

Revenue recognition: At last, a common universal language for top line reporting

A single globally converged accounting standard on revenue recognition is done and dusted. It is time for entities to get a head start on implementation.

By the staff of the Singapore Accounting Standards Council (ASC) – June 2014



After more than a decade of joint deliberation, the IASB¹ and the US FASB² (collectively the Boards) finally issued the new standard on revenue recognition – possibly the only converged solution from the Boards’ remaining major joint projects that is symbolic of the ups and downs of the convergence process.

The new standard heralds a new beginning for the ever important top line revenue reporting, which is regarded by many as a measure of the size of an entity and an indication of earnings quality. It introduces a single, comprehensive control-based revenue recognition model for all contracts with customers (other than financial instrument, insurance or lease contracts) and harmonises revenue reporting across entities, industries, and geographical boundaries.

¹ International Accounting Standards Board

² Financial Accounting Standards Board

One revenue recognition model for entities across industries and geographical boundaries

For this, the Boards' efforts to achieve a converged solution are truly commendable, and the result is irrefutably remarkable.

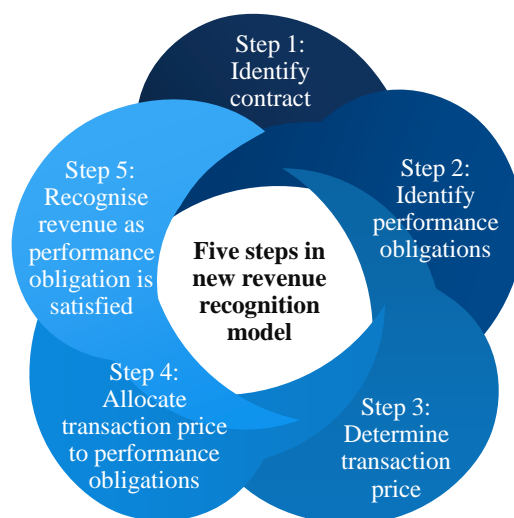
On the home front, the ASC would deliberate the adoption of the new standard as Singapore Financial Reporting Standard in due course. Invariably, the new standard impacts some entities more than others, given the myriad revenue transactions that exist in practice. Getting ready to apply the new standard when it becomes effective on 1 January 2017 would be of priority.

Time and tide wait for no man – entities are encouraged to gear up early for the implementation of this important new standard

What's the new revenue recognition model?

The core principle of the new model is really quite simple – an entity should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Yet, the devil is always in the details. For the simplest transactions, the conclusion is almost instantaneous. As the transactions become more complex, applying the core principle invariably requires more judgement. What the Boards have done is to introduce a coherent and systematic five-step approach to help entities achieve this core principle.



Let's start with the end in mind

Of utmost interest to most entities and users of financial statements is arguably the timing of revenue recognition. Determining when the transfer of a good or service occurs under the new standard is based on when the customer obtains control of that good or service, which can happen either over time or at a point in time. This is perhaps the most judgemental area in the new top line reporting.

Revenue is recognised when control of a good or service is transferred to the customer

The transfer of control model

The new single transfer of control model represents one of the most notable changes to the existing requirements. It removes the form-driven distinction between sale, service and construction transactions – generally point-in-time revenue recognition for sales and over-time revenue recognition for others – and replaces the transfer of risks and rewards model to harmonise the use of the control notion in IFRS.

Control of a good or service refers to the ability in – or to prevent others from – directing the use of, and obtaining substantially all of the remaining benefits from, that good or service

A mindset shift is needed for entities to move away from the risks and rewards model in order to get round to applying the new control model. Some changes to the timing of revenue recognition can be expected.

Two approaches to revenue recognition – either over time or at a point in time

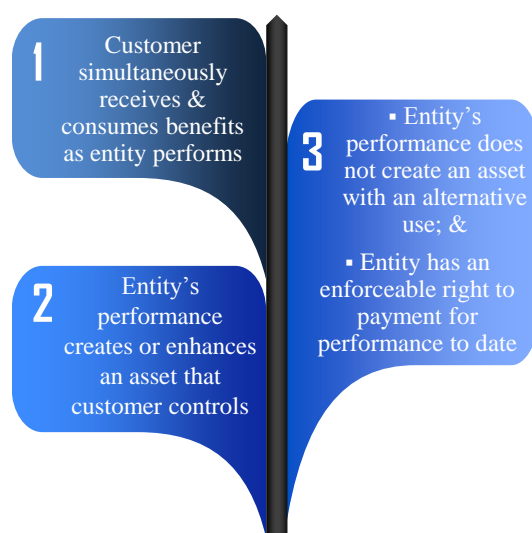
For most pure services and straight forward sales of completed goods, the assessment of when control of the services or goods is transferred to the customer is relatively clear cut. For example, a grocery store would recognise revenue for merchandise sold over the counter at the point of sale, which is when control of the merchandise is transferred to the customer.

