

IFRS 15, *Revenue from Contracts with Customers*

OVERVIEW

- The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) issued a new revenue recognition standard on 28 May 2014.
- IFRS 15 replaces both IAS 18 Revenue and IAS 11 Construction Contracts. It is effective for reporting periods beginning on or after 1 January 2018.
- IFRS 15 *Revenue from Contracts with Customers* establishes a single and comprehensive framework which sets out how much revenue is to be recognised, and when.
- The impact to financial statements, business processes and internal controls will likely be significant for some entities.

- IFRS 15 *Revenue from Contracts with customers* defines revenue as income that arises in the course of an entity's **ordinary activities**.
- The core principle of IFRS 15 is that revenue should be recognised from the transfer of goods or services to a customer in an amount that reflects the consideration that the entity expects to be entitled to in exchange for the goods or services.
- Under IFRS 15 the Transfer of good and services is based upon the transfer of **control**, rather than the transfer of risks and rewards as in IAS 18. **Control of an asset** is described in standard as the ability to direct the use of, and obtain substantially all of the remaining benefits from the asset.

SCOPE AND SCOPE EXCEPTIONS

What is in scope or affected by the standard:

- ▶ Contracts with customers
- ▶ Sale of some non-financial assets that are not an output of the entity's ordinary activities (e.g., property, plant and equipment, intangible assets)

What is not in scope:

- ▶ Leasing contracts within the scope of IFRS 16
- ▶ Insurance contracts
- ▶ Financial instruments and other contractual right and obligations within the scope of IFRS 9, IFRS 10, IFRS 11, IAS 27, IAS 28.
- ▶ non-monetary exchanges between entities in the same line of business An example is a contract between two oil companies that agree to exchange oil in different locations in order to fulfil demand from their customers.
- ▶ Certain put options on sale and repurchase agreements

DEFINITIONS

Income: Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.

Revenue: Income arising in the course of an entity's ordinary activities.

Contract: An agreement between two or more parties that creates enforceable rights and obligations.

Contract Asset: An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer, when that right is conditioned on something **other than the passage of time**, for example the entity's future performance.

Receivable: An entity's right to consideration that is unconditional only the passage of time is required before payment is due.

Contract Liability: is presented in the statement of financial position where a customer has paid an amount of consideration prior to the entity performing by transferring the related good or service to the customer.

Customer: a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

Performance obligation: A promise in a **contract** with a **customer** to transfer to the customer either:

- a) A good or service (or a bundle of goods or services) that is distinct; or
- b) A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Stand-alone selling price: The price at which an entity would sell a promised good or a service separately to the customer (not in the bundle).

Transaction price: amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

THE FIVE-STEP REVENUE RECOGNITION MODEL

Step 1

- Identify the contract(s) with a customer

Step 2

- Identify the performance obligation(s) in the contract

Step 3

- Determine the transaction price

Step 4

- Allocate the transaction price to the performance obligations in the contract

Step 5

- Recognise revenue when (or as) the entity satisfies a performance obligation

STEP 1: IDENTIFY THE CONTRACT(S) WITH THE CUSTOMER

A contract with a customer is within the scope of IFRS 15 only when **all** of the following Criteria have been met:

- Could be written, oral or implied
- Does not exist if both parties can cancel without penalty
- Contract has commercial substance
- The parties are committed to perform the terms of the contract.
- Parties can identify the rights in the contract.
- Payment terms can be identified
- Collectability is probable. The new standard requires entities to evaluate a customer's credit risk at contract inception. An entity can only recognize revenue when payment is likely to be received. For more information and collection is probable Collectability can be assessed based on the customer's financial capacity and intent to pay.

EXAMPLE 1

Aluna Co has a year end of 31 December 20X1.

On 30 September 20X1, Aluna Co signed a contract with a customer to provide them with an asset on 31 December 20X1.

The customer will pay \$1m on 30 June 20X2.

By 31 December 20X1, Aluna Co did not believe that it was probable that it would collect the consideration that it was entitled to.

Therefore, the contract cannot be accounted for and no revenue should be recognised.

STEP 2: IDENTIFY THE PERFORMANCE OBLIGATIONS IN THE CONTRACT

The key point is distinct goods or services. A contract includes promises to provide goods or services to a customer. Those promises are called performance obligations.

A good or service is distinct if both of the following criteria are met:

- (1) The customer can benefit from the good or service on its own or with resources the customer already has access to, and
- (2) The good or service can be transferred independent of other performance obligations in the contract (even if it is transferred with other goods or services). Goods or services that are not considered distinct should be combined with other goods or services until the bundle is distinct.

The standard directs entities to consider performance obligations that are explicitly outlined in the contract as well as any obligations the customer may expect because of established business history. For example, if a vendor has always provided free shipping on goods to a client such that the client expects the goods it purchases to be delivered for free, then the shipping represents a performance obligation—even if it is not expressly stated in the contract.

EXAMPLE 2

Software Co enters into a contract with a customer to provide The following:

- Software license.
- installation services.
- Software updates
- Technical sport for Three years.

The entity sells the above separately. The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

How many performance obligations are in the contract?

Answer:

The software is delivered before the other goods or services and remains functional without the updates and the technical support, therefore the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available.

The promise to transfer each good and service to the customer is separately identifiable from each other. In particular, the installation service does not significantly modify or customize the software itself and, as such, the software and the installation service are separate outputs promised by the entity instead of inputs used to produce a combined output.

Based on the assessment, four performance obligations in the contract have been identified for all four of the above goods or services.

EXAMPLE 3

Software Co enters into a contract with a customer to provide The following:

- Software license.
- installation services.
- Software updates
- Technical sport for Three years.

The entity sells the above separately. The installation service the software is to be substantially customized in order to add significant new functionality to enable the software to interface with other software already being used by the customer. The customized installation service can be provided by a number of unrelated vendors.

How many performance obligations are in the contract?

Answer:

In this case, although the installation service could be provided by other entities, the analysis required by IFRS 15 indicates that within the context of its contract with the customer, the promise to transfer the license is not separately identifiable from the customized installation service. In contrast and as before, the software updates and technical updates are separately identifiable.

