Co-funded by the Erasmus+ Programme of the European Union

PASSFR.EU

A Digital Learning Platform for Generation Z: Passport to IFRS®

A Digital Learning Platform for Generation Z: Passport to IFRS®

IFRS® Standard 15 Revenue from Contracts with Customers

Funded by the Erasmus+ Program of the European Union. However, European Commission and Turkish National Agency cannot be held responsible for any use which may be made of the information contained therein.

IFRS® Standard 15 Revenue from Contracts with Customers

Scope and Key Definitions

The recognition of revenue in accounting is a significant and complex issue. With the development of new forms of business, the content of contracts signed with customers has changed due to new marketing tools, new pricing systems, new methods for the delivery of goods and the conditions of the provision of services as well as other factors. Therefore, the previous existing IFRS® Standards could not cover the emerging innovations in business any longer. Thus, in 2014, IFRS® Standard 15 Revenue from Contracts with Customers was issued, and constantly updated ever since to reflect relevant changes and developments in the business world.

Accounting results are necessary for the preparation of financial reports, as they reveal their users a fair and true situation of an entity. IFRS 15 establishes the principles and rules on how revenue arising from the contracts signed with customers should be accounted and how the information should be disclosed in financial statements, taking into account the size, nature, timing and other aspects of the cash flow and revenue.

Therefore, the IFRS 15 defines how an entity must recognize revenue related to the delivery of the promised services or goods to their customers. It also considers the amount that the entity, having assessed the terms of customer contract and all relevant facts and circumstances, expects to receive for those goods or services in exchange.

The IFRS 15 is intended to account for each individual contract, but in practice, the accounting may be performed for contracts with parallel characteristics or to a portfolio of contracts, depending on the size and composition of the portfolio.

The IFRS 15 also deals with the records for the costs incurred in concluding or performing a contract, provided the said costs are related to the contract signed with a customer (or part thereof).

<u>Key Definitions (IFRS 15. Appendix A):</u>

Contract – refers to an agreement establishing enforceable rights and obligations between several (two or more) parties.

Customer – refers to a party seeking to obtain goods or services that result from the regular activities of an entity and enters into a contract with such entity.

Revenue – refers to income from the ordinary activities of the entity.

Fundamental Issues: Recognition

The elements and content of a contract with customers are important for the recognition of revenue and recording it in accounting. Therefore, IFRS 15 establishes stages for the analysis of contracts with customers. This analysis is important for revenue recognition from contracts with customers and includes five stages (see Fig. 5): 1) contract identification; 2) combination of related contracts; 3) identification of existing contract modification; 4) identification of performance obligations; 5) fulfilment of the obligations.

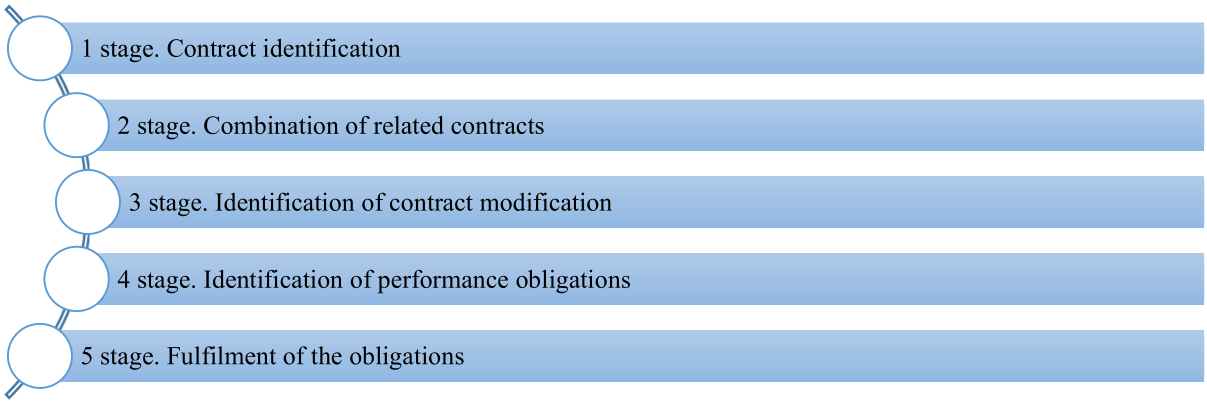

Figure 1. Stages of revenue recognition from contracts with customers

The first stage of contract identification assesses the contract approvement between the parties, the rights of the contract party related to goods or services, payment terms, contracts, commercial substance, amount of consideration.

