Introduction to SLFRS 15

Example: Revenue recognition

X Plc sells mobile phones and network contracts either together or separately at the following prices.

	Handset ($)	Contract ($per month)	Contract period (months)	Total network contract ($)	Total cost ($)
Separately	531	25	24	600	1,131
As a bundle	nil	50	24	1,200	1,200

Revenue from selling a bundle (handset together with a network contract) would be recognised using the following steps.

Step 3: Determine the transaction price

The transaction prices are $531 for the handset and $600 ($25 per month for 24 months) giving a total of $1,131 if sold separately.

The transaction price is $1,200 for the handset and the contract sold as a bundle.

Example (continued): Revenue recognition price (ignoring time value)

Step 4: Allocate the transaction price

The transaction price is allocated in proportion to the stand-alone selling prices of distinct goods and services promised in the contract.

Thus the revenue allocation is as follows:

	$
Handset ($1,200 □ $531/$1,131)	563.4
Network contract ($1,200 □ $600/$1,131)	636.6
	1,200.0

Step 5: Recognise revenue

The revenue for the handset is recognised when it is delivered at the start of the contract. There is no cash received at this point in time so a receivable is recognised to complete the revenue double entry.

	Dr	Cr
Receivable	563.4	
Revenue		563.4

The revenue for the network contract is recognised over the life of the contract. The difference between the cash received each month and the amount recognised as revenue in the statement of profit or loss reduces the receivable to zero by the end of the 24 month contract period.

	Dr	Cr
Cash	50	
Revenue ($636.6 ÷ 24 months)		26.53
Receivable		23.47

Or over the life of the contract (as a proof)	**Dr**	**Cr**
Cash	1,200	
Revenue ($636.6 ÷ 24 months)		636.6
Receivable		563.4

The above example does not take time value into account.

The standalone selling prices used above are inconsistent with each other. The $531 for the hand set is payable up front but the $600 for the contract is payable by a series of monthly payments over a 24 month period.

This example has been built using a discount rate of 1% per month. The 24 monthly payments should be discounted to arrive at a value for the standalone contract price that is comparable to that of the handset.

Example (continued): Revenue recognition (taking time value into account)

	Handset ($)	**Contract ($per month)**	**Annuity factor (24 months, 1% per month)**	**Total network contract ($)**	**Total cost ($)**
Separately	531	25	21.24	531	1,062

The steps would then proceed as follows:

Step 4: Allocate the transaction price

The transaction price is allocated in proportion to the stand-alone selling prices of distinct goods and services promised in the contract.

Thus the revenue allocation is as follows:

	$
Handset ($1,062 □ $531/$1,062)	531
Network contract ($1,062 □ $531/$1,062)	531
	1,062

Step 5: Recognise revenue

The revenue for the handset is recognised when it is delivered at the start of the contract.

Dr		**Cr**
Receivable	531	
Revenue		531

The monthly payments of $50 comprise 2 amounts. $25 pays for the network contract and the balance (also $25) pays off the receivable. Over the life of the contract the receivable is reduced to zero after taking time value into account.

The double entry at the end of the first month would be as follows:

	Dr	**Cr**
Cash	50	
Revenue		25
eceivable		25
and		
Receivable	5.31	
Revenue (interest)		5.31

Another way of thinking saying this is that the amount initially recognised for the hand set is the present value of the $25 per month that relates to it.

A full amortisation table is shown below in order to illustrate this.

Example (continued): Revenue recognition (taking time value into account)

Period	Amount receivable at the start	Interest at 1%	Cash flow	Amount receivable at the end
1	531.00	5.31	(25.00)	511.31
2	511.31	5.11	(25.00)	491.42
3	491.42	4.91	(25.00)	471.34
4	471.34	4.71	(25.00)	451.05
5	451.05	4.51	(25.00)	430.56
6	430.56	4.31	(25.00)	409.87
7	409.87	4.10	(25.00)	388.97
8	388.97	3.89	(25.00)	367.86
9	367.86	3.68	(25.00)	346.53
10	346.53	3.47	(25.00)	325.00
11	325.00	3.25	(25.00)	303.25
12	303.25	3.03	(25.00)	281.28
13	281.28	2.81	(25.00)	259.09
14	259.09	2.59	(25.00)	236.69
15	236.69	2.37	(25.00)	214.05
16	214.05	2.14	(25.00)	191.19
17	191.19	1.91	(25.00)	168.10
18	168.10	1.68	(25.00)	144.79
19	144.79	1.45	(25.00)	121.23
20	121.23	1.21	(25.00)	97.45
21	97.45	0.97	(25.00)	73.42
22	73.42	0.73	(25.00)	49.15
23	49.15	0.49	(25.00)	24.65
24	24.65	0.25	(25.00)	-0.11

Factors affecting the transaction price
Example: Variable consideration

X Plc sells 1,000 products to customers at a cost of $120 per product.
Cash is received when control of a product transfers.
X Plc allows customers to return any unused product within 60 days and receive a full refund.
The cost of each product to X Plc is $90.
X plc has considerable experience of selling this type of product. Based on this experience it estimates that 950 products will not be returned. Therefore X plc will not recognise the revenue on 50 products.
X Plc will recognise the following on the inception of the contracts:

	Dr	Cr
Cash (1,000 □ $120)	120,000	
Revenue (950 □ $120)		114,000
Refund liability (50 □ $120)		6,000

In addition, X plc will recognise an asset of $4,500 (50 □ $90) for its right to recover products on settling the refund liability.
This is of the nature of an inventory adjustment. (Remember that the cost of 1,000 items ($90,000) would not be included in inventory after they are sold).

Example: Allocation of discount

X Plc sells three products at the following stand-alone selling prices:

	Stand-alone selling price
Product A	100
Product B	140
Product C	110

X Plc sells one each of the products to Y Plc for $300 in total. Products B and C are sold regularly together for $200 (a discount of $50 on the combined standalone selling prices).

