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COVID-19: Accounting considerations for CFOs

Five accounting considerations relating to revenue recognition

As a result of COVID-19, entities are generally expecting to experience significant declines in revenue and decreases in progress of delivery of performance obligations for long-term contracts.

These declines in revenue may arise from decreases in volume and changes in variable consideration. It is likely that, as a result of changes in the economic environment, customers will seek to modify contracts; it is also possible that the ability of customers to pay for goods may be called into question prior to delivery occurring.

The entity may choose to transact in this situation notwithstanding the uncertainty. Both trade receivables and contract assets may also be subject to additional credit risk. Finally, onerous contracts may arise as contracts become loss making through either a decrease in variable consideration or an increase in contract costs.

This article highlights key aspects of PFRS 15 'Revenue from Contracts with Customers', that are expected to be particularly relevant during the COVID-19 pandemic.

1. Applying the '5 step model'

PFRS 15 is based on a core principle that requires an entity to recognise revenue in a manner that depicts the transfer of goods or services to customers and at an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services. Applying this principle involves following the '5-step model'.

In the current economic climate, entities may more often enter into contracts with customers with a high risk of non-payment. If collecting the consideration is not probable at contract inception, the normal PFRS 15 guidance does not apply. Instead, the supplier recognises revenue only if/when it collects the consideration and has no remaining obligations to perform. In effect, the entity should cash account for transactions of this nature.

Generally, once a contract meets the conditions to apply the normal PFRS 15 model, any deterioration in the customer's ability to pay is accounted for under the expected credit loss model set out in PFRS 9 'Financial Instruments'. However, if the customer's ability to pay deteriorates significantly while the contract is still in progress the entity should reassess whether collection is probable.

2. Variable consideration

Variable consideration is any consideration which is not fixed in the contract. Variable consideration changes can potentially impact the assumptions used in measuring revenue from goods or services which have already been delivered, especially where contracts contain:

- penalties including liquidated damages
- rights of return
- performance bonuses (esp. time-based bonuses)
- volume-based variable pricing
- price concessions (see note below)
- unpriced change orders.

For contracts with variable consideration, PFRS 15 requires these factors to be reassessed and if necessary, adjusted at each reporting date for both the best estimate and the (so-called) constraint. The impact of the above will therefore be required to be included in revenue at each reporting date. A significant reversal of revenue is possible as each of the above is remeasured which may, for a contract, result in negative revenue in the current reporting period. Management's assumptions concerning variable consideration (based on facts and circumstances at the reporting date) will need to be reviewed in the context of COVID-19.

A price concession granted to a customer could be within the scope either of the variable consideration guidance or the contract modification guidance depending on the facts and circumstances.

Example

EnginCo, an entity with a 31 December year end, commenced a contract with CustomerCo in May 2018 involving the production of eight tractors. CustomerCo agreed to pay EnginCo CU1,000 upon delivery of each tractor, with a bonus of CU2,000 if all tractors are delivered by 30 June 2020. At 31 December 2019, six tractors had been delivered, with the seventh nearing completion and the eighth on schedule for delivery 31 May 2020. On 31 March 2020, EnginCo ceased construction due to social distancing rules with seven tractors delivered. Assume no contractual ability to terminate under force majeure. Assume also that point-in-time revenue recognition is appropriate.

As of 31 December 2019, EnginCo recognised the following revenue:

Delivery of 6 tractors (CU1,000 × 6):	CU6,000
Share of bonus (CU2,000 × 6/8):	CU1,500
Total revenue recognised:	CU7,500

It was appropriate to recognise the share of performance bonus at 31 December 2019 – at that date, it was "highly probable that a significant reversal in the amount of cumulative revenue will not occur when the uncertainty associated is subsequently resolved" (PFRS 15.56). Note that the hurdle is "highly probable" not "certain" – it may have been reasonable, at 31 December 2019, to not anticipate a pandemic.

For the half-year ended 30 June 2020, it is apparent that the performance bonus will not be received. As of 31 March 2020, the aggregate amount of revenue to be recognised is:

Delivery of 7 tractors (CU1,000 × 7):	CU7,000
Share of performance bonus	–
Total revenue recognised:	CU7,000

This results in a required reduction in revenue recognised of CU500 – negative revenue results.

3. Contract modifications

The COVID-19 pandemic may result in entities having to renegotiate customer contracts. Depending on the type of modification, 'contract modification' accounting may apply. Where a customer encounters financial difficulty or reduced demand, it may request a contract modification (alternatively referred to as a 'change order', 'variation' or 'amendment') to alter the scope of the contract. If the scope of the contract decreases, or the scope increases but pricing does not change by the stand-alone selling price of that increase, contract modification accounting is applied (PFRS 15.20).

If contract modification accounting is applied, the entity should apply the most appropriate of the following methods:

- treating completion-to-date as a terminated contract, with unrecognised revenue and undelivered performance obligations being allocated to a 'new' contract [PFRS 15.21(a)].
- if a performance obligation is partially satisfied, reassess revenue as if the modified contract was effective from the initial date of the contract and adjust revenue up or down, as appropriate, as of the date of the modified contract [PFRS 15.21(b)], or
- if appropriate, a combination of the two approaches [PFRS 15.21(c)].

4. Recoverability

Revenue where significant uncertainty of receipt of payment exists

IFRS 15 also requires an entity to recognise revenue from contracts only where the customer is expected to meet its obligations under the contract. Though management would continue to supply to the customer, revenue should only be recognised when it is probable that the customer will be able to pay the transaction price [PFRS 15.9(3)]. In such an instance, the entity should defer recognition of any revenue until collection becomes probable. The costs to fulfil the contract cannot be deferred and should be recognised as incurred as they are not 'expected to be recovered' [PFRS 15.95(c)].

Contract assets

Change in expected contract profitability and/or the customer's ability to pay could affect the recoverability of assets recognised in accordance with PFRS 15. Contract assets (sometimes referred to as unbilled revenue or similar) are subject to the PFRS 9 expected credit loss model.

Assets recognised for the incremental costs of obtaining a contract or costs to fulfil a contract are subject to a specific impairment test set out in PFRS 15. In summary, these assets are impaired if they exceed the future profits expected on the contract (ie unrecognised revenue less future costs).

5. Onerous contracts

Contracts that were previously expected to be profitable may become loss-making due to a decrease in variable consideration (see above) and/or an increase in contract costs. Contracts in the scope of PFRS 15 are subject to the onerous contract requirements of PAS 37.

An onerous contract is defined by PAS 37 as one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it (PAS 37.10). The accounting for onerous contracts includes creating a provision based on the unavoidable costs of meeting the entity's obligation under the contract (PAS 37.66).

Entities must consider whether any of their contracts may have become onerous due to the downturn in the global economy as a result of COVID-19 or an increase in costs to fulfil a contract that may arise from the effect of COVID-19 on working practices. In addition, an entity should review contracts to determine if there are any special terms that may relieve either party to the contract of its obligations under it (force majeure).

Recently, the IASB published a clarification to IAS 37 that states that the onerous contract assessment should be based on the directly attributable costs of fulfilling the contract (i.e. not only the incremental costs).

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