THE FINANCIAL REPORTING WORKSHOP- A FOCUS ON SMEs

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IFRS 15 - Revenue from Contract with Customers

Background

IFRS 15 *Revenue from Contracts with Customers* was issued on 28 May 2014.

It replaces the previous revenue Standards:

- IAS 18 Revenue;
- IAS 11 Construction contracts; and
- The related Interpretations on revenue recognition*:*
  - *IFRIC 13 Customer Loyalty Programmes;*
  - *IFRIC 15 Agreements for the Construction of Real Estate;*
  - *IFRIC 18 Transfers of Assets from Customers; and*
  - *SIC-31 Revenue – Barter Transactions Involving Advertising Services.*

Effective from **1 January 2018**; and earlier application is permitted.

IFRS 15 – Project Objective

One Model

A single, joint revenue standard to be applied across all industries and capital markets

- ***Clear principles***
- ***Robust framework***
- ***Comparability across industries***
- ***Enhanced disclosures***
- ***Simplified guidance***

Definitions

Revenue is income from ‘ordinary activities’.

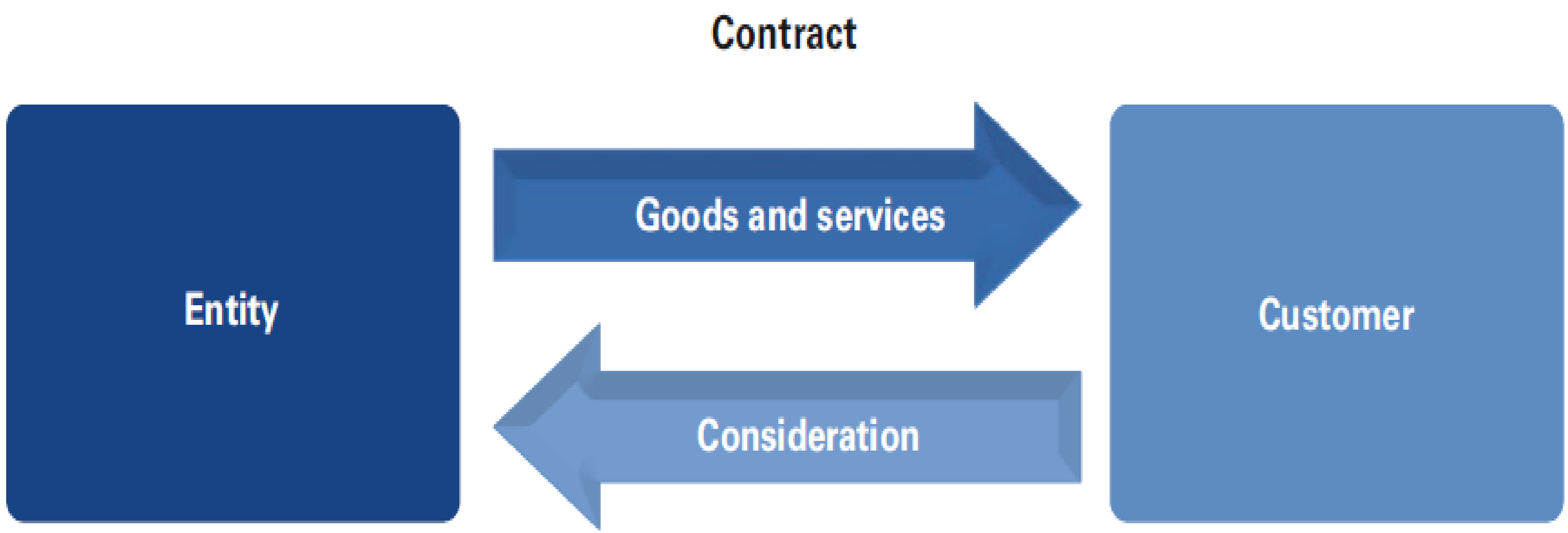
A **contract** is an agreement that *creates enforceable rights and obligations* between two or more parties.

