IFRS 15: Revenue from Contract with Customers

Agenda

- **Overview**

- **Illustrations**

Definition of revenue

Revenue is the fair value of consideration received or receivable for the sale of goods or services.

- **In the course of the ordinary activities of the entity.**
- **Gross inflow of economic benefits**
- **Result in an increase in equity**
- **Excludes contributions from equity participants**

Revenue recognition criteria – IAS 18

- Depends on the source of revenue
  - Sale of goods
  - Provision of services
  - Royalties, Dividends and Interest

♦ **Common features**

- Inflow of future economic benefits is probable
- Revenue is measurable reliably
- Costs (incurred and expected) are identifiable and measurable reliably

Measurement – IAS 18

- **Overall principle**
  - Fair value of the consideration received or receivable
    - net of related taxes (VAT), discounts or rebates
    - at present value if payment deferred beyond normal credit terms

Types of Income and related Standards

Income

Revenue in course of ordinary activity

- Sales of goods
- Rendering services
- Use of assets, yielding:
    - interest
    - royalty
    - dividend

IAS 18 - Revenue
IFRIC 13 - Customer loyalty programmes
IFRIC 15 - Agreements for the Construction of real estate

Revenue from construction contracts

IAS 11 - Construction Contracts
IFRIC 15 - Agreements for the Construction of real estate

Other types of income (gains)

Framework, other standards and Interpretations

- IFRS 4
- IFRIC 4 / IAS 17
- IFRIC 12
- IFRIC 13
- IFRIC 15
- IAS 39
- IAS 41
- IAS 28
- IAS 16
- IAS 40

IFRS 15 – Objectives of the new standard

Remove inconsistencies and weaknesses in existing requirements

Provide a more robust framework for addressing revenue issues

IASB Converged Standard

Provide more useful information through improved disclosure requirements

Simplify preparation of financial statements by reducing the number of requirements by having one revenue framework

Standards Replaced

–Single standard (IFRS 15) replaces:

- IAS 11 *Construction Contracts*
- IAS 18 *Revenue*
- IFRIC 13 *Customer Loyalty Programmes*
- IFRIC 15 *Agreements for the Construction of Real Estate*
- IFRIC 18 *Transfers of Assets from Customers*
- SIC-31 *Revenue – Barter Transactions Involving Advertising Services*

Background to IFRS 15
Scope and effective date

What is in?	What is out?
• Applies to **contracts** with customers • Assess contracts with **collaborators** or **partners** • Transfer or sale of **non-financial assets** • Incremental **costs** of obtaining and costs incurred to fulfil a contract	• **Lease** contracts • **Insurance** contracts • **Financial instruments** and other contractual rights or obligations within the scope of other Standards • **Non-monetary exchanges** between entities in the same line of business to facilitate sales to customers or potential customers

Certain transactions may fall partially within the scope of IFRS 15 and partially within the scope of other standards

Effective date

- Annual reporting periods beginning on or after **January 1, 2018**, including interim reporting periods **therein** (FY **2018**)
- Early application **is** permitted under IFRS

Background (cont'd) The revenue model

Core principle – Recognize revenue to depict the **transfer of promised goods or services to customers** in an amount that reflects **the consideration the entity expects to be entitled** in exchange for those goods or services

Recognition Para. 9–21	Recognition Para. 22–30	Measurement Para. 46–72	Measurement Para. 73–90	Recognition Para. 31–45
Identify the contract with a customer (Step 1)	**Identify the performance obligations in the contract (Step 2)**	**Determine the transaction price (Step 3)**	**Allocate the transaction price to performance obligations (Step 4)**	**Recognize revenue when (or as) the entity satisfies a performance obligation (Step 5)**

This revenue recognition model is based on a **control approach** which differs from the risks and rewards approach applied under existing IFRS.

Step I – Identify the contract with the customer

A contract is defined as "… an agreement between two or more parties that creates enforceable rights and obligations."

