CHEAT SHEET

IMPORTANT CHANGES TO *OVER-TIME* REVENUE RECOGNITION

IS THIS RELEVANT TO ME?

This "Cheat Sheet" will be relevant to you if:

- Your entity is a *for-profit* entity
- Your entity currently recognises revenue *over-time* on a *percentage-of-completion* (PoC) basis, and/or
- Your entity operates in the construction, logistics, professional services, customised products industries, or any other entity that applies *over-time*, PoC accounting.

WHAT MIGHT THE CHEAT SHEET REVEAL?

This "Cheat Sheet" might reveal that:

- Your entity may not meet the new criteria that requires revenue to be recognised *over-time*, or
- Your entity may now be required to recognise revenue *over-time*, and/or
- Your overall accounting for contracts recognised on an *over-time* basis may change, as a consequence of the PoC basis no longer available with respect to (construction/input) costs.

Your entity may need to engage legal experts to determine whether particular aspects of the new *over-time* criteria are met (or not).

Also, if the numbers in the financial statements are required to change, managemet will need to consider the consequential impacts to areas such as bank covenants, staff bonuses, earn-out clauses etc.

NEED ASSISTANCE WITH ASSESSING THE IMPACT?

BDO *Accounting Advisory Services* is a dedicated service line available to assist entities in transitioning to new accounting standards. Further details are provided on the following pages for your information.

BACKGROUND

A number of for-profit entities in New Zealand will be busy considering the impacts of the new revenue recognition standard (NZ IFRS 15) for their current reporting periods[1].

While this should absolutely be a focus for all *for-profit* Tier 1 and 2 *general purpose* reporting entities currently preparing financial statements under NZ IFRS and NZ IFRS (RDR) respectively, entities currently preparing financial statements under *special purpose* accounting frameworks (SPFR) still need to sit up and take notice.

This is because if the application of NZ IFRS 15 would push a current SPFR entity above the "large entity" revenue thresholds[2] , then (i) they will be scoped into NZ IFRS (RDR), and (ii) therefore need to be applying NZ IFRS 15, in future financial periods[3].

This will be particularly relevant for entities that recognise revenue *over-time* at present, but would fail the new criteria imposed by NZ IFRS 15 to do so – i.e. resulting in a more "lumpy", *point-in-time* revenue recognition profile which may consequentially aggregate revenue from specific contracts within a single, specific period.

SO WHAT HAS CHANGED AND WHAT DO I NEED TO BE AWARE OF?

There are two significant changes that we would like to highlight in this Cheat Sheet:

A. There is a new *over-time* revenue recognition criteria that **ALL** entities must initially assess.

   This means that *point-in-time* revenue recognition applies if, and only if, none of the *over-time* criteria are met).

   Also, it is key to note that *over-time* recognition under NZ IFRS 15 may not necessarily result in the same revenue recognition profile as the PoC basis currently.

B. PoC accounting, as it is currently applied with respect to (construction/input) costs, is no longer available.

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[1] Being year ends 31 December 2018 and beyond (i.e. 31 March 2019, 30 June 2019 etc).

[2] *NZ companies*: $60m assets, or $30m revenue, *Foreign owned companies*: $20m assets, or $10m revenue; in the preceding two years.

[3] For the financial year immediately following two consecutive years of breaching the "large entity" thresholds.

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A. NEW OVER-TIME REVENUE RECOGNITION CRITERIA

The new criteria has been introduced to make the distinction between *over-time* and *point-in-time* revenue recognition a binary and mutually exclusive determination (i.e. if it is not one, it is the other).

If an entity satisfies any of the three new criteria, revenue MUST be recognised *over-time* – it is not a choice.

Previously, the distinction was open to interpretation and judgement resulting in different revenue recognition practices for the same transactions of different entities – for example, there has been up until now inconsistent revenue recognition application from entities operating in the logistics industry (i.e. revenue recognised proportionally *over-time* as the delivery is provided over days/months, or only at a *point-in-time* upon delivery when the customer receives the completed service). The new *over-time* requirements of NZ IFRS 15 have now resolved these inconsistencies.