The following distinct goods or services are identified:

- Software license and customized installation service.
- Software updates.
- Technical support.

EXAMPLE 4

Software Co enters into a contract with a customer to provide The following:

- Software license.
- installation services.
- Software updates
- Technical sport for Three years.

The Software Co is the only supplier that is capable of carrying out the customized installation service. And The software updates and technical support are essential to ensure that the software continues to operate satisfactorily, and the customer's employees continue to be able to operate the related IT systems. No other entity is capable of providing the software updates or the technical support.

How many performance obligations are in the contract?

Answer:

In this case, the analysis required by IFRS 15 indicates that in the context of its contract with the customer, the promise is to transfer a combined service. This combined service is identified as the single distinct good or service.

EXAMPLE 5:

Software Co enters into a contract with a customer to provide anti-virus software

Under the contract Software Co promises to provide the customer with when and if available updates to the software during license period.

How many performance obligations are in the contract?

How many performance obligations are in the contract?

Answer:

The license and the update are not separately identifiable because the update is critical to the continued use of the anti-virus software and the software and services are inputs into a combined item in the contract.

Therefore Software Co accounts for license and the updates as a single performance obligation.

STEP 3: DETERMINE THE TRANSACTION PRICE

The transaction price is the amount of consideration an entity expects to be entitled to for transferring promised goods or services.

The consideration amount can be fixed, variable, or a combination of both. The entity excludes amounts third parties will eventually collect, such as sales tax, when determining the transaction price.

The transaction price would reflect the company's probability weighted estimate of variable consideration in addition to the effects of the customer's credit risk and the time value of money.

Variable consideration are only included where it is highly probable that there will not be a reversal of revenue when any uncertainty associated with the variable consideration is resolved.

Example of where variable consideration can arise include:

Discounts, Rebates, bonus, Refund, Price concessions, credits and penalties.

EXAMPLE 6

Telco B enters into an agreement to provide data hosting services to a large business customer, Company C, for a period of five years.

Certain services level agreement (SLAs) are signed by B as part of the contract with C. Specifically, the SLAs will result in a reduction of consideration paid by C to B, if B doesn't meet a specified level of service.

What is the correct treatment for penalties?

Answer:

B should estimate the amount of the penalties at contract inception in determining the transaction price.

EXAMPLE 7

Taplop supplies laptop computers to large businesses. On 1 July 20X5, Taplop entered into a contract with TrillCo, under which TrillCo was to purchase laptops at \$500 per unit. The contract states that if TrillCo purchases more than 500 laptops in a year, the price per unit is reduced retrospectively to \$450 per unit. Taplop's year end is 30 June.

- (a) As at 30 September 20X5, TrillCo had bought 70 laptops from Taplop. Taplop therefore estimated that TrillCo's purchases would not exceed 500 in the year to 30 June 20X6, and TrillCo would therefore not be entitled to the volume discount.
- (b) During the quarter ended 31 December 20X5, TrillCo expanded rapidly as a result of a substantial acquisition, and purchased an additional 250 laptops from Taplop. Taplop then estimated that TrillCo's purchases would exceed the threshold for the volume discount in the year to 30 June 20X6.

Required

Calculate the revenue Taplop would recognise in:

- (a) Quarter ended 30 September 20X5
- (b) Quarter ended 31 December 20X5

We need to apply the principles of IFRS 15 *Revenue from Contracts with Customers*.

ANSWER:

- (a) Applying the requirements of IFRS 15 to TrillCo's purchasing pattern at 30 September 20X5, Taplop should conclude that it was highly probable that a significant reversal in the cumulative amount of revenue recognised (\$500 per laptop) would not occur when the uncertainty was resolved, that is when the total amount of purchases was known.

Consequently, Taplop should recognise revenue of $70 \times \$500 = \$35,000$ for the first quarter ended 30 September 20X5.

- (b) In the quarter ended 31 December 20X5, TrillCo's purchasing pattern changed such that it would be legitimate for Taplop to conclude that TrillCo's purchases would exceed the threshold for the volume discount in the year to 30 June 20X6, and therefore that it was appropriate to reduce the price to \$450 per laptop.

Taplop should therefore recognise revenue of \$109,000 for the quarter ended 31 December 20X5. The amount is calculated as from \$112,500 (250 laptops \times \$450) less the change in transaction price of \$3,500 (70 laptops \times \$50 price reduction) for the reduction of the price of the laptops sold in the quarter ended 30 September 20X5.

EXAMPLE 8

A construction company enters into a contract with a customer to supply a new building. Control over the completed building will pass to the customer in two years time (the performance obligation will be satisfied at a point in time). The contract contains two payment options.

Either the customer can pay CU 5 million in two years time when it obtains control of the building, or

the customer can pay CU 4 million on inception of the contract.

The customer decides to pay CU 4 million on inception.

The vendor concludes that because of the significant period of time between the date of payment by the customer and the transfer of the asset to the customer, that there is a significant financing component.

The interest rate implicit in the transaction is 11.8%. However, under IFRS 15 the company is required to consider its own incremental borrowing rate which is determined to be 6%.

The accounting entries required are as follows:

Contract inception:

	<i>CU '000</i>	<i>CU '000</i>
<i>Cash</i>	<i>4,000</i>	
<i>Contract liability</i>		<i>4,000</i>

Recognition of a contract liability for the payment in advance

Over the two year construction period:

<i>Interest expense</i>	<i>494</i>	
<i>Contract liability</i>		<i>494</i>

Accretion of the contract liability at a rate of 6%

At the date of transfer of the asset (the building) to the customer:

<i>Contract liability</i>	<i>4,494</i>	
<i>Revenue</i>		<i>4,494</i>

STEP 4: ALLOCATE THE TRANSACTION PRICE

An entity shall allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

Where a contract has many performance obligations, an entity shall allocate the transaction price to the performance obligations in the contract by reference to their relative stand-alone selling prices. If a stand-alone selling price is not directly observable, an entity will need to estimate it.