A **customer** is a party contracted

- *to obtain goods or services that are*
- *output of entity's ordinary activities*
- *in exchange for consideration*

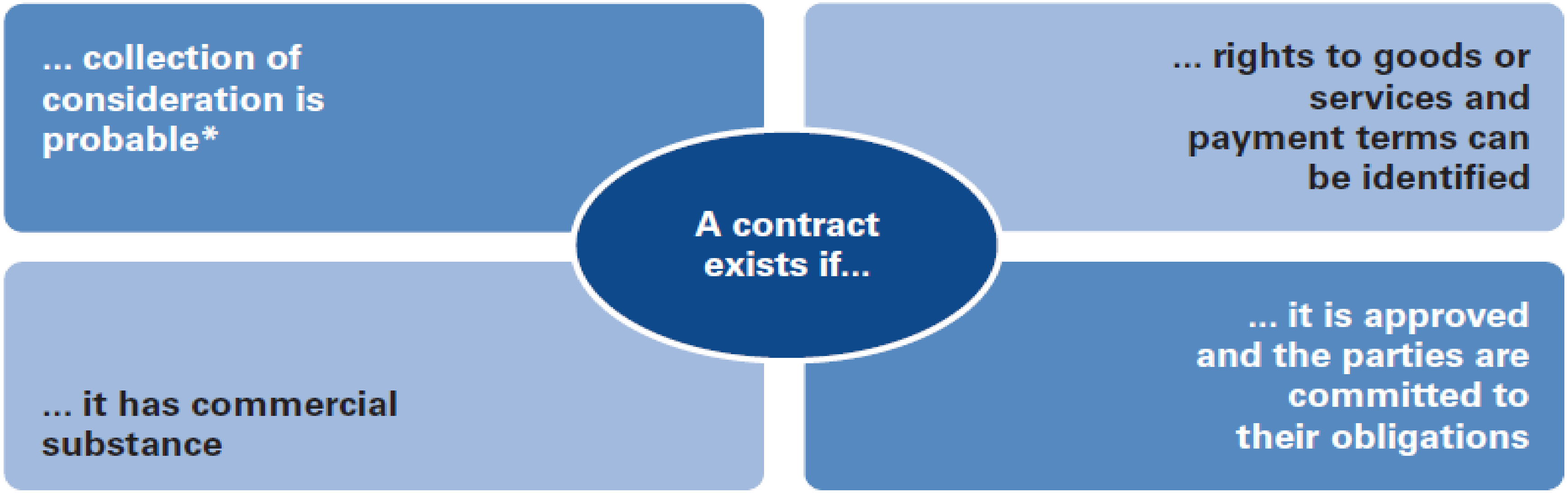
Customer

A customer is 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.



Contract

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:-



Scope Exclusion

- Lease contracts - IAS 17 *Leases*
- Insurance contracts - IFRS 4 *Insurance Contracts*
- Financial Instruments and other contractual rights or obligations within the scope of IFRS 9 *Financial Instruments*
- IFRS 10 *Consolidated Financial Statements*
- IFRS 11 *Joint Arrangements*
- IAS 27 *Separate Financial Statements, and*
- IAS 28 *Investments in Associates and Joint Ventures; a*nd
- Non-monetary exchanges between entities in same line of business

Contracts with elements in multiple standards

Evaluate under other standards first

Convergence

•Joint project between IASB and FASB:

•Establishes a single, comprehensive framework for revenue recognition.

•to be applied consistently across transactions, industries and capital markets, and will improve comparability in the ‘top line’

•The IASB and the FASB have formed **Transition Resource Group** a group of external stakeholders to identify and discuss issues that may arise

What changes

IAS 18 /11	*IFRS 15*
Separate models for: • Construction contracts • Goods • Services	**Single model for performance obligations:** • Satisfied over time • Satisfied at a point in time
Focus on risk and rewards	**Focus on control**
Limited guidance on: • Multiple element arrangements • Variable consideration • Licences	**More guidance:** Separating elements, allocating the transaction price, variable consideration, licences, options, repurchase arrangements **and so on….**

What changes

For straightforward contract such as retail transactions, IFRS 15 will have little, if any, effect on the amount and timing of revenue recognition.

For other contracts, such as long-term service contracts and multiple-element arrangements, IFRS 15 could result in some changes either to the amount or timing of the revenue recognised by a company.

