previously recognised on a stage of completion basis. The potential challenges for that industry in implementing the new standard are significant, and we considered them in detail in RSM's publication on revenue recognition in the construction industry.

Outside the construction industry, there has often been a belief that the new standard, while theoretically different, will not result in significant change in practice. This is often incorrect. Even where the end result might be similar, such a conclusion cannot be reached without undertaking an analysis of the impact of the new standard, which may be complex and time consuming.

This paper considers each of the five steps above, and considers common examples where the new standard may result revenue being recognised differently from previous practice.

Identification of contract(s) with customers

In order to recognise a contract with a customer, it has to meet all of the following criteria:

- The parties have approved the contract
- The entity can identify each party's rights regarding the goods or services to be transferred
- The entity can identify the payment terms for the goods or services to be transferred
- The contract has commercial substance
- It is probable that the entity will collect the consideration to which it will be entitled under the contract

In many cases, it will be clear whether a contract exists. However, there may be judgment involved in determining whether a contract is collectible. It will also be necessary to consider whether multiple contracts should be considered separately or together for accounting purposes. Contracts should be combined if:

- the contracts are negotiated as a package with a single commercial objective
- the amount of consideration to be paid in one contract depends on the price or performance of the other contract
- the goods or services promised in the contracts are a single performance obligation

EXAMPLE 1: A NON-COLLECTIBLE CONTRACT

Medical Research Co (MRC) has developed a new technology for delivery of certain medicines, over which it holds a patent. It licenses the technology to TreatmentCo in return for a royalty based on the usage volume, with royalty payments to be made quarterly in arrears commencing from 1 January 2017. Prior to the agreement, MRC carries out a credit check on TreatmentCo, and determines that it is in good financial standing.

In 2017, TreatmentCo provides MRC with a usage statement at the end of each quarter, based on which MRC recognises revenue. TreatmentCo makes payments to MRC in accordance with the agreement, which specifies 30 day credit terms.

In 2018, TreatmentCo continues to provide quarterly statements, but does not make payments on a timely basis, and, for the last two quarters does not pay the full balance owing, but makes payments on account. The Directors of MRC understand that TreatmentCo is experiencing cash flow issues. Under AASB 15, revenue would still be recognised, but an appropriate impairment of MRC's trade receivables would be recognised as an expense.

Following review of TreatmentCo's 2018 financial statements, the Directors of MRC note that TreatmentCo is now in a precarious financial position, and has lost several major customers. TreatmentCo continues to use the patent, but no longer makes any further payments, although it continues to provide quarterly statements to MRC. As a result, the Directors of MRC conclude that it is no longer probable that the licence revenue to which MRC is contractually entitled will be collected. Therefore the "probable collection" requirement of AASB 15 is no longer met, and MRC should no longer recognise further revenue in respect of the royalty.

Modifications

Modifications to contracts include any change in scope or pricing. They typically include change orders, variations, and supplements to existing contracts. Judgment will be required in assessing whether modifications should be treated as separate contracts, or as a continuation of the same contract.

EXAMPLE 2: MODIFICATION OF CONTRACTS

SafestShoes Ltd is an importer and distributor of safety footwear for use in the mining and construction industry. It signs a contract with a large mining company, AJQ Mining Ltd, to deliver 600 pairs of steel-cap boots, which, for practical reasons, will be delivered at the rate of 200 pairs per month on the 15th of each month, commencing on15 May 2017. Each pair of boots will cost $150.

On 15 May, SafestShoes makes its first delivery, and recognises revenue of $30,000 for the 200 pairs delivered.

On the following day, AJP requests a further 600 pairs of boots, to be delivered in August, September, and October, In view of the increased volume ordered, and the potential of further business from AJP, SafestShoes agrees to a contract price of $100 per pair for this additional order of 600 pairs of boots.

A second delivery of 200 pairs is made on 15 June.

Under the previous standard, AASB 118, the two orders would have been treated as two separate contracts, and therefore, SafestShoes would have recognised a further $30,000 on 15 June 2016, in line with the price specified in the original order. However, under AASB 15, the discount received on the second order suggests that the two contracts are linked, as the second contract does not reflect the stand-alone price of the additional goods. Therefore it is treated as if the original contract had been terminated, and a new contract created on 16 May. Under the new combined contract, there are a total of 1,000 pairs left to deliver, and a total consideration to be paid of $120,000 (being 400 pairs at $150/pair and 600 pairs at $100/pair), meaning that the consideration for each pair delivered is now $120.