So, if any entity sells a bundle of goods and/ or services which it also supplies unbundled, the separate performance obligations in the contract should be priced in the same proportion as the unbundled prices.

EXAMPLE 9

A mobile phone company gives customers a free handset when they sign a two-year contract for provision of network services. The handset has a stand-alone price of \$100 and the contract is for \$20 per month.

Prior to IFRS 15, the company would recognise no revenue in relation to the handset and a total of \$240 per annum in relation to the contract.

What is the correct treatment under IFRS 15 ?

ANSWER:

Under IFRS 15, revenue must be allocated to the handset because delivery of the handset constitutes a performance obligation. This will be calculated as follows:

	\$	%
Handset	100	17%
Contract – two years	<u>480</u>	<u>83%</u>
Total value	<u>580</u>	<u>100%</u>

As the total receipts are \$480, this is the amount which must be allocated to the separate performance obligations. Revenue will be recognised as follows (rounded to nearest \$).

	\$
Year 1	
Handset ($480 \times 17\%$)	82
Contract $(480 - 82)/2$	<u>199</u>
	<u>281</u>
Year 2	
Contract as above	<u>199</u>

So application of IFRS 15 has moved revenue of \$41 from Year 2 to Year 1.

EXAMPLE 10

Company E licenses enterprise resource planning (ERP) software to its customers and provides post-contract support services throughout the licence period. To retain its existing customers, E has developed a practice of frequently giving its customers a discount on the post-contract support fees stated in the original contract for the final year. This discount has ranged from 20% to 60% with no discernible pattern.

E enters into a contract with Customer C for a three-year licence of its ERP software for 300,000 (paid up-front) and 180,000 in total for three years of post-contract support services, paid in three 60,000 instalments at the beginning of each year. The software licence and the post-contract support services constitute two separate performance obligations. E transfers the software licence to C at contract inception.

E concludes that its history of providing post-contract support fee discounts means that the transaction price is variable and therefore needs to be estimated. E uses an expected value method because there are many possible outcomes. It estimates that it will give C a discount of 42% on the Year 3 post-contract support fees.

Consequently, E’s estimate of the transaction price at contract inception – before applying the constraint – is 454,800¹. Assuming that the stand-alone selling prices of the licence and the post-contract support services are 300,000 and 200,000 respectively, the relative stand-alone selling price allocation would be as follows. Discounts and variable consideration are allocated between all distinct goods or services in the contract unless specific criteria are met

	Stand-alone selling price	Relative stand-alone selling price
Licence	300,000	272,880
Post-contract support	200,000	181,920

$$300,000 + 120,000 + (60,000 * (1 - 42\%)) = 454,800$$

STEP 5: RECOGNISE REVENUE WHEN A PERFORMANCE OBLIGATION IS SATISFIED

If a performance obligation is satisfied at a point in time then the entity must determine the point in time at which a customer obtains control of a promised asset.

Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits (inflows or savings in outflows) from, the asset. Control includes the ability to prevent other entities from obtaining benefits from an asset.

The following are indicators of the transfer of control:

- The entity has a present right to payment for the asset
- The customer has legal title to the asset
- The entity has transferred physical possession of the asset
- The customer has the significant risks and rewards of ownership of the asset
- The customer has accepted the asset.

STEP 5: RECOGNISE REVENUE WHEN A PERFORMANCE OBLIGATION IS SATISFIED

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognise revenue over time, if one of the following criteria is met:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs
- The entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced, or
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date

The amount of revenue recognised is the amount allocated to that performance obligation in Step 4.

An entity must be able to **reasonably measure** the outcome of a performance obligation before the related revenue can be recognised.

In some circumstances, such as in the early stages of a contract, it may not be possible to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred. In these circumstances, revenue is recognised only to the extent of costs incurred.

The incremental costs of **obtaining** a contract (such as sales commission) are **recognised as an asset** if the entity expects to recover those costs.

Costs that would have been incurred regardless of whether the contract was obtained are recognised as an expense as incurred.

Costs incurred in **fulfilling** a contract, unless within the scope of another standard (such as IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*) are recognised as an asset if they meet the following criteria (IFRS 15: para. 95):

- (a) The costs relate directly to an identifiable contract (costs such as labour, materials, management costs)
- (b) The costs generate or enhance resources of the entity that will be used in satisfying (or continuing to satisfy) performance obligations in the future; and
- (c) The costs are expected to be recovered

Costs recognised as assets are amortised on a systematic basis consistent with the transfer to the customer of the goods or services to which the asset relates.

OTHER ISSUES

- Warranties:

If a customer has the option to purchase a warranty separately from the product to which it relates, it constitutes a distinct service and is accounted for as a separate performance obligation. This would apply to a warranty which provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

If the customer does not have the option to purchase the warranty separately, for instance if the warranty is required by law, that does not give rise to a performance obligation and the warranty is accounted for in accordance with IAS 37

If the warranty – or part of it – is considered to be a performance obligation, then the entity allocates a portion of the transaction price to the service performance obligation by applying the requirements in Step 4 of the model

OTHER ISSUES

Principal versus Agent:

An entity must establish in any transaction whether it is acting as principal or agent.

It is a principal if it controls the promised good or service before it is transferred to the customer. When the performance obligation is satisfied, the entity recognises revenue in the gross amount of the consideration to which it expects to be entitled for those goods or services.

It is acting as an agent if its performance obligation is to arrange for the provision of goods or services by another party. In this case the agent's revenue is measured at the fee or commission that it expects to be entitled to for arranging the provision of goods or services by the other party.

Indicators that an entity is a principal include the following:

- (a) The entity is primarily responsible for fulfilling the contract (eg it has responsibility for the goods or services meeting customer specifications).**
- (b) The entity has inventory risk before the goods have been transferred to a customer or after transfer of control to the customer.**
- (c) The entity has discretion in establishing prices for the specified goods or services.**

EXAMPLE 11:

Fancy Goods Co (FG) operates a website that enables customers to purchase goods from a range of suppliers. The suppliers set the price that is to be charged and deliver directly to the customers, who have paid in advance. FG's website facilitates payment by customers and the entity is entitled to commission of 5% of the sales price.