Why the change?

- Significant diversity in revenue recognition practices
- Limited guidance on many important topics, such as accounting for arrangements with multiple elements.
- Difficult for investors and analysts (‘investors’) to understand and compare a company’s revenue.
- Difficult to apply to complex transactions due to lack of basis for conclusions.
- numerous industry and transaction specific requirements, which often resulted in economically similar transactions being accounted for differently.
- new types of transactions emerges.
- Inadequate disclosure or information disclosed was often ‘boilerplate’ in nature or was presented in isolation and without explaining how the revenue recognised related to other information in the financial statements.

IFRS 15 addresses those deficiencies by specifying a comprehensive and robust framework for the recognition, measurement and disclosure of revenue.

The revenue model

The principle behind revenue recognition under this standard is that:

"a company should recognise revenue when there is a **transfer of promised goods or services** to the customer in an **amount that reflects the consideration** to which the company **expects to be entitled in exchange** for those goods or services"

Five step approach

Core principle

Revenue recognised to **depict transfer of goods or services**

Step 1 - Identify the contract with the customer

Step 2 - Identify the performance obligations in the contract

Step 3 - Determine the transaction price

Step 4 - Allocate the transaction price

Step 5 - Recognise revenue when (or as) a performance obligation is satisfied

Step I (Contract)

Agreement between two or more parties that creates **enforceable rights and obligations**

No contract unless customer committed, criteria include:

it is probable that the entity will collect the consideration to which it will be entitled

Combine two or more contracts with the same customer when:

negotiated as a package with a single commercial objective;

amount of consideration to be paid in one contract depends on the price or performance of the other contract; or Goods or services promised in the contracts are a single performance obligation (see step 2)

Step II (Performance obligation)

•Performance obligations are **promises to transfer goods or services to a customer that are**:

explicit,

implicit, or

•arise from customary business practices

•Identifying performance obligations is critical to measurement and timing of recognition

Determination of separate performance obligations

Example 1

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 $600,000.

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

Determination of separate performance obligations

Example 1 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 (Transaction price)

- **Probability weighted or best estimate method**
- **More specific guidance covering:**
  - time value of money
  - constraint on variable consideration
  - non-cash consideration
- **Consideration payable to customers: reduction to transaction price unless for a distinct good or service.**

Variable consideration

Example 2

Catherine's Costumes sells 1,000 Halloween costumes to a wholesaler for total consideration of $20 per costume. The contract provides the customer with the right to return all unsold costumes after Halloween. Due to its extensive experience in this industry, Catherine's Costumes can reliably provide the following range of probability of returns based on this sales volume.

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

- What is the estimated transaction price for the contract if Catherine's Costumes uses the expected value method?
- The most likely amount method?

Variable consideration

Example 2 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 \$20) + (925 x 45% x \$20) + (900 x 15% x \$20)

= \$7,600 + \$8,325 + \$2,700

= \$18,625

Most likely amount method: based on the highest probability of 45% for 75 costumes being returned, this would be considered the most likely amount. Therefore, Catherine's Costumes will calculate using 925 costumes multiplied by \$20 per costume for a total estimated contract price of \$18,500.

The time value of money

Example 3

Madison Wholesalers enters into a contract with a customer to sell a product for $200,000. The product will be delivered in two years, but the customer pays for it today. Typical credit rates in the industry are 5% annually.

- Would you assess that the financing component of the contract is significant?
- What are the journal entries that Madison Wholesalers will record over the two-year period?

The time value of money

Example 3 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 5%.

Therefore, given the significance of the financing component, this should be recognized in the revenue amount.

The time value of money

Example 3 solution (continued)

What are the journal entries that Madison Wholesalers will record over the two-year period?

At the date that Madison Wholesalers receives the cash, Madison Wholesalers should make the following entry:

Cash	**\$200,000**	
Deferred revenue		**\$200,000**

During the two-year period, Madison Wholesalers will recognize interest income of \$20,500 (200,000 x (1.05^2-1)).

