ADVISOR ALERT

ASPE and ASNPO: How changes to Section 3400 Revenue could affect your financial statements

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PART 2 Determining the appropriate manner and timing of revenue recognition for each unit of account

Introduction

Financial statement preparers that apply Accounting Standards for Private Enterprises (ASPE) or Accounting Standards for Not-for-Profit Organizations (ASNPO) will want to review their revenue recognition accounting policies to consider additional guidance. For many entities, accounting for revenue can be complex as every revenue stream, sales contract, and transaction is unique. This additional guidance, now included in Section 3400 Revenue (in Part II of the CPA Canada Handbook – Accounting), eliminates room for interpretation in many areas; however, professional judgment will still be required.

In Part 2 of this three-part series, we provide further guidance on how to determine the appropriate manner and timing of revenue recognition. This guidance refers to the final step in the five-step revenue recognition assessment model introduced in Part 1. The other publications in this series address the following topics:

PART 1	Five-step revenue recognition assessment model
PART 3	Applying the percentage of completion method

In this series, we explain some of the additional guidance included in Section 3400 and provide practical insights to help financial statement preparers and users evaluate the impact of these changes on an entity's financial statements.

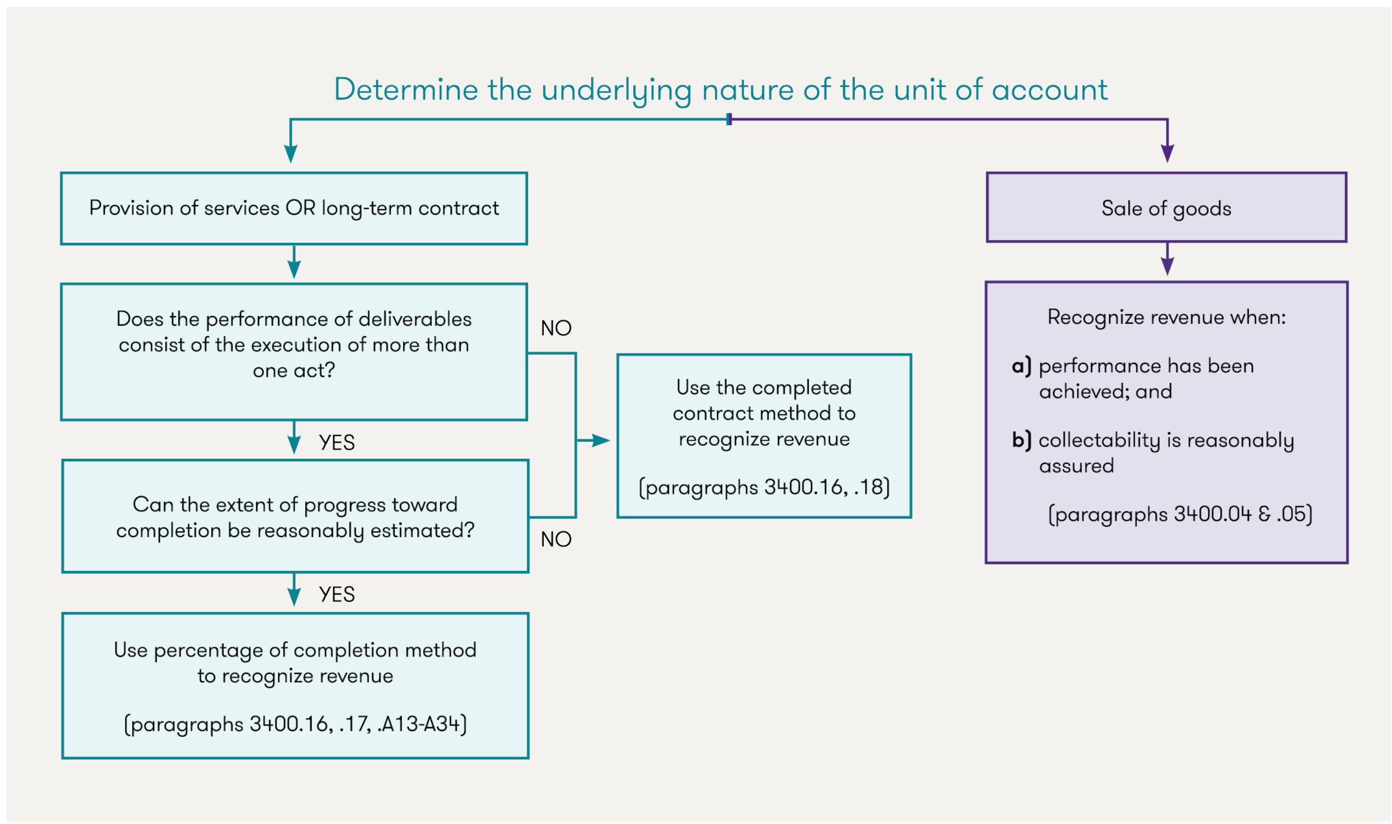
Practitioners are encouraged to read this series of publications in order and alongside Section 3400 to fully understand the requirements, as accounting for revenue contains many nuances. As entities prepare their financial statements under amended Section 3400, it's important to also take note of CPA Canada's publication, "ASPE briefing: Additional guidance added to Section 3400 Revenue", which provides:

- detailed guidance on each of the areas of revenue recognition impacted by the amendments;
- application guidance for not-for-profit organizations;
- additional resources; and
- comprehensive illustrative examples

For further background on the Accounting Standards Board's 2019 amendments to Section 3400, see Advisor Alert: How Section 3400 Revenue amendments could impact your enterprise's financial statements.

