INTRODUCTION TO IFRS 15 - REVENUE

Revenue from Contracts with Customers

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What to expect

- Understand the objectives of IFRS 15 – Revenue from Contracts with Customers.
- Know the basic terminologies of IFRS 15, including contracts, customer, income, performance obligations, and revenue.
- Appreciate the five steps to recognising revenue from contracts with customers.

Objectives of IFRS 15

- The main objective of IFRS 15 is to establish principles to be applied in reporting useful information to users of financial statements about
  - the nature,
  - amount,
  - timing, and
  - uncertainty of revenue and cash flows

arising from a contract with a customer, thereby promoting consistency and comparability across industries and capital markets.

The Background

- IFRS 15 Revenue from Contracts with Customers was issued on 28 May 2014.
- It replaces:
  - IAS 18 - Revenue
  - IAS 11 - Construction contracts.
  - IFRIC 13 - Customer Loyalty Programmes,
  - IFRIC 15 - Agreements for the Construction of Real Estates,
  - IFRIC 18 - Transfers of Assets from Customers, and
  - SIC 31 - Revenue - Barter Transactions Involving Advertising Services)
- The effective date for IFRS 15 was January 1, 2018

The Essence

- Revenue recognition
- Arising from the transfer of promised goods or services to customers by a vendor at a consideration which the vendor is entitled to in exchange for those goods or services.
- The core principle is that a vendor should recognise revenue to demonstrate the transfer of promised goods or services to customers.
- **Revenue will now be recognised by a vendor when or as control over the goods or services is transferred to the customer.**

Basic terminologies

- **Contract:** An agreement between two or more parties that creates enforceable rights and obligations. A contract exists if the agreement creates rights and obligations that are enforceable against the parties.
- **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.
- **Income:** Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that increase equity, other than those relating to contributions from equity participants.

Basic terminologies

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

IFRS 15 Revenue Model - Steps

Step 1	Step 2	Step 3	Step 4	Step 5
☐ Identify the contract(s) with the customer	☐ Identify the performance obligations in the contract	☐ Determine the transaction price	☐ Allocate the transaction price	☐ Recognise revenue when a performance obligation is satisfied

Step 1 - Identify the Contract with a Customer

- The first step is to identify the contract(s) with the customer.
- A contract in the context of IFRS 15 is an agreement between parties that creates enforceable rights and obligations.
- Contract can have a written and non-written form or be implied (contract may not be limited to goods or services explicitly mentioned in a contract, but also include those expected to be delivered due to business practices or statements made).

Step 1 - Criteria for a contract

A contract with a customer will fall within the scope of IFRS 15 when all the following criteria are met:

- The contract must be approved by the parties who are committed to performing their contractual obligations.
- The rights of each party to the contract can be identified.

Step 1 - Criteria for a contract - Contd

- The payment terms of the contract have been identified.
- The contract has commercial substance, and
- The probability of collecting a substantial part of the consideration is high.

Important notice

- If the arrangement does not meet the five criteria for recognising a contract, an accounting contract does not exist, even though a legal contract may exist.

Practical Illustration on Contract Criteria - 1

- Coy ABC has a customer, Coy XYZ, which is undergoing restructuring due to issues relating to liquidity. Coy ABC has decided not to do any further business with Coy XYZ. In response, Coy XYZ informed Coy ABC that it would get a letter of credit from a nationalised bank against which Coy ABC can dispatch goods worth $15,000. Coy ABC has already manufactured the goods exclusively for Coy XYZ, but the letter of credit has not yet been finalised.
- When should Coy ABC recognise the revenue?

Practical Illustration on Contract Criteria - Analysis

- IFRS 15 requires that for a contractual relationship to be recognised, it should be probable that the entity will collect the money it is entitled to in exchange for the goods or services that will be transferred to the customer.
- If a contract with a customer does not meet the initial criteria in IFRS 15 for identifying contracts with customers that are within the scope of the Standard, an entity must continue to assess the contract to determine whether the criteria are subsequently met.
- Additionally, if the initial criteria are not met but an entity receives consideration from the customer, there are additional criteria to assess to determine whether to recognise revenue.

