REVENUE

RELEVANT TO ACCA QUALIFICATION PAPER P2

This article looks at the contentious current issue of revenue. This is a key area of development for the International Accounting Standards Board (IASB) and the project appears within the examinable documents of Paper P2, *Corporate Reporting*.

REVENUE DEVELOPMENT

The concept of revenue and the related IAS (IAS 18) comes to us from a period in financial reporting when the focus was on profit. This performance focus was the cornerstone of financial reporting for roughly 50 years from 1950 to 2000. You probably know this idea as the concept of matching and probably know that for many years it was the key to understanding accounting standards.

Since the IASB took over the development of accounting standards in 2001, its focus has been on assets and liabilities. This change of focus left IAS 18 out of step with the new ideas.

This probably would not have been enough to raise revenue above some of the other problems that are faced by the IASB were it not for one salient factor: the US and its dominance of financial reporting. The US government highlighted the problems with revenue recognition as a stumbling block on the road to convergence with International Financial Reporting Standards (IFRS).

This article uses the vehicle of a question to illustrate how the subject might be examined. The revenue project is enormously conceptual and even the big brains on the IASB find it a challenge. So all I'll say now is good luck and here is the question.

ILLUSTRATIVE QUESTION: RAMIFICATION

Ramification is an engineering company. It has two contracts nearing completion at its year end. The company has made certain assumptions related to revenue recognition and wants to know if these would be acceptable under current revenue rules. Further the company is aware of a discussion paper on revenue. The company would like to know what affect the revenue proposals would have upon the revenue of Ramification should the proposals be accepted.

Contract X

This is a restoration project. Ramification has been contracted to restore an old prestigious building in a city centre. The contract provides that $1m will be payable to Ramification in two equal instalments of $500,000 each. The first instalment is payable on completion of work to the foundations, which is considered to be half the work. The final instalment is payable on completion of the work to the visible brickwork, which is considered to be the other half of the work. The first instalment is due one year from the current year end (providing the foundation work is complete). The final instalment is due two years from the current year end (provided the brickwork is complete).

The contract requires that a surveyor verifies the work completed. At the year end, the surveyor has reported that the foundation work is entirely complete and that the brickwork is nearing completion. He has, therefore, reported that the whole contract is approximately 90% complete.

Ramification proposes to base revenue for contract X on the assumption that the contract is a construction contract. So Ramification proposes to recognise revenue using the surveyor's percentage and proposes to ignore the time value of money. The cost of capital is 10%.

Contract Y

This is a small building contract. Ramification built a small hut for housing equipment. Ramification agreed a sale price of $20,000, but also offered a three-month warranty. The building itself is finished, but the warranty is still open. The warranty is an offer to rebuild the hut should anything happen to it within three months from the date of handover. Handover took place two days before the year end and nothing has happened so far. There remains almost three full months before the warranty lapses and nothing is expected to happen.

Previous similar contracts have been sold at $18,000 for the hut and $3,000 for the warranty. Therefore Ramification proposes to recognise $20,000 in revenue and a provision of $3,000 representing the fair value of the obligation.

Required

(a) Discuss the problems with existing revenue recognition rules that have led to the issue of the discussion paper on revenue.

(7 marks)

Studying Paper P2?
Performance objectives 10 and 11 are relevant to this exam

THE CONCEPT OF REVENUE AND THE RELATED IAS (IAS 18) COMES TO US FROM A PERIOD IN FINANCIAL REPORTING WHEN THE FOCUS WAS ON PROFIT.

(b) Discuss the appropriateness of the assumptions utilised by Ramification in contracts X and Y above. Calculate the revenue recognised in the current year based on those assumptions.
(6 marks)

(c) Briefly explain the basis of the proposals put forward by the discussion paper to create a comprehensive standard for revenue recognition.
(8 marks)

(d) Explain how the application of the proposals would affect the revenue recognition of Ramification for contracts X and Y.
(4 marks)
(25 marks)

Answer commentary

The first thing I would advise you, before we get into the answer proper, is be realistic. In the exam you would have 45 minutes to complete your answer. That includes reading time, momentary panicking time and thinking time. So do not think you are going to be able to deliver the perfect answer that covers all the issues.

It can be daunting to look at past exam answers. The volume and detail included can lead you to think that this is what is expected from you in the exam. This is simply not true. The exam answers are teaching answers. They are idealised answers that are there to instruct. In order to score full marks, you do not need a perfect answer. You simply need a clear concise answer that covers the appropriate number of key points.

Let us move to requirement (a) to further explain what I mean. Clearly, if you had time you could write a book about the problems with existing revenue recognition. Do not try. Just produce at least seven points as quickly as you can that address the principal problems.

Do not be afraid of putting down what you really think. The examiner frequently gives full marks to a narrative answer that is not the same as his own so long as that answer has the appropriate number of ideas clearly expressed.

Next I would like to remind you of the marking guide used extensively throughout Section B. It is one mark for one relevant point well expressed. It is the marking guide that is the driver behind the style of answer that you see below. Each idea is delivered in one or two sentences and capped by one heading. This is of enormous assistance to your marker who can now see instantly each point you are trying to deliver.