The second stage seeks to combine the relevant contracts, if several (two or more) contracts related to the same customer and established for the same time exist. If several contracts meet these criteria, then combined contracts account as a single contract: 1) the subject of the negotiations is a package of contracts with a single commercial aim; 2) the amount to be paid depends on another contract price or other obligations to perform the contract; 3) the services or goods promised to customer through contracts are a single performance obligation.

The third stage includes contract modifications that cover the changes of prices, the rights of a party and obligations which have been established in writing or through an oral agreement. Contract modification may be treated as a separate contract, provided a separate contract increases the supplement of goods or services and the price increases of these promised services or goods, too.

The fourth stage is related to the imposition of performance obligations – it identifies promises existing in contracts and distinct services or goods. Here we also need to estimate the price that was set in the contract or its modification and assign the price to the corresponding obligations.

In stage five, the entity shall recognise revenue, whether it fulfils the obligation by sending the promised services or goods to the customer and transferring to the customer the full control of the asset.

Table 1 provides examples of revenue recognition following five stages.

Table 1. Examples of revenue recognition

Stages	Examples
Stage 1. Contract identification	A contract has been signed with entity B for the long-term supply of goods.
Stage 2. Combination of related contracts	In addition, a transportation contract was signed for the transportation of goods to entity B.
Stage 3. Identification of contract modification	After a while, the main supply contract was supplemented by stating that the minimum order quantity can be 500 units of goods.
Stage 4. Identification of performance obligations	It is known that on 15 February, a shipment of goods was delivered to the customer for CU10,000 with a transportation charge of CU3,000. Under the terms of the contract, the risk associated with the goods is transferred upon delivery of the goods to the entity's B warehouse. The goods reached the warehouse on the 10th of March.
Stage 5. Fulfilment of the obligations	Revenue will be recognized in March as CU13,000.

After the fifth stage, revenue can be recognized and recorded in the accounting (see Table 1). However, to know what amount of revenue should be recorded and shown in the financial statements, it is necessary to evaluate the applicable pricing and determine the value of the transaction.

In accordance with IFRS 15 paragraph 32, for each performance obligation, an entity determines whether it satisfies the performance obligation over time or at a certain point in time. In addition, the performance obligation is satisfied at a point in time, if an entity does not satisfy the performance obligation over time.

Fundamental Issues: Measurement

IFRS 15 sets the rules on how the amount of revenue that can be recorded in the accounting must be determined. The revenue related to customer contracts can be recorded when the performance obligation is satisfied according to the price of the transaction. Revenue measurement is carried out in three steps (see Fig. 2): *step 1*, the transaction price is determined; *step 2*, the transaction price is allocated according to the fulfilled obligations; *step 3*, the changes in the transaction price are estimated.