The entity has no further obligation to the customer after arranging for the products to be supplied.

Required

Is FG a principal or an agent?

Answer:

The following points are relevant:

- The supplier is primarily responsible for fulfilling a customer order rather than FG; FG is not obliged to provide goods if the supplier fails to deliver to the customer.
- FG does not have inventory risk at any time, as it does not deal with inventories at all.
- FG does not establish prices.

FG is therefore acting as an agent and should recognise revenue equal to the amounts received as commission.

Repurchase agreements:

Under a repurchase agreement an entity sells an asset and promises, or has the option, to repurchase it. Repurchase agreements generally come in three forms.

- (a) An entity has an obligation to repurchase the asset (a forward contract).
- (b) An entity has the right to repurchase the asset (a call option).
- (c) An entity must repurchase the asset if requested to do so by the customer (a put option).

In the case of a forward or a call option the customer does not obtain control of the asset, even if the customer has physical possession. The entity will account for the contract as:

- (a) A lease in accordance with IFRS 16, if the repurchase price is below the original selling price; or
- (b) A financing arrangement if the repurchase price is equal to or greater than the original selling price. In this case the entity will recognise both the asset and a corresponding liability.

If the entity is obliged to repurchase at the request of the customer (a put option), it must consider whether or not the customer is likely to exercise that option.

If the repurchase price is lower than the original selling price and it is considered that the customer does not therefore have significant economic incentive to exercise the option, the contract should be accounted for as an outright sale, with a right of return. If the customer is considered to have a significant economic incentive to exercise the option, the entity should account for the agreement as a lease in accordance with IFRS 16.

If the repurchase price is greater than or equal to the original selling price and is above the expected market value of the option, the contract is treated as a financing arrangement.

Example 12:

A Co enters into a contract with a customer (B Co) for the sale of a tangible asset on 1 January 20X7 for \$1m. The contract includes a call option that gives A Co the right to repurchase the asset for \$1.1m on or before 31 December 20X7.

This means that B Co does not obtain control of the asset, because the repurchase option means that it is limited in its ability to use and obtain benefit from the asset.

As control has not been transferred, A Co accounts for the transaction as a **financing arrangement**, because the exercise price is above the original selling price. A Co continues to recognise the asset and recognises the cash received as a financial liability. The difference of \$0.1m is recognised as interest expense.

If on 31 December 20X7 the option lapses unexercised, B Co now obtains control of the asset. A Co will derecognise the asset and recognise revenue of \$1.1m (the \$1m already received plus the \$0.1m charged to interest).

Example 13:

The same contract as above includes instead a put option that obliges A Co to repurchase the asset at B Co's request for \$900,000 on or before 31 December 20X7, at which time the market value is expected to be \$750,000.

In this case B Co has a significant economic incentive to exercise the put option because the repurchase price exceeds the market value at the repurchase date. This means that control does not pass to B Co. Since B Co will be exercising the put option, this limits its ability to use or obtain benefit from the asset.

In this situation A Co accounts for the transaction as a lease in accordance with IFRS 16. The asset has been leased to the customer for the period up to the repurchase and the difference of \$100,000 will be accounted for as payments received under an operating lease.

Consignment arrangements

When a product is delivered to a customer under a consignment arrangement, the customer (dealer) does not obtain control of the product at that point in time, so no revenue is recognised upon delivery.

Indicators of a consignment arrangement include:

- (a) The product is controlled by the entity until a specified event occurs, such as the product is sold on, or a specified period expires.
- (b) The entity can require the return of the product, or transfer it to another party.
- (c) The customer (dealer/distributor) does not have an unconditional obligation to pay for the product.

Required accounting

The following apply where it is concluded that control of the inventory has been transferred to the dealer.

- (a) The inventory should be recognised as such in the dealer's statement of financial position, together with a corresponding liability to the manufacturer.
- (b) Any deposit should be deducted from the liability and the excess classified as a trade payable.

Where it is concluded that control of the inventory has not been transferred to the dealer, the following apply.

- (a) The inventory should not be included in the dealer's statement of financial position until the transfer of control has taken place.
- (b) Any deposit should be included under 'other receivables'.

Example 14:

Consignment arrangement

A wholesaler supplies goods to a retailer on a consignment basis. The wholesaler retains title until the goods are sold by the retailer. The retailer does not pay the wholesaler until the goods are sold and any unsold goods can be returned.

In this situation control of the goods is not transferred to the retailer until the goods are sold to the end-user, so it is only at that point that the wholesaler can recognise the revenue.

Example 15:

Jameson is a retailer of high-value items of diamond jewellery. A significant proportion of the items available for sale in Jameson's stores were handmade by Rochester Diamonds.

These items are held under a contractual arrangement with Rochester Diamonds, the terms of which specify that Rochester Diamonds retains the ability to change the selling price of the jewellery, and that Jameson is required to return any unsold jewellery after a period of nine months. When Jameson sells an item of jewellery to a customer, legal title to the jewellery passes from Rochester Diamonds to the customer.

Jameson has paid a significant deposit to Rochester Diamonds in order to hold the jewellery in its stores. This deposit is deducted, on a proportionate basis, from the amount payable to Rochester Diamonds when items are sold, or is refunded in full if items are returned. Jameson is not required to pay in full for the jewellery until it is sold on to a customer.

Should Jameson include the items of jewellery in its inventories balance?

Answer:

Under IFRS 15, the items of jewellery should be recognised in the inventories of Jameson when Jameson obtains control of them. Therefore we need to assess whether Jameson has control of the items of jewellery.

Rochester Diamonds retains legal title to the items while they are with Jameson, and when they are sold, this title passes straight to the customer. Thus Jameson does not ever have legal title of the jewellery.

Rochester Diamonds retains the ability to change the selling price of the jewellery and is also exposed to the risk of the items not being sold, as unsold items must be returned after nine months. The risks and rewards of ownership of the jewellery therefore appear to lie with Rochester Diamonds, and not with Jameson.

