

SLFRS 15 - Revenue from Contracts with Customer

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1.0 Key Definitions

- 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.
- Revenue - Income arising in the course of an entity's ordinary activities
- Contract - An agreement between two or more parties that creates enforceable rights and obligations.
- Transaction Price - 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.
- Stand-alone selling price - The price at which an entity would sell a promised good or service separately to a customer.

2.0 SLFRS 15 uses a principles-based 5-step approach to apply to contract with customers.

The five steps are as follows:



1. Identification of contracts
2. Identification of performance obligations (goods, services or a bundle of goods and services)
3. Determination of transaction price
4. Allocation of the price to performance obligations
5. Recognition of revenue when/as performance obligations are satisfied

3.0 Recognition

3.1. Identifying the contract

- IFRS 15 Revenue from Contracts with Customers is applied to contracts with customers that meet all of the following five criteria:
- The contract has been approved in writing, orally, or in accordance with other customary business practices and the parties are committed to perform their obligations in the contract;
- Each party's rights regarding the goods or services to be transferred can be identified;
- The payment terms for the goods or services to be transferred can be identified;
- The contract has commercial substance (i.e. the risk, timing or amount of the vendor's future cash flows is expected to change as a result of the contract);
- It is probable that the consideration for the exchange of the goods or services that the vendor is entitled to will be collected. For the purposes of this criterion, only

the customer's ability and intention to pay amounts when they become due are considered.

3.1.1 Combination of contracts

Two or more contracts that are entered into at (or near) the same time, and with the same customer or related parties of the customer, are accounted for as if they were a single contract for accounting purposes, if one of the following criteria are met:

- The contracts are negotiated as a package with a single commercial objective;
- The amount of consideration in one contract depends on the price or performance of the other contract(s); or
- The goods or services that are promised in the contracts (or some of the goods or services) represent a single performance obligation.

EXAMPLE 01

A PLC promises to sell 120 products to a customer for LKR 120,000 (LKR 1,000 /-). The products are transferred to the customer over a six-month period. A PLC transfers control of each product at a point in time. After the A PLC has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

When the contract is modified, the price of the contract modification for the additional 30 products is an additional LKR 28,500 or LKR 950 per product.

Discuss, whether these can be considered as single contract?

3.2 Step Two – Identify separate performance obligations in the contract

Having identified the contract for accounting purposes in Step one, a vendor is then required to identify the performance obligations(s) contained in that contract. A performance obligation is a promise to a customer to transfer:

- A good or 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.

EXAMPLE 03.01

Office Solutions, a limited company, has developed a communications software package called CommSoft. Office Solutions has entered into a contract with Logistcity to supply the following:

- a) License to use Commsoft
- b) Installation service. This may require an upgrade to the computer operating system, but the software package does not need to be customized.
- c) Technical support for three years
- d) Three years of updates for Commsoft

Office Solutions is not the only company able to install CommSoft, and the technical support can also be provided by other companies. The software can function without the updates and technical support.

Required

Explain whether the goods or services provided to Logisticity are distinct in accordance with SLFRS 15 Revenue from contracts with customers.

EXAMPLE 03.02

Liver Tech is a computer business that primarily sells computer hardware. As well as selling computers, it also supplies and installs the software to its customers and provides a technical support package over a number of years. The business commonly sells the supply and installation, and technical support in a combined goods and services contract

Required

Explain whether the goods or services provided to Liver Tech are distinct in accordance with SLFRS 15 Revenue from contracts with customers.

3.3 Determine the transaction price of the contract

The transaction price is the amount of consideration that a vendor expects to be entitled to in exchange for the goods or services. This will often be the amount specified in the contract. However, the vendor is also required to consider its customary business practices and, if these indicate that a lower amount will be accepted, then this would be the transaction price.

Although a number of estimates about the future may need to be made when determining the transaction price, these are based on the goods and services to be transferred in accordance with the existing contract. They do not take into account expectations about whether the contract will be cancelled, renewed or modified.

The vendor must also consider the effects of the following:

- Variable consideration;
- Constraining estimates of variable consideration;
- The existence of a significant financing component;
- Non-cash consideration;
- Consideration payable to a customer

EXAMPLE 04

Luckers Co. sells a machinery to a customer for LKR 100,000, offering interest-free credit for a three-year period. The car is delivered to the customer immediately. The annual market rate of interest on the provision of consumer credit to similar customers is 5%.

What is the transaction price?

3.4 Allocate the transaction price to the performance obligations

Having determined the transaction price of the contract in Step 3, it is then necessary to allocate that transaction price to each of the performance obligations identified in Step 2.

The objective is to allocate an amount to each performance obligation that reflects the consideration to which a vendor expects to be entitled in exchange for transferring the distinct goods or services (comprising each identified performance obligation in Step 2) to the customer. The starting point for the allocation is to determine the stand-alone selling prices of each of those performance obligations.

