Nexia Australia

Accounting Update

Applying AASB 15 *Revenue*

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The new revenue standard has the potential to change the way some entities recognise revenue from their customers. In this publication we explore the new revenue model and what it means for some types of revenue.

AASB 15 *Revenue from Contracts with Customers* replaces AASB 118 *Revenue*, AASB 111 *Construction Contracts* and four related interpretations. The new Standard mandatorily applies to for-profit entities for annual reporting periods beginning on or after 1 January 2018 and for not-for-profit entities from 1 January 2019.

The new model

The core principle of AASB 15 is that revenue is recognised on a basis that reflects the transfer of promised goods or services to customers at an amount that reflects the consideration the entity expects to receive in exchange for those goods or services.

The new revenue model comprises the following five steps:

1. Identify the contract with a customer

In most cases this is straightforward. However, a 'contract' does not have to be a formal written document, but can also be verbal or implied, depending on the customary form for the specific arrangement. For the purpose of the Standard, a contract exists if the parties rights can be identified, they agree and are committed to perform their respective obligations, and the payment terms can be identified. Hence, although there is no written contract in a standard retail sale, such transaction is still considered to arise from a contract with a customer.

Usually, each contract is accounted for separately, but it may be necessary to either combine or separate multiple contracts depending of the substance of the arrangement.

2. Identify the performance obligations in the contract

At contract inception, it is necessary to identify all the distinct performance obligations within the contract. If those goods or services are distinct, the promises are performance obligations and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer and the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Example – Indentifying the obligations in contracts

An entity enters negotiates an agreement with an IT supplier to acquire computer software licence, perform an installation service and provide software updates and technical support for 3 years. The software licence and support services are detailed in two separate agreements, signed at the same time, for a single total price. The supplier provides stand-alone maintenance and support services to other customers.

The installation service is routinely performed by other suppliers and does not significantly modify the software. The software remains functional without the updates and the technical support. In this scenario, the entity identifies four performance obligations in the contract:

c. the software licence;

d. an installation service;

e. future software updates; and

f. technical support,

and would allocate and recognise revenue separately in relation to each of those four components.

However, consider if the software was to be substantially customised to add significant new functionality and to enable the software to interface with other customised software applications used by the customer. In this case, the entity is using the licence and the customised installation service as inputs to produce a combined output (ie, a functional and integrated software system) specified in the contract.

In this case, the entity identifies three performance obligations in the contract:

a. customised installation service (that includes the software licence);

b. future software updates; and

c. technical support,

and would allocate and recognise revenue in relation to these three components.

3. **Determine the transaction price**

An entity must determine the amount of consideration it expects to receive in exchange for transferring promised goods or services to a customer. Usually, the transaction price is a fixed amount. However, the transaction price can vary because of discounts, rebates, price concessions, refunds, volume bonuses, or other factors. An entity should consider the effects of variable consideration and include those elements in the transaction price. Those variable elements should be included 'where it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved'.

When a contract has a significant financing element, the effects of the time value of money are taken into account by adjusting the transaction price and recognising interest income over the financing period. Separately recognising the effect of discounting is not required if the period between the supply of the goods or services and payment is less than one year.

4. **Allocate the transaction price to the performance obligations**

Where a contract contains more than one distinct performance obligation (see the Example in Step 2, above), the transaction price determined in Step 3 is allocated to each distinct performance obligation on the basis of relative stand-alone selling price. The best evidence of stand-alone selling price is the price at which the good or service is sold separately by the entity.

If a stand-alone selling price is not directly observable, an entity should estimate a stand-alone value taking into account market conditions, entity-specific factors and information about the customer or class of customer. This could be done by using an 'adjusted market assessment approach' which may include referring to competitors' prices for similar goods or services; or an 'expected cost plus approach' in which an entity estimates its costs to satisfy that performance obligation and then adds an appropriate margin.

In any case, an entity should not account for components within multiple performance obligations arrangements as representing 'free' goods or services and attributing no transaction price to them.

