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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

CL 02 – Financial Reporting and Governance

Corporate Level

(SLFRS 15 – Revenue from Contract with Customers)

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Revenue from Contract with Customers

Topic No 12

1. INTRODUCTION

SLFRS 15 Revenue from Contracts with Customers is applicable to all contracts with customers with limited exceptions. It provides guidance on the recognition and measurement of revenue, costs associated with a contract and amounts to be recognised in the statement of financial position.

1.1 Scope

SLFRS 15 applies to all contracts with customers except:

- Leases within the scope of SLFRS 16 Leases
- Insurance contracts within the scope of SLFRS 17 Insurance Contracts
- Financial instruments and other contractual rights and obligations within the scope of SLFRS 9, SLFRS 10, SLFRS 11, LKAS 27 or LKAS 28
- Non-monetary exchanges between entities in the same line of business in order to facilitate sales

1.2 Key definitions

Revenue	Income arising in the course of an entity's ordinary activities
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
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
Contract	An agreement between two or more parties that creates enforceable rights and obligations

Revenue does not include sales taxes, value added taxes or goods and service taxes which are only collected for third parties, because these do not represent an increase in economic benefit for the entity.

Revenue is generated through company's ordinary trading and operating activities. It can be different from company to company depending on the industry they are engaged in. Further, it may be called different names, such as sales, turnover or fees

2. REVENUE RECOGNITION PROCESS - The five-step model

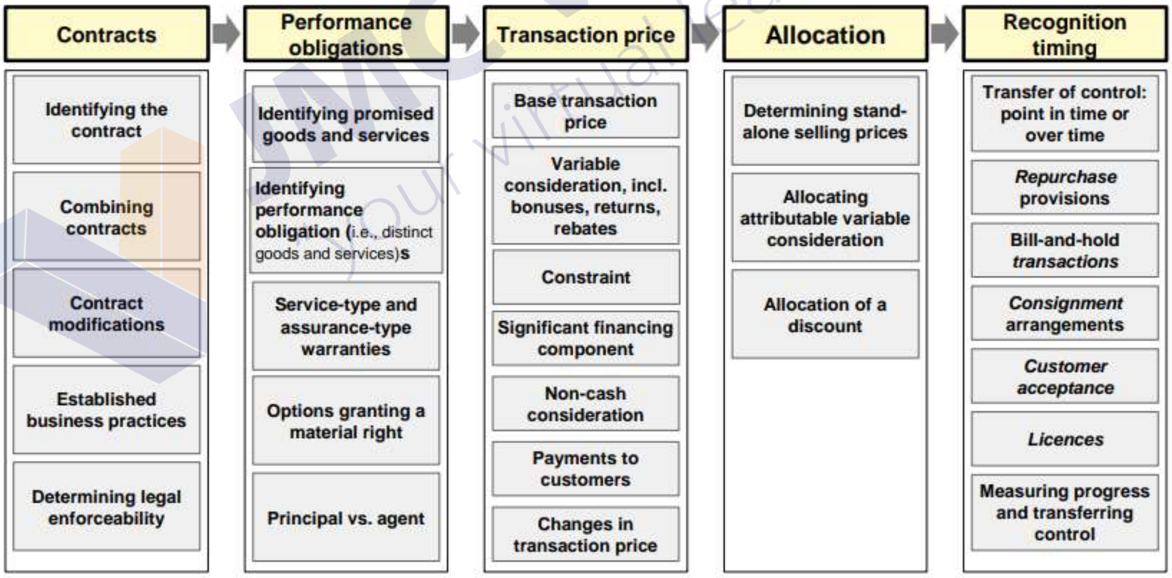
SLFRS 15 provides a five-step model to measure and recognise revenue; the principle of the model is that an entity recognises revenue to depict the transfer of promised goods/services in an amount that reflects the consideration to which the entity expects to be entitled.

Core principle	an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

The **five steps identified by SLFRS 15** are as follows. An entity have to recognize the revenue based on this 5 steps.

