Financial Accounting & Reporting

[AA31]

Supplementary for
Chapter 03 - Part II
(From Sub Topic 3.2.3 to 3.2.3.5)

Accounting Standards

Testing from JULY 2019 Examination

3. Accounting Standards - Part II

SLFRS 15 – Revenue from Contracts with Customers

SLFRS 15 replaces the following standards and interpretations.

LKAS 11	Construction contracts
LKAS 18	Revenue
IFRIC 13	Customer Loyalty Programmes
IFRIC 15	Agreements for the Construction of Real Estate
IFRIC 18	Transfers of Assets from Customers
SIC 31 Revenue	Barter Transactions Involving Advertising Services

1. Core principle

The core principle is that an entity will recognise revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer.

2. Revenue recognition

Revenue from Contracts with Customers states that an entity recognizes revenue by applying the following five steps;

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognise revenue when the entity satisfies a performance obligation.

Example 01

The following example may help you to understand the core principle of the SLFRS 15 revenue recognition model.

On 1st January 2018 Z Co. entered into an agreement with a customer to sell an air conditioner along with maintenance services for 2 years. Z Co. delivers the air conditioner and the legal ownership of the equipment to the customer at the inception.

The customer agreed to pay LKR 120,000/- for both air conditioner and maintenance service. If sold separately, the selling price of the air conditioner is LKR 100,000 and the selling price of the maintenance services is LKR 50,000.

Requirement:

Apply the five steps model of SLFRS 15 and estimate how much revenue Z Co. should recognize for the year ended 31.12.2018.

Answer

Application of five steps model

Step 1 - Identify the contract

There is an agreement between Z Co. and its customer to provide the goods and services as specified in the agreement.

Step 2 - Identify the separate performance obligations within a contract

There are two performance obligations (promises) within the contract:

- Sale of the air conditioner
- Sale of maintenance services

Step 3 - Determine the transaction price

The total transaction price is LKR 120,000.

Step 4 - Allocate the transaction price to the performance obligations in the contract

Based on the given stand-alone selling prices LKR 120,000 should be allocated to two performance obligations (POs) as follows;

Identified POs	Stand-alone selling prices (LKR)	Transaction price allocation (LKR)
1. Air conditioner	100,000	**80,000** (100,000/150,000x120,000)
2. Maintenance service	50,000	**40,000** (50,000/150,000x120,000)
Total	**150,000**	**120,000**

Step 5 - Recognise revenue when (or as) a performance obligation is satisfied

- Control over the air conditioner has been transferred to the customer at the inception. So the full revenue of LKR 80,000 allocated to the supply of the air conditioner should be recognized on 1st January 2018.
- The maintenance services is provided over time, so the revenue allocated to this should be recognised over time. In the year ended 31 December 2018, revenue of LKR 20,000 (1/2 x LKR 40,000) should be recognised for the provision of maintenance services.

3. The five steps model of SLFRS 15 on revenue recognition is given in detail below;

Step 1 - Identify the contract

According to SLFRS 15, contract is an agreement which creates enforceable rights and obligations. Such contracts may be written, oral or implied by an entity's customary business practices.

If an entity has an established practice of starting performance based on oral agreements with its customers, it may determine that such oral agreements meet the definition of a contract.

An entity can only account for revenue from a contract if it meets the following criteria;

(a) The parties to the contract have approved the contract and are committed to perform their respective obligations;

(b) The entity can identify each party's rights regarding the goods or services to be transferred;

(c) The entity can identify the payment terms for the goods or services to be transferred;

(d) The contract has commercial substance (i.e. the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract); and

(e) 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.

Eg: Example 02

Identification of the contract

Alfa Co. entered into a contract with a customer to supply an equipment on 15th October 2018.

Control over this equipment transferred to the customer on 20th December 2018. The customer agreed to pay LKR 500,000 on 31st March 2019.

A Answer

Alfa Co's. year end is 31st December. By 31 December 2018, as a result of changes in the economic conditions, Alfa Co did not believe it was probable that it would collect the consideration that it was entitled to. Therefore, the contract cannot be accounted for and no revenue should be recognised.

Step 2 - Identify the separate performance obligations within a contract

An entity has to determine which of the promised goods and services will be treated as separate performance obligations.

Promised goods and services in a revenue contract represent separate performance obligations if the goods or services are distinct. (by themselves, or as part of a bundle goods and services)

If a promised good or service is not distinct, an entity should combine that good or service with other promised goods or services until it identifies a bundle of goods or services that, together, is distinct.