The products are to be delivered at three different points in time. The delivery of each product is a separate performance obligation.

X Plc regularly sells Products B and C together for $200 and Product A for $100. Therefore, the entire discount should be allocated to the promises to transfer Products B and C.

The discount of $50 is allocated as follows:

	Stand-alone selling price ($)	Allocated discount ($)	Allocated transaction price ($)
Product A	100		100
Product B	140	(140 □ 50/250) = 28	112
Product C	110	(110 □ 50/250) = 22	88
	350		300

Note that if the contract required delivery of B and C at the same time, X Plc could account for that delivery as a single performance obligation.

The discount of $50 would then be allocated as follows:

	Stand-alone selling price ($)	Allocated discount ($)	Allocated transaction price ($)
Product A	100		100
Product B and C	250	50	200
	3450		300

In other cases, the discount is allocated proportionately to all performance obligations in the contract

Example: Allocation of discount
X Plc sells three products at the following stand-alone selling prices:

	Stand-alone selling price ($)
Product A	100
Product B	140
Product C	110

Products are not usually sold at a discount but X Plc agrees to sell one each of the products to Y Plc for $300 in total.
The products are to be delivered at three different points in time. The delivery of each product is a separate performance obligation.
There is no observable evidence about which performance obligation has attracted the discount.

The discount of $50 is allocated on a proportionate basis as follows:

	Stand-alone selling price ($)	Allocated discount ($)	Allocated transaction price ($)
Product A	100	(100 □ 50/350) = 14.3	85.7
Product B	140	(140 □ 50/350) = 20.0	120.0
Product C	110	(110 □ 50/350) = 15.7	94.3
	350		300.0

Example: Financing component

An enterprise sells a machine on 1 January 2015. The terms of sale are that the enterprise will receive $5 million on 31 December 2016 (2 years later).
An appropriate discount rate is 6%.

1 January 2015 – Initial recognition

Initial measurement of the consideration $\$5m \times \frac{1}{(1 + 0.06)^2} = \$4,449,982$

	Debit	Credit
Receivables	4,449,982	
Revenue		4,449,982

31 December 2015

Recognition of interest revenue $4,449,982 @ 6% = 266,999

	Debit	Credit
Receivables	266,999	
Revenue – interest		266,999

Balance on the receivable	$
Balance brought forward	4,449,982
Interest revenue recognised in the period	266,999
Carried forward	4,716,981

31December 2016

Recognition of interest revenue	$4,716,981 @ 6%	= 283,019
	Debit	**Credit**
Receivables	283,019	
Revenue – interest		283,019
Balance on the receivable		$
Balance brought forward		4,716,981
Interest revenue recognised in the period		283,019
Consideration received		(5,000,000)
Carried forward		□

Example: Contract modification results in new contract

X Plc enters into a contract to sell 100 units of a product to Y Plc for $14,000 ($140 per unit).
X Plc transfers control of each unit at a point in time.
X Plc transfers control of 55 units to Y Plc.

Contract modification

The contract is modified to require delivery of an additional 20 units to Y Plc at a price of $130 per unit which reflects the stand-alone selling price of the units at the time of the modification. The additional units are distinct.

Analysis

The contract modification for the additional 20 products is, in effect, a new and separate contract that does not affect the accounting for the existing contract.
X Plc recognises revenue of $140 per product for the 45 remaining products in the original contract and $130 per product for the 20 products in the new contract.
A contract modification might not result in a new contract. This might be because the increase in the price of the contract due to the modification does not reflect the stand-alone selling prices for the new goods and services.
If a contract modification does not result in a new contract the resultant treatment depends on whether the remaining goods or services to be supplied under the original contract are distinct or not.

	$
Remaining revenue on original contract (45 units × $140)	6,300
Revenue on new contract (20 units × $100)	2,000
	8,400
Number of units (45 units + 20 units)	65

Price per unit	129.23

Example: Contract modification results in termination of the original contract and creation of a new contract

X Plc enters into a contract to sell 100 units of a product to Y Plc for $14,000 ($140 per unit).
X Plc transfers control of each unit at a point in time.
X Plc transfers control of 55 units to Y Plc.

Contract modification

The contract is modified to require delivery of an additional 20 units to Y Plc at a price of $100 per unit which does not reflect the stand-alone selling price of the units at the time of the modification. The reduced price is agreed to compensate Y plc for late delivery of the first 55 units transferred.

Analysis

The contract modification for the additional 20 products is not at the stand alone selling price for such contracts. Therefore, this cannot be treated as a new separate contract.
Goods remaining under the original contract are distinct.
The original contract is terminated and the modification results in a new contract.
The amount recognised as revenue for each of the remaining units is as follows:

Example: Contract modification
X Plc enters into a contract to construct a building for Y Plc for $1 million.
X Plc determines that the contract contains a single performance obligation satisfied over time.
X Plc uses costs incurred as a percentage of total expected costs as a measure of progress towards complete satisfaction of the performance obligation.

Transaction price
The following forecasts were made at the inception of the contract.

	$
Transaction price	1,000,000
Total expected costs	700,000

End of year 1

X Plc has incurred costs to date of $420,000 which is 60% of the total expected costs ($700,000).
The cumulative revenue and costs recognised for the first year are as follows:

	$
Revenue (60% of 1,000,000)	600,000
Cost of sales (60% of 700,000)	(420,000)
Gross profit	180,000

Example (continued): Contract modification Year 2

The contract is modified, early in year 2, by changing the specification for the location of the stairwells. The customer agreed to pay an extra $250,000 for the modification resulting in a new total contract price of $1,250,000.
The expected extra cost of the modification is $100,000 so that the total expected costs become $800,000.
X Plc evaluates the modification and concludes that the remaining goods and services to be provided using the modified contract are not distinct from the goods and services transferred on or before the date of contract modification.