5. **Recognise revenue as the performance obligations are satisfied**

An entity recognises revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service).

A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer).

For revenue recognised at a point in time, AASB 15 requires the entity to determine that point in time by reference to when control of the goods transfer to the customer, whereas IAS 18/ AASB118 focuses on the transfer of risks and rewards of the goods. This change may cause the timing of some revenue items to change under the new Standard, eg, real estate sales.

Contract costs

The Standard differentiates between the costs to *obtain* a contract and the costs to fulfil a contract.

The incremental costs of *obtaining* a contract can be recognised as an asset provided the entity expects to recover those costs. The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission). Costs to obtain a contract that would have been incurred regardless of whether the contract was won or obtained shall be recognised as an expense when incurred.

Example – Tender costs

Company A incurs the following costs in relation to tendering for a contract. All costs are expected to be recovered from contract revenues:

Staff time to prepare the proposal	$ 30,000
External legal fees for due diligence	$5,000
Travel costs for site visit	$7,000
Commissions to sales employees on contract signing	$10,000
Total costs incurred	$ 52,000

Company A recognises an asset for $10,000, being the incremental sales commission costs of obtaining the contract. Although the other costs are related to obtaining the contract, those costs would have been incurred regardless of whether the entity was successful in its bid. Hence, they are not incremental to obtaining (ie, signing) the contract.

Application of principles to types of revenue

Non-refundable up-front fees

In some contracts, an entity charges a customer a non-refundable upfront fee at or near contract inception. Examples include joining fees in health club membership contracts, activation fees in telecommunication contracts, setup fees in some services contracts and initial fees in some supply contracts.

In these cases, an entity shall assess whether the fee relates to the transfer of a promised good or service at contract inception. Sometimes, even though a non-refundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception to fulfil the contract, that activity does not result in the transfer of a promised good or service to the customer. Instead, the upfront fee is an advance payment for future goods or services and, therefore, would be recognised as revenue when those future goods or services are provided. In some cases, this treatment may be different to current practice.

Licensing

A licence can provides a customer with either a right to access an entity's intellectual property or a right to use an entity's intellectual property.

When the licence provides the customer with a right to the entity's intellectual property, the performance obligation will be satisfied at a point in time and revenue is recognised at that time. However, a customer cannot direct the use of, and obtain substantially all of the remaining benefits from, a licence if the intellectual property to which the customer has rights changes throughout the licence period. Consequently, if the licence allows access to the intellectual property which the licensor can change over time, then the revenue is recognised over time.

Example – Licences

a. A customer buys a licence to use a developer's software. The licence enables the customer to use the existing version of the developer's software. The licence does not entitle the customer to any future upgrades to the software. The licence gives the customer a right to use the developer's intellectual property embodied in the software and revenue is recognised when the control of the software passes to the customer.