- **Step 1** Identify the contract(s) with the customer (as per SLFRS 15)
- **Step 2** Identify the performance obligations within the contract
- **Step 3** Determine the transaction price
- **Step 4** Allocate the transaction price to the performance obligations
- **Step 5** Recognise revenue when (or as) the entity satisfies a performance obligation

2.1 Overview of SLFRS 15



Question 01 – Five Step Model - Overview

On 1 December 2021, Wade receives an order from a customer for a computer as well as 12 months of technical support. Wade delivers the computer (and transfers its legal title) to the customer on the same day. The customer paid $420 on 1

December 2021. The computer normally sells for $300 and the technical support for $120.

Required: Apply the 5 stages of revenue recognition, per SLFRS 15, to determine how much revenue Wade should recognize in the year ended 31 December 2021

STEP 01 - IDENTIFY THE CONTRACT(S) WITH THE CUSTOMER

The standard defines a 'contract' as an agreement between two or more parties that creates enforceable rights and obligations and species that enforceability is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. ***(Para 10)***

A contract does not exist when each party has the unilateral right to terminate a wholly unperformed contract without compensation. ***(Para 12)***

- A contract is wholly unperformed when the entity has not yet transferred any promised goods or services to the customer and the entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

A contract with a customer is in the scope of the standard when it is legally enforceable and **meets all of the following criteria**. ***(Para 09)***

- the parties to the **contract have approved** the contract and are committed to perform their respective obligations
- the entity can identify **each party's rights** regarding the goods or services to be transferred
- the entity can identify the **payment terms** for the goods or services to be transferred
    - *When there is an enforceable right to payment and contract contains sufficient information to enable the entity to estimate the transaction price*
- the contract has **commercial substance** (ie the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract)
    - *The entity must be able to demonstrate a substantive business purpose exists, considering the nature and structure of its transactions.*
- it is probable that the entity **will collect the consideration** to which it will be entitled in exchange for the goods or services that will be transferred to the customer

These criteria are **assessed at the inception** of the arrangement

- If the criteria are met at inception, reassessment only occurs if there is a significant change in facts and circumstances

- If the criteria are not met at inception, continue to reassess

Collectability assessment

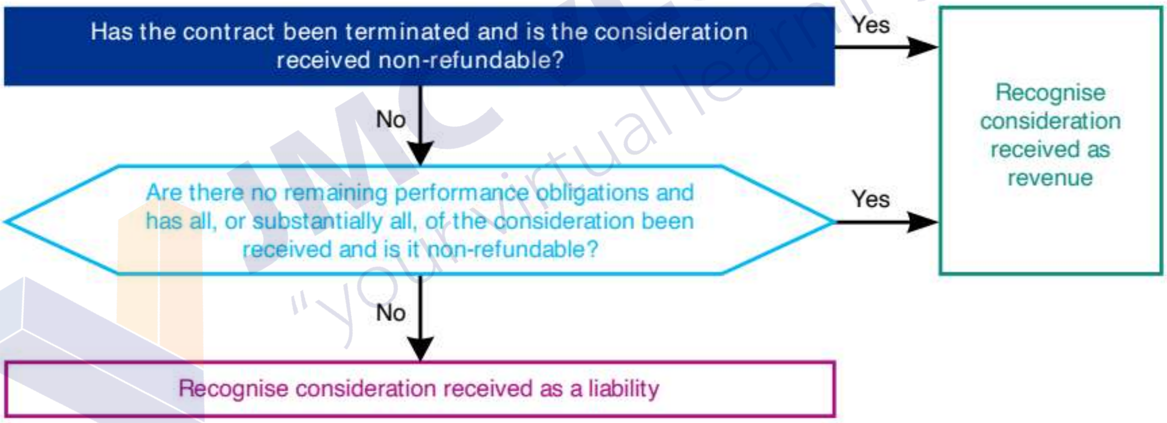
Collectability	Collectability refers to the customer's **intent** and **ability** to pay the amount of promised consideration

In making the collectability assessment, an entity considers the customer's **ability** and **intention** (which includes assessing its credit-worthiness) to pay the amount of consideration when it is due. This assessment is made **after taking into account any price concessions** that the entity may offer to the customer. So it will be assessed whether it is **probable** that the price will be collected.

However, **significant judgement** will be required to determine if a partial payment is an implied price concession or an impairment loss.

Consideration received before a contract exists *(Para 15-16)*

The following -flowchart outlines when consideration received from a contract that is not yet in the scope of the standard can be recognized.