Practical Illustration on Contract Criteria - 2

- On 1 April 2024, BigBoss Ltd agrees to sell 1,000 Endoscopy Machine to SmallBoss Ltd, which are produced using pre-fabricated tool supplied by another vendor. The payment terms between BigBoss Ltd and SmallBass Ltd have not been decided as they are dependent on the price of the pre-fabricated tool, which is yet to be finalised. BigBoss Ltd was paid a non-refundable amount of $4,500.
- Question
  - How should BigBoss Ltd account for this transaction under IFRS 15 if BigBoss was the principal in this transaction?

Solution

- The payment terms have not been identified; hence, the contract does not meet all of the criteria in IFRS 15 for determining a contract with a customer within the scope of the Standard.
- The non-refundable amount of $4,500 BigBoss Ltd must be accounted for as a liability by BigBoss.
- Consequently, BigBoss will continue to account for the non-refundable amount, as well as any future payments, as a liability until the criteria for identifying a contract with a customer within the scope of the Standard are met.

Step 2 - Identify the Performance Obligations

- A performance obligation is a distinct promise to transfer specific goods or services, distinct from other goods or services
- At contract inception, an entity shall assess the goods or services that have been promised to the customer, and shall identify as a performance obligation:
  - A good or a service (or a bundle of goods or services) that is distinct; or
  - A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Criteria for classifying good and services as distinct

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

- The customer can benefit from the good or service on its own or together with other readily available resources to the customer.
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.
- It is separable from other obligations in the contract – goods or services offered are not integrated or dependent on other goods or services provided already under the contract.

Illustration

- ABC Limited enters a contract with a customer to supply a licence for a standard software product. ABC Limited will also install the software, provide updates to the software and technical support for five years.
- ABC Limited sees the licence and technical support separately; the software will continue to operate without the software updates, and ABC Limited sub-contracts the installation of the software to several approved installers throughout the country.

Analysis

- *Given the above information, we can analyse the scenario as follows:*
  - *The customer can benefit from each of the goods or services either on their own or altogether.*
  - *The promise to transfer goods or services means that they are separately identifiable.*
- *Consequently, there are several distinct goods or services identified,*
  - *software licence,*
  - *installation service,*
  - *software updates, and*
  - *technical support.*

Step 3 - Determine the Transaction Price

- The transaction price is the amount of consideration to which the entity expects to be entitled in exchange for transferring promised goods or services to the customer, excluding amounts collected on behalf of third parties (for example, some sales taxes)
- Determinants of the transaction price include:
  - the terms of the contract,
  - past customary business practices when making this determination
  - Factors such as returns, bonuses, discounts, rebates, and variable considerations play a pivotal role in this calculation, necessitating meticulous attention to detail.

Step 3 - Determine the Transaction Price – Cont'd

- The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event.
- The transaction price may be adjusted for the effects of the time value of money if the contract includes a significant financing component.

Illustration

- ABC Limited enters into a contract with XYZ to sell its product for ₦200 per unit for the year 01.01.17 – 31.12.17. If XYZ purchases more than 1,200 units in the year, the price will decrease to ₦150 per unit. ABC Limited does not believe at the date of the contract was initiated that XYZ would purchase more than 1,200 from it due to past trading patterns with this customer.
- On 30.06.17, XYZ bought 600 units and another 500 units on 01.10.17. ABC Limited believes that XYZ would meet the target based on its sales of 1,100 units as at that date. On 01.11.17, XYZ informed management of ABC Limited that it would be placing a further order of 200 units on 1 December 2017. **How should ABC Limited account for its sales to the customer for the period from 01.01.17 – 31.12.17?**

Solution

Based on the fact that ABC Limited does not believe that the customer will achieve the target, it should account for the sales using a sales price per unit of ₦200 i.e. sales of 600 units x ₦200 per unit = ₦120,000 as follows:

- Dr. Trade Receivables ₦120,000.00
- Cr. Revenue ₦120,000.00

On the basis that ABC Limited now believes that the customer will reach its target ,its second transaction should be posted as follows: 500 units x ₦150 = ₦75,000

- Dr. Trade Receivables ₦75,000
- Cr. Revenue ₦75,000

Order of 200 units x ₦ 150 = ₦30,000

- Dr. Trade Receivables ₦30,000
- Cr. Revenue ₦30,000

Recalculating the sales value of the original 600 units sold in the first six months at ₦200 per unit instead of ₦150 per unit i.e. ₦50 difference in selling price i.e. 600 units x ₦50 per unit difference = ₦30,000 as follows:

- Dr. Revenue ₦30,000
- Cr. Trade Receivables ₦30,000.