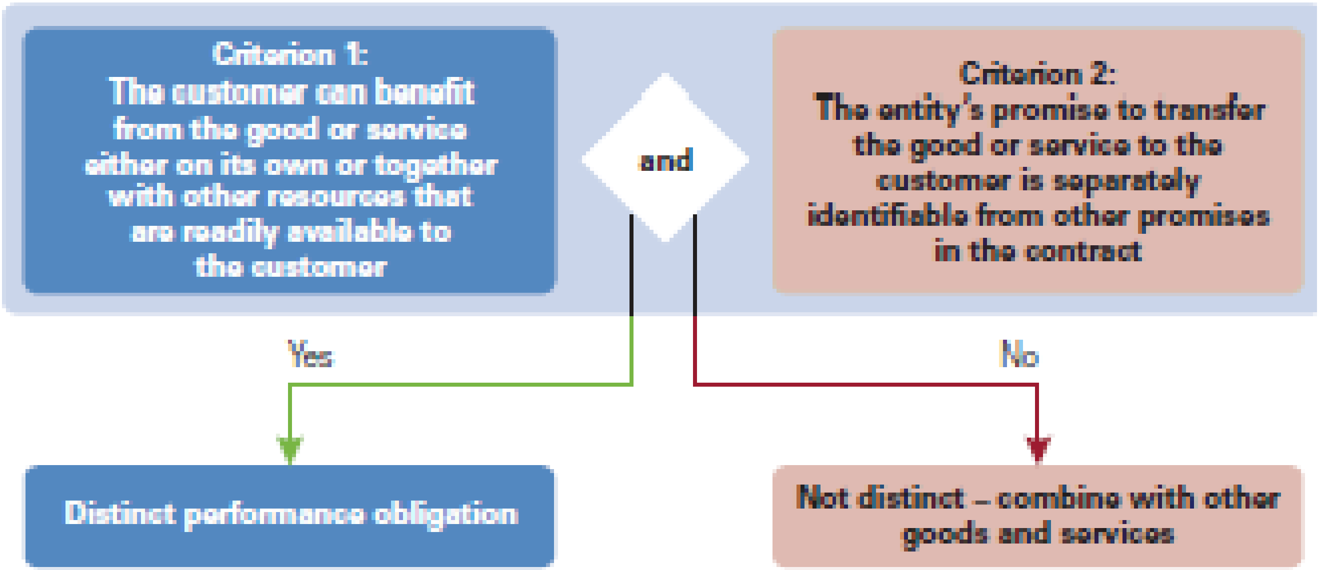
A contract with a customer is in the scope of the new standard when it is legally enforceable and it meets all of the following criteria:-

Step I – Identify the contract with the customer (continued)

- Contracts can be combined if:
  - they are negotiated "as a package with a single commercial objective."
  - The amount of consideration in one contract depends on the price or performance in the other contract.
- The goods or services identified in the contracts are a single performance obligation.

Step II – Identify the performance obligations in the contract

- A performance obligation is **a contractual promise with a customer to transfer a service or good to the customer.**



Step II – Identify the performance obligations in the contract (continued)

- Factors that indicate goods/services are not distinct include the following:
  - The goods or services are highly interrelated and the entity must provide a significant service to integrate the goods or services into the combined item(s) for the customer.
  - The goods or services are significantly modified or customized in order to fulfill the contract.

Determination of separate performance obligations

Example I

An entity licenses customer relationship management software to a customer. In addition, the entity promises to provide consulting services to significantly customize the software to the customer's information technology environment for total consideration of KES 6,000,000.

Are the software and consulting services one performance obligation or two?