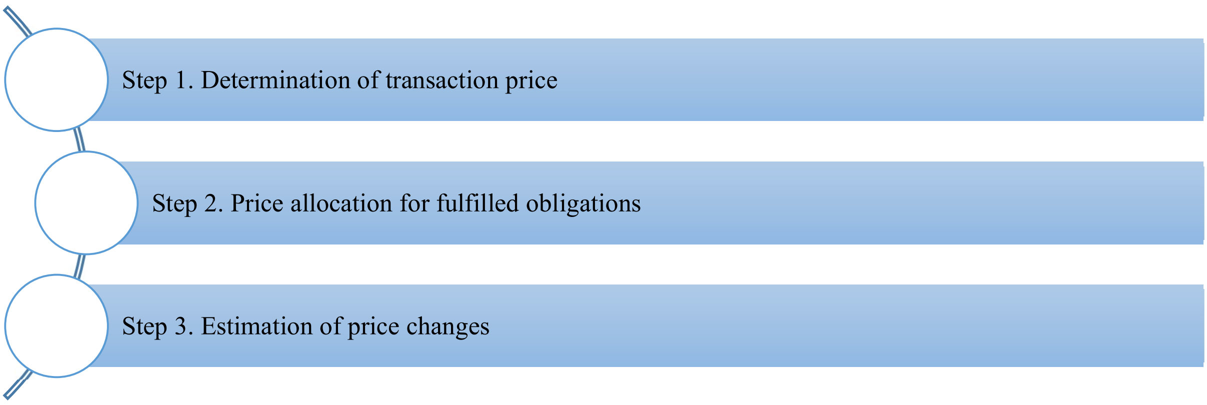

Figure 2. Steps of the transaction price evaluation

The composition of the transaction price can vary; therefore, for the correct recognition of the revenue, it is needed to evaluate the terms of the price discussed in the contract signed with customers. Different pricing methods in business result in different types of prices set in contracts (see Fig. 3).

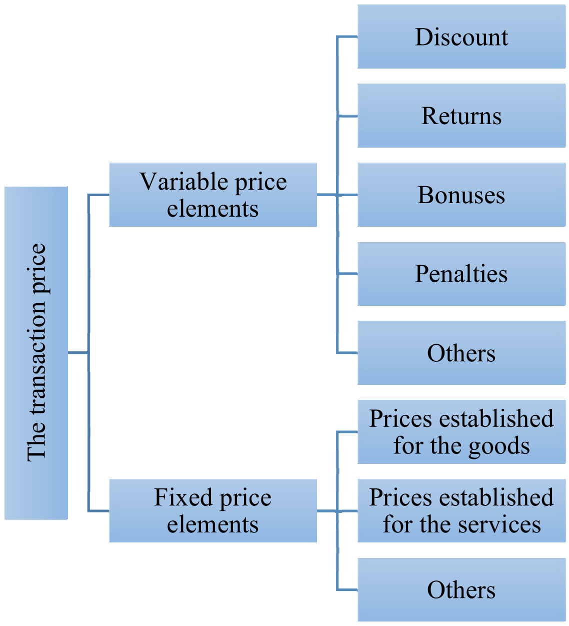

Figure 3. Types of prices

The transaction price may include variable consideration (examples: discounts, refunds, returns, credits, price concessions, performance bonuses, incentives, penalties or other similar items). Other aspects regarding the variable consideration include thresholds of variable consideration; the significant financing component; non-cash consideration; amounts payable to a customer.

The contract may specify a variable price that includes the amount of consideration that the entity will receive in exchange for delivering the promised goods or services to the customer. In addition, the variable price that has been considered may occur, if the right of the customer to this consideration depends of some future aspects, which may occur or not. Price variability may be clearly defined in the contract, but in addition to the terms of the contract, price variability may depend on normal entity practices, published policies, and specific statements, likely bids below the contract price, such as discounts, credits, or refunds; other facts and circumstances that indicate that the entity wants to offer a discount to the customer. Table 2 provides examples of variable pricing.

Table 2. Variable pricing examples

Variable price depends on:	Examples
Promised goods or services	The advertising brochure printing entity has set the following prices in the long-term contract with the customer: ● when up to 10,000 pieces of brochures are ordered per month, the price is CU3.0 per unit; ● when 10,000–15,000 pieces of brochures are ordered per month, the price is CU2.5 per unit;

	• when 15,000 pieces of brochures are ordered per month, the price is CU2.0 per unit.
Future aspects	The paper manufactory sets the following pricing in a contract with customers. When a customer orders paper products for more than CU10,000 per month, the said customer is given 10% discount.
Entity policy	In the contract with a customer, the entities set penalty at the rate of 0.05% for late payment. However, the entity's internal policy establishes a 3-day grace period, where no penalty is charged to the customer, if the said customer is late with the payment for up to 3 days after the deadline.

An entity should estimate the amount of variable price using one of the following methods to predict the amount of consideration better – the expected value or the most likely amount methods. The method of expected value – the estimated value is the sum of the probability-weighted mounts from the range of possible amounts. The expected value may be an adequate estimate of the amount of a variable price, provided the entity has several contracts with similar characteristics. The methods of the most likely amount – the most probable amount is the only most probable amount in the range of possible consideration amounts. The most likely amount may be an appropriate estimate of the amount of variable consideration, provided the contract has only two possible outcomes. The entity must apply the method chosen consistently throughout the contract and take into account all information (from the past, the present, and the predictable future).