Furthermore, Jameson does not have an unconditional obligation to pay for the jewellery; payment is conditional on the jewellery being sold to customers.

The arrangement therefore appears to be a consignment arrangement and control of the jewellery remains with Rochester Diamonds. As such, the jewellery should not be included in the inventories balance of Jameson.

BILL-AND-HOLD ARRANGEMENTS:

Bill-and-hold arrangements involve the vendor invoicing a customer for goods, but instead of delivering them to the customer, the vendor retains physical possession with the goods being shipped or delivered to the customer at a later date. A customer might request this type of arrangement if, for example, it does not have sufficient space of its own to accommodate the product. The effect is that in addition to selling the product, the vendor provides a custodial service.

In addition to evaluating whether control of the goods has transferred to the customer in the same way as for any other sale (or performance obligation) to be recognised at a point in time, all of the following criteria are required to be met for the vendor to recognise revenue:

- The reason for the bill and hold arrangement must be substantive (for example, the arrangement might be requested by the customer because of a lack of physical space to store the goods)
- The product must be identified separately as belonging to the customer (that is, it cannot be used by the supplier to satisfy other orders)
- The product must currently be ready for physical transfer to the customer
- The vendor cannot have the ability to use the product, or to direct it to another customer.

Example 16:

An entity enters into a contract with a customer on 1 January 20X8 for sale of a machine and spare parts. It takes two years to manufacture these and on 31 December 20X9 the customer pays for both the machine and the spare parts but only takes physical possession of the machine. The customer inspects and accepts the spare parts but requests that they continue to be stored at the entity's warehouse.

There are now three performance obligations – transfer of the machine, transfer of the spare parts and the custodial services. The transaction price is allocated to the three performance obligations and revenue is recognised when (or as) control passes to the customer.

The machine and the spare parts are both performance obligations satisfied at a point in time, and for both of them that point in time is 31 December 20X9. In the case of the spare parts, the customer has paid for them, the customer has legal title to them and the customer has control of them as they can remove them from storage at any time.

The custodial services are a performance obligation satisfied over time, so revenue will be recognised over the period during which the spare parts are stored.

SALE WITH A RIGHT OF RETURN:

Where goods are sold with a right of return, an entity should not recognise revenue for goods that it expects to be returned. It can calculate the level of returns using the expected value method (the probability-weighted sum of amounts) or simply estimate the most likely amount. This will be shown as a refund liability and a deduction from revenue.

The entity also recognises an asset (adjusted against cost of sales) for its right to recover products from customers on settlement of the refund liability

Example 17:

Entity R, a clothes retailer, grants customers a right to return any goods within 3 months of purchase for a full refund or an exchange of goods for equivalent value, if undamaged. At the reporting date, sales made in the previous 3 months amount to CU 1 million, with those goods costing Entity R CU 750,000. Entity R's historical experience is that 8% (by sales value) of goods on average are returned, with a 90% confidence that the value of goods that are returned will fall in the range of 6% to 10% of sales value.

Answer:

The following entries before accounting for customers' rights of return:

Dr Cash	1,000,000
Cr Revenue	1,000,000
Dr Cost of Sales	750,000
Cr Inventory	750,000

The following accounting entries at the reporting date:

Dr Revenue	100,000
Cr Refund liability	100,000
Dr Inventory to be returned	75,000
Cr Cost of Sales	75,000

PRESENTATION:

Contracts with customers will be presented in an entity's statement of financial position as a contract liability, a contract asset or a receivable, depending on the relationship between the entity's performance and the customer's payment.

A **contract liability** is recognised and presented in the statement of financial position where a customer has paid an amount of consideration prior to the entity performing by transferring control of the related good or service to the customer.

When the entity has performed but the customer has not yet paid the related consideration, this will give rise to either a **contract asset** or a **receivable**. A contract asset is recognised when the entity's right to consideration is conditional on something other than the passage of time, for instance future performance. A receivable is recognised when the entity's right to consideration is unconditional except for the passage of time.

Where revenue has been invoiced a receivable is recognised. Where revenue has been earned but not invoiced, it is recognised as a contract asset.

A performance obligation satisfied over time meets the criteria in Step 5 above and, if it entered into more than one accounting period, would previously have been described as a long-term contract.

In this type of contract an entity often has an enforceable right to payment for performance completed to date. The standard describes this as an amount that approximates the selling price of the goods or services transferred to date (for example recovery of the costs incurred by the entity in satisfying the performance plus a reasonable profit margin).

Methods of measuring the amount of performance completed to date encompass **output methods** and **input methods**.

Output methods recognise revenue on the basis of the value to the **customer** of the goods or services transferred. They include surveys of performance completed, appraisal of units produced or delivered etc.

Input methods recognise revenue on the basis of the **entity's** inputs, such as labour hours, resources consumed, costs incurred. If using a cost-based method, the costs incurred must contribute to the entity's progress in satisfying the performance obligation.

Example 18:

P Co has the following contract in progress:

	\$m
Total contract price	750
Costs incurred to date	225
Estimated costs to completion	340
Payments invoiced and received	290

Now we will calculate the amounts to be recognised for the contract in the statement of profit or loss and statement of financial position assuming the amount of performance obligation satisfied is calculated using the proportion of costs incurred method.

Answer:

1	<i>Estimated profit</i>	
		\$m
	Total contract price	750
	Less costs incurred to date	(225)
	Less estimated costs to completion	<u>(340)</u>
	Estimated profit	<u>185</u>
2	<i>Percentage complete</i>	
	Costs to date/total estimated costs: $225 / (225 + 340) = 40\%$	
3	<i>Statement of profit or loss</i>	
		\$m
	Revenue (40% × \$750)	300
	Cost of sales (40% × (225 + 340))	<u>(226)</u>
	Profit (40% × 185)	<u>74</u>
4	<i>Statement of financial position</i>	
		\$m
	Costs incurred to date	225
	Recognised profits	74
	Less receivable	<u>(290)</u>
	Contract asset	<u>9</u>

Example 19:

How would we account for this if it was a **loss-making contract**?