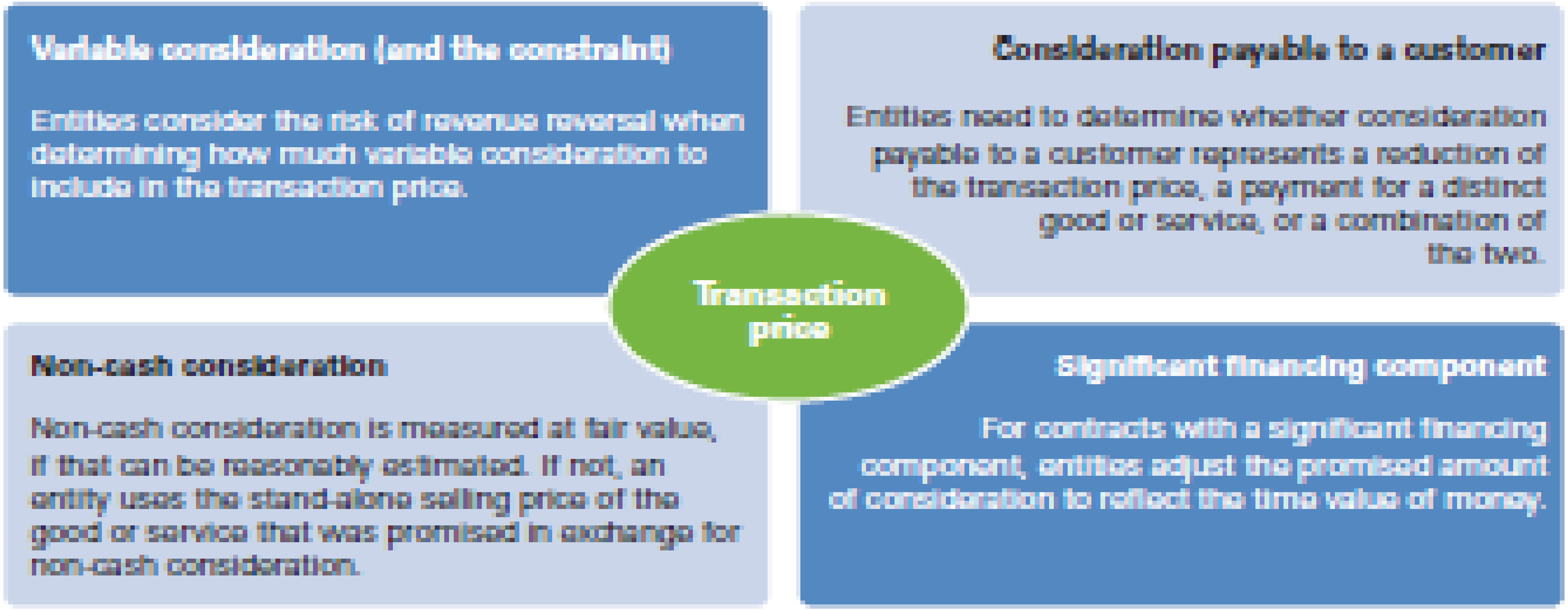
Determination of separate performance obligations

Example I - Solution

The entity is providing a significant service of integrating the goods and services (the license and the consulting services) into the combined item for which the customer has contracted. The software is significantly customized by the entity in accordance with the specifications negotiated with the customer. Thus, the goods and services are not distinct as the criterion that the customer can benefit from the customer management software on a stand-alone basis has not been met. Therefore, the entity would account for the license and consulting services together as one performance obligation.

Step III – Determine the transaction price

- The transaction price is the amount that the entity expects to be entitled to as a result of transferring goods or services to the customer.



Variable consideration

- Contract consideration could be variable due to the existence of discounts, incentives, refunds, rebates, contingencies, price concessions, etc.

- If the consideration specified in the contract is variable and it is **probable that a significant revenue reversal will not occur**, then the entity should include an estimate of the variable consideration to which the entity will be entitled in order to determine the transaction price.

Variable consideration

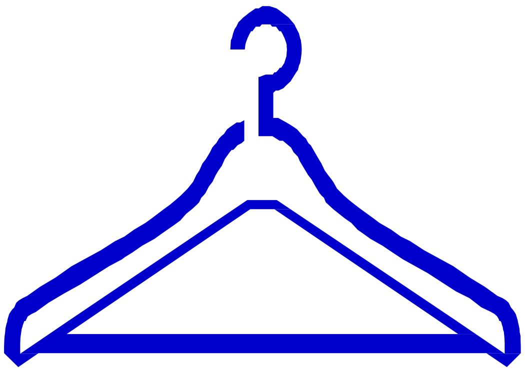
- The entity may use one of two estimation methods as described. The chosen method should be applied consistently throughout the contract.
  - **The expected value method:** the estimate is measured as "the sum of the probability-weighted amounts in a range of possible consideration amounts."
  - **The most likely amount method:** the estimate is measured as "the single most likely amount in a range of possible consideration amounts."

Variable consideration

Example 2

Mwaniki Stores sells 1,000 umbrellas to a wholesaler for total consideration of 200 per umbrella. The contract provides the customer with the right to return all unsold umbrellas after El-Nino. Due to its extensive experience in this industry, Mwaniki can reliably provide the following range of probability of returns based on this sales volume.

