

IFRS 15 Revenue from Contracts with Customers

Overview

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

- IAS 18 *Revenue*;
- IAS 11 *Construction contracts*;
- 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*.

IFRS 15 will improve comparability of reported revenue over a range of industries, companies and geographical areas globally.

Objective

To establish principles that an entity shall apply to report 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.

Scope

The new revenue model would apply to all contracts with customers except leases, insurance contracts, financial instruments, guarantees and certain non-monetary exchanges. The sale of non-monetary financial assets, such as property, plant and equipment, real estate or intangible assets will also be subject to some of the requirements of the new model.

A contract with a customer may be partially within the scope of IFRS 15 and partially within the scope of another standard, in which case:

- If the other standards specify how to separate and/or initially measure one or more parts of the contract, then an entity shall apply those separation and measurement requirements first. The transaction price is then reduced by the amounts that are initially measured under other standards.
- If other standards do not provide guidance on how to separate and/or initially measure one or more parts of the contract, then IFRS 15 will be applied.

Effective date

IFRS 15 is effective for annual periods beginning on or after 1 January 2017 with early application permitted. It applies to existing contracts that are not yet complete as of the effective date and new contracts entered into on or after the effective date. Therefore, in the first year of adoption, the current year figures will be measured and disclosed as if the new revenue model had always been applied.

Defined terms

IFRS 15 defines the following terms that form an integral part of this IFRS.

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

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 result in an increase in equity, other than those relating to contributions from equity participants.

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.

Transaction price (for a contract with a customer) – The 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 revenue model

The standard introduces a revenue model in which the core principle is that an entity should recognise revenue to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

To recognise revenue the following five steps should be applied:



Step 1: Identify the contract(s) with the customer

A contract can be oral, written or implied by an entity's business practice. A contract with a customer will fall within the scope of IFRS 15 when all the following criteria are met:

- The parties to the contract have approved the contract;
- Each party's rights in relation to the goods or services to be transferred can be identified;
- The payment terms and conditions for the goods or services to be transferred can be identified;
- The contract has commercial substance; and
- The collection of an amount of consideration to which the entity is entitled to in exchange for the goods or services is probable.

If the above criteria are met, a contract shall not be re-assessed unless there is an indication of a significant change in facts or circumstances, however if the contract *does not* meet the above criteria the entity will continue to re-assess the contract going forward to determine whether the criteria are subsequently met.

The model is to be applied on an individual contract basis. However, as a practical expedient, a portfolio approach is permitted for contracts with similar characteristics provided it is reasonably expected that the impact on the financial statements will not be materially different from applying this model to the individual contracts.

A contract modification shall be accounted for as a separate contract if the following conditions are met:

- There is an addition of promised goods or services that are distinct and which increases the scope of the contract; and
- The price of the goods of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices of the additional goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract.

If the above conditions are not met, a contract modification will be accounted for prospectively or retrospectively (depending on whether the remaining goods or services to be delivered after the modification are distinct from those delivered prior to the modification) by modifying the accounting for the current contract with the customer.

Step 2: Identify the performance obligations in the contract

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.

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; and
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

A series of distinct goods or services has the same pattern of transfer to the customer if the following criteria are met:

- Each distinct good or service that the entity promises to transfer consecutively to the customer would be a performance obligation that is satisfied over time; and
- The same method of measuring progress would be used to measure the entity's progress towards the complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

Factors for consideration as to whether an entity's promise to transfer the good or service to the customer is separately identifiable include, but are not limited to:

- The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract.
- The good or service does not significantly modify or customize another good or service promised in the contract.
- The good or service is not highly dependent on or highly interrelated with other goods or services promised in the contract.

Example – Determining whether goods or services are distinct

This is an adaptation from IFRS 15, Illustrative examples, Example 11.

An entity, a software developer, enters into a contract with a customer to transfer the following:

- Software licence;
- Installation service (includes changing the web screen for each user);
- Software updates; and
- Technical support for 2 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.

Are the goods or services promised to the customer distinct in terms of IFRS 15?

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.

Step 3: Determine the transaction price

The transaction price would be the amount of consideration that an entity expects to be entitled to in exchange for transferring promised goods or services to a customer. An entity will consider the terms of the contract and past customary business practices when making this determination.