SLFRS 15 outlines a two-step process for determining whether a promised good or service (or a bundle of goods and services) is distinct:

- Consideration at the level of the individual good or service (i.e. the good or service is capable of being distinct).

- Consideration of whether the good or service is separable from other promises in the contract (i.e. the good or service is distinct within the context of the contract).

Both of these criteria must be met to conclude that the good or service is distinct. If these criteria are met, the individual good or service must be accounted for as a separate unit of account (i.e. a performance obligation).

Some revenue contracts contain more than one performance obligations.

For example:

- Sale of software with implementation and maintenance
- Provide a meal at a hotel with a discount of a price for a future reservation
- Sale of an apartment with free maintenance for one year

Principal Vs Agent considerations

When more than one party is involved in providing goods or services to a customer, SLFRS 15 requires an entity to determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer.

- An entity is a **principal** if it controls a promised good or service before transferring that good or service to the customer.
- An entity is an **agent** if its role is to arrange for another entity to provide the goods or services.

If an entity is the principal, it should records revenue on a **gross basis** and if the entity acts as an agent, records as revenue the **net amount** that it retains for its agency services.

Step 3 - Determine the transaction price

The transaction price is 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 (ex: some sales taxes).

The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

When determining the transaction price, the impact of following must be considered:

- Variable consideration
- Significant financing components
- Non cash consideration
- Consideration payable to a customer

Variable consideration

If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exhcnage for transferring the promised goods or services to customer.

An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items.

This estimate can only be included in the transaction price to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved.

Exercise 01

XYZ Company enters into a contract with a customer on 1 June 2018 to sell Product A for LKR100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to LKR 90 per unit. Financial year end of the company is 31st December.

Requirement:

Discuss the accounting treatment of the above scenario for the financial statements as at 31st December 2018 if;

(a) Entity has previous experience with this customer and it is highly probable that the number of products will exceed the given threshold.

(b) Entity has no previous experience with this customer and is unsure if the number of products will exceed the given threshold.

Solutions

(a) In the light of the previous experience, the entity estimates that the customer's purchases will exceed the 1,000-unit threshold for the calendar year and therefore company considers the price LKR 90 to estimate revenue.

(b) The entity determines that it has significant experience with this product and with the purchasing pattern of the entity. Thus, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognized will not occur when the uncertainty is resolved. Therefore, company considers the price LKR 100 to estimate revenue

- 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.

Significant financing components

For some transactions, the receipt of the consideration does not match the timing of the transfer of goods or services to the customer.

Example: the consideration is prepaid or is paid after the services are provided

When the customer pays in arrears, the entity is effectively providing financing to the customer.

On the other hand, when the customer pays in advance, the entity has effectively received financing from the customer.

SLFRS 15 provides the following indications of a **significant financing component**:

- The difference between the amount of promised consideration and the cash selling price of the promised goods or services
- The length of time between the transfer of the promised goods or services to the customer and the payment date combined with prevailing interest rate.

If there is a financing component, then the consideration receivable needs to be discounted to present value using the interest rate that would use if it were to enter into a separate financing transaction with the customer.

Exercise 02

ABC Company enters into a contract with a customer to sell an equipment on 30th November 2018.

Control of the equipment transfers to the customer at the inception. The price stated in the contract is Rs 5 Mn and is due on 30th November 2020.

Applicable interest rate is 10%.

Requirement;

Explain how this transaction should be accounted in the financial statements of the entity for the year ended 31 December 2018.

Solutions

The transaction price should be separated into the revenue component and the financing component using the interest rate 10%.

Therefore revenue for the transaction – LKR 4.1 Mn

Financing element applicable for the transaction – LKR LKR 0.9 Mn

Non cash consideration

Customer consideration may be in the form of goods, services or other non-cash consideration. **Example: property, plant and equipment, a financial instrument.**

When an entity receives, or expects to receive, non-cash consideration, the **fair value** of the non-cash consideration is included in the transaction price.

Consideration payable to a customer.

Many entities make payments to their customers.

In some cases, the consideration paid or payable represents purchases by the entity of goods or services offered by the customer that satisfy a business need of the entity, then it should be accounted for as a **purchase transaction**.

In other cases, the consideration paid or payable represents incentives given by the entity to motivate the customer to purchase, its goods or services, (not in exchange for a distinct good or service) an entity should account for it as a **reduction of the transaction price**.