Step 4 - Allocate the Transaction Price

- This is the distribution of the transaction price to the identified performance obligations based on their stand-alone selling prices of each distinct good or service promised in the contract.
- 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.
- 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.
- If a stand-alone selling price is not observable, an entity estimates it.

Analysis

- *Given the above information, we can analyse the scenario as follows:*
  - *The customer can benefit from each of the goods or services either on their own or altogether.*
  - *The promise to transfer goods or services means that they are separately identifiable.*
- *Consequently, there are several distinct goods or services identified,*
  - *software licence,*
  - *installation service,*
  - *software updates, and*
  - *technical support.*

Transaction Price Allocation – Illustration 1

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1. A software company sells a bundle that includes both a software license and a 12-month support service for a total price of ₦1,200,000. If sold separately, the software license would cost ₦1,000,000 and the support service ₦300,000.
2. How would you allocate the transaction price?

Solution to Illustration 2

a. Calculate the total standalone selling prices:
   ₦1,000,000 + ₦300,000 = ₦1,300,000.
b. Determine the allocation ratio for the software:
   ₦1,000,000 ÷ ₦1,300,000 = 76.92%.
c. Determine the allocation ratio for the support service:
   ₦300,000 ÷ ₦1,300,000 = 23.08%.
d. Allocate the transaction price:
   i. Software gets 76.92% of ₦1,200,000 = ₦922,400,
   ii. Support service gets 23.08% of ₦1,200,000 = ₦277,600.

Using this method, the company recognises revenue for each component based on its relative standalone selling price.

Illustration 2

- A retailer sells a customer a package consisting of a computer and a printer for ₦700,000. The retailer realises that there are two separate performance obligations involved. It regularly sells the computer for ₦500,000 and the printer for ₦300,000.
- Calculate how the retailer will allocate the total transaction price for both the computer and printer?

Solution – Illustration 2

- The transaction price is ₦700,000.
- Stand-alone prices.
  - Computer 500,000. Printer 300,000. Total 800,000
- To allocate the transaction price, calculate the ratio:
  - Computer: ₦500,000/₦800,000 x ₦700,000 = €437.500
  - Printer: ₦300,000/₦800,000 x ₦700,000= ₦262.500
- There is an inherent discount of ₦100, which does not relate to a specific performance obligation; therefore, allocated to all performance obligations on a standalone selling price basis.

Step 5 - Recognise Revenue When Performance Obligati Satisfied

- An entity shall recognise revenue when (or as) it fulfils a performance obligation by transferring a promised good or service to a customer, which is, when control is passed.

- The principle is based on the point at which the customer obtains control of the good or service. **Control of an asset means having the ability to direct the use of, and obtain all of the remaining benefits from, the asset.**

- Factors which may indicate that control is passed at a point in time include, but are not limited to:
    i. The entity has a present right to payment for the asset;
    ii. The customer has legal title to the asset;
    iii. The entity has transferred physical possession of the asset;
    iv. The customer has significant risks and rewards related to the ownership of the asset; and
    v. The customer has accepted the asset.

Step 5 - Recognise Revenue When Performance Obligat Satisfied

- Recognition of revenue can occur at
  i. point in time
  ii. over a time frame.
- This is dependent on the nature of the obligation; point in time is (typically for transfer of the promised goods) or over a time frame (typically for promises to transfer services to a customer)
- For revenue recognised at point in time, the following are the indicators that control has been transferred:
  i. The entity has a present right to payment for the goods and services.
  ii. The customer has received the legal title of goods and services.
  iii. The customer has physical possession
  iv. The customer has the significant risks and rewards of ownership of the asset; and
  v. The entity has evidence of the customer's acceptance of the asset.

Step 5 - Recognise Revenue When Performance Obligati Satisfied

- When revenue is recognised over time, revenue is deemed to be recognised to the extent that each of the vendor's performance obligations has been fulfilled. An entity recognises revenue over time if one of the following criteria is met:
    - The customer simultaneously receives and consumes the benefit provided by the entity as the entity performs;
    - The entity's performance creates or enhances an asset 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 the performance completed to date.

- For a performance obligation satisfied over time, an entity would select an appropriate measure of progress to determine how much revenue should be recognised as the performance obligation is satisfied.