Grant Thornton

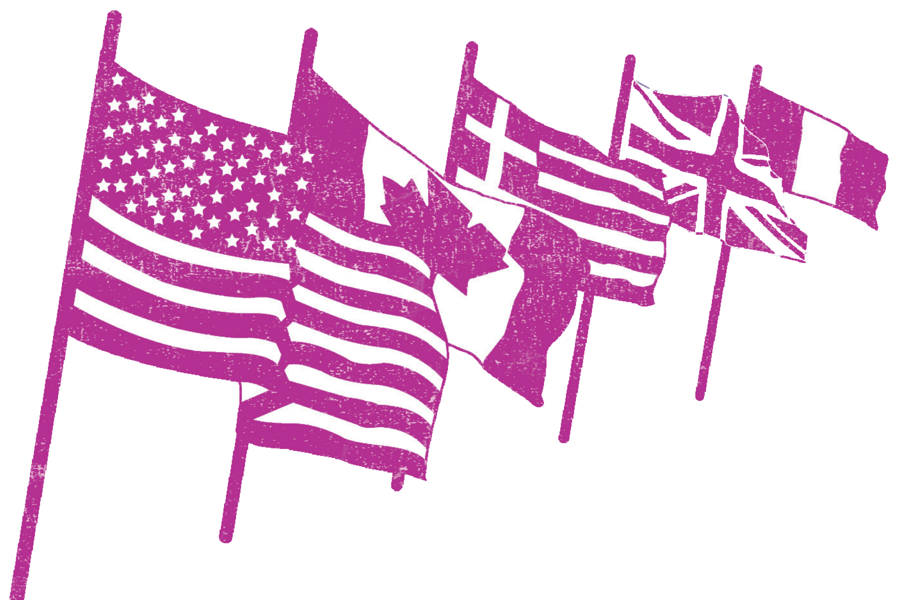
An instinct for growth™

MFRS Hot Topics

Revenue recognition and foreign currency translation

JULY 2016

Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This publication will provide guidance on the accounting in recognising revenue denominated in foreign currency.



If an entity earns revenues denominated in foreign currency:

- how are these revenues translated into the entity's functional currency?
- are related deferred revenue (advance payments) and accrued revenue amounts treated as monetary or non-monetary items for the purposes of MFRS 121 The Effects of Changes in Foreign Exchange Rates

Contents

2 Guidance

3 Discussion

Guidance

Revenues denominated in foreign currency are translated into functional currency at the closing (or spot) rate on the dates those revenues are recognised in accordance with MFRS 111 Construction Contracts, MFRS 118 Revenue or other applicable MFRS (MFRS 121.21 and 22). The timing of invoicing does not have any direct effect on the translation of the foreign currency revenue into the reporting entity's functional currency. However, the timing of the receipt of payment for the goods or services rendered should be considered carefully to determine the impact on the amount recognised as revenue on translation from the foreign currency to the functional currency. This analysis involves the determination of whether the received/receivable balance is determined to be a monetary or non-monetary item.

Payments received in arrears

Receivables and amounts recognised for goods and services for which revenue has been recognised, including net unbilled contract revenue recognised in accordance with MFRS 111 are generally treated as monetary items because they usually represent amounts to be received in a fixed or determinable number of units of currency (see discussion below).

Accordingly, these amounts are retranslated at the applicable closing rate at each reporting date. Related gains and losses are included in the income statement (MFRS 121.28). *In our view,* these exchange gains and losses are not part of revenue.

Payments received in advance

When the cash is received, the deferred revenue/advance payment is initially recorded in the financial statements in the functional currency at the spot rate on the date of receipt. The assessment of whether this balance should be treated as monetary or non-monetary is often difficult. For non-refundable deposits or advance payments recognised before the revenue recognition criteria of MFRS 118 are satisfied, the amount recognised is likely to be classed as non-monetary as this represents, in effect, an obligation to deliver future goods and services and so will not be settled in a fixed or determinable number of currency units. However, if the amount received in advance is refundable, it would be acceptable to classify it as a monetary item.

The determination of the classification of advances recognised under the percentage of completion method of revenue recognition in accordance with MFRS 111 or for services under MFRS 118 is less clear. Management judgement is needed depending on the facts and circumstances.

If an advance payment is considered as a monetary item, the deferred revenue balance is retranslated at the applicable closing rate at each reporting date. Related gains and losses are included in the income statement (MFRS 121.28). In our view, these exchange gains and losses are not part of revenue. Future revenues will continue to be recorded in the functional currency at the spot rate on the date of recognition.