Umbrellas returned	Probability
50	40%
75	45%
100	15%



- What is the estimated transaction price for the contract if Mwaniki Stores uses the expected value method?
- The most likely amount method?

Variable consideration

Example II - Solution

Expected value method: the estimated contract price is measured using the sum of the probability-weighted amounts in the range of possible consideration amounts. Therefore, the calculation is as follows:

Estimated contract price = (950 x 40% x 200) + (925 x 45% x 200) + (900 x 15% x 200)

= 76,000 + 83,250 + 27,000

= 186,250

Most likely amount method: based on the highest probability of 45% for 75 umbrellas being returned, this would be considered the most likely amount. Therefore, Mwaniki's will calculate using 925 umbrellas multiplied by 200 per umbrella for a total estimated contract price of 185,000.

Time value of money

- If the time between (1) when the entity provides the goods or services and (2) the customer makes the payment for these goods or services is more than one year, the entity may need to adjust the amount of the consideration to reflect the time value of money.

- if the contract has a financing component that is significant to the contract, then the entity should only recognize revenue at an amount that reflects what the cash selling price would be at the point that the goods or services were transferred. The impact on net income of this financing component should be presented separately on the statement of comprehensive income as interest income or expense.

Time value of Money

The following factors should be considered by the entity when determining whether the financing component is significant:

- The expected length of time between payment and transfer of the goods or services
- Whether the amount of consideration would differ substantially if the customer paid cash promptly in accordance with typical credit terms in the industry
- The differences between the interest rate in the contract and the prevailing interest rates in the market

Time value of Money

Example III

Kibet Limited enters into a contract with a customer to sell a product for 2,000,000. The product will be delivered in two years, but the customer pays for it today. The credit rates in the industry are 21% annually.

- Would you assess that the financing component of the contract is significant? Explain.
- What are the journal entries that Kibet Limited will record over the two-year period?

Example III - Solution

Is the financing component significant to the contract?

In evaluating whether the financing component is significant, one could argue that a two-year period of time between the payment and the transfer of the goods is significant. One could also argue that the amount of consideration would differ significantly based on typical credit terms in the industry of 21%. Therefore, given the significance of the financing component, this should be recognized in the revenue amount.

Time value of Money

Example III

Journal entries

At the date that Kibet Limited receives the cash, they should make the following entry:

Cash	2,000,000	
Deferred revenue		2,000,000

During the two-year period, Kibet Limited will recognize interest expense of 928,200 [(2,000,000 x (1.21)^2-2,000,000]

Interest expense	928,200	
Deferred revenue		928,200

When the product is transferred in two years, Kibet Limited will recognize revenue based on the balance of the deferred revenue account.

Deferred revenue	2,928,200	
Revenue		2,928,200

Non Cash consideration

- If the consideration that the entity receives is noncash, **the transaction price is measured as the fair value of the noncash consideration.**

- Where the fair value of the noncash consideration cannot be reliably measured, then the transaction price is measured as the standalone selling price of the goods or services promised to the customer in the contract.

Non Cash consideration

Example IV

ABC Computing provides computer installation services to a customer. The standalone value of these services is 430,000. In exchange, the customer gave ABC Computing several used computers. These used computers have a fair value of 450,000.

- What is the journal entry that ABC Computing will make to record the sale?
- What would the journal entry be if the fair value of the used computers was not available?

Non Cash consideration

Example IV Solution

What is the journal entry that ABC Computing will make to record the sale?

ABC Computing will record the transaction price as the fair value of the noncash consideration received.

Computer inventory	450,000	
Service revenue		450,000

What would the journal entry be if the fair value of the used computers was not available?

If the fair value of the computers is not available, ABC Computing will record the transaction at the standalone selling price of the services.

Computer inventory	430,000	
Service revenue		430,000

Consideration Payable

- If an entity expects to pay a customer an amount in the form of cash, "… credit or other items (for example, a voucher) that can be applied against amounts owed to the entity …," this is referred to as a consideration payable.

- Consideration payable to a customer should be treated as a reduction of the transaction price unless the payment is in exchange for a distinct service or good.

Consideration Payable

Example V

- What is the amount of revenue that XYZ Limited will record in the first quarter? The second quarter?