The entity is, however, required to reassess the arrangement and, if Step 1 of the model is subsequently met, begin applying the revenue model to the arrangement.

Question 02 – Identifying the contract

An entity, a real estate developer, enters into a contract with a customer for the sale of a building for Rs.1 million. The customer intends to open a restaurant in the building. The building is located in an area where new restaurants face high levels of competition, and the customer has little experience in the restaurant industry.

The customer pays a non-refundable deposit of Rs.50,000 at inception of the contract and enters into a long-term financing agreement with the entity for the remaining 95% of the promised consideration. The financing arrangement is provided on a non-recourse basis, which means that if the customer defaults, the entity can repossess the building, but cannot seek further compensation from the customer, even if the collateral does not cover the full value of the amount owed.

The entity's cost of the building is Rs.600,000. The customer obtains control of the building at contract inception.

Required: Identify how the above arrangement would be treated under SLFRS 15.

STEP 02 - IDENTIFY THE PERFORMANCE OBLIGATIONS WITHIN THE CONTRACT

A contract contains **promises** to the customer (eg to deliver goods, provide a service or construct an asset). These **promises may form one or more separate performance obligations**.

Where a contract contains a single promise, it is clear that there is a single performance obligation; **where a contract contains a number of promises** (eg where an entity promises to deliver a training course and provide text books) then the **seller must determine how many performance obligations** are contained within the contract. The number of performance obligations may not be equal to the number of identified promises because promises may be combined.

Performance Obligation	An entity assesses the goods or services promised in a contract with a customer and identifies as a performance obligation either a: • **good or service** (or a bundle of goods or services) that is ***distinct*** • **series of *distinct* goods or services** that are substantially the same and that have the same pattern of transfer to the customer *(i.e. each distinct good or service in the series is satisfied over time and the same method is used to measure progress)*

Distinct goods or services *(Para 22)*

A single contract may contain promises to deliver to the customer more than one good or service.

For example:

- *An entity may enter into a contract with a customer to **sell a car**, which includes one year's free **servicing and maintenance**.*

- *An entity might enter into a contract with a customer to provide 5 **lectures**, as well as to provide a **textbook** on the first day of the course.*

At **contract inception**, an entity evaluates the promised goods or services to determine which goods or services (or bundle of goods or services) are distinct and therefore constitute performance obligations. ***(Para 22)***

A good or service is '**distinct'** if **both of the following** criteria are met.

Criteria 01: ***Capable of being distinct***		Criteria 02: ***Distinct within the context of the contract***
Can the customer benefit from the good or service on its own or together with other readily available resources?	+	Is the entity's promise to transfer the good or service separately identifiable from other promises in the contract?

Yes → **Distinct – Performance obligation**

No → **Not distinct – Combine with other goods and services**

Citeria 01: Good or service is capable of being distinct ***(28)***	A customer can benefit from a good or service if it can be used, consumed, sold for an amount that is greater than scrap value or otherwise held in a way that generates economic benefits. A customer can benefit from a good or service on its own or in conjunction with: • other readily available resources that are sold separately by the entity or by another entity; or • resources that the customer has already obtained from the entity (e.g. a good or service delivered up-front) or from other transactions or events. The fact that a **good or service is regularly sold separately** by the entity is an indicator that the customer can benefit from

	a good or service on its own or with other readily available resources.
Citeria 02: Good or service is capable of being distinct ***(29)***	The **objective** when assessing whether an entity's promises to transfer goods or services are distinct within the context of the contract is **to determine whether the nature of the promise** is to transfer each of those goods or services **individually**, or whether the promise is to transfer a **combined** item or items to which the promised goods or services are inputs. The standard provides the **following indicators** to help in evaluating whether two or more promises to transfer goods or services to a customer are **not separately identifiable**. • The entity provides a significant service of **integrating** the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the **combined** output or outputs for which the customer has contracted. This occurs when the entity is using the goods or services as inputs to produce or deliver the output or outputs specified by the customer. A combined output (or outputs) might include more than one phase, element or unit. • One or more of the goods or services **significantly modifies or customizes**, or is significantly modified or customized by, one or more of the other goods or services promised in the contract. • The goods or services are **highly interdependent** or **highly inter-related**, such that each of the goods or services is significantly affected by one or more of the other goods or services

If a promised good or service is determined not to be distinct, then an entity continues to combine it with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, this results in the entity accounting for all of the goods or services promised in a contract as a single performance obligation.