On the other hand, if an advance payment balance is considered to be a non-monetary item, the balance is not retranslated at each reporting date. Instead, the amount recognised is allocated to the future periods over which the services are rendered and no translation differences arise.

Discussion

Translation of revenues denominated in foreign currency

Foreign currency transactions are recorded at the at the date of the transaction (MFRS 121.21). For this purpose, the date of the transaction is determined based on when the transaction qualifies for recognition in accordance with applicable MFRS (MFRS 121.22).

Application of these requirements to revenues denominated in foreign currency therefore involves translating the revenues at the spot rate on the date (or dates) that the revenues are recognised in accordance with MFRS 111, MFRS 118 or other applicable MFRS. This is straightforward in situations such as a sale of goods for which revenue is recognised on a single date and invoicing takes place on or close to that date. Revenue and the related receivable (a financial asset) are both recorded at the applicable spot rate on the date the sale is made. The receivable, which is a monetary asset, is re-translated at the applicable closing rate at future reporting dates whilst it remains outstanding (MFRS 121.23(a)).

Foreign currency effects are more complicated where revenue is recognised over a period of time. Revenue on many construction and other service contracts is recognised by reference to the stage of completion of the contract work (subject to various conditions) (MFRS 111.22 and MFRS 118.20). If cash receipts are closely linked to the timing of revenue recognition then, in our view, application of MFRS 121 to foreign currency revenues in this type of contract generally requires:

- determining the amount of revenue denominated in foreign currency to be recognised
- translating each incremental revenue denominated in foreign currency amount into functional currency at the spot rates as the work is performed. In practice, a weekly or monthly average rate is often used as a reasonable approximation. However, this is appropriate only if exchange rates do not fluctuate significantly in the period (MFRS 121.22).

However, complications arise when exchange rates change between the timing of recognition of revenue and the receipt of cash.

Revenue-related accruals and deferrals

It is common in many revenue-contracts:
- for payments to be received in advance of revenue being recognised (giving rise to deferred revenue or advance payments) or
- revenue to be recognised in advance of payment or contractual invoicing (giving rise to accrued revenue or unbilled revenue for contract work).

A question arises as to whether these revenue-related accruals and deferrals are:
- monetary items to be retranslated at each period end at the applicable spot rate under MFRS 121.23(a) or
- non-monetary items to be translated at the date of the transaction.

Monetary items are defined in MFRS 121 as:

> "units of currency held and assets or liabilities to be received or paid in a fixed or determinable number of units of currency" (MFRS 121.8).

In our view, revenue-related accruals should be treated as monetary items. This is because accrued or unbilled revenue represents a right to receive a determinable amount of currency (the proportion of the total contract consideration that has been 'earned' to date in accordance with MFRS 111, 18 etc).

By contrast:
- non-refundable deferred revenue or advance payments recognised under MFRS 118 represent an outstanding performance obligation that will be settled only by future delivery of goods or performance of services and so are non-monetary items
- refundable deferred revenue or advance payments recognised under MFRS 118 may be viewed as an outstanding performance obligation that are expected to be settled by future delivery of goods or performance of services (non-monetary) or they could be viewed as monetary because there is the possibility that they will be refunded in cash. Management judgement is needed to determine a suitable accounting policy to be applied consistently
- advances received for construction or service contracts before the related work is performed are more complex because they are calculated as a balancing figure resulting from the mechanics of recognising costs and revenues in accordance with the percentage of completion method in MFRS 111. Consequently, management judgement is needed to decide on an accounting policy choice. In practice, some entities recognise these as monetary items on the basis that they represent a determinable amount of currency received or receivable from a customer, but not yet earned in accordance with MFRS 111. An alternative view is to treat the balance as a non-monetary item on the grounds that the deferred revenue represents a non-monetary performance obligation (ie a liability to perform further work specified under the contract).

Example

Foreign currency construction contract
A Swiss Franc (SFR) functional construction company undertakes a construction contract with total revenue of US$100,000. Work started on 1 January 20X0 and completed on 31 December 20X0. It is assumed that there are no embedded derivatives that require separation.

- At 30 November 20X0 the work was 60% complete. Accordingly, the cumulative US$ revenue recognised is US$60,000 (US$100,000 * 60%)
- At 31 December 20X0, the work was 100% complete. Accordingly, the cumulative US$ revenue recognised is US$100,000.

The applicable foreign exchange rates are:
- from 1 January to 30 November 20X0: 0.6 SFR = 1.0 US$ (it is assumed there are no movements in this period to simplify the calculations)
- average FX rate for December 20X0: 0.7 SFR = 1.0 US$
- closing rate at 31 December 20X0: 0.8 SFR = 1.0 US$

Scenario 1: payment is 100% in arrears on 31 December X0:
Each month's revenue is translated at that month's average rate, because that is when the transaction is deemed to occur for MFRS 121.21 purposes. It is also consistent with the principle that revenue is recognised as the work is performed. Revenue earned to November is US$60,000 and in December is US$40,000.