IFRS 15 states that an entity's right to payment for performance completed to date should approximate the selling price of the service completed to date. Selling price would be recovery of costs incurred plus a reasonable profit margin. Where no profit can be estimated, revenue is limited to recoverable costs.

Where a loss is anticipated, this means that a proportion of the entity's costs will not be recovered, and this needs to be recognised.

We will reduce P Co's contract price to \$550m.

Answer:

1 *Estimated loss*

	\$m
Total contract price	550
Less costs incurred to date	(225)
Less estimated costs to completion	<u>(340)</u>
Estimated loss – costs not recoverable	<u><u>(15)</u></u>

Note that the **full** estimated loss is recognised, even though the contract is only **partially complete**.

2 *Percentage complete*

Costs to date/total estimated costs: $225 / (225 + 340) = 40\%$

3 *Statement of profit or loss*

	\$m
Revenue (40% × \$550)	220
Cost of sales (balancing figure)	<u>(235)</u>
Loss	<u><u>(15)</u></u>

4 *Statement of financial position*

	\$m
Costs incurred to date	225
Recognised loss	(15)
Less receivable	<u>(290)</u>
Contract liability	<u><u>(80)</u></u>

Example 20:

The main business of Santolina Co is building work. At the end of September 20X3 there is an uncompleted contract on the books, details of which are as follows.

Date commenced	1.4.X1
Expected completion date	23.12.X3
	\$
Total contract revenue	290,000
Costs to 30.9.X3	210,450
Value of performance obligations satisfied to 30.9.X3	230,000
Amounts invoiced for work certified to 30.9.X3	210,000
Cash received to 30.9.X3	194,000
Estimated costs to completion at 30.9.X3	20,600

Santolina calculates satisfaction of performance obligations based on work certified as a percentage of contract price.

Required

Prepare calculations showing the amount to be included in the statement of profit or loss and statement of financial position at 30 September 20X3 in respect of the above contract.

Answer:

This is a contract where performance obligations are recognised over time. It will be included in the statement of financial position at cost plus recognised profit less amounts invoiced.

The estimated final profit is:

	\$
Final contract price	290,000
Less: costs to date	(210,450)
estimated future costs	<u>(20,600)</u>
Estimated final profit	<u>58,950</u>

The recognised profit is found as follows:

$$\text{Estimated final profit} \times \frac{\text{Work certified}}{\text{Total contract price}}$$

$$\$58,950 \times \frac{230,000}{290,000} = \$58,950 \times 79.31\%$$

Profit recognised = \$46,753

STATEMENT OF PROFIT OR LOSS

	\$
Revenue (work certified)	230,000
Cost of sales ((210,450 + 20,600) × 79.31%)	<u>(183,247)</u>
Gross profit	<u>46,753</u>

STATEMENT OF FINANCIAL POSITION

Contract asset

	\$
Costs to date	210,450
Attributable profit	<u>46,753</u>
	257,203
Amounts invoiced	<u>(210,000)</u>
Contract asset	<u>47,203</u>
Contract receivables (210 – 194)	16,000

Example 21:

Haggrun Co has two contracts in progress, the details of which are as follows.

	<i>Happy (profitable)</i>	<i>Grumpy (loss-making)</i>
	\$'000	\$'000
Total contract revenue	300	300
Costs incurred to date	90	150
Estimated costs to completion	135	225
Payments invoiced and received	116	116

Haggrun measures satisfaction of performance obligations based on percentage of work certified as complete.

Required

Show extracts from the statement of profit or loss and other comprehensive income and the statement of financial position for each contract, assuming they are both certified as:

- (a) 40% complete; and
- (b) 36% complete.

Answer:

Happy contract

(a) 40% complete

\$'000

Statement of profit or loss

Revenue (300 × 40%)	120
Cost of sales ((90 + 135) × 40%)	<u>(90)</u>
	<u>30</u>

Working

Profit to date

\$'000

Total contract revenue	300
Costs to date	(90)
Cost to completion	<u>(135)</u>
Total expected profit	<u>75</u>
Profit to date (75 × 40%)	30

Statement of financial position

\$'000

Costs to date	90
Profit recognised to date	30
Amounts invoiced	<u>(116)</u>
Contract asset	<u>4</u>

(b) 36% complete

\$'000

Statement of profit or loss

Revenue (300 × 36%)	108
Cost of sales ((90 + 135) × 36%)	<u>(81)</u>
Profit to date (75 × 36%)	<u>27</u>

Statement of financial position

Costs to date	90
Profit recognised to date	27
Amounts invoiced	<u>(116)</u>
Contract asset	<u>1</u>

Grumpy contract

(a) 40% complete

\$'000

Statement of profit or loss

Revenue (300 × 40%)	120
Cost of sales (balancing figure*)	<u>(195)</u>
Foreseeable loss (W)	<u>(75)</u>

Note that the **full foreseeable loss** is recognised even though the contract is **only partially complete**.

Working

\$'000

Total contract revenue	300
Costs to date	(150)
Costs to complete	<u>(225)</u>
Foreseeable loss – costs which will not be recovered	<u>(75)</u>

Statement of financial position

Costs to date	150
Foreseeable loss	(75)
Amounts invoiced	<u>(116)</u>
Contract liability	<u>(41)</u>
*Costs to date (150 + 225) × 40%	150
Foreseeable loss (75) × 60%**	45
	<u>195</u>

The other 40% is taken into account in costs to date. We make this adjustment to bring in the **whole of the foreseeable loss.