However, judgement is required, albeit of varying degree, when applying the transfer of control model to long-term built-to-purpose contracts, such as those involving off-plan real estate sales, ship building and system development.

For such contracts, control is transferred over time if, for example, the good or service does not have an alternative use to the entity and the entity has an enforceable right to receive payment for performance completed to date.

An asset has no alternative use if the entity is restricted contractually or limited practically from readily directing it for another use. A contractual right to receive payment may not be enforceable if there is legislation or legal precedent that overrides these terms.

Three criteria for over-time revenue recognition



The assessment becomes increasingly judgemental as the degree of customisation in the good or service and the certainty of enforceability over the entity's right to receive payment decline.

If none of the three criteria for over-time revenue recognition is met, control is transferred to the customer at a point in time. For instance, there are indications that control has transferred when the customer obtained legal title to the promised asset and the entity has a present right to receive payment for that asset.

Determining the exact point when control is transferred could be judgemental, particularly if the entity retains certain rights, and consequently, the customer does not have an unlimited ability to direct the use of and obtain substantially all remaining benefits from the asset.

Increased use of judgement in determining how and when control is transferred to the customer

Is the transfer of control model new?

Some may consider that the transfer of control model is not new. In particular, IFRIC 15 on construction of real estate requires an entity to recognise revenue progressively if it transfers to the customer control of the work in progress as construction progresses, amongst other requirements.

However, IFRIC 15 is seen as rigid and not always reflecting the economic reality of real estate transactions. Determining when and how transfer of control takes place along the construction continuum for real estate sales can also be challenging.

In response, the ASC took steps to actively shape and influence the IASB's development of the new standard, including advancing arguments to strengthen the transfer of control model proposed in the Boards' first Exposure Draft in 2010 to better reflect economic substance. It studied the fact patterns of real estate sales across jurisdictions in Asia-Oceania and commissioned research into the notion of control, amongst various initiatives, to build its case for a more robust transfer of control model that permits broad-based application.

The new revenue recognition model that more faithfully portrays the transfer of control – either over time or at a point in time – signifies the strengthening collaboration between the IASB and national standard setters. The ASC made significant inroads with the IASB into widening the net for recognising revenue over time potentially to more real estate sales in Singapore and other long-term built-to-purpose contracts with certain features – an affirmation that substance-over-form reporting within the context of legal framework should prevail.

The ASC made significant headway with the IASB in developing a new transfer of control model that reflects the economic substance of the underlying transactions

Applying the model to performance obligations

The new standard requires the core principle of revenue recognition to be applied at the performance obligation – rather than contract – level. For instance, a car dealer that enters into a contract to sell a car and to provide maintenance services would assess revenue recognition for the car sale and maintenance services separately. While component accounting in revenue recognition is an old concept, what is new perhaps is the basis on which performance obligations are identified.

How does one go about identifying the performance obligations in a contract? The key lies in whether a promised good or service is distinct from other goods or services promised in the contract. This would be the case if the customer can benefit from the good or service on its own – or together with other readily available resources – and the good or service is separately identifiable from other goods or services in the contract.

A performance obligation is either a distinct good or service, or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer

The result is that a promise to deliver bricks is a separate performance obligation in a sales contract, but not in a contract for the construction of a building – an outcome that most would agree is intuitive and appropriate. In other cases, such as the bundling of goods or services to provide marketing incentives, entities may end up recognising revenue, and potentially at different timing, for goods or services that are not otherwise sold on a stand-alone basis in their businesses. For example, a car dealer that offers free holiday packages to entice a customer to purchase a car would have to recognise revenue for the holiday packages separately.

Increase in the use of estimates

Another area that deserves mention is the likely increased use of estimates under the new standard. This is particularly the case in accounting for variable consideration and determining stand-alone selling prices to allocate the consideration to separate performance obligations.