XYZ Limited sells 500 machine-embroidered tote bags to a customer for 250/- per bag in the first quarter of the year. XYZ Limited has a contract with the customer that if they purchase more than 3,000 tote bags during the year, they will receive a retroactive, 50/- per-bag discount. In the first quarter, XYZ Limited does not anticipate that the customer will earn the volume discount. However, during the second quarter, the customer purchases 3,000 bags

Consideration Payable

Example V - Solution

What is the amount of revenue that XYZ Limited will record in the first quarter?

XYZ Limited records the transaction price of 250 per bag in the first quarter because it does not anticipate that the customer will earn the discount. Consequently, XYZ Limited will record total revenue of 125,000 in the first quarter (500 bags x 250 per bag).

What is the amount of revenue that XYZ Limited will record in the second quarter?

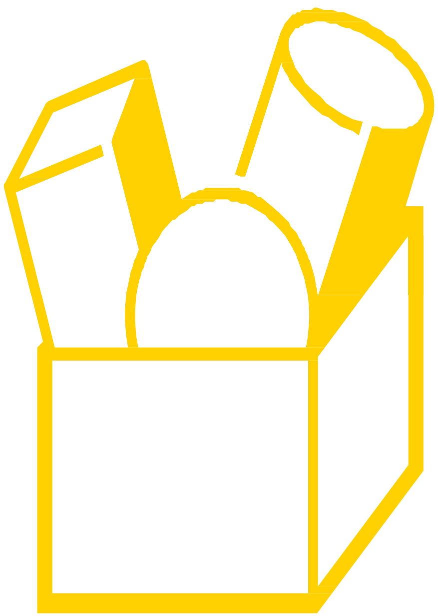
Amount	Calculation
600,000	3,000 bags sold in second quarter x 200 (250 per bag less 50-per-bag volume discount)
(25,000)	500 bags sold in first quarter x 50-per-bag volume discount
575,000	Revenue to recognize

Step IV - Allocate the transaction price to the separate performance obligations in the contract

- If the contract has multiple performance obligations, then the transaction price should be allocated across the performance obligations.
- The entity first determines the standalone selling price of each good or service underlying each performance obligation at the inception of the contract.
  - The standalone selling price is the amount that the seller would charge if it were to sell the good or service separately.
    - The best way to determine the standalone selling price is to use the price the seller would actually charge when it sells the same good or service to similar customers under similar circumstance.

Step IV - Allocate the transaction price to the separate performance obligations in the contract

Example VI



LED Company enters into a contract with a customer to sell three products for a total transaction price of 50,000. Each product is appropriately classified as a separate performance obligation. LED Company typically sells these three products on a standalone basis for the following prices:

Product	Standalone selling price
A	10,000
B	22,000
C	20,000
Total	52,000

Example VI - Solution

LED Company should allocate the 50,000 transaction price based on the products' relative, standalone selling prices as follows:

Product	Standalone selling price	Percentage	Allocated transaction price
A	10,000	19.2%	9,600
B	22,000	42.3%	21,150
C	20,000	38.5%	19,250
Total	52,000	100.0%	50,000

Step IV - Allocate the transaction price to the separate performance obligations in the contract

- Where the seller cannot directly observe a standalone selling price, the seller must **estimate a standalone selling price**.
- The following methods are suitable:
  - Adjusted market assessment approach: the entity estimates the price that customers in the market in which it sells the goods or services would be willing to pay. This approach might include referring to prices charged by competitors.
  - Expected cost plus a margin approach: the entity forecasts the costs associated with providing the good or service and adds an appropriate margin.
  - Residual approach: the entity estimates the standalone selling price by subtracting the standalone selling prices of the goods or services that underlie the other performance obligations from the total transaction price.

Step IV - Allocate the transaction price to the separate performance obligations in the contract

- If the sum of the standalone selling prices is greater than the transaction price, then the entity typically should allocate the discount to the separate performance obligations on a relative, standalone-selling-price basis. There are exceptions to this rule, which are not covered in this lecture.

- If the transaction price includes an amount that is contingent on a future event or circumstance, it generally should be allocated to the separate performance obligations.

Step IV – Estimation of standalone selling price

Example VII

- H. Industries enters into a contract with a customer to sell three products for a total transaction price of 430,000. Each product is appropriately classified as a separate performance obligation. H. Industries only sells products A and B on an individual basis so it must estimate the standalone selling prices.