Therefore, X Plc accounts for the contract modification as if it were part of the original contract.

Accounting

X Plc measures progress at 52.5% ($420,000/$800,000).
This requires a catch up adjustment at the date of the modification as follows.

	$
Revenue (52.5% of 1,250,000)	656,250
Revenue recognised to date	(600,000)
Catch-up adjustment	56,250

Contract costs

Example: Incremental costs of obtaining a contract

X Plc wins a competitive bid to provide consulting services to a new customer.
X Plc incurred the following costs to obtain the contract:

	$
Commissions to sales employees for winning the contract	10,000
External legal fees for due diligence	15,000
Travel costs to deliver proposal	25,000
Total costs incurred	50,000

Analysis

The commission to sales employees is incremental to obtaining the contract and should be capitalised as a contract asset.

The external legal fees and the travelling cost are not incremental to obtaining the contract because they have been incurred regardless of whether X Plc obtained the contract or not.

A supplier may recognise the incremental costs of obtaining a contract as an expense when incurred if the amortisation period of the asset that the entity otherwise would have recognised is one year or less.

Example: Amortisation of contract costs

X Plc wins a 5 year contract to provide a service to a customer.
The contract contains a single performance obligation satisfied over time.
X Plc recognises revenue on a time basis
Costs incurred by the end of year 1 and forecast future costs are as follows:

	$
Costs to date	10,000
Estimate of future costs	18,000
Total expected costs	28,000

Analysis

Costs must be recognised in the P&L on the same basis as that used to recognise revenue.

X Plc recognises revenue on a time basis, therefore 1/5 of the total expected cost should be recognised = $5,600 per annum.

Example: Amortisation of contract costs

X Plc wins a contract to build an asset for a customer. It is anticipated that the asset will take 2 years to complete
The contract contains a single performance obligation. Progress to completion is measured on an output basis.
At the end of year 1 the assets is 60% complete.
Costs incurred by the end of year 1 and forecast future costs are as follows:

	$
Costs to date	10,000
Estimate of future costs	18,000
Total expected costs	28,000

Example: Amortisation of contract costs

X Plc wins a 5 year contract to provide a service to a customer.
The contract contains a single performance obligation satisfied over time.
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Costs incurred by the end of year 1 and forecast future costs are as follows:

	$
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Analysis

Costs must be recognised in the P&L on the same basis as that used to recognise revenue.
X Plc recognises revenue on a time basis, therefore 1/5 of the total expected cost should be recognised = $5,600 per annum.

Example: Amortisation of contract costs

X Plc wins a contract to build an asset for a customer. It is anticipated that the asset will take 2 years to complete
The contract contains a single performance obligation. Progress to completion is measured on an output basis.
At the end of year 1 the assets is 60% complete.
Costs incurred by the end of year 1 and forecast future costs are as follows:

	$
Costs to date	10,000
Estimate of future costs	18,000
Total expected costs	28,000

Analysis
Costs must be recognised in the P&L on the same basis as that used to recognise revenue.
Therefore 60% of the total expected cost should be recognised ($16,800) at the end of year 1.

Example: Contract assets
X Plc enters into a contract to construct a building for Y Plc for $1 million to be invoiced on completion.
The contract is expected to take two years to complete. X Plc started work on the contract on the first day of its accounting period.
At the end of year 1 X Plc assessed the contract to be 60% complete.
The double entry to recognise revenue is as follows:

	Dr	Cr
Contract asset	600,000	
Revenue (60% of $1,000,000)		600,000

The $600,000 is not recognised as receivable because X Plc's right to consideration will not become unconditional until it has the right to invoice for the amount. When this occurs the contract asset at that date would be reclassified as a receivable.

Example: Agency
X plc distributes goods for Y plc under an agreement with the following terms:
X plc is given legal title to the goods by Y plc and sells them to the retailers.
Y plc sets the selling price and X plc is given a fixed margin on all sales.
Y plc retains all product liability and is responsible for any manufacturing defects.

X plc has the right to return inventory to Y plc without penalty.
X plc is not responsible for credit risk on sales made.

Analysis:
Y plc retains all significant risks and rewards of ownership of the goods transferred to X plc.
In substance, X plc is acting as an agent for Y plc.

Year ended 31 December 20X3
Y plc transferred legal title of goods which had cost $1,500,000 to X plc.
X Plc is to sell these goods for Y Plc at a mark-up of 30%.
X plc is entitled to a fee of 4% of the selling price of all goods sold.

As at 31 December X plc had sold 80% of the goods and collected all cash due but had not yet remitted any cash to Y plc.

X plc would recognise:	**Dr**	**Cr**
Cash (80% □ ($1,500,000 □ 130%))	1,560,000	
Revenue (4% □ $1,560,000)		62,400
Liability (balance = 96% □ $1,560,000)		1,497,600

Y plc would recognise:	**Dr**	**Cr**
Receivable	1,497,600	
Revenue		1,497,600

Y plc would also recognise the unsold inventory of $300,000 (20% □ %1,500,000) as part of its closing inventory.

Example: Non-refundable up-front fee

X Ltd operates a health club.Club membership requires an up-front fee of $100 followed by a monthly membership fee of $50 paid at the end of each month. The same fees are required both for new joiners and existing members.

Up-front fee ($)	**Monthly fee ($)**	**Contract period (months)**	**Total monthly fees ($)**	**Total fee ($)**
100	50	12	600	700

Analysis

The fee does not relate to a good or service provided at the start of the contract but rather to the delivery of a service over the life of the contract.

The fee is part of the overall transaction price for 12 months of health club membership. It should be added to the monthly fee to arrive at the transaction price and this should be recognised on a monthly basis over 12 months in the amount of $58.33 ($700/12)

Double entry	**(Credit entries in brackets)**	
	Contract	**Profit or**

	Cash ($)	liability ($)	loss
Start of the contract	100	(100.00)	
Each month:			
Cash receipt	50		(50.00)
Release of the liability		8.33	(8.33
			58.33

Example: Non-refundable up-front fee

X Ltd operates a health club.