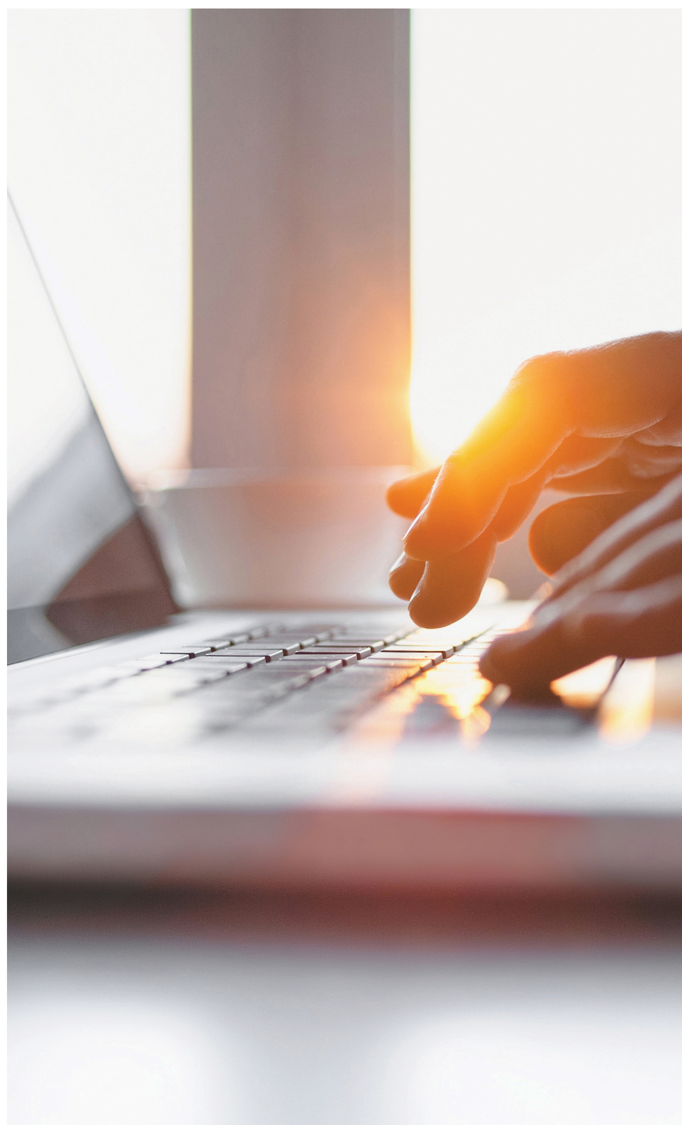
a. The same facts as above, except the licence entitles the customer to receive free upgrades and enhancements to the software if and when they are released by the developer. In this case, the intellectual property will change over time as the developer undertakes activities that significantly affect the intellectual property to which the customer has rights. In this scenario, the licence provides the customer with a right to access the developer's intellectual property and revenue is recognised over the period of the licence period. This is regardless of the timing of the cash flow from the transaction.

Warranties

When an entity sells a product (whether that product is a good or service) to a customer, the entity may also provide the customer with a warranty on that product in accordance with local consumer law. Warranties might be described as a manufacturer's warranty, a standard warranty or an extended warranty.

Where an entity is required to repair or replace products that develop faults within a specified period from the time of sale in accordance with statutory requirements, these are not recognised as separate performance obligations. Instead, they are measured and recognised as separate liabilities in accordance with AASB 137.

However, where an entity either sells separately or negotiates separately with a customer so that the customer can choose whether to purchase the warranty coverage, or an extended warranty, the warranty provides a service to the customer in addition to the promised product. For example, a customer buys a new television (which is subject to the standard statutory warranties) and, in addition, pays for an extended 5-year warranty plan. Consequently, this type of extended warranty is a separate performance obligation which should be accounted for separately in accordance with AASB 15.



Right of return

In some cases, customers have the right to return goods to the supplier for a full refund. A customer's right of return may only exist for a short period of time. In these cases, revenue would only be recognised to the extent that it is highly probable that a significant reversal in the amount of revenue recognised will not occur by the end of the return period. This may require the entity to analyse past patterns of returns and estimate the extent to which customers seek refunds. When the entity determines that it cannot recognise all of the consideration received as revenue for the sale of goods with a right of return, the entity would recognise some of the consideration received as a refund liability. Exchanges of similar goods would not cause a reversal of the amount of revenue recognised.

Not-for-profit entities

AASB 15 will apply to revenue from contracts with customers of not-for-profit entities. Not-for-profit entities will also need to apply AASB 1058 *Income of Not-for-Profit Entities* and the amendments to AASB 15 contained in AASB 2016-8 *Australian Implementation Guidance for Not-for-Profit Entities*. However, not-for-profit entities are not required to apply these standards until annual reporting periods beginning on or after 1 January 2019. More information on the requirements applicable to not-for-profit entities are contained in Nexia's *Accounting Update – Income of Not-for-Profit Entities*.

Conclusion

The introduction of AASB 15 has the potential to change the timing of revenue recognition for many types of transactions. Nexia's Financial Reporting Advisory specialists can assist you analyse the potential impacts of the new revenue model on your operations and whether any changes to your current procedures may be needed.

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