- Information related to these three products is provided in the following table.

Product	Standalone selling price	Market competitor prices	Forecasted cost
A	100,000	99,000	79,000
B	250,000	255,000	200,000
C	Not available	85,000	65,000
Total		439,000	344,000

- How should H. Industries allocate the transaction price to the three products using the adjusted market assessment approach? The cost plus margin approach? The residual approach?

Example VII - Solution

Adjusted market assessment approach:

H. Industries should allocate on a relative basis as follows:

Product	Forecasted cost	Allocated transaction price
A	79,000	98,750
B	200,000	250,000
C	65,000	81,250
Total	344,000	430,000

Step IV – Estimation of standalone selling price

Example VII - Solution

Expected cost plus margin approach

Given a total cost of 344,000 and a total transaction price of 430,000, an appropriate margin would be 25% (430,000/344,000). Thus, to get the allocated transaction price for each product, we multiply the forecasted cost of each product by 1.25

Product	Forecasted cost	Allocated transaction price
A	79,000	98,750
B	200,000	250,000
C	65,000	81,250
Total	344,000	430,000

Example VII - Solution

Residual approach

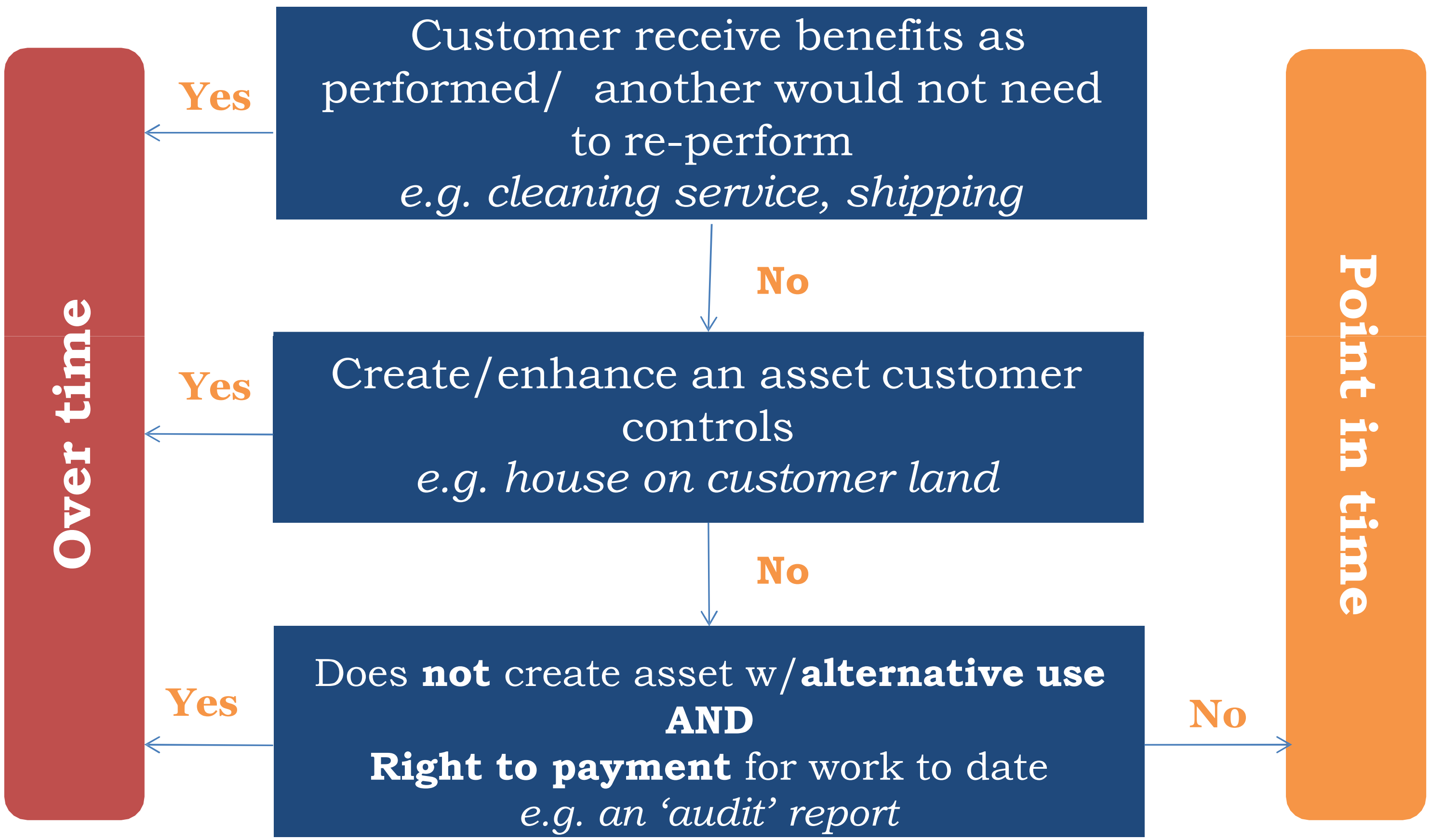
Using the residual approach, the standalone selling prices that are available for products A and B are reduced from the total transaction price to arrive at the standalone selling price for product C, which is 80,000.