Revenue is therefore reported as: From 1 January to 30 November 20X0: US$60,000 * 0.6 = SFR36,000 For December 20X0: US$40,000 * 0.7 = SFR28,000 Total contract revenue = SFR64,000

Unbilled revenue is regarded as a monetary asset and translated to closing rate at each month-end. FX movements are reported as income or expenses but not as part of revenue. Hence a foreign exchange gain of SFR16,000 arises, based on the revaluation of the unbilled revenue. As there are no exchange rate movements between 1 January and 30 November, the cumulative unbilled revenue to 30 November is translated to the 31 December closing rate. The revenue earned in December is translated from that month's average rate to the closing rate:

US$60,000 * (0.8 - 0.6) = SFR12,000
US$40,000 * (0.8 - 0.7) = SFR4,000

On 31 December 20X0, the company collects the consideration of US$100,000, which is equivalent to SFR80,000 based on the spot rate at that date. This in turn corresponds to the total income recorded in SFR (revenue of 64,000 and foreign exchange gains of 16,000). The amount of revenue recognised represents the value of the revenue at the time when revenue was recognised. The gain on foreign exchange is attributable to the Company's decision to enter into an arrangement whereby payment is received at a later date. As such, the gain is not considered as revenue.

Scenario 2: payment is 100% upfront on 1 January 20X0 - accounting policy choice to treat as a monetary item
Contract revenue is SFR64,000 as above. This amount is not affected by the timing of payment.

The advance payment at each period end is treated as a monetary item. There are no exchange rate movements between 1 January and 30 November. Accordingly only the advance payment at 30 November needs to be translated (ie the US$40,000 received but not recognised as revenue at 30 November). A foreign exchange loss of SFR4,000 arises on this amount:

US$40,000 * (0.7 - 0.6) = SFR4,000

The aggregate of the contract revenue and the exchange loss is therefore SFR60,000. This corresponds to the cash collected at 1 January 20X0 (US$100,000) translated at the closing rate (0.6 SFR = 1.0 US$) on that date. Similar to scenario 1, the amount of revenue recognised is based on the exchange rates at the dates when revenue was recognised. It is the Company's decision to accept payment at the beginning of the contract, thus any exposure to fluctuation of exchange rates is borne by the Company.

Scenario 3: payment is 100% upfront on 1 January 20X0 - accounting policy choice to treat as a non-monetary item
The advance payment is translated on receipt and recorded in cash and deferred revenue at SFR60,000. This is considered a non-monetary item. It is not retranslated and so no foreign exchange difference arises.

The deferred revenue of SFR60,000 is recognised as revenue in the income statement as the work is performed, allocated to the periods based on the percentage of completion of the work done.

During the period 1 January through 30 November, 60% of the work is completed and so SFR36,000 is recognised as revenue for the period and released from the deferred revenue balance.

During December, the contract is completed and the remaining balance of deferred revenue is released to income statement and recognised as revenue of SFR24,000 (60-36). In this scenario, revenue of SFR60,000 is recognised in total but there are no exchange gains or losses.

KUALA LUMPUR

Levels 11,15 & 8
Sheraton Imperial Court
Jalan Sultan Ismail
50250 Kuala Lumpur

T +603 2692 4022
F +603 2721 5229
E info@my.gt.com

PENANG

51-8-A,
Menara BHL Bank
Jalan Sultan Ahmad Shah
10500 Penang

T +604 228 7828
F +604 227 9828

JOHOR BAHRU

Unit 29-08, Level 29
Menara Landmark
12 Jalan Ngee Heng
80000 Johor Bahru, Johor

T +607 223 11848
F +607 224 9848

KUANTAN

A-105A, 1st Floor
Sri Dagangan, Jalan Tun Ismail
25000 Kuantan
Pahang

T +609 515 6124
F +609 515 6126

© 2016 Grant Thornton International Ltd. All rights reserved. "Grant Thornton" refers to the brand under which the Grant Thornton member firms provide assurance, tax and advisory services to their clients and/or refers to one or more member firms, as the context requires. SJ Grant Thornton is a member firm of Grant Thornton International Ltd (GTIL). GTIL and the member firms are not a worldwide partnership. GTIL and each member firm is a separate legal entity. Services are delivered by the member firms. GTIL does not provide services to clients. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions.

www.grantthornton.com.my