If a contract contains a variable amount, the entity will estimate the amount to which it will be entitled under the contract. The consideration can also vary if an entity's right to consideration is contingent on the occurrence of a future event. The variable consideration is only included in the transaction price to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

Examples of where a variable consideration can arise

- | | |
|-----------------------|--------------|
| • Discounts | • Rebates |
| • Refunds | • Credits |
| • Price concessions | • Incentives |
| • Performance bonuses | • Penalties |

An adjustment for the time value of money is made to a transaction price for the effects of financing, if present and significant to the contract, for example, where a consideration is paid in advance or in arrears. A practical expedient is available where the interval between the transfer of promised goods or services and the payment by the customer is expected to be less than 12 months.

Example – Volume discount incentive

This is an adaptation from IFRS 15, Illustrative examples, Example 24.

Big Bed enters in a contract with a customer to sell beds for \$400 per bed on 1 January 2017. If the customer purchases more than 1000 beds in a calendar year, the contract states that the price per unit is retrospectively reduced to \$380 per unit. As a result of this the consideration in the contract is variable.

As at 31 March 2017, Big Bed sells 80 beds to the customer, therefore Big Bed estimates that the customer's purchase will not exceed the 1000 bed threshold required for the volume discount in the calendar year.

When considering the requirements of IFRS 15 (in particular paragraphs 56 – 58) and the significant experience Big Bed has with this product and the entity's purchasing pattern, it was concluded that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (\$400 per bed) will not occur when the uncertainty is resolved (i.e. when the total amount of purchases is known). Consequently, the entity recognises revenue of \$32,000 (80 beds x \$400) for the first quarter ended 31 March 2017.

At the beginning of June 2017, the customer acquires another company and at the end of the second quarter, 30 June 2017, Big Bed sells an additional 500 beds to the customer. In light of the new fact, Big Bed estimates that the customer's purchases will exceed the 1000 bed threshold for the calendar year and therefore it would have to retrospectively reduce the price per unit.

Big Bed therefore recognizes revenue of \$188,400 for the quarter ended 30 June 2017. The amount is calculated from \$190,000 (500 beds x \$380) less the change in transaction price of \$1,600 (80 beds x \$20 price reduction) for the reduction of the beds sold in the first quarter.

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. IFRS 15 suggests various methods that may be used, including:

- Adjusted market assessment approach;
- Expected cost plus a margin approach; or
- Residual approach (only permissible in limited circumstances).

Sometimes the transaction price may include a discount. Any overall discount is allocated between the performance obligations on a relative stand-alone selling price basis. In some circumstances it may be appropriate to allocate the discount to some but not all of the performance obligations.

Example – Allocating a discount to one or more performance obligations

This is an adaptation from IFRS 15, Illustrative examples, Example 34.

A fashion outlet named Fashionable regularly sells scarves, shoes and handbags individually, thereby establishing stand-alone selling prices as illustrated below.



In addition, Fashionable regularly sells shoes and handbags together for \$60.

Fashionable enters into a contract with a customer to sell all three products in exchange for \$100. Fashionable will satisfy the performance obligations for each of the products at different points in time.

The contract includes a discount of \$40 on the overall transaction. This discount will be allocated proportionately to all three obligations when allocating the transaction price using the relative stand-alone selling price

method. However, because Fashionable regularly sells shoes and handbags together for \$60 and Scarves for \$40, it has evidence that the entire discount should be allocated to the promises to transfer shoes and handbags in accordance with paragraph 82 of IFRS 15.

If Fashionable transfers control of the shoes and handbags at the same point in time, then Fashionable could as a practical matter account for the transfer of those products as a single performance obligation. That is, the entity could allocate \$60 of the transaction price to the single obligation and recognise revenue of \$60 when shoes and handbags are simultaneously transferred to the customer.

If the contract requires Fashionable to transfer the control of the shoes and handbags at different points in time, then the amount of \$60 is individually allocated to the products based on their stand-alone selling price as follows:

Shoes	= \$33 ($\$55 \div \100 [total stand-alone selling price] x \$60)
Handbag	= \$27 ($\$45 \div \100 [total stand-alone selling price] x \$60)
Total	= \$60

Step 5: Recognise revenue when a performance obligation is satisfied

An entity shall recognise revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer, which is when **control** is passed, either over time or at a point in time.

Control of an asset means having the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

An entity recognises revenue *over time* if one of the following criteria are 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.

Factors which may indicate that control is passed *at a point in time* include, but are not limited to:

- 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 significant risks and rewards related to the ownership of the asset; and
- The customer has accepted the asset.