The contract with the customer may establish a refund of the consideration; if such a refund is established, this shall be recognized as a refund liability. A refund liability is the consideration that is expected to be repaid (in part or in full) and is measured at the amount of the consideration (receivable) to which the entity does not expect to be entitled (e.g. an amount not included in the transaction price). The refund liability must be renewed at the end of each reporting period due to the changes in it.

It must be taken into account whether the contract signed provides a significant financing mechanism for the customer. It must also identify whether the contract specifies the terms on which the entity should adjust the promised price (consideration) to reflect the effect of the time value of money. The financing component may exist independently, or it could be stated in the contract as a financing promise or implied in the payment terms agreed between the parties to the contract. When adjusting the consideration for a significant financing component, the entity recognizes revenue as an amount that reflects the price that the customer would have paid in cash for those goods or services, when it would be transferred to the customer. It is necessary to assess when the financing mechanism discussed with the client is considered significant, and when it is insignificant. Table 3 provides examples of financing components.

Table 3. Examples of the financing components

The financing component is significant	**The financing component is insignificant**
Both of the following should be considered: 1) the difference between the price promised (consideration) and the cash price of the goods or services promised; 2) the combined effect of both of these factors:	Whether any of the following factors exists: 1) the customer has paid for the goods/services in advance and the time for the delivery depends on the customer; 2) a significant part of the transaction price is variable, and the amount or timing of that price

- the estimated time from the moment the goods/services are delivered to the customer until the time the customer pays for it; - and interest rates prevailing in the relevant market.	varies depending on the future event or the customers; 3) the difference between the transaction price promised and the cash sale price of the good/service arises for reasons other than financing to the customer or the entity, and the difference between those amounts is proportionate to the reason for the difference.
<u>Example:</u> *On July 5, 20xx, an entity signed a contract with the customer for the sale of the goods, which is a new product in the market. The contract establishes the sale price of goods as CU130,000. In the contract, the entity provided conditions for a financing scheme and undertook to compensate the customer for its losses, if the customer experienced them due to the fall of the price of the goods in the market. The loss is expected to be offset, if the price of goods falls until November 1, 20xx. The entity has no information on the amount of losses that may need to be compensated.* *On October 12, 20xx, due to the false information about the quality of goods in the fake news, the price of goods on the market began to fall. Until November 1, 20xx the customer sold 20% of the goods. It is estimated that from October 12 to 1 November, the entity must compensate the customer 10% for the decrease of the selling price on the market from the selling price of 20% of the goods sold.*	***<u>Example:</u>*** *On July 5, 20xx, an entity signed a contract with the customer for the sale of the goods. The contract establishes the sale price of goods for CU130,000. The contract establishes the delivery of goods only after receiving the customer's advance payment. The delivery term specified in the contract is 30 days.* *The customer paid on August 25, 20xx, and the goods were delivered on September 20, 20xx.* *On September 10, 20xx, information was received about market changes, which caused the value of goods to fall by 15% in the market and the customer will suffer a loss.* *In this case, the entity is not obliged to adjust the promised amount of remuneration to the customer.*

The consideration may take the form of cash, non-cash or other forms of payment. There may be different cases in practice that lead to different payment methods. Often entities apply various customer loyalty programs, where the customer buys goods (services) and at the same time gets some loyalty points that have monetary value. Such different customer loyalty programs require adjustments to the consideration for the transaction with the customer. Table 4 presents examples of payment methods.

Table 4. Payment methods examples

Payment methods	Explanation
Non-cash payment	Contracts may be entered into, when the customer pays for non-cash goods, then goods/services are exchanged for other goods/services. Then, the entity should measure the received amount estimate (for the goods or services) at fair value. If it is not practicable to set fair value, an entity should measure the transaction amount by indirectly referring to the separate selling price of the goods or services promised to the customer in exchange for the consideration.