(b) 36% complete	\$'000
<i>Statement of profit or loss</i>	
Revenue (300 × 36%)	108
Cost of sales*	<u>(183)</u>
Foreseeable loss	<u>(75)</u>
<i>Statement of financial position</i>	
Costs to date	150
Foreseeable loss	(75)
Amounts invoiced	<u>(116)</u>
Contract liability	<u>(41)</u>
*Costs to date $(150 + 225) \times 36\%$	135
Foreseeable loss $(75) \times 64\%^{**}$	<u>48</u>
	<u>183</u>

Example 22:

Delta is an entity which prepares financial statements to 30 September each year. Each year the financial statements are authorised for issue on 30 November. During the year ended 30 September 2014, the following transactions occurred:

- (a) On 1 October 2013, Delta sold a machine to a customer for a total price of \$500,000. Delta invoiced the customer for \$500,000 on 1 October 2013 and the customer made a payment of \$500,000 to Delta on 15 October 2013. The terms of sale included an arrangement that Delta would service and maintain the machine for a four-year period from 1 October 2013. Delta would normally charge an annual fee of \$37,500 for a service and maintenance arrangement of this nature. The normal selling price of the machine without a service and maintenance arrangement was \$450,000. **(9 marks)**

Answer:

- (a) IFRS 15 *Revenue from Contracts with Customers* regards a transaction such as this as being made up of two separately identifiable performance obligations – the supply of the machine and the supply of the servicing agreement.

The total revenue of \$500,000 would need to be allocated between the two separate performance obligations in proportion to their stand-alone selling prices.

The selling price of the machine is \$450,000 and the normal selling price of the supply of services is \$150,000 ($4 \times \$37,500$). The total stand-alone selling prices therefore total \$600,000.

Revenue of **\$375,000** ($\$500,000 \times 450,000/600,000$) is allocated to the supply of the machine. The balance of revenue of **\$125,000** is allocated to the supply of services.

On 1 October 2013, Delta would recognise revenue from the supply of the machine of \$375,000.

On the same date Delta would recognise a receivable of \$500,000.

The balance of \$125,000 would initially be recognised as deferred income.

On 15 October 2013, the receivable of \$500,000 would be de-recognised when the payment was received from the customer.

In the year ended 30 September 2014, service revenue of \$31,250 ($\$125,000 \times \frac{1}{4}$) can be recognised.

The closing balance of deferred income on 30 September 2014 will be \$93,750 ($\$125,000 - \$31,250$).

\$31,250 of this balance will be shown as a current liability as this refers to service revenue to be recognised in the year ended 30 September 2015.

The balance of deferred income of \$62,500 ($\$125,000 - \$31,250 - \$31,250$) would be shown as a non-current liability.

Summary of reported amounts (for tutorial purposes)

- *Revenue from the supply of goods – \$375,000*
- *Revenue from the provision of services – \$31,250*
- *Cash balance – \$500,000*
- *Deferred income in non-current liabilities – \$62,500*
- *Deferred income in current liabilities – \$31,250*

Example 23:

- (a) IFRS 15 *Revenue from Contracts with Customers* was issued in 2014 and replaces the previous international financial reporting standard relating to revenue.

Required

- (i) Identify the five steps which need to be followed by entities when recognising revenue from contracts with a customer.
- (ii) Explain how IFRS 15 is expected to improve the financial reporting of revenue. **(5 marks)**
- (b) Kolya prepares financial statements to 30 September each year. During the year ended 30 September 20X5, Kolya entered into the following transactions:
- (i) On 1 September 20X5, Kolya sold a machine to a customer. Kolya also agreed to service the machine for a two-year period from 1 September 20X5 for no additional charge. The total amount payable by the customer for this arrangement was agreed to be:
- \$800,000, if the customer paid by 31 December 20X5
 - \$810,000, if the customer paid by 31 January 20X6
 - \$820,000, if the customer paid by 28 February 20X6

The directors of Kolya consider that it is highly probable the customer will pay for the products in January 20X6. The stand-alone selling price of the machine was \$700,000 and Kolya would normally expect to receive \$140,000 in consideration for providing two years' servicing of the machine. The alternative amounts receivable are to be treated as variable consideration. **(10 marks)**

- (ii) On 20 September 20X5, Kolya sold 100 identical items to a customer for \$2,000 each. The items cost Kolya \$1,600 each to manufacture. The terms of sale are that the customer has the right to return the goods for a full refund within three months. After the three-month period has expired the customer can no longer return the goods and payment becomes immediately due. Kolya has entered into transactions of this type with this customer previously and can reliably estimate that 4% of the products are likely to be returned within the three-month period. **(5 marks)**

Required

Explain and show how both these transactions would be reported in the financial statements of Kolya for the year ended 30 September 20X5.

Answer:

- (a)
- (i) The five steps to be followed are to:
- Identify the contract(s) with the customer
 - Identify the performance obligations the contract(s) create
 - Determine the transaction price
 - Allocate the transaction price to the separate performance obligations
 - Recognise the revenue associated with each performance obligation as the performance obligation is satisfied
- (ii) The IASB issued IFRS 15 because the existing criteria for revenue recognition outlined in IASs 11 and 18 were considered to be very subjective. Therefore it was difficult to verify the accuracy of the reported figures for revenue and associated costs.
- One of the fundamental qualitative characteristics of useful financial information which is referred to in the IASB *Conceptual Framework* is faithful representation. Information needs to be verifiable in order to ensure it meets this fundamental characteristic. IFRS 15 provides a more robust framework upon which to base the revenue recognition decision, thus increasing the verifiability of the revenue figure and hence its usefulness.

- (b) (i) Kolya has **two** performance obligations – to provide the machine and provide the servicing.

The total transaction price consists of a fixed element of \$800,000 and a variable element of \$10,000 or \$20,000.

The variable element should be included in the transaction price based on the probability of its occurrence. Therefore a variable element of \$10,000 should be included and the total transaction price will be \$810,000.

The transaction price should be allocated to the performance obligations based on their stand-alone fair values. In this case, these are \$700,000:\$140,000 or 5:1.

Therefore \$675,000 ($\$810,000 \times 5/6$) should be allocated to the obligation to supply the machine and \$135,000 ($\$810,000 \times 1/6$) to the obligation to provide two years' servicing of the machine.

The obligation to supply the machine is satisfied fully in the year ended 30 September 20X5 and so revenue of \$675,000 in respect of this supply should be recognised.

Only 1/24 of the obligation to provide the servicing is satisfied in the year ended 30 September 20X5 and so revenue of \$5,625 ($\$135,000 \times 1/24$) in respect of this supply should be recognised.