Eg: Example 03

Manufacturers of consumer products commonly pay retailers fees to have their goods displayed prominently on store shelves. Generally, such fees do not provide a distinct good or service to the manufacturer and are **treated as a reduction of the transaction price**.

Step 4 - Allocate the transaction price to the performance obligations in the contract

The allocation objective is to allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled.

This allocation needs to be done in proportion to **stand alone selling prices**.

The best evidence of a stand-alone selling price is the observable price when the good or service is sold separately.

If a stand-alone selling price is not directly observable then it must be estimated. Observable inputs should be maximized whenever possible.

If a customer is offered a discount for purchasing a bundle of goods and services, then the discount should be allocated across all performance obligations within the contract in proportion to their stand-alone selling prices.

Eg: Example 04

- ▲ Company A enters into an agreement to sell hardware, software and maintenance services for LKR 2,000,000
- ▲ Company A determines that each of the promised goods or services represents a separate performance obligation
- ▲ Because Entity A frequently sells software and maintenance on a standalone basis, it uses those transactions to determine standalone selling prices of LKR 250,000 and LKR 150,000, respectively.
- ▲ Company A rarely sells the hardware on a standalone basis, so it estimates the standalone selling price at LKR 1,850,000 based on the hardware's underlying cost.

Requirement:

Allocate the transaction price into the identified performance obligations.

Answer

Identified POs	Stand-alone selling prices (LKR)	Transaction price allocation (LKR)
1. Hardware	1,850,000	**1,644,444** (1,850,000/2,250,000x2,000,000)
2. Software	250,000	**222,222** (250,000/2,250,000x2,000,000)
3. Maintenance	150,000	**133,334** (150,000/2,250,000x2,000,000)
Total	**2,250,000**	**2,0000,000**

Step 5 - Recognise revenue when (or as) a performance obligation is satisfied

According to SLFRS 15, an entity only recognises revenue when it satisfies an identified performance obligation by transferring a promised good or service to a customer.

A good or service is considered to be transferred when the customer obtains control.

An entity must determine at contract inception whether it satisfies the performance obligation over time or satisfies the performance obligation at a point in time.

Recognition of revenue over time

SLFRS 15 states that an entity transfers control of a good or service over time (and, therefore, satisfies a performance obligation and recognises revenue over time) if one of the following criteria is met;

(a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;

(b) the entity's performance creates or enhances an asset (e.g. work in progress) that the customer controls as the asset is created or enhanced; or

(c) the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date

If a performance obligation is satisfied over time, then revenue is recognised over time based on progress towards the satisfaction of that performance obligation.

Example 05

An entity enters into a contract on 1st June 2018 to provide monthly payroll processing services to a customer for one year. Entity's year end is 31st December.

What is the accounting treatment for the financial statements of the entity for the year ended 31st December 2018.

Answer

The promised payroll processing services are accounted for as a single performance obligation as per SLFRS 15. The performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction as and when each transaction is processed.

The entity recognises revenue over time by measuring its progress towards complete satisfaction of that performance obligation.

Example 06

On 15th January 2018, A Co. enters into a contract to construct a specialised asset for a customer. The customer paid an upfront deposit which is only refundable if A Co. fails to complete construction based on the contract terms and conditions. The remainder of the price is payable when the customer takes possession of the asset. If the customer defaults on the contract before completion of the asset, A Co. only has the right to retain the deposit.

Can A Co. recognise revenue from the above transaction over time?

Answer

- At contract inception, the entity determines whether its promise to construct and transfer the specialized asset to the customer is a performance obligation satisfied over time.
- The entity determines that it does not have an enforceable right to payment for performance completed to date. Because, until construction of the asset is complete, the entity only has a right to the deposit paid by the customer.
- Because the entity does not have a right to payment for work completed to date, the entity's performance obligation is not a performance obligation satisfied over time.
- Instead, the entity accounts for the sale of the asset as a performance obligation satisfied at a point in time.

Methods of measuring progress towards satisfaction of a performance obligation include:

- Output methods (such as surveys of performance, or time elapsed)
- Input methods (such as costs incurred as a proportion of total expected costs).

If progress cannot be reliably measured then revenue can only be recognised up to the recoverable costs incurred.

Recognition of revenue at a point in time

If a performance obligation is not satisfied over time then it is satisfied at a point in time.

The entity must determine the point in time at which a customer obtains control of a promised asset.