Club membership requires an up-front fee of $100 followed by a monthly membership fee of $50 paid at the end of each month.

Membership can be renewed at the end of each year for no further joining fee with members continuing to pay the original monthly fee without increase.

X Ltd determines that members renew their membership once on average before leaving the club.

Analysis

X Ltd is entering into two separate performance obligations at the start of the contract. These are the provision of monthly membership and the granting of a renewal option to members.

Transaction price is normally allocated to each performance obligation with reference to relative stand-alone selling price. However, this contract gives a customer a material right to acquire future services similar to the original services in accordance with the terms in the original contract. X Ltd is allowed (as a practical alternative) to allocate the transaction price to the optional services by reference to those expected to be provided and the corresponding expected consideration.

Up-front fee ($)	Monthly fee ($)	Expected contract period (months)	Total monthly fees ($)	Total fee ($)
100	50	24	1,200	1,300

The total fee should be recognised as revenue over the 24 months (in the monthly amount of $54.17 ($1,300/12)).

A supplier might charge a non-refundable fee in part as compensation for costs incurred in setting up a contract. If those setup activities do not satisfy a performance obligation, they are disregarded when measuring the progress of the contract.

PRACTICE QUESTIONS

QUESTION 01

Fiskerton has entered into a sales contract for the construction of an asset with a customer whereby the customer pays an initial deposit. The deposit is refundable only if Fiskerton fails to complete the construction of the asset. The remainder is payable on delivery of the asset. If the customer defaults on the contract prior to completion, Fiskerton has the right to retain the deposit. The managing director believes that, as completion of the asset is performed over time, revenue should be recognised accordingly. He has persuaded the accountant to include the deposit and a percentage of the remaining balance for construction work in revenue to date.

ANSWER

At the inception of the contract, Fiskerton must determine whether its promise to construct the asset is a performance obligation satisfied over time. Fiskerton only has rights during the production of the asset over the initial deposit paid. They have no enforceable rights to the remaining balance as construction takes place. Therefore they would not be able to receive payment for work performed to date. Additionally, Fiskerton has to repay the deposit should they fail to complete the construction of the asset in accordance with the contract. There is a single performance obligation which is only met on delivery of the asset to the customer. Revenue should not be recognised on a stage of completion basis but must be deferred and recognised at a point of time. That is, on delivery of the asset to the customer.

QUESTION 02

Kiki is a public limited entity. It designs and manufactures children's toys. It has a reporting date of 31 December 20X7 and prepares its financial statements in accordance with International Financial Reporting Standards. The directors require advice about the following situations.

A. Kiki sells $50 gift cards. These can be used when purchasing any of Kiki's products through its website. The gift cards expire after 12 months. Based on significant past experience, Kiki estimates that its customers will redeem 70% of the value of the gift card and that 30% of the value will expire unused. Kiki has no requirement to remit any unused funds to the customer when the gift card expires unused. The directors are unsure about how the gift cards should be accounted for. (6 marks)

B. Kiki's best-selling range of toys is called Scarimon. In 20X6 Colour, another listed company, entered into a contract with Kiki for the rights to use Scarimon characters and imagery in a monthly comic book. The contract terms state that Colour must pay Kiki a royalty fee for every issue of the comic book which is sold. Before signing the contract, Kiki determined that Colour had a strong credit rating. Throughout 20X6, Colour provided Kiki with monthly sales figures and paid all amounts due in the agreed-upon period. At the beginning of 20X7, Colour experienced cash flow problems. These were expected to be short term. Colour made nominal payments to Kiki in relation to comic sales for the first half of the year. At the beginning of July 20X7, Colour lost access to credit facilities and several major customers. Colour continued to sell Scarimon comics online and through specialist retailers but made no further payments to Kiki. The directors are unsure how to deal with the above issues in the financial statements for the year ended 31 December 20X7. (6 marks)

Required: Advise the accountant on the matters set out above with reference to International Financial Reporting Standards.

ANSWER

(a) Gift cards IFRS 15 Revenue from Contracts with Customers says that revenue should be recognised when or as a performance obligation is satisfied by transferring the promised good or service to the customer.

When a customer buys a gift card they are pre-paying for a product. Revenue cannot be recognised because the entity has not yet transferred control over an asset and so has not satisfied a performance obligation. As such, cash received in respect of gift cards should be initially recognised as a contract liability.

IFRS 15 refers to a customer's unexercised rights as breakage. The guidance for variable consideration is followed when estimating breakage. In other words, the expected breakage is included in the transaction price if it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur once the uncertainty is subsequently resolved.

This means that if the company is unable to reliably estimate the breakage amount, then revenue for the unused portion of the gift card is recognised when the likelihood of the customer exercising their remaining rights becomes remote.

However, if an entity is able to reliably estimate the breakage amount, then it recognises the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer.

In relation to Kiki, it appears that the amount of breakage can be reliably determined and so this should be recognised in revenue as the gift card is redeemed. For every $1 redeemed, Kiki should recognise $1·43 ($1 x 100/70) in revenue.

(b) Royalty According to IFRS 15, an entity should only account for revenue from a contract with a customer when it meets the following criteria:

–The contract has been approved;
– Rights regarding goods and services can be identified;
– Payment terms can be identified;
– It is probable the seller will collect the consideration it is entitled to.

At inception of the agreement, Kiki and Colour entered an explicit contract which specified payment terms and conditions. Moreover, Colour had a strong credit rating and so payment was probable. As such, it would seem that the above criteria were met.

IFRS 15 says that revenue from a usage-based royalty should be recognised as the usage occurs.

Whether a contract with a customer meets the above criteria is only reassessed if there is a significant change in facts and circumstances.