Criteria[4]	Example
1. *The customer simultaneously receives and consumes the economic benefits provided by the entity's performance*	• **Cleaning service** (the customer receives portions of the cleaned premises as and when the entity performs the cleaning). • **Logistics service** (as the entity performs the service, the customer is receiving the economic benefit of their goods being closer to the final destination – i.e. these services do not need to be re-performed if performance ceased).
2. *The entity creates or enhances an asset controlled by the customer*	• **Vehicle modifications and maintenance** (goods and/or services are being applied directly to an asset (vehicle) controlled by the customer). • **Construction on the customer's premises** (goods and/or services are being applied directly to an asset (land and/or building) controlled by the customer).
3. *Both of the following are present:* i. *The entity's performance does not create an asset for which the vendor has an alternative use, **and*** ii. *The entity has an **enforceable right** to payment for performance completed to date at all times[5].*	The following **might** meet this criteria (refer to below "discussion") • **Professional services** (such as lawyers, accountants, engineering consultants etc). • **Construction or development of a specified property** (i.e. if the property contracted for cannot be redirected to another customer, or substituted). • **Construction or development of a customised item** (i.e. a specific item of inventory or component for customer's fixed asset, such that if the customer walked away mid contract the item couldn't be resold to another customer without more than insignificant rework).

Discussion on the third over-time criteria above

The analysis of the third *over-time* criteria has proved to be the most problematic and "involved" in applying NZ IFRS 15.

Ordinarily, the first "prong" **(i)** looking at ***alternative use*** is fairly easy to determine:

- For **professional services**, it may be contractually prohibited and/or practically impossible to utilise the result of the service provided for an alternate customer, if the current customer were to "walk away" mid contract (i.e. a specific report etc.).
- For **construction or development of a specified property** (i.e. land title plot, apartment number etc.) ordinarily the specified property, and only the specified property, must be delivered to the customer in all instances – i.e. the entity cannot substitute in an alternative property to satisfy the contract with the customer.
- For **construction or development of a customised item** (i.e. component to be fixed to an entities asset, specialised inventory etc.) it may be contractually prohibited and/or practically impossible to utilise the item produced for an alternate customer (without more than insignificant rework) if the current customer were to "walk away" mid contract.

However, it is the second "prong" **(ii)** looking at ***enforceable rights*** to payment where things can come undone. This is because:

- *"Payment for performance completed to date"* is referring to payment in the amount of **revenue** that has been recognised for **accounting**, and NOT any form of contractual progress or milestone (cash) payments, and
- *"Enforceability"* is referring to LEGAL enforceability.

  As such, irrespective of what the contract says around recourse and repayment over the term of the contract if the customer were to "walk away" mid contract, would the courts in the jurisdiction where recourse would be sought uphold (i.e. enforce) this.

  This is a question of law rather than accounting, and therefore almost always requires the advice of legal experts, both in the entity's country of incorporation AND any separate jurisdictions that an entity operates and/or sells within.

  It may be that in some case, for certain contracts, that the courts instead require an entity to mitigate their losses by finding an alternate purchaser for the item, and then subsequently, only being able to recover any actual incurred losses from the original customer (i.e. particularly common in contracts relating to property). In such a scenario (i.e. recovery only of losses/costs) the *"Enforceability"* requirement is not met under NZ IFRS 15.

[4] Refer NZ IFRS 15 para 35(a), (b), (c)).

[5] This must include an element of margin. Merely having a right to recover costs is not sufficient to meet NZ IFRS 15's "enforceable right to payment" requirement.

B. REMOVAL OF PERCENTAGE-OF-COMPLETION (POC) ACCOUNTING WITH RESPECT TO COSTS

The objective of the previous construction contract accounting standard (NZ IAS 11), which in practice was applied more broadly than to just contracts related to the construction of property, was to achieve a "smoothing" of **gross margin** over the contract term.

This was achieved by NZ IAS 11 requiring the PoC approach to be applied not only to revenue, but also to (construction/input) costs.

This application to (construction/input) costs is not addressed in NZ IFRS 15, nor any other accounting standard.

This now means that construction costs are recognised on an as-incurred basis, in line with general accrual accounting principles.

When these costs relate to physical goods that are yet to be deployed to satisfying a customer's contract, these would be recognised as the entity's inventory (work-in-progress) until deployed (as the entity maintains control over such items until control is transferred to the customer upon deployment).

However in other cases (i.e. costs related to services being provided) these are recognised as cost of sales as they are incurred (and not a "WIP" asset held in the balance sheet), against the revenue that has been recognised for accounting purposes.