Product	Standalone selling price
Total	430,000
A	(100,000)
B	(250,000)
C	80,000

Step V - Recognise revenue when (or as) a performance obligation is satisfied

- The entity should recognize as revenue the
  - amount of the transaction price allocated to a performance obligation when it satisfies that performance obligation by transferring a good or service to a customer.
  - Transfer occurs when the customer obtains control of the asset.
    - IFRS 15 defines control as "the ability to direct the use of and obtain substantially all of the remaining benefits from the asset."

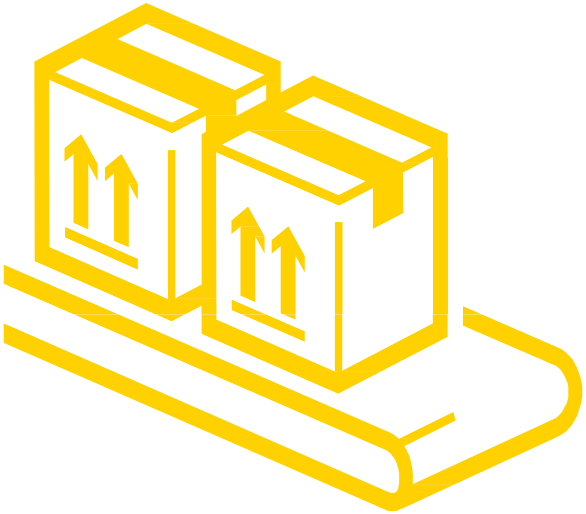
Step V – Recognise revenue (point in time or over time).



Step V - Recognise revenue when (or as) a performance obligation is satisfied (continued)

- At a point in time, if satisfied at a point in time, then revenue is recognized when control is transferred. Some indications of change in control are as follows:
  - The seller has a present right to payment.
  - The customer has a legal title to the asset.
  - The seller has transferred physical possession of the asset to the customer.
  - The customer has significant risks and rewards of ownership of the asset.
  - The customer has accepted the asset.

Example 8



K. Associates enters into a contract to sell a product to a customer. The product is shipped free on board shipping point.

- Should K. Associates recognize revenue when the product is shipped or received by their customer?

Example VIII - Solution

K. Associates can recognize revenue when the product is shipped because the customer obtains control of the product when it is shipped. Although the customer doesn't have physical possession of the product when it is shipped, it has legal title and the risks and rewards of ownership.

Recognition over a period of time Example

Over time:

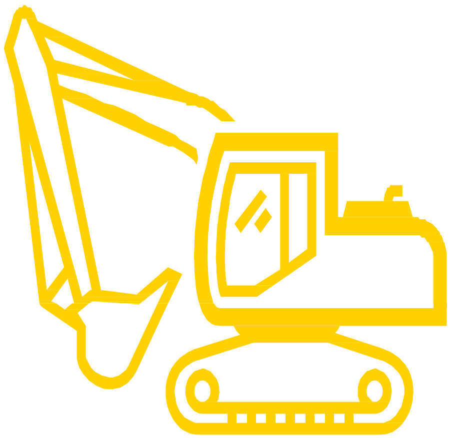
- An entity "satisfies a performance obligation and recognizes revenue over time if one of the following criteria is met":
  - The customer is receiving and consuming the benefits of the seller's performance as the seller performs.
  - The seller creates or enhances an asset that the customer controls as it is created or enhanced.
  - The asset created by the seller does not have an alternative use and the seller has a right to payment for performance completed to date.