SLFRS 15 brings a substantial change in approach because existing SLFRSs contain very little guidance for allocating a transaction price to components (commonly referred to as the 'unbundling' of contracts). Therefore, some entities followed the detailed guidance in US GAAP, in particular those in the software and technology sectors.

EXAMPLE 05

Richer Co. sells home entertainment systems including a two-year repair and maintenance package for LKR 10,000. The price of a home entertainment system without the repair and maintenance contract is LKR 9,000 and the price to renew a two-year maintenance package is LKR 2,000.

How the LKR 10,000 contract price is allocated to the separate performance obligations?

EXAMPLE 06

A mobile phone company gives customers a free handset when they sign a two-year contract for provision of network services. The handset has a stand-alone price of \$100 and the contract is for \$20 per month.

Under SLFRS 15, how the revenue must be allocated to the handset because delivery of the handset constitutes a performance obligation.

3.5 Recognize revenue when each performance obligation is satisfied

Having allocated in Step 4 the transaction price (as determined in Step 2) to the performance obligations (identified in Step 3) it is then necessary to determine when the revenue allocated to each performance obligation should be recognized.

A vendor recognizes revenue when (or as) goods or services are transferred to a customer. A vendor satisfies a performance obligation (that is, it fulfils each promise to the customer) by transferring control of the promised good(s) or service(s) underlying that performance obligation to the customer.

3.5.1 Performance obligations satisfied over time

A vendor satisfies a performance obligation and recognizes revenue over time when one of the following three criteria is met:

- i. The customer simultaneously receives and consumes the economic benefits provided by the vendor's performance;
- ii. The vendor creates or enhances an asset controlled by the customer;
- iii. The vendor's performance does not create an asset for which the vendor has an alternative use, the vendor has an enforceable right to payment for performance completed to date

3.5.2 Revenue recognition at a point in time

If a performance obligation is not satisfied over time, a vendor satisfies the performance obligation at a point in time. A vendor considers indicators of the transfer of control, which include the following:

- i. The vendor has a present right to payment for the asset. If the customer is obliged to pay for the asset, this indicates that the customer may have the ability to obtain substantially all of the remaining benefits from the asset;
- ii. The customer has legal title to the asset.

- iii. The customer has physical possession of an asset. This may indicate that the customer has the ability to direct the use of and obtain substantially all of the remaining benefits from the asset
- iv. Significant risks and rewards of ownership. When evaluating whether the customer has the risks and rewards of ownership of an asset, a vendor considers any risks that may give rise to a performance obligation in addition to the performance obligation to transfer the asset
- v. Acceptance of the asset. The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of and obtain substantially all of the remaining benefits from the asset.

EXAMPLE 07

A property developer constructs 50 identical residential units and enters into sales

Contracts as follows:

- 10% Deposit payable at the date of signing
 - 50% payment 1 year from signing date
 - 40% payment on completion
- 1) Contract A to sell unit 1 at LKR 20,000,000 with no other specific terms
 - 2) Contract B to sell unit 2 at LKR 20,000,000 with the following terms:
 - a) Buyer has an exclusive right to purchase unit 2 which cannot be transferred to any other party unless the buyer defaults
 - b) Buyer is legally required to exchange and complete
 - c) Property developer is entitled to full consideration, even if the buyer defaults
 - d) Buyer has requested custom-made higher spec fit-out rather than standard Discuss how the revenue will be recognized, is it over the time or at the point in time?

4.0 Contract costs

- ✓ Incremental costs of obtaining a contract An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.
- ✓ The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).
- ✓ Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.
- ✓ Costs to fulfil a contract If the costs incurred in fulfilling a contract with a customer are not within the scope of another Standard (for example, LKAS 2 Inventories, LKAS 16 Property, Plant and Equipment or LKAS 38 Intangible Assets), an entity shall recognize an asset from the costs incurred to fulfil a contract only if those costs meet all of the following criteria:

- the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved);
- The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; and (c) the costs are expected to be recovered.

Special Cases

1.0 Warranties

If a customer has the option to purchase a warranty separately from the product to which it relates, it constitutes a distinct service and is accounted for as a separate performance obligation. This would apply to a warranty which provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

If the customer does not have the option to purchase the warranty separately, for instance if the warranty is required by law, that does not give rise to a performance obligation and the warranty is accounted for in accordance with LKAS 37.

2.0 Principal versus agent

An entity must establish in any transaction whether it is acting as principal or agent. It is a principal if it controls the promised good or service before it is transferred to the customer.

When the performance obligation is satisfied, the entity recognizes revenue in the gross amount of the consideration to which it expects to be entitled for those goods or services. It is acting as an agent if its performance obligation is to arrange for the provision of goods or services by another party. Satisfaction of this performance obligation will give rise to the recognition of revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the other party to provide its goods or services.

Indicators that an entity is an agent rather than a principal include the following:

- Another party is primarily responsible for fulfilling the contract.
- The entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return.
- The entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited.
- The entity's consideration is in the form of a commission.
- The entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.