Interest expense	**\$20,500**	
Deferred revenue		**\$20,500**

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

Deferred revenue	**\$220,500**	
Revenue		**\$220,500**

Non-cash consideration

Example 4

ABC Computing provides computer installation services to a customer. The standalone value of these services is $4,300. In exchange, the customer gave ABC Computing several used computers. These used computers have a fair value of $4,500.

- 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?

Noncash consideration

Example 4 solution

See guidance in ASC 606-10-32-21 and 22.

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	$4,500	
Service revenue		$4,500

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	$4,300	
Service revenue		$4,300

Consideration payable

Example 5

MMR Wholesalers sells 500 machine-embroidered tote bags to a customer for $25 per bag in the first quarter of the year. MMR Wholesalers has a contract with the customer that if they purchase more than 3,000 tote bags during the year, they will receive a retroactive, $5-per-bag discount. In the first quarter, MMR Wholesalers does not anticipate that the customer will earn the volume discount. However, during the second quarter, the customer purchases 3,000 bags

- **What is the amount of revenue that MMR Wholesalers will record in the first quarter? & the second quarter?**

Consideration payable

Example 5 solution

What is the amount of revenue that MMR Wholesalers will record in the first quarter?

MMR Wholesalers records the transaction price of $25 per bag in the first quarter because it does not anticipate that the customer will earn the discount. Consequently, MMR Wholesalers will record total revenue of $12,500 in the first quarter (500 bags x $25 per bag).

What is the amount of revenue that MMR Wholesalers will record in the second quarter?

As the customer has earned the volume discount, MMR Wholesalers

Amount	Calculation
$60,000	3,000 bags sold in second quarter x $20 ($25 per bag less $5-per-bag volume discount)
(2,500)	500 bags sold in first quarter x $5-per-bag volume discount
$57,500	Revenue to recognize

Step IV (Allocate the transaction price)

Allocate transaction price to separate performance obligations based on relative standalone selling price:

•Actual or estimated

•Residual 'approach' if selling price is highly variable or uncertain (change from current practice)

Initial allocation and changes to variable consideration might be allocated to a single performance obligation if:

•Contingent payment relates only to satisfaction of that performance obligation, and

•Allocation is consistent with the amount the entity expects to be entitled to for that performance obligation.

Allocation of the transaction price

Example 6

LEDD 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. LEDD 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

- **How should LEDD Company allocate the transaction price to the three products?**

Allocation of the transaction price

Example 6 solution

LEDD 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 V (Recognise revenue)

•Guidance applies to each separate performance obligation.

•First, evaluate if performance obligation satisfied ‘over time’.

•recognise revenue based on the pattern of transfer to the customer.

•If not point in time recognise revenue when control transfers.

Recognition at a point in time

Example 8

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

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

Recognition at a point in time

Example 8 solution

Kentucky 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 9

PJG has entered into a two-year contract to build a 25-mile toll road for $50 million. 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 $30 million of road construction material and 400,000 construction hours at an average cost of $25 per hour.**

At the end of year one, 10 miles 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 $15 million and 200,000 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 9 solution

Input method:

Revenue using 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 ($15 million/$30 million) and 50% of the construction hours (200,000 hours/400,000 hours). Therefore, $25 million should be recognized as revenue at the end of year one, calculated as 50% of the $50 million.**

Output method:

Revenue using the output method should be based on the value of the goods transferred to the customer. PJG has completed 10 miles of road and turned them over to the toll road operator. The remaining 15 miles are not currently available to the toll road operator. Therefore, **$20 million should be recognized as revenue at the end of year one, calculated as 40% (10 miles/25 miles) of the $50 million.**

Indicators of control transfer

If not over time, then point in time….

Recognise revenue when control transfers

Indicators that customer has obtained control of a good or service:

- **Right to payment for asset**
- **Customer has accepted the asset**
- **Legal title to asset**
- **Physical possession of asset**
- **Customer has significant risk and rewards**

Disclosures

•Both qualitative and quantitative information including:

✓Disaggregated information

✓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

Implementation Guidance

- ✓Customer options
- ✓Warranties
- ✓Breakage
- ✓Non-cash consideration
- ✓Consideration payable to the customer
- ✓Returns
- ✓Repurchase options
- ✓Principal or agent

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

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