Determining the underlying nature of the unit of account

To appropriately determine how and when to recognize revenue in your financial statements, it's necessary to consider whether the underlying nature of the unit of account represents the sale of goods, the provision of services, or a long-term contract. Section 3400 (Appendix) includes the decision tree below to help an entity make this determination:



If the underlying nature of the unit of account is not identified appropriately, then the manner and timing of revenue recognition could be incorrect. For example, if an entity wrongly identifies the sale of goods as a long-term contract, it may recognize revenue over a period of time (via the percentage of completion method). Instead, the entity should recognize revenue at a specific point in time (i.e., when performance has been achieved and collectability is reasonable assured for the sale of goods).

Here are some examples of sales arrangements that constitute the sale of goods versus the provision of services or a long-term contract:

Sales of goods

- Retail sales
- Resale of prefabricated equipment
- Sale of widgets over a period of time

Provision of services and long-term contracts

- Legal services
- Cleaning services
- HR services
- Research and development
- Design and build custom equipment
- Construction contracts

A unit of account is generally considered the sale of goods in instances where an entity sells ready-made goods to a customer—whether the entity transfers the goods to the customer all at once or over a period of time. For example, if an entity sells prefabricated widgets to a customer, the underlying nature of the unit of account is the sale of goods, regardless of whether the sale takes place all at once (e.g., 2,400 units on February 1) or over time (e.g., 200 units each month for one year).

To determine whether a unit of account represents a long-term contract, professional judgement will likely need to be applied as ASPE doesn't define this term. Note that in an arrangement that contains multiple units of account, it's possible that an entity must apply two or more of the methods of revenue recognition when accounting for the sales transaction.

General principles of revenue recognition

There are general principles that apply for recognizing revenue, regardless of the nature of the unit of account. Revenue can be recognized for the sale of goods, services, or long-term contracts when performance has been achieved and ultimate collection is reasonably assured.

Performance is achieved when the following conditions are met:

1. Persuasive evidence that an arrangement exists;
2. Delivery has occurred or services were rendered; and
3. The seller's price to the buyer is fixed or determinable.

Methods to recognize revenue for the provision of services or long-term contracts

To recognize revenue for a unit of account that represents the provision of services or a long-term contract, an entity must use either the completed contract method or the percentage of completion method.

Completed contract method

When an entity uses the completed contract method, revenue is recognized only once the contract is complete or substantially complete, and once collectability is reasonably assured. An entity can only use the completed contract method when:

- the service arrangement or long-term contract consists of the execution of a single act; or
- the extent of progress towards completion **cannot** be reasonably estimated.

If the service or long-term contract does not meet either of the criteria above, an entity must recognize revenue using the percentage of completion method.

An entity can also use the completed contract method for service or long-term contracts when the extent of progress towards completion **cannot** be reasonably estimated. For example, a very small entity may not have access to any software or other tools needed to help it track the progress toward completion of its contracts.

Percentage of completion method

When an entity uses the percentage of completion method, revenue is recognized over time, proportionate to the degree of completion of the service or the long-term contract. An entity must use this method when the service or long-term contract consists of:

- executing more than one act (i.e., a **significant** activity that the customer benefits from as the entity makes progress towards performing the service or completing the long-term contract); and
- the extent of progress towards completion can be reasonably estimated.

Note that the extent of work that goes into performing the activity does not necessarily determine whether it is significant; therefore, it's important to consider whether the customer will benefit from the activity to assess whether it can be considered an act.

For example, an entity that builds custom equipment and has a contract with a customer to build a piece of custom equipment would need to complete a series of activities such as source materials, build the exterior of the equipment, assemble internal components like wiring, etc. Each of these activities would qualify as an act because they benefit the customer.

Under this method, revenue is recognized on a rational and consistent basis. Entities should use a basis that most accurately reflects how the work is accomplished (i.e., the extent of performance achieved).

For more in-depth details on using the percentage of completion method, see Part 3 of this article series.

Determining whether an entity uses the completed contract method or the percentage of completion method should be based on the facts and circumstances that apply to each unit of account and is **NOT** an accounting policy choice. If a service or long-term contract consists of the execution of more than one act and an entity can reasonably estimate the extent of progress towards completion, the entity **must** use the percentage of completion method.

Conclusion

Accounting for revenue recognition is complex and many nuances exist when applying the guidance in practice. Furthermore, determining the manner and timing of revenue recognition for a particular unit of account is often preceded by several decisions. For example, if the underlying nature of the unit of account is not identified appropriately, then the manner and timing of revenue recognition could be incorrect.

Additionally, refer to Grant Thornton's other publications on revenue recognition:

PART 1	Five-step revenue recognition assessment model
PART 3	Applying the percentage of completion method

We can help.

If you have any questions about the amendments or applying the five-step revenue recognition assessment model, reach out to your Grant Thornton advisor today.

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