In July 20X7, Colour lost major customers and sources of finance.

As such, it was no longer probable that Kiki would collect the consideration it was entitled to. From July 20X7, no further revenue from the contract should be recognised.

According to IFRS 9 Financial Instruments, non-payment is an indicator that the outstanding receivables are credit impaired. A loss allowance should be recognised equivalent to the difference between the gross carrying amount of the receivables and the present value of the expected future cash flows receivable from Colour.

Any increase or decrease in the loss allowance is charged to profit or loss

QUESTION 03

Carsoon constructs retail vehicle outlets and enters into contracts with customers to construct buildings on their land. The contracts have standard terms, which include penalties payable by Carsoon if the contract is delayed, or payable by the customer, if Carsoon cannot gain access to the construction site.

Due to poor weather, one of the projects was delayed. As a result, Carsoon faced additional costs and contractual penalties. As Carsoon could not gain access to the construction site, the directors decided to make a counter-claim against the customer for the penalties and additional costs which Carsoon faced. Carsoon felt that because claims had been made against the customer, the additional costs and penalties should not be included in contract costs but shown as a contingent liability. Carsoon has assessed the legal basis of the claim and feels it has enforceable rights.

In the year ended 28 February 2017, Carsoon incurred general and administrative costs of $10 million, and costs relating to wasted materials of $5 million.

Additionally, during the year, Carsoon agreed to construct a storage facility on the same customer's land for $7 million at a cost of $5 million. The parties agreed to modify the contract to include the construction of the storage facility, which was completed during the current financial year. All of the additional costs relating to the above were capitalised as assets in the financial statements.

The directors of Carsoon wish to know how to account for the penalties, counter claim and additional costs in accordance with IFRS 15 Revenue from Contracts with Customers.

ANSWER

IFRS 15 Revenue from Contracts with Customers specifies how to account for costs incurred in fulfilling a contract which are not in the scope of another standard.

Costs to fulfil a contract which is accounted for under IFRS 15 are divided into those which give rise to an asset and those which are expensed as incurred.

Entities will recognise an asset when costs incurred to fulfil a contract meet certain criteria, one of which is that the costs are expected to be recovered.

For costs to meet the 'expected to be recovered' criterion, they need to be either explicitly reimbursable under the contract or reflected through the pricing of the contract and recoverable through the margin.

The penalty and additional costs attributable to the contract should be considered when they occur and Carsoon should have included them in the total costs of the contract in the period in which they had been notified.

As regards the counter claim for compensation, Carsoon accounts for the claim as a contract modification in accordance with IFRS 15. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation.

Consequently, Carsoon should account for the modification by updating the transaction price and the measure of progress towards complete satisfaction of the performance obligation.

A contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations which are created or changed by a modification are enforceable, an entity should consider all relevant facts and circumstances including the terms of the contract and other evidence. On the basis of information available, it is possible to feel that the counter claim had not reached an advanced stage, so that claims submitted to the client could not be included in total revenues.

When the contract is modified for the construction of the storage facility, an additional $7 million is added to the consideration which Carsoon will receive. The additional $7 million reflects the stand-alone selling price of the contract modification. The construction of the separate storage facility is a distinct performance obligation; the contract modification for the additional storage facility would be, in effect, a new contract which does not affect the accounting for the existing contract. Therefore the contract is a performance obligation which has been satisfied as assets are only recognised in relation to satisfying future performance obligations.

General and administrative costs cannot be capitalised unless these costs are specifically chargeable to the customer under the contract. Similarly, wasted material costs are expensed where they are not chargeable to the customer. Therefore a total expense of $15 million will be charged to profit or loss and not shown as assets.

QUESTION 04

(i) Tang enters into a contract with a customer to sell an existing printing machine such that control of the printing machine vests with the customer in two years' time. The contract has two payment options. The customer can pay $240,000 when the contract is signed or $300,000 in two years' time when the customer gains control of the printing machine. The interest rate implicit in the contract is 11·8% in order to adjust for the risk involved in the delay in payment. However, Tang's incremental borrowing rate is 5%. The customer paid $240,000 on 1 December 2014 when the contract was signed. (4 marks)

(ii) Tang enters into a contract on 1 December 2014 to construct a printing machine on a customer's premises for a promised consideration of $1,500,000 with a bonus of $100,000 if the machine is completed within 24 months. At the inception of the contract, Tang correctly accounts for the promised bundle of goods and services as a single performance obligation in accordance with IFRS 15. At the inception of the contract, Tang expects the costs to be $800,000 and concludes that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will occur. Completion of the printing machine is highly susceptible to factors outside of Tang's influence, mainly issues with the supply of components.
At 30 November 2015, Tang has satisfied 65% of its performance obligation on the basis of costs incurred to date and concludes that the variable consideration is still constrained in accordance with IFRS 15.
However, on 4 December 2015, the contract is modified with the result that the fixed consideration and expected costs increase by $110,000 and $60,000 respectively. The time allowable for achieving the bonus is extended by six months with the result that Tang concludes that it is highly probable that the bonus will be achieved and that the contract still remains a single performance obligation. Tang has an accounting year end of 30 November. (6 marks)

Required:
Discuss how the above two contracts should be accounted for under IFRS 15. (In the case of (b)(i), the discussion should include the accounting treatment up to 30 November 2016 and in the case of (b)(ii), the accounting treatment up to 4 December 2015.)

ANSWER
The contract contains a significant financing component because of the length of time between when the customer pays for the asset and when Tang transfers the asset to the customer, as well as the prevailing interest rates in the market.