Determining the consideration may not be entirely straightforward, especially if the arrangement involves variable consideration such as discounts, returns and performance bonuses. Not only should an entity identify a reasonable number of possible consideration amounts, the entity must also apply a constraint that permits variable consideration to be recognised only if it is highly probable that a significant reversal in the future will not occur.

An entity may need to develop estimates when it determines the stand-alone selling price of goods or services within bundled contracts that it does not sell on a stand-alone basis. For most goods and services, this requirement may be less daunting than it appears. For others, such as goods or services that are highly customised, determining the stand-alone selling price may require the use of non-observable inputs.

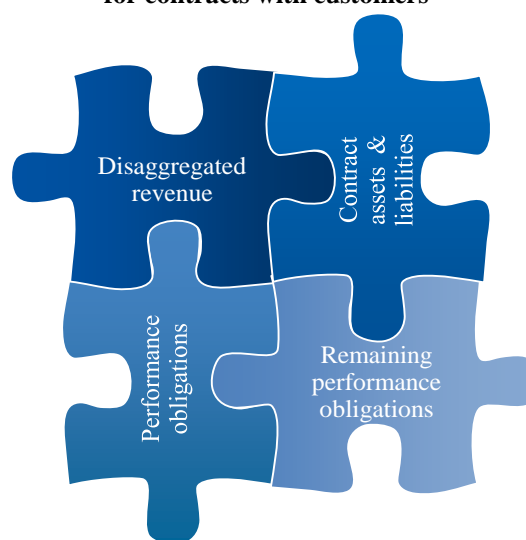
Increased use of estimates, particularly on variable consideration and stand-alone selling price

More extensive disclosures

Revenue is a critical performance measure and it is hardly surprising that the new standard requires broader and deeper disclosures about an entity’s contracts with customers, assets recognised from costs of obtaining or fulfilling these contracts, and significant judgements in applying the model.

The enhanced disclosures are expected to provide better insights into the nature, amount, timing and uncertainty of future revenue and cash flows. Users of financial statements can also expect greater transparency on an entity’s judgements, estimates and methods, particularly in areas that impact the amount and timing of revenue most.

Four broad disclosure requirements for contracts with customers

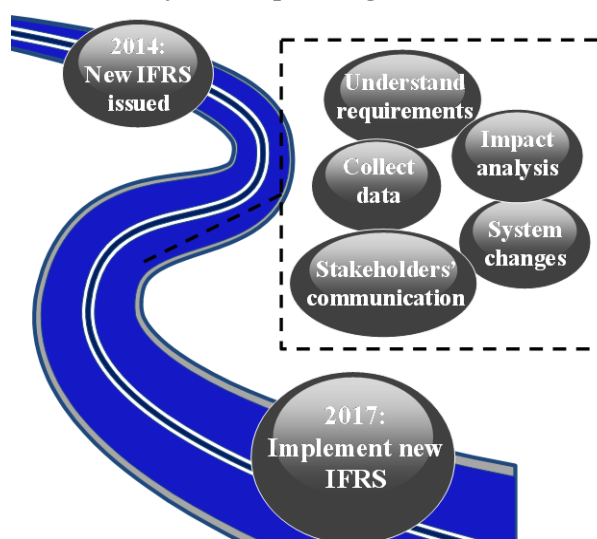


What’s next?

A single converged standard on revenue recognition is undeniably a giant leap towards improving financial reporting and meeting the information needs of users of financial statements. Even so, the new revenue recognition model is only as good as its application.

Entities are strongly encouraged to start their impact assessment now, beginning with a comprehensive review of existing contracts, regulations and legal framework. For entities operating in multiple jurisdictions, the accounting could differ across jurisdictions as a result of the different legal environments.

Activity roadmap leading to 2017



Entities should also consider if changes to their information systems and processes are needed to implement the new standard. On top of that, entities should initiate a process to gather historical data, such as variable consideration information, while keeping in mind the new requirements when drafting new contracts. Last but not least, entities should not lose sight of stakeholders' communications on the impact of the new standard.

All said, the new revenue recognition standard will become effective in 2017 and the implementation efforts required of entities cannot be underestimated.

About the ASC

The ASC is the independent accounting standard setting body established under the Accounting Standards Act for companies, charities, co-operative societies and societies in Singapore.

In carrying out its mandate, the ASC takes into account:

- The information needs of the stakeholders of the entities;
- Facilitation of comparability, disclosure and transparency;
- Compatibility with relevant international standards; and
- Singapore's reputation as a trusted international business and financial hub.

www.asc.gov.sg