On 30 September 20X5, Kolya will recognise a receivable of \$810,000 based on the expected transaction price. This will be reported as a current asset.

On 30 September 20X5, Kolya will recognise deferred income of \$129,375 ($\$810,000 - \$675,000 - \$5,625$). \$67,500 ($\$129,375 \times 12/23$) of this amount will be shown as a current liability. The balance of \$61,875 ($\$129,375 - \$67,500$) will be non-current.

- (ii) When the customer has a right to return products, the transaction price contains a variable element.

Since this can be reliably measured, it is taken account of in measuring the revenue and the total revenue will be \$192,000 ($96 \times \$2,000$).

\$200,000 ($100 \times \$2,000$) will be recognised as a trade receivable.

\$8,000 ($\$200,000 - \$192,000$) will be recognised as a refund liability. This will be shown as a current liability.

The total cost of the goods sold is \$160,000 ($100 \times \$1,600$). Of this amount, only \$153,600 ($96 \times \$1,600$) will be shown as a cost of sale. The other \$6,400 ($\$160,000 - \$153,600$) will be shown as a right of return asset under current assets.

Example 24:

- (a) On 1 March 20X1, Mocca entered into a contract with Reven for the sale of plant for \$500,000. The contract included a call option that gave Mocca the right to repurchase the plant for \$550,000 on or before 27 February 20X2.

Required

Discuss how the above transaction would be treated in the following year's financial statements of Mocca, ie for the year ended 31 March 20X2. **(5 marks)**

- (b) IFRS 15 *Revenue from Contracts with Customers* deals with accounting requirements for contracts in respect of which performance obligations are satisfied over time.

Required

- (i) Describe the issues of revenue and profit recognition relating to contracts where performance obligations are satisfied over time. **(5 marks)**
- (ii) On 1 October 20X0 Mocca entered into a contract where performance obligations were deemed to be satisfied over time. The contract was expected to take 27 months and therefore be completed on 31 December 20X2. Details of the contract are:

	\$'000
Total contract revenue	12,500
Estimated total cost of contract (excluding plant)	5,500

Plant for use on the contract was purchased on 1 January 20X1 (three months into the contract as it was not required at the start) at a cost of \$8m. The plant has a four-year life and after two years, when the contract is complete, it will be transferred to another contract at its carrying amount. Annual depreciation is calculated using the straight-line method (assuming a nil residual value) and charged to the contract on a monthly basis at 1/12 of the annual charge.

The correctly reported profit or loss results for the contract for the year ended 31 March 20X1 were:

	\$'000
Revenue recognised	3,500
Contract expenses recognised	<u>(2,660)</u>
Profit recognised	<u>840</u>

Details of the progress of the contract at 31 March 20X2 are:

	\$'000
Contract costs incurred to date (excluding depreciation)	4,800
Agreed value of work completed and invoiced to date	8,125
Total cash received to date (payments on account)	7,725

The percentage of performance obligation satisfied is calculated as the agreed value of work completed as a percentage of the agreed contract price.

Required

Calculate the amounts which would appear in the statement of profit or loss and statement of financial position of Mocca, including the disclosure note of contract assets/liabilities, for the year ended/as at 31 March 20X2 in respect of the above contract.

(10 marks)

Answer:

- (a) Reven does not obtain control of the plant, because the repurchase option means that it is limited in its ability to use and obtain benefit from the plant.

As **control has not been transferred**, Mocca must account for the transaction as a **financing arrangement**, because the exercise price is above the original selling price. Mocca must continue to recognise the plant and recognise the cash received as a financial liability. The difference of \$50,000 is recognised as interest expense.

If, on 31 March 20X2, the option lapses unexercised, Reven will then obtain control of the plant. In this case, Mocca **must will derecognise the plant and recognise revenue of \$550,000** (the \$500,000 already received plus the \$50,000 charged to interest).

- (b) (i) Revenue recognition is an important issue in financial reporting and it is generally accepted that revenue is **earned when goods have been accepted by the customer or services have been delivered**. At that stage the **performance obligation has been satisfied** and revenue is said to have been realised. However, if this were applied to contracts where performance obligations are satisfied over time, the effect would not necessarily be to give a faithful representation.

As a contract where performance obligations are satisfied over time can span several accounting periods, if no revenue were recognised until the end of the contract, this would certainly be prudent but would **not be in accordance with the accruals concept**. The financial statements would show all of the profit in the final period, when in fact some of it had been earned in prior periods. This is remedied by **recognising attributable profit** as the performance obligations are satisfied, as long as ultimate profitability is expected. Any foreseeable loss is recognised immediately.

The **time value of money** could also be an issue in a contract where performance obligations are satisfied over time, for example if there is a long delay between when an entity satisfies a performance obligation and when the customer is due to pay the promised consideration.

(ii) <i>Profit or loss amounts</i>	\$'000
Revenue (8,125 – 3,500)	4,625
Cost of sales ((9,500 (W1) × 65%) – 2,660)	<u>(3,515)</u>
Profit (1,950 (W2) – 840)	<u>1,110</u>
 <i>Statement of financial position amounts</i>	
	\$'000
<i>Non-current assets</i>	
Plant (8,000 – 2,500 (W1))	5,500
<i>Current assets</i>	
Trade receivables (8,125 – 7,725)	400
Contract asset (see below)	1,125
<i>Contract asset</i>	
	\$'000
Costs to date (4,800 + 2,500)	7,300
Profit to date (W2)	1,950
Less amounts invoiced	<u>(8,125)</u>
Contract asset	<u>1,125</u>

Workings

1	<i>Total contract profit</i>	\$'000
	Total contract revenue	
	Costs to date	4,800
	Further costs to complete (5,500 – 4,800)	700
	Plant depreciation to date (8,000 × 15/48)	2,500
	Remaining depreciation (8,000 × 9/48)	<u>1,500</u>
	Total expected costs	
	Total expected profit on contract	
2	<i>Profit to date</i>	
	% work completed = 8,125/12,500 = 65%	
	Profit to date = 3,000 × 65% = 1,950	