A contract with a customer which has a significant financing component should be separated into a revenue component (for the notional cash sales price) and a loan component. Consequently, the accounting for a sale arising from a contract which has a significant financing component should be comparable to the accounting for a loan with the same features.
An entity should use the discount rate which would be reflected in a separate financing transaction between the entity and its customer at contract inception. The interest rate implicit in the transaction may be different from the rate to be used to discount the cash flows, which should be the entity's incremental borrowing rate.
IFRS 15 would therefore dictate that the rate which should be used in adjusting the promised consideration is 5%, which is the entity's incremental borrowing rate, and not 11·8%.
Tang would account for the significant financing component as follows:
Recognise a contract liability for the $240,000 payment received on 1 December 2014 at the contract inception:
Dr Cash $240,000
Cr Contract liability $240,000
During the two years from contract inception (1 December 2014) until the transfer of the printing machine, Tang adjusts the amount of consideration and accretes the contract liability by recognising interest on $240,000 at 5% for two years.
Year to 30 November 2015
Dr Interest expense $12,000
Cr Contract liability $12,000
Contract liability would stand at $252,000 at 30 November 2015.
Year to 30 November 2016
Dr Interest expense $12,600
Cr Contract liability $12,600
Recognition of contract revenue on transfer of printing machine at 30 November 2016 of $264,600 by debiting contract liability and crediting revenue with this amount.

(ii) Tang accounts for the promised bundle of goods and services as a single performance obligation satisfied over time in accordance with IFRS 15. At the inception of the contract, Tang expects the following:
Transaction price $1,500,000
Expected costs $800,000
Expected profit (46·7%) $700,000
At contract inception, Tang excludes the $100,000 bonus from the transaction price because it cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur. Completion of the printing machine is highly susceptible to factors outside the entity's influence. By the end of the first year, the entity has satisfied 65% of its performance obligation on the basis of costs

incurred to date. Costs incurred to date are therefore $520,000 and Tang reassesses the variable consideration and concludes that the amount is still constrained.

Therefore at 30 November 2015, the following would be recognised:
Revenue $975,000
Costs $520,000
Gross profit $455,000

However, on 4 December 2015, the contract is modified. As a result, the fixed consideration and expected costs increase by $110,000 and $60,000, respectively. The total potential consideration after the modification is $1,710,000 which is $1,610,000 fixed consideration + $100,000 completion bonus. In addition, the allowable time for achieving the bonus is extended by six months with the result that Tang concludes that it is highly probable that including the bonus in the transaction price will not result in a significant reversal in the amount of cumulative revenue recognised in accordance with IFRS 15. Therefore the bonus of $100,000 can be included in the transaction price.

Tang also concludes that the contract remains a single performance obligation. Thus, Tang accounts for the contract modification as if it were part of the original contract. Therefore, Tang updates its estimates of costs and revenue as follows:

Tang has satisfied 60·5% of its performance obligation ($520,000 actual costs incurred compared to $860,000 total expected costs). The entity recognises additional revenue of $59,550 [(60·5% of $1,710,000) – $975,000 revenue recognised to date] at the date of the modification as a cumulative catch-up adjustment. As the contract amendment took place after the year end, the additional revenue would not be treated as an adjusting event.

QUESTION 05

IFRS 15 Revenue from Contracts with Customers provides detailed and consistent guidance regarding revenue recognition. IFRS 15 sets out a five-step model, which applies to revenue earned from a contract with a customer with limited exceptions, regardless of the type of revenue transaction or the industry. Step one in the five-step model requires the identification of the contract with the customer and is critical for the purpose of applying the Standard. The remaining four steps in the Standard's revenue recognition model are irrelevant if the contract does not fall within the scope of IFRS 15.

Required

(a)

(i) Discuss the criteria which must be met for a contract with a customer to fall within the scope of IFRS 15. (5 marks)

(ii) Discuss the four remaining steps which lead to revenue recognition after a contract has been identified as falling within the scope of IFRS 15. (9 marks)

(a) (i) Criteria for a contract under IFRS 15 Definition of a contract The definition of what constitutes a contract for the purpose of applying IFRS 15 is critical. A contract exists when an agreement between two or more parties creates enforceable rights and obligations between those parties. The agreement does not need to be in writing to be a contract but the decision as to whether a contractual right or obligation is enforceable is considered within the context of the relevant legal framework of a jurisdiction. Thus, whether a contract is enforceable will vary across jurisdictions. The performance obligation could include promises which result in a valid expectation that the entity will transfer goods or services to the customer even though those promises are not legally enforceable.

An entity should only account for a contract with a customer within the scope of IFRS 15 when all of the following five criteria have been met.

(1) Contract approved and committed to perform obligations

The first criteria set out in IFRS 15 is that the parties should have approved the contract and are committed to perform their respective obligations. It would be questionable whether that contract is enforceable if this were not the case. In the case of oral or implied contracts, this may be difficult but all relevant facts and circumstances should be considered in assessing the parties' commitment. The parties need not always be committed to fulfilling all of the obligations under a contract. IFRS 15 gives the example where a customer is required to purchase a minimum quantity of goods but past experience shows that the customer does not always do this and the other party does not enforce their contract rights. The IFRS 15 criterion could still be satisfied in this example if there is evidence that the parties are substantially committed to the contract.

(2) Entity can identify each party's rights

It is essential that each party's rights can be identified regarding the goods or services to be transferred. Without this criterion, an entity would not be able to assess the transfer of goods or services and therefore, the point at which revenue should be recognised.

(3) Entity can identify each party's payment terms

It is essential that each party's payment terms can be identified regarding the goods or services to be transferred. This requirement is the key to determining the transaction price.

(4) Contract has commercial substance

The contract must have commercial substance before revenue can be recognised, as without this requirement, entities might artificially inflate their revenue and it would be questionable whether the transaction has economic consequences. The contract is deemed to have commercial substance when the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract.

(5) Probable consideration

It should be probable that the entity will collect the consideration due under the contract. An assessment of a customer's credit risk is an important element in deciding whether a contract has validity but customer credit risk does not affect the measurement or presentation of revenue.