Contract cost

Incremental costs of obtaining a contract

If the entity expects to recover incremental costs of obtaining a contract with a customer, the entity shall recognise those costs as an asset. The incremental costs are those costs that an entity incurs to obtain a contract that it would not have incurred if the contract had not been successfully obtained, for example, a sales commission. A practical expedient however exists, allowing the incremental costs of obtaining a contract to be expensed if the amortisation period would be one year or less.

Example – Incremental costs of obtaining a contract

This is an adaptation from IFRS 15, Illustrative examples, Example 36.

A consulting services entity, wins a competition bid to provide consulting services to a new customer. The following costs were incurred by the entity to obtain the contract:

	\$
External legal fees for due diligence	15,000
Travel costs to deliver the proposal	25,000
Commissions paid to sales employees	10,000
Total costs incurred	<u>50,000</u>

In accordance with IFRS 15 (paragraph 91), the entity recognises an asset for the \$10,000 (commission) incremental costs of obtaining the contract because the entity expects to recover those costs through future fees for consulting services. The entity also pays discretionary annual bonuses to sales employees based on annual sales targets, overall profitability and individual performance. Taking into account IFRS 15 (paragraph 91), the entity does not recognise an asset for the bonuses paid because they are not incremental to obtaining a contract. The bonus amounts are discretionary and are based on other factors, including the overall profitability of the entity and the individuals' performance therefore they are not directly attributable to identifiable contracts.

The legal fees and travel costs would have been incurred whether the bid was won or not, therefore those costs are recognised as expenses when incurred (IFRS 15, paragraph 93), unless they are within the scope of another Standard, in which case the relevant provisions of that standard apply.

Costs to fulfil a contract

Costs incurred to fulfil a contract with a customer are recognised as an asset only if **all** the following criteria are met:

- The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify;
- The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and
- The costs are expected to be recovered.

An asset recognised with regard to the above cost shall be amortised on a systematic basis that is consistent with the pattern of transfer of the goods or services to which the asset relates.

Examples of the type of costs that may be incurred to fulfil a contract

- Direct labour
- Direct materials
- Allocation of overheads that relate directly to the contract
- Cost that are explicitly chargeable to the customer under the contract
- Other costs that are incurred only because an entity entered into the contract

Presentation

An entity shall present the performance of a contract in the statement of financial position as a contract asset or contract liability, depending on the relationship between the entity's performance and the customer's payment. Any unconditional rights to consideration shall be presented separately as a receivable.

Where a customer has paid an amount of consideration prior to the entity transferring the related good or service to the customer, a contract liability will be presented in the statement of financial position.

Where the customer has not yet paid the related consideration for the transfer of a good or service, a contract asset (right to consideration is conditional on something other than the passage of time) or receivable (right to consideration is unconditional except for the passage of time) is presented in the statement of financial position. Contract assets and receivables together with any impairment shall be accounted for in accordance with IFRS 9 *Financial Instruments*. The difference between the initial recognition of a receivable and the amount of revenue should be presented as an expense.

Disclosure

Sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contract with customers shall be disclosed. To achieve this, an entity shall disclose the qualitative and quantitative information about all of the following:

Revenue recognised from contracts with customers, including

- The disaggregation of revenue into appropriate categories
- For contract balances
 - The opening and closing balances of receivables, contract assets and contract liabilities
 - Revenue recognised in the reporting period that was included in the contract liabilities opening balance
 - Revenue recognised in the reporting period from performance obligations satisfied in previous periods
- For performance obligations, a description of
 - When the company typically satisfies its performance obligations
 - The significant payment terms
 - The nature of the goods or services that the entity has promised to transfer
 - Obligations for returns, refunds and other similar obligations
 - Types of warranties and related obligations
- The amount of the transaction price that is allocated to the remaining performance obligations in a contract

The significant judgements, and changes in judgements, made in applying this standard to those contracts, in particular

- The timing of satisfaction of performance obligations
- The transaction price and the amounts allocated to performance obligations

Any assets recognised from the costs to obtain or fulfil a contract with a customer, including

- A description of the judgements made in determining the amount of the costs and the amortisation method used for each reporting period
- The closing balances of the assets
- The amount of amortisation and any impairment losses recognised in the reporting period

Transition

Entities are allowed to choose whether to apply IFRS 15 retrospectively to each prior period presented (with optional practical expedients) or retrospectively according to an alternative transition method. Under the alternative transition method, restatement of comparative years is not required but the cumulative effect of initially applying IFRS 15 should be recognised as an adjustment to the opening retained earnings on the effective date (in the year of initial application). Additional disclosures are then required to illustrate the effects of applying the standard.