My exam answer:

(a) **Current revenue recognition**

IAS18 distinguishes two types of revenue: 'At' revenue is recognised at the point risks and rewards for transferred (sale of goods) and 'Over' revenue which is recognised over the period (sale of services).

Intuitive

There is very little else in IAS 18. It is left to the user to interpret the revenue recognition from there. The great strength of IAS 18 is that it is intuitive – but that has now become its weakness.

Distinction

In many sales situations it is obvious whether the revenue should be recognised 'At' or 'Over'. But in other situations one revenue stream could be recognised either 'At' or 'Over'.

Example: Film making

A good example is film making. This could be interpreted as providing a service over a period or it could be interpreted as delivering intellectual property at a point in time.

Unbundling

Then IAS 18 has the problem of unbundling. Unbundling is the process of splitting a compound revenue stream into its component parts. The IAS requires unbundling but does not say when or how.

Example: Furniture and finance

For example, the bundled sale of furniture with hidden finance must be unbundled but IAS 18 gives no guidance to the retailer.

Other IFRS
Another irritation in existing revenue guidance is that it is mostly in IAS 18 but there are other IFRS that give (sometime contradictory) guidance:

Industry	*IFRS*
Construction	Construction Contracts (IAS 11)
Leasing	Leasing (IAS 17)
Insurance	Insurance Contracts (IFRS 4)

US
The IASB may have made do with existing IFRS guidance on revenue had the US not made improved revenue recognition a condition of convergence.

(b) **Introduction**
As explained in part (a) above, existing revenue reporting is intuitive; it is interpretive. The result is that when revenue becomes more complex, as it does in these two examples, there are various ways of recognising the revenue. So I cannot say that the revenue recognition suggested is right or wrong. I can only comment on its reasonableness.

Assumption (1) (X) 90%
Restoration is not construction but it is very similar so I think using construction contract accounting and therefore 90% is reasonable.

Assumption (2) (X) Time value
Construction contract accounting does ignore the time value of money so this assumption also seems reasonable.

Revenue (X)
So based on the above assumptions the revenue would be:

Revenue = ($1m) 90% = $900k

Assumption (1) (Y) Hut
Ramification has assumed that the sales proceeds relate exclusively to the hut. Personally, I do not see the contract this way but the assumption is acceptable. In fact, this is the existing culture for the recognition of a sale with a warranty.

Assumption (2) (Y) Provision
Ramification also assumes that the warranty gives rise to an obligation and not revenue. I suppose this is acceptable.

Revenue (Y)
The assumptions result in the following in the current financial statement:

Sales = $20k
Provision = $3k

(c) **Comprehensive**
The first proposal is that new revenue rules should be comprehensive and, therefore, all industries would be using the same one rule.

Framework
More importantly the proposal is to create revenue guidance based on the framework and the key elements of assets/liabilities.

AS EXPLAINED IN PART (A), EXISTING REVENUE REPORTING IS INTUITIVE; IT IS INTERPRETIVE. THE RESULT IS THAT WHEN REVENUE BECOMES MORE COMPLEX, AS IT DOES IN THESE TWO EXAMPLES, THERE ARE VARIOUS WAYS OF RECOGNISING THE REVENUE.

Asset/liability
To paraphrase the framework 'An asset/liability is a present right/obligation to a future economic inflow outflow'.

Change
The IASB are proposing a change from performance reporting to positional reporting.

Contract
The proposal proposes that at the point of contract signature the supplier has an interlocked asset and liability. The asset is the right to the cash from the customer and the liability is the obligation to perform.

Performance obligation
Once the supplier has fulfilled the performance obligation, the interlocked liability is removed and the remaining asset is revealed and recognised.

Revenue
At this point the revenue is recognised almost as an afterthought. Notice that the proposal focuses on the asset and liability first. Then once the asset is revealed the revenue is recognised.

Discounting
Because the asset is a right to a cash flow and timing makes a difference to value, the IASB are proposing discounting.

Unbundling
Because a bundled transaction has two performance obligations, unbundling becomes compulsory. So the one sale of two things must be split into two (see Part (d) proposed (Y) revenue below).

(d) **Proposed (X) Revenue explanation**
In order to assess the performance of performance obligations, Ramification would refer to the contract and the survey. Ramification would see that the foundations are complete and the brickwork is not. So an asset of $500k in year one would be recognised.

IN PART (C), ONCE THE SUPPLIER HAS FULFILLED THE PERFORMANCE OBLIGATION, THE INTERLOCKED LIABILITY IS REMOVED AND THE REMAINING ASSET IS REVEALED AND RECOGNISED.

Proposed (X) Revenue
The result would be the following revenue:

Asset (revenue) = $500k/1.1 = $455k

Proposed (Y) Revenue explanation
Under the proposal this second contract must be unbundled; that is broke down into its two parts, hut revenue and warranty revenue. This would be done using the hut and warranty separate sales figures.

Proposed (Y) Revenue
This is as follows:

Asset (Revenue) = $20,000 (18/18+3) = $17,143

CONCLUSION
The above covers the highly conceptual revenue development project and also gives you an example of how to answer the current issues question.

Martin Jones is lecturer at the London School of Business and Finance