Under AASB 15, SafestShoes would therefore recognise revenue of $24,000 on 15 June 2017, for the 200 pairs delivered to AJP. The revenue already recognised in May 2017 is unaffected.

Identification of Performance Obligations

The next step is to determine what performance obligations (obligations to deliver goods or services to the customer) are present. Performance obligations can arise either because they are specified in the contract, or because the customer has an expectation that they will be performed, as they are part of the entity's customary practice or policies.

Each good or service that is distinct and is capable of being sold separately is a performance obligation. Performance obligations may be satisfied either at a point in time (such as through delivery of goods) or over time (for example a subscription service).

EXAMPLE 3: UNBUNDLING OF SERVICES

A technology company enters into a contract with a customer to supply and install new software. The contract includes the following services:

- A software licence
- Installation of the software
- Updates of the software as they become available
- User training for 100 users
- Technical support and a phone helpdesk for users

The software is delivered before the other goods and services and remains functional without the updates and the technical support. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available. Each element of the contract is therefore separately identifiable, and represents a separate performance obligation. The total revenue will therefore be associated across the different performance obligations and recognised when each obligation is delivered.

For software licenses, and similar intellectual property, there may be complexity in determining whether revenue should be recognised at a point in time, or over the term of the licence. This is based on whether the entity sells a "right to use" the software as it exists in a point in time, or a "right to access" as it exists throughout the licence. This involves the application of judgment, and readers should refer to the application guidance and examples in AASB 15.

EXAMPLE 4: IMPLICIT PERFORMANCE OBLIGATIONS

Vehicle Fleet Solutions Company, a motor dealership, sells fleets of commercial vehicles to corporate customers. Its usual practice for many years has been to offer these customers a free "maintenance check service" on new vehicles they have purchased after 6 months of ownership. This is not included as a term in the sales contract, and there is no specified scope of work for such a service.

The provision of a "maintenance check service" is part of the motor dealership's customary business practice. Therefore it is considered a performance obligation. A portion of the sales price must be allocated to this performance obligation, and only recognised when it is delivered.

Determination of the Transaction Price

The transaction price is the amount of consideration which the entity expects to be entitled to in return for delivering performance obligations. While this may be simple to determine in some cases, the following situations represent potential changes to previous practice:

- Variable consideration can include discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. AASB 15 requires the entity's best estimate of the likely amount of variable consideration to be included in the transaction price
- AASB 15 permits revenue to be recognised only to the extent that it is highly unlikely that previously recognised revenue would need to be reversed – therefore, where a range of different results is possible, it is likely that the most conservative one will be selected
- This will require estimates of, for example, the likelihood of the customer receiving prompt payment discounts or volume rebates
- If the likely payment period is over a year, the time value of money must be incorporated into the transaction price

EXAMPLE 5: CUSTOMER RIGHT OF RETURN

Hottest Fashions is a retailer which specialises in the sale of designer clothing. They offer customers a "no questions asked" right to return purchases within one month, providing that the merchandise is returned in saleable condition. Historically, 5% of all merchandise sold has been returned. Gross sales in each month (before returns) are typically $2m, and the company makes a gross margin of 40%.

Under AASB 15, a right of return is considered to be variable consideration. The amount of expected returns should not be treated as revenue, but must be recognised as a refund liability on the balance sheet. An asset should also be recognised, being the right to.

Hottest Fashions would recognise a refund liability of $100,000, being 5% of its monthly turnover. However, it would also recognise a refund asset of $60,000, being the value of the merchandise to be received back from customers, recorded at cost.

Note that the requirement to provide would only occur where there is a right to a refund. A right to exchange the goods purchased for similar goods would not create an obligation to refund revenue.

EXAMPLE 6: VOLUME DISCOUNTS

HardAsNails Group is a manufacturer of industrial drill components. It agrees a contract with a customer to supply drill heads at $2,000 each, but with a retrospective reduction to $1,800 if more than 500 drill heads are purchased in a calendar year. The contract commences on 1 July 2017.