Question 03 – Identifying the performance obligations

Contractor Q, a construction firm, enters into a contract with a customer to **design** and **construct** a concert hall. The project has two phases, design and construction and the contract provides separate compensation for each phase. Assume that the individual goods and services provided in each phase are capable of being distinct.

Contractor Q provides a significant service of: (1) integrating the various design services to produce project plans in the design phase; and (2) integrating the various materials and construction services to build the concert hall in the construction phase.

Required: Identify how many performance obligations are included in the above arrangement as per SLFRS 15.

Question 04 – Identifying the performance obligations

Construction Company C enters into a contract with Customer D to design and build a hospital. C is responsible for the overall management of the project and identifies goods and services to be provided – including engineering, site clearance, foundation, procurement, construction, piping and wiring, installation of equipment and finishing.

C identifies goods and services that will be provided during the hospital construction that might otherwise benefit D on its own. For example, if each construction material is sold separately by other entities, then it could be resold for more than scrap value by D. It could also be sold together with other readily available resources such as additional materials or the services of another contractor.

Required: Identify how many performance obligations are included in the above arrangement as per SLFRS 15.

Question 05 – Identifying the performance obligations

Telco T has a contract with Customer R that includes the delivery of a handset and two years of voice and data services. The handset can be used by R to perform certain functions – e.g. calendar, contacts list, email, internet access, accessing apps via Wi-Fi and to play music or games.

Additionally, there is evidence of customers reselling handsets on an online auction site and recapturing a portion of the selling price of the phone. T also regularly sells its voice and data services separately to customers, through renewals or sales to customers who acquire handsets from an alternative vendor – e.g. a retailer.

Required: Identify how many performance obligations are included in the above arrangement as per SLFRS 15.

Question 06 – Identifying the performance obligations

Kandy Office Solutions (KOS) has developed a communications software package called CommSoft. KOS has entered into a contract with a customer 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 KOS 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 the customer are distinct in accordance with SLFRS 15 Revenue from contracts with customers.

Series of distinct goods or services *(Para 22)*

A contract may contain promises to deliver a series of distinct goods or services that are substantially the same. At contract inception, an entity assesses the goods or services promised in the contract and determines whether the series of goods or services is a single performance obligation. This is the case when they meet the following criteria.

The goods or services are substantially the same

+

Each distinct good or service in the series is a performance obligation satisfied over time

+

The same method would be used to measure progress towards satisfaction of each distinct good or service in the series

=

A single performance obligation

Question 07 – Identifying the performance obligations

Contract Manufacturer X agrees to produce 1,000 customized widgets for use by Customer C in its products. X concludes that the widgets will transfer to C over time because:

- they have no alternative use to X; and
- C is contractually obliged to pay X for any finished or in-progress widgets, including a reasonable margin, if C terminates the contract for convenience.

X already has the process in place to produce the widgets and is given the design by C, such that X does not expect to incur any significant learning curve or design and development costs. X uses a method of measuring progress towards complete satisfaction of its manufacturing contracts that takes into account work in progress and finished goods controlled by C.

Required: Identify how many performance obligations are included in the above arrangement as per SLFRS 15.

STEP 03 - DETERMINE THE TRANSACTION PRICE

The '**transaction price**' is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – *e.g. certain sales taxes. To determine this amount, an entity considers multiple factors*

In determining the transaction price, an entity considers the following components.

- **Variable consideration** (and the constraint)
  - *An entity estimates the amount of variable consideration to which it expects to be entitled, giving consideration to the risk of revenue reversal in making the estimate*
- **Significant financing component**
  - *For contracts with a significant financing component, an entity adjusts the promised amount of consideration to reflect the time value of money*
- **Non-cash consideration**
  - *Non-cash consideration is measured at **fair value**, if that can be reasonably estimated; if not, then an entity uses the stand-alone selling price of the good or service that was promised in exchange for non-cash consideration*
- **Consideration payable to a customer**
  - *An entity needs to determine whether consideration payable to a customer represents a **reduction of the transaction price**, a payment for a distinct good or service, or a combination of the two*