Depending on what basis (i.e. input or output) the entity is recognising its revenue on, this will likely result in varying margins over the contractual period.

This will be almost always the case where an *output-method* is used (i.e. appraisals of results, milestones reached, units produced and units delivered etc.). This is because the cumulative (or periodic) outputs driving the amount of revenue to recognise may not be commensurate with the cumulative (or periodic) costs incurred.

As a result, in some cases, losses may be experienced in some periods, particularly in the early stages of the contract, even though the contract is anticipated to be profitable overall.

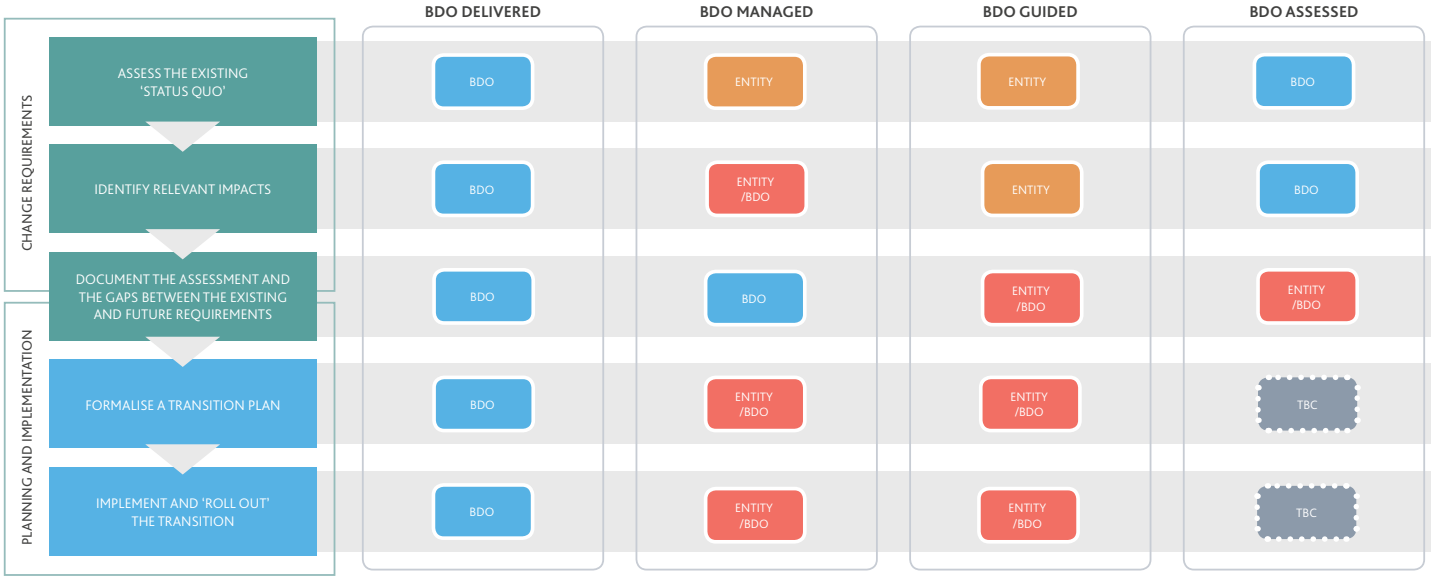
This is a substantial change from how entities have previously been required to account for these contracts, and may require significant "unpicking" of the accounting applied in both the current (transition) year, and comparative periods presented.

BDO ACCOUNTING ADVISORY SERVICES - TAILORED TRANSITION ASSISTANCE

BDO adopts a flexible approach to assisting entities with their transition to new accounting standards including NZ IFRS 15, meaning we can be as involved as an entity requires, based on their own in-house resourcing and expertise at their disposal.

Often entities don't know exactly where to start or focus their energies, and just want to get the ball rolling.

We have found our BDO Guided and BDO Assessed approaches fit well to accommodate this, whilst also retaining the ability to scale up involvement quickly if need be – either way, we work WITH you.



For more information as to how BDO Accounting Advisory Services might assist with assessing the impact of your transition to NZ IFRS and any other new accounting standards please contact James Lindsay at BDO *Accounting Advisory Services* (james.lindsay@bdo.co.nz ☎ +64 21 166 0844), and visit our webpage below.

https://www.bdo.nz/en-nz/services/specialist-services/accounting-advisory-services/impact-assessments

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