The consideration may be different to the contract price because of discounts and bonus offerings. The entity should assess the ability of the customer to pay and the customer's intention to pay the consideration.

Reassessment

If a contract with a customer does not meet these criteria, the entity can continually reassess the contract to determine whether it subsequently meets the criteria. Combination of contracts Two or more contracts which are entered into around the same time with the same customer may be combined and accounted for as a single contract, if they meet the specified criteria. Contract modifications The Standard provides detailed requirements for contract modifications. A modification may be accounted for as a separate contract or a modification of the original contract, depending upon the circumstances of the case.

(ii) Four remaining IFRS 15 steps As explained in part (a)

(i), step one in the five-step model requires the identification of the contract with the customer. After a contract has been determined to fall under IFRS 15, the following steps are required before revenue can be recognised.

Step 2: Identify the performance obligations in the contract This step requires the identification of the separate performance obligations in the contract. This is often referred to as 'unbundling', and is done at the beginning of a contract. The key factor in identifying a separate performance obligation is the distinctiveness of the good or service, or a bundle of goods or services. A good or service is distinct if the customer can benefit from the good or service on its own or together with other readily available resources and is separately identifiable from other elements of the contract. IFRS 15 requires a series of distinct goods or services which are substantially the same with the same pattern of transfer, to be regarded as a single performance obligation. A good or service, which has been delivered, may not be distinct if it cannot be used without another good or service which has not yet been delivered. Similarly, goods or services which are not distinct should be combined with other goods or services until the entity

identifies a bundle of goods or services which is distinct. IFRS 15 provides indicators rather than criteria to determine when a good or service is distinct within the context of the contract. This allows management to apply judgement to determine the separate performance obligations which best reflect the economic substance of a transaction.
Step 3: Determine the transaction price This step requires the entity to determine the transaction price, which is the amount of consideration which an entity expects to be entitled to in exchange for the promised goods or services. This amount excludes amounts collected on behalf of a third party, for example, government taxes. An entity must determine the amount of consideration to which it expects to be entitled in order to recognise revenue.

The transaction price might include variable or contingent consideration. Variable consideration should be estimated as either the expected value or the most likely amount. Management should use the approach which it expects will best predict the amount of consideration and should be applied consistently throughout the contract.
An entity can only include variable consideration in the transaction price to the extent that it is highly probable that a subsequent change in the estimated variable consideration will not result in a significant revenue reversal.
If it is not appropriate to include all of the variable consideration in the transaction price, the entity should assess whether it should include part of the variable consideration. However, this latter amount still has to pass the 'revenue reversal' test.
Additionally, an entity should estimate the transaction price taking into account noncash consideration, consideration payable to the customer and the time value of money if a significant financing component is present.
The latter is not required if the time period between the transfer of goods or services and payment is less than one year. If an entity anticipates that it may ultimately accept an amount lower than that initially promised in the contract due to, for example, past experience of discounts given, then revenue would be estimated at the lower amount with the collectability of that lower amount being assessed. Subsequently, if revenue already recognised is not collectable, impairment losses should be taken to profit or loss.

Step 4: Allocate the transaction price to the performance obligations in the contract This step requires the allocation of the transaction price to the separate performance obligations. When a contract contains more than one distinct performance obligation, an entity allocates the transaction price to each distinct performance obligation on the basis of the relative standalone selling prices of the goods or services promised.
This allocation is made at inception of the contract. It is not adjusted to reflect subsequent changes in the standalone selling prices of those goods or services. The best

evidence of standalone selling price is the observable price of a good or service when the entity sells that good or service separately.
If that is not available, an estimate is made by using an approach which maximises the use of observable inputs. For example, expected cost plus an appropriate margin or the assessment of market prices for similar goods or services adjusted for entity-specific costs and margins or in limited circumstances a residual approach. Where the transaction price includes a variable amount and discounts, consideration needs to be given as to whether these amounts relate to all or only some of the performance obligations in the contract. Discounts and variable consideration will typically be allocated proportionately to all of the performance obligations in the contract. However, if certain conditions are met, they can be allocated to one or more separate performance obligations.

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation This final step requires revenue to be recognised as each performance obligation is satisfied. An entity satisfies a performance obligation by transferring control of a promised good or service to the customer, which could occur over time or at a point in time. The definition of control includes the ability to prevent others from directing the use of and obtaining the benefits from the asset. Where an entity satisfies its performance obligation over time, revenue is recognised over time in line with the pattern of transfer.

The consideration may be different to the contract price because of discounts and bonus offerings. The entity should assess the ability of the customer to pay and the customer's intention to pay the consideration.
Reassessment
If a contract with a customer does not meet these criteria, the entity can continually reassess the contract to determine whether it subsequently meets the criteria. Combination of contracts Two or more contracts which are entered into around the same time with the same customer may be combined and accounted for as a single contract, if
they meet the specified criteria. Contract modifications
The Standard provides detailed requirements for contract modifications. A modification may be accounted for as a separate contract or a modification of the original contract, depending upon the circumstances of the case.

QUESTION 06

(a)Blochberger is a manufacturer of consumer goods. On 30 November 20X7, Blochberger entered into a one-year contract to sell goods to a large global chain of retail stores. The customer committed to buy at least $30 million of products over the one year contract. The contract required Blochberger to make a non-refundable payment of $3 million to the customer at the inception of the contract. The $3 million payment is to

compensate the customer for the changes required to its shelving to accommodate Blochberger's products. Blochberger duly paid this $3 million to the customer on 30 November 20X7.
In December 20X7, Blochberger transferred goods to the customer worth $4 million to the customer and invoiced them for this amount. (6 marks)