Variable consideration (and the constraint)

An entity assesses whether, and to what extent, it can include an amount of variable consideration in the transaction price at contract inception. This might include,

• Discounts	• Rebates	• Refunds	• Rights of return
• Early settlement discounts	• Credits	• Price concessions	• Incentives
• Performance bonuses	• Penalties		

- Promised consideration **can also vary if it is contingent** on the occurrence or non-occurrence of a future event – *e.g. the sale of an office building in which the consideration depends on the level of occupancy of the building at a future date*.
- Variability may be explicit or implicit, arising from customary business practices, published policies or specific statements, or any other facts and circumstances that would create a valid expectation by the customer.

Is the consideration variable or fixed?

Fixed

Variable

Estimate the amount using either the expected value or most likely amount method for each type of variable consideration

Apply the constraint – *i.e. determine the portion, if any, of that amount for which it is highly probable that a significant revenue reversal will not subsequently occur*

Include the amount in the transaction price

An entity recognizes a refund liability for consideration received or receivable if it expects to refund some or all of the consideration to the customer.

Estimation of variable consideration *(Para 53)*

When estimating the transaction price for a contract with variable consideration, an entity's initial measurement objective is to determine which of the following **methods** best predicts the consideration to which the entity will be entitled.

Expected value	• The entity considers the **sum of probability-weighted amounts** for a range of possible consideration amounts. • This may be an appropriate estimate of the amount of variable consideration if an entity has **a large number of contracts** with similar characteristics
Most likely amount	• The entity considers the **single most likely amount** from a range of possible consideration amounts. • This may be an appropriate estimate of the amount of variable consideration if the **contract has only two (or perhaps a few) possible outcomes**.

Question 08 – Variable consideration – Expected Value

Electronics Manufacturer M sells 1,000 televisions to Retailer R for 500,000 (500 per television). M provides price protection to R by agreeing to reimburse R for the difference between this price and the lowest price that it offers for that television during the following six months. Based on M's extensive experience with similar arrangements, it estimates the following outcomes.

Price reduction in next 6 months	Probability
0	70%
50	20%
100	10%

Required: Identify what shall be the transaction price as per SLFRS 15.

Question 09 – Variable consideration – Most Likely Outcome

Construction Company C enters into a contract with Customer E to build an asset. Depending on when the asset is completed, C will receive either 110,000 or 130,000.

Outcome	Consideration	Probability
Project completes on time	130,000	90%
Project is delayed	110,000	10%

Required: Identify what shall be the transaction price as per SLFRS 15.

Question 10 – Variable consideration – Volume Discount

Fonseka Solutions Company (FSC) supplies laptop computers to large businesses. On 1 July 2015, FSC entered into a contract with a customer, under which the customer was to purchase laptops at Rs. 113,000 per unit.

The contract states that if the customer purchases more than 500 laptops in a year, the price per unit is reduced retrospectively to Rs. 100,000 per unit. FSC's year end is 30 June.

(a) As at 30 September 2015, the customer had bought 70 laptops from FSC. FSC therefore estimated that the customer's purchases would not exceed 500 in the year to 30 June 2016, and it would therefore not be entitled to the volume discount.

(b) During the quarter ended 31 December 2015, the customer expanded rapidly as a result of a substantial acquisition and purchased an additional 250 laptops from FSC. FSC then estimated that the customer's purchases would exceed the threshold for the volume discount in the year to 30 June 2016.

Required: Advise how much revenue is recognized in the quarters ended 30 September 20X5 and 31 December 2015.

Refunds

If a product is sold with a right to return it then the consideration is variable. The entity must estimate the variable consideration and decide whether or not to include it in the transaction price. The refund liability should equal the consideration received (or receivable) that the entity does not expect to be entitled to.

Question 11 – Variable consideration – Refund

Nardone enters into 50 contracts with customers. Each contract includes the sale of one product for $1,000. The cost to Nardone of each product is $400. Cash is received upfront and control of the product transfers on delivery. Customers can return the product within 30 days to receive a full refund. Nardone can sell the returned products at a profit.

Nardone has significant experience in estimating returns for this product. It estimates that 48 products will not be returned.

Required: How should the above transaction be accounted for?