For the quarter ending 30 September 2017, HardAsNails sells 50 drill heads. Based on this, they do not expect the customer to achieve the annual target, and recognise revenue of $100,000.

In the second quarter, ending 31 December 2017, the customer has a significant increase in activity, and therefore purchases 300 further drill heads. It now appears likely that the customer will meet the annual threshold for the volume rebate.

HardAsNails therefore must recognise revenue on the basis that all drill heads sold to date under the contract will have a sales price of only $1,800. For the quarter ended 31 December 2017, they will recognise revenue of $530,000. This consists of $540,000 for the 300 drills sold at $1,800 each, less $10,000, being the $200 price reduction on the 50 drills already sold in the first quarter.

This analysis will be required for any similar payments, including incentives, advertising allowances, future free products, or coupons for discounts on future purchases.

Allocation of the transaction price to performance obligations in the contract

If there is more than one performance obligation in the contract, then the transaction price will need to be allocated across the different obligations. Each obligation may have its own price specified in the contract, but this is not necessarily the basis on which the total contract value is split. The basis of allocation should be (in order of descending preference):

- the relative stand-alone selling prices of each component; or, if not available
- an estimate of the likely relative prices based on competitor prices
- the forecast expected costs of satisfying each performance obligation
- the residual method, being the total transaction price, less the sum of the stand-alone prices for known components

EXAMPLE 7: ALLOCATION OF THE TRANSACTION PRICE

The Clifftop Hotel sells a "Romance Weekend Package" for $1,000, which includes 3 nights of accommodation, breakfast each morning, a bottle of champagne on arrival, a sight-seeing helicopter tour, and a voucher for $150 off any future stay. The package includes distinct goods and services, and are considered separate performance obligations.

The components of the package are available separately at the following prices – $800 for the accommodation, $150 for the breakfasts, $100 for the champagne, and $200 for the sightseeing. The voucher is not available separately, and the hotel has no history of similar offers from which to estimate the likelihood of redemption. It is therefore considered to have a face value of $150. The total of the elements sold individually is $1,400, which would be allocated to each of the components:

Accommodation – $800 x (1000/1400) = $571
Breakfast – $150 x (1000/1400) = $107
Champagne– $100 x (1000/1400) = $72
Sightseeing– $200 x (1000/1400) = $143
Voucher– $150 x (1000/1400) = $107

Each element of revenue would be recognised only when the associated performance obligation is delivered (see below). In particular, $107 would be deferred, and only recognised when the voucher is redeemed or expires.

Recognition of revenue when performance obligations are met

Revenue should be recognised when performance obligations are satisfied. This can be either at a point in time or over time, depending on the nature of the goods or services that are being provided.

AASB 118 previously specified that goods were to be recognised at a point in time, while services were to be recognised over time. This is no longer the case under AASB 15. Revenue is recognised based on when the customer has control of the asset, or when the customer has received substantially all the benefits of the services.

Control may pass to the customer ahead of physical delivery of an asset – for example if a specialised asset is under construction, and the entity has an enforceable right to payment for any work completed to date.

This requirement may significantly impact entities that previously recognised non-refundable membership or entrance fees up-front. Affected entities may include sporting clubs, membership organisations, and timeshare resorts.

EXAMPLE 8: NON-REFUNDABLE UP-FRONT MEMBERSHIP FEES

The FitterBodies Club operates a chain of gymnasiums and sporting clubs. Members gain unlimited access for a monthly membership fee of $80. New members are charged an initial joining fee of $360, which is non-refundable, and the minimum membership term is 12 months.

Under AASB 118, the joining fee would have been recognised up front, as it is non-refundable. However, under AASB 15, it is considered part of the transaction price, and must be allocated against performance obligation in the contract, which is the provision of sporting facilities.

Therefore, after a new member joins, the joining fee would be recognised as a deferred revenue liability. FitterBodies would recognise $110 per month in revenue for the next 12 months, being the $80 monthly fee received, and $30 of the initial joining fee.

Conclusion

The scope and impact of AASB 15 is wide, and few entities will be completely unaffected. It is important to assess the impact and to begin the transition process early, as it may require some change to systems and processes.

The Australian Accounting Standards Board has provided a comprehensive set of examples of application of the new standard, from which the examples in this guide are partly derived.

For further information please contact Ralph Martin or your local RSM practitioner.

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