(b) On 1 July 20X7, Blochberger entered into a contract with another customer to sell Product A
for $200 per unit. If the customer purchases more than 1,000 units of Product A in a 12-month period, the contract specifies that the price per unit is retrospectively reduced to $180 per unit.
For the quarter ended 30 September 20X7, Blochberger sold 75 units of Product A to the customer. At that date, Blochberger estimated that the customers' purchases would not exceed the 1,000-unit threshold required for the volume discount.
In October 20X8, the customer acquired another company and in the quarter ended 31 December 20X7, Blochberger sold an additional 500 units of Product A to the customer. In light of this, Blochberger now estimates that the customer's purchases will exceed the 1,000- unit threshold (in the 12 months to 30 June 20X8) and therefore, it will be required to retrospectively reduce the price per unit to $180. (7 marks)

(c) On 31 December 20X7, Blochberger sold Product B to a customer for $12,100 payable 24 months after delivery. The customer obtained control of the product at contract inception. However, the contract permits the customer to return the product within 90 days. The product is new and Blochberger has no relevant historical evidence of product returns or other available market evidence.
The cash selling price of Product B is $10,000, which represents the amount that the customer would pay upon delivery of the same product sold under otherwise identical terms and conditions as at contract inception. The cost of the product to Blochberger is $8,000. (7 marks)

(d) On 1 September 20X7, Blochberger purchased a new machine for use in its factory. The directors have capitalised the purchase price but are unsure how to treat the following related costs. $400,000 was spent on testing whether the machine was functioning properly. During the testing period (September–October 20X7), samples were produced and sold for a total of $75,000. $300,000 was also spent on training existing employees how to operate the new machine. The machine is being used to manufacture a new product, Product C and $1 million was spent of advertising this new product. Testing was completed and commercial production of Product C commenced on 31 October 20X7. (5 marks)
Required

Advise Blochberger on how the above transactions should be dealt with in its financial statements for the year ended 31 December 20X7 (and up to 31 March 20X8 for part (c)). Note. The mark allocation is shown against each of the four issues above.

(Total = 25 marks)

QUESTION 07

Minco is a major property developer. On 1 June 20X3, Minco entered into a contract with Holistic Healthco for the sale of a building for $3 million. Holistic Healthco intends to use the building as a fitness and leisure centre. The building is located in a busy city, where there are many gyms and leisure centres. Holistic Healthco's experience to date has been in stores selling health foods and aromatherapy oils, and it has no experience of the fitness industry.

Holistic Healthco paid Minco a non-refundable deposit of $150,000 on 1 June 20X3 and entered into a long-term financing agreement with Minco for the remaining 95% of the promised consideration. The terms of the financing arrangement are that if Holistic Healthco defaults, Minco can repossess the building, but cannot seek further compensation from Holistic Healthco, even if the collateral does not cover the full value of the amount owed. The building cost Minco $1.8 million to construct. Holistic Healthco obtained control of the building on 1 June 20X3.

Minco argues that this contract falls within the scope of IFRS 15 Revenue from Contracts with Customers, and that the non-refundable deposit should be recognised as revenue. (8 marks)

QUESTION 08

You are the newly appointed financial controller of Havanna and have been asked to give advice to the board of directors on the following transactions it entered into in the year ended 30 November 20X3.

Havanna owns a chain of health clubs and has entered into binding contracts with sports organisations, which earn income over given periods. The services rendered in return for such income include access to Havanna's database of members, and admission to health clubs, including the provision of coaching and other benefits. These contracts are for periods of between 9 and 18 months. Havanna's accounting policy for revenue recognition is to recognise the contract income in full at the date when the contract is signed. The rationale is that the contracts are binding and at the point of signing the contract, the customer gains access to Havanna's services. The directors are reluctant to change their accounting policy.

Required

Advise the directors, with reference to the underlying principles of IFRS 15 Revenue from Contracts with Customers, how the revenue in relation to the contracts should be recognised. (10 marks)

QUESTION 09
Alexandra enters into contracts with both customers and suppliers. The supplier solves system
problems and provides new releases and updates for software. Alexandra provides maintenance services for its customers. In previous years, Alexandra recognised revenue and related costs on software maintenance contracts when the customer was invoiced, which was at the beginning of the contract period. Contracts typically run for two years.
During 20X0, Alexandra had acquired Xavier Co, which recognised revenue, derived from a similar type of maintenance contract as Alexandra, on a straight-line basis over the term of the contract. Alexandra considered both its own and the policy of Xavier Co to comply with the requirements of IFRS 15 Revenue from Contracts with Customers but it decided to adopt the practice of Xavier Co for itself and the group. Alexandra concluded that the two recognition methods did not, in substance, represent two different accounting policies and did not, therefore, consider adoption of the new practice to be a change in policy.
In the year to 30 April 20X1, Alexandra recognised revenue (and the related costs) on a straight-line basis over the contract term, treating this as a change in an accounting estimate. As a result, revenue and cost of sales were adjusted, reducing the year's profits by some $6 million.
Required
Explain, with reference to the principles of relevant IFRSs, the appropriate accounting treatment for the above issue in Alexandra's financial statements for the year ended 30 April 20X1. (5 marks)

QUESTION 10
Verge entered into a contract with a government body on 1 April 20X1 to undertake maintenance services on a new railway line. The total revenue from the contract is $5 million over a three-year period. The contract states that $1 million will be paid at the commencement of the contract but although invoices will be subsequently sent at the end of each year, the government authority will only settle the subsequent amounts owing when the contract is completed. The invoices sent by Verge to date (including $1 million above) were as follows:
Year ended 31 March 20X2 $2.8 million
Year ended 31 March 20X3 $1.2 million
The balance will be invoiced on 31 March 20X4. Verge has only accounted for the initial payment in the financial statements to 31 March 20X2 as no subsequent amounts are to be paid until 31 March 20X4. The amounts of the invoices reflect the work undertaken in the period. Verge wishes to know how to account for the revenue on the contract in the financial statements to date.

The interest rate that would be used in a separate financing transaction between Verge and the government agency is 6%. This reflects the credit characteristics of the government agency.