An entity controls an asset if it can direct its use and obtain most of its remaining benefits.

SLFRs 15 states the following indicators of the transfer of control:

- The entity has a present right to payment for the asset
- The customer has legal title to the asset
- The entity has transferred physical possession of the asset
- The customer has the significant risks and rewards of ownership of the asset
- The customer has accepted the asset

4. Other considerations

4.1 Warranties

Warranties are commonly included in arrangements to sell goods and services. Generally, a warranty is assurance that a product will function as agreed in the contract. If this is the case, then the warranty will be accounted under LKAS 37 Provisions, Contingent Liabilities and Contingent Assets.

If the customer has the option to purchase the warranty separately or warranty provides a service to the customer beyond fixing defects that existed at the point of sale, then it should be **treated as a distinct performance obligation**.

This means that a portion of the transaction price must be allocated to it.

4.2 Contract costs

SLFRS 15 specifies the accounting treatment for costs an entity incurs to obtain and fulfil a contract to provide goods and services to customers.

An entity only applies those requirements costs incurred that relate to a contract with a customer that is within the scope of SLFRS 15.

As per SLFRS 15 following costs must be capitalised:

- The costs of obtaining a contract. This must exclude costs that would have been incurred regardless of whether the contract was obtained or not (such as some legal fees, or the costs of travelling to a tender).
- The costs of fulfilling a contract if they do not fall within the scope of another standard (such as LKAS 16 Property, Plant and Equipment) and the entity expects them to be recovered.

The capitalised costs of obtaining and fulfilling a contract will be amortised to the statement of profit or loss as revenue is recognised.

5. Presentation and Disclosures

When an entity has recognised revenue before it has received consideration, then it should recognise either;

- A receivable if the right to the consideration is unconditional, or
- A contract asset.

A **contract liability** should be recognised if the entity has received consideration (or has an unconditional right to receive consideration) before the revenue is recognised.

SLFRS 15 require disclosures to enable users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers as follows;

- Revenue recognised from contracts with customers
- Contract balances and assets recognised from costs incurred obtaining or fulfilling contracts
- Significant judgements used, and any changes in judgements.

Exercise 03

Century Link is a telecommunication company selling branded Tablet Units and providing network connection facilities. Company entered into a contract with a customer to supply a tablet and network facility for 2 years for a monthly rental of Rs. 10,000/-.

The market price of the tablet is Rs. 80,000/- and network charge is Rs. 5,000/- per month.

Required:

You are required to show the accounting entries for year 01 and year 02 for the recognition of revenue in line with SLFRS 15.

Solution

Step 01: Identify the contract with the customer.

There is a valid contract between the Century Link and the Customer to provide a tablet and connection facilities.

Step 2: Identify the performance obligations in the contract.

Two performance obligations are included.

1. Delivery of tablet
2. Provide connection facilities

Step 3: Determine the transaction price.

Transaction price is Rs. 240,000/- (Rs. 10,000 x 24 months = Rs. 240,000/-)

Step 4: Allocate the transaction price.

Transaction price need to be allocated based on the standalone transaction price.

Performance obligation	Standalone transaction price (Rs.)	Allocation of the transaction price (Rs.)
Delivery of tablet	80,000	(240,000 / 200,000) x 80,000 = 96,000
Connection facility	120,000 (5,000 x 24)	(240,000 / 200,000) x 120,000 = 144,000
	200,000	**240,000**

Step 5 : Recognize revenue when a performance obligation is satisfied.

Company can recognize revenue of Rs. 96,000/- on the delivery of tablet, service fee of Rs. 6,000/- (Rs. 144,000/24) can be recognized monthly over 02 year period.

Receivable from customer

Year 01					
01/01/Y1	Revenue	96,000	31/12/Y1	Cash	120,000
31/12/Y1	Service fee	72,000	31/12/Y1	Balance C/d	48,000
		168,000			**168,000**
Year 02					
01/01/Y2	Balance B/F	48,000	31/12/Y2	Cash	120,000
31/12/Y2	Service fee	72,000			
		120,000			**120,000**

Revenue

31/12/Y1	P/L	96,000	01/01/Y1	Receivable from customer	96,000
		96,000			**96,000**

Service Fee

31/12/Y1	P/L	72,000	31/12/Y1	Receivable from customer	72,000
		72,000			**72,000**
31/12/Y2	P/L	72,000	31/12/Y2	Receivable from customer	72,000
		72,000			**72,000**