Recognition over a period of time Example

- If a performance obligation is satisfied over time, then revenue should be recognized in accordance with the progress toward completion of the performance obligation, if the entity can reasonably measure its progress toward completing the obligation. In measuring progress, either input ***or*** output methods may be used. The *method* an entity chooses *should be used for all similar performance obligations and in similar circumstances*.
  - Input method: revenue is recognized based on the seller's efforts or inputs toward completion of the performance obligation.
  - Output method: revenue is recognized based on the value (to the customer) of the goods or services that have been transferred.

Recognition over a period of time Example

The PJG has extensive experience in the road construction business. PJG has an excellent track record in estimating costs of projects and is a very efficient construction company. PJG has entered into a two-year contract to build a 25-Km toll road for 500 million. The toll road is adjacent to an old gravel road. The toll road operator plans on opening the toll road in five-mile sections as the paving is completed. PJG estimates this project will require 300 million of road construction material and 40,000 construction hours at an average cost of 2,500 per hour.



At the end of year one, 10 kms of toll road have been turned over and are in use by the toll road operator. Some work has also been done on the next section of the road. Road material costs of 150 million and 20,000 construction hours have been incurred.

- What revenue should PJG record for this performance obligation at the end of year one using the input method? The output method?

Recognition over a period of time Example

Input method:

The input method should be based on the seller's efforts to satisfy its performance obligation. PJG has incurred 50% of the road material costs (150 million/300 million) and 50% of the construction hours (20,000 hours/40,000 hours). Therefore, 25 million should be recognized as revenue at the end of year one, calculated as 50% of the 50 million.

Output method:

The output method should be based on the value of the goods transferred to the customer. PJG has completed 10 kms of road and turned them over to the toll road operator. The remaining 15 kms are not currently available to the toll road operator. Therefore, 200 million should be recognized as revenue at the end of year one, calculated as 40% (10 kms/25kms) of the 500 million.

Disclosures

Both qualitative and quantitative information including;

- Contract balances and a description of significant changes
- Amount of revenue related to remaining performance obligations and an explanation of when revenue is expected to be recognised
- Significant judgments and changes in judgments

Revenue impacts the entire organisation

Accounting & Reporting

- Changes to revenue model
  - Number of things to track
  - Allocation of revenue
  - Timing of recognition
- Changes beyond revenue
  - collectibility; time value of money; sales commissions
- Judgment & estimates
- Additional disclosures
- Transition considerations

Process & Systems

- Impacts across quote-to-cash cycle
- Involvement of IT is paramount
- Likely to accelerate trend of revenue automation (replacing Excel and manual processes)
- Potentially IT 3-5 year roadmaps
- Significant Cost trigger

Cross-functional Impacts

- Executive management
- Audit Committee
- Investor Relations
- Financial Planning & Analysis
- Sales
- Legal
- HR
- Tax
- Accounting and IT Functions

Business Changes

- Changing business models
  - Organic changes
  - M&A activity
- Opportunity to structure and go-to-market differently
- Pricing strategy
- Impact on compensation
- Executive communication and awarenes

Impact of IFRS 15 - Research

Automotive — high
- Subsidized services/warranties
- Tooling and products

Software — high
- Licenses
- Multiple element arrangements
- Variable consideration

Healthcare & Pharma — med
- Subsidized services/products
- Licenses
- Milestone payments
- Multiple element arrangements

Media — med
- Licenses
- Variable consideration
- Multiple element arrangements
- Subsidized hardware

Energy — low
- Variable consideration

Real Estate — med
- Repurchase agreements
- Variable consideration
- Time value of money
- Contract costs

Construction/ Engineering — med
- Milestone payments
- Variable consideration
- Warranties,
- Time value of money

Retail — low
- Material rights (Gift cards)
- Right of return

Transportation & Logistics — low
- Combination of contracts
- Milestone payments

Telecommunication — high
- Multiple element arrangements
- Collectability
- Contract cost

Disclosures are affected

Staff training and education needed

Review of all contracts is required

Assessment of collectability, time value of money, ...

Interactive Session

Thank you