Cash payment	Remuneration includes the amounts of cash that the entity pays or expects to pay to the customer (or other parties that purchase the entity's goods/services from the customer).
Credit or other items (for example, a coupon or a voucher) of payment	Credits and other items may be used to pay the customer for amounts owed to the subject. These debts reduce the transaction cost and revenue.
Debt settlement	If the entity is in debt to the buyer for a separate customer good/service, then this is accounted for as other purchases from suppliers. If the amount of this purchase payable to the customer exceeds the fair value for a good or a service, the entity recognizes the excess as a reduction in the transaction price.

One of the steps discussed was the allocation of the price according to the fulfilled obligations. In order to allocate the transaction price for each fulfilled obligation, it is necessary to refer to the signed contract and to assess whether separate prices were set for a specific good or service in the contract or whether a proportional calculation needs to be applied. IFRS 15 recommends that these methods may be used to calculate the stand-alone selling price of a good (service): adjusted market assessment, expected cost plus a margin or residual approaches (see Table 5).

Table 5. The stand-alone selling price methods examples

Situation The contract specifies the sale of windows together with the installation service. The contract does not set a separate price for the goods and services. The value of the transaction specified in the contract is CU20,000. The entity delivered the windows to the customer (transferred control) but did not install them yet due to the change in circumstances. In order to recognize revenue, an entity should allocate the transaction price to separate obligations (goods – windows; services – installation).		
The stand-alone selling price methods	**Explanation**	**Examples**
Adjusted market assessment	An entity can estimate the market price of goods/services and estimate the price that a customer is willing to pay for those goods/services in that market. This method may also include a reference to the prices of the entity's competitors for similar goods/services and adjusting those prices, if necessary, to reflect the entity's costs and margins.	*An entity has chosen to apply the adjusted market assessment methods for the valuation of windows price. It was determined that the market value of windows is CU14,000. The price distributed for windows is CU14,000 and CU6,000 for installation works.*
Expected cost plus a margin	The entity could estimate the cost of goods (service) and	*An entity has chosen to apply the expected cost plus a margin method for the valuation of price for*

	then add an appropriate margin to that good or service.	*windows. It was determined that the manufacturing costs for windows was CU11,000 and expected margin is 20%. The price is distributed for windows CU13,200 and for installation works it is CU6,800.*
Residual	An entity may apply a separate selling price by reference to the total contract price minus the sum of the observed separate selling prices of other goods or services promised in the other contracts.	*The entity has chosen to apply residual methods for the valuation of the price for windows. It is known that on the basis of the contract signed with other customers (at a similar time), the price for the same window was CU13,000. The price distributed for windows CU13,000 and for installation works is CU7,000.*

If necessary, the entity can use a combination of several methods to set the stand-alone selling price of a good (service). It is also important to assess whether any circumstances have arisen since the conclusion of the contract that could lead to a change in price. The entity shall attribute any changes in the transaction price to contract performance obligations on the same basis as at the inception of the contract. The entity shall not reallocate the price of a transaction due to a change in price and, accordingly, changes in price under the allocation of obligations shall be recognized as revenue or a decrease in revenue, when the price of the transaction changes.

Fundamental Issues: Procedures

Proper recognition of the costs resulting from the contracts signed with customers must be carried out. Incremental costs incurred in concluding a contract must be recognized as an asset, provided it is known that these costs would not have been incurred in cases, when the contract has not been obtained. Incremental costs of contract may be recognized as an expense immediately, provided the costs were accounted as an asset and its amortisation would be recognized as an expense in less than one year. Incremental costs must be recognized as expenses directly, provided the costs incurred independently of the contract signed.

Costs incurred when fulfilling a contract with a customer are recognized as an asset when the costs are directly attributable to the contract signed with customers. Costs to fulfil a contract create or increase the resources of the entity to satisfy performance obligations in the future and the costs are expected to be recovered. Costs to fulfil a contract directly attributable to the contracts include direct labour, direct materials, other directly attributable costs and costs incurred by the customer. Costs to fulfil a contract, which by their nature are general and administrative, waste of resources, costs related to performance obligations that have already been satisfied, costs that cannot be identified or are related to the performance obligations satisfied are recognized as expenses. Figure 4 summarises the accounting treatment of contract costs.

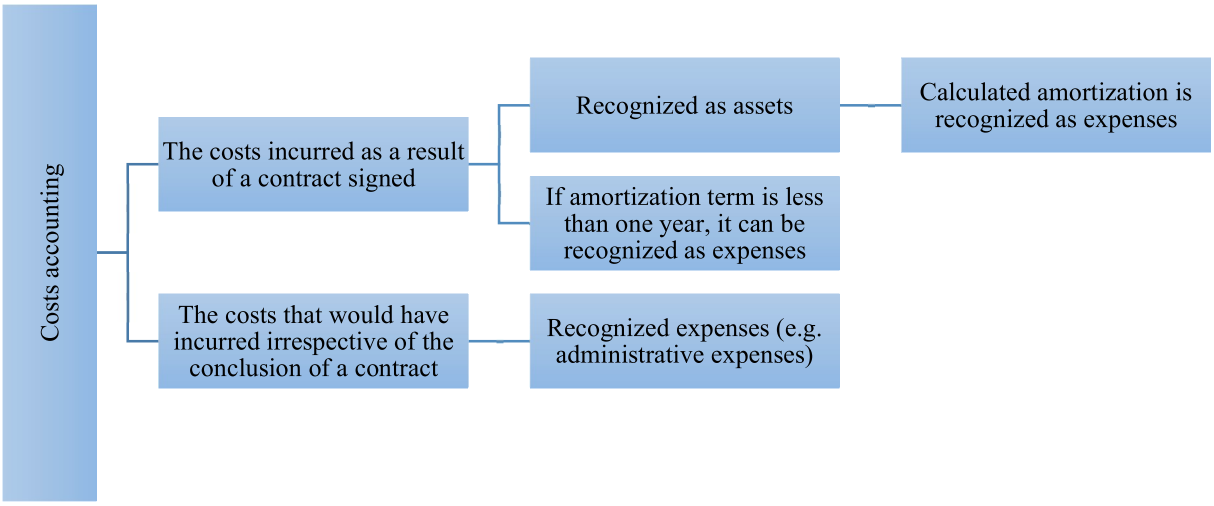

Figure 4. Accounting for contract cost

If the costs have been recognized as an asset, the costs shall be amortised on a periodic basis. Depreciable assets in accordance with IFRS 15 paragraph 99 must be systematically amortised in accordance with the transfer to the customer of the goods or services to which the asset relates. If the changes are made in the contract for the timing of the goods and services, the changes must also be made in the amortisation time and the value of assets must be recalculated in accordance with the IAS® Standard 8 Accounting Policies, Changes in Accounting Estimates and Errors. A change in the value of an asset due to a change in amortisation is recognized in the statement of profit and loss and other comprehensive income as a profit or loss. Impairment of assets may also be assessed in accordance with other standards, given that the assets accounted for must be measured through the exposure to credit risk of the customer.

Disclosures

When preparing a set of financial statements, an entity must provide quantitative and qualitative data about the entity's financial situation for the users of financial reports. Here the IFRS 15 prescribes what revenue-related information should be disclosed to the customers. Financial information disclosure is necessary to understand the amount, nature, timing and uncertainty of the revenue and cash flows related to customer’s contracts.

In financial reports, the information disclosed specifies the significant judgements, changes in judgements, and any assets recognized as costs in order to complete the contract. The level of detail of the information is determined by the entity to be sufficient to disclose the information. When providing information, an entity should aggregate or disaggregate the information, so that the useful information would not be obscured by various insignificant details.

A set of financial statements prepared by an entity must disclose information about revenue recognition resulting from contracts with customers, display them separately of other revenue, provide information about any impairment losses recognized on contract assets or any receivables arising from the entity contracts, which must be disclosed individually from the amounts of other contracts.

Revenue information disclosure is related to the operating segments, provided the entity applies IFRS Standards Operating Segments. Then, the revenue recognized must be split into categories that reflect the effects of the economic factors (amount, nature, timing and uncertainty) of cash flows and revenue.

An entity shall disclose information about the opening and closing balances of receivables, assets and liabilities related to contracts; revenue recognized in the period that is included in the contract liability balance; and revenue recognized in the period from performance obligations satisfied during the previous periods.

An entity must explain and disclose significant changes related to customer contracts in the balance sheet – changes of assets and liabilities (see Table 6).

Table 6. Disclosure Example No. 1

Notes to the financial statement: Contact liabilities When purchasing the goods, customers often make a prepayment. Advances paid by customers are settled when the goods are sold and it usually takes up to 6 months. A customer may hold extended warranties for the purchase of goods which are recognized in revenue over the warranty period (up to 3 years).		
Liabilities (20x3)	Liabilities (20x2)	Liabilities (20x1)
Advances from customers	Advances from customers	Advances from customers
Extended warranties	Extended warranties	Extended warranties
Total:	Total:	Total:

The information about the remaining performance obligations, including the amount of their transaction price for the remaining outstanding, the expected time of recognition of revenue, the time to fulfil the remaining obligation in quantitative terms, and the assessment of qualitative information shall also be disclosed.

An entity must provide information about the methods which are used to recognize revenue. There must also be an explanation provided about how those methods are used to accurately reflect the transfer of goods or services (see Table 7). The contemporary methods used to determine the transaction price evaluating account the measurement of variable price, the adjustment of the remuneration to the effect of the time value of money and the assessment of the non-cash consideration, and the allocation of the transaction price to a specific part of the contract and returns, refunds and other similar obligations.

Table 7. Disclosure Example No. 2

The table below shows the methods used to recognize revenue over time. Methods were applied in our services reflecting the variability in contracts with customers and performance obligations.				
Methods	**Services**			
	Software license	**Computer Services**	**Support Services**	**Consulting**
Costs incurred	X	X	X	
Labour hours expended		X	X	X

Assets recognized from the costs are disclosed in the judgments made about the costs incurred to obtain or fulfil the contract with the customer and the amortisation method used. Information is provided on the balances of these assets, as well as depreciation amounts and impairment losses during the reporting period.

Example

Situation:

It is known that on 2 June, 20xx, an entity entered into a contract with a customer in regard to the sale of the smart tables for the period of 12 months. The price set in contract was CU120 per unit. The contract had a condition for a discount, i.e. the discount was applicable, if orders for the table per month amounted to CU10,000. The rate of the discount was 5% of the total sales value. The other condition of the contract stipulated that a customer must pay for the goods within 14 days after the invoice is received. The delayed payment fine was 0.2% per day.

An entity entered into one more contract on 2 June, 20xx with the customer for the transportation services. The transportation service price is CU200 per order. The conditions for the customer payment included settling the invoice received within 14 days. The delayed payment fee was 0.02% per day. Transportation services were to be provided within 10 days after the customer had placed an order for goods. The contract condition for the delay of goods transportation was set at 5% for each day delayed.

On 1 August, 20xx the contract had a modification, and the discount rate was increased to 6%, provided the amount for orders per month was more than CU12,000.

It is known that the following transactions have taken place in relation to both contracts:

Month	Sold Smart Tables	Goods Delivery	Customer Payment
June, 20xx	1st order 60 units; 2nd order 50 units	On time	On time
July, 20xx	3rd order 60 units; 4th order 60 units	3rd – on time; 4th – delay of 3 days	On time
August, 20xx	5th order 70 units; 6th order 40 units	On time	5th – on time; 6th – delay of 5 days

The following is the solution on how to apply the IFRS 15.

Solution:

Contract identification	**Contract to sell smart tables.**
Combination of related contracts	Related contract for goods transportation.
Identification of contract modification	After two months, the discount conditions have changed.

Identification of performance obligations	There are two obligations: ● To sell smart tables; ● To provide transportation services within 10 days after the order for the goods has been placed. The transaction price is set for obligations: ● Smart tables – price CU120 per unit; discount 5%, if monthly sales per month are more than CU10,000 for June and July, 20xx and discount 6%, if sales per month are more than CU12,000 since August, 20xx; the payment delay fine is 0.2% per day. ● Transportation – price CU200 per order; the payment delay fine is 0.02% per day; the delivery delay fine 5% per day.
Fulfilment of the obligations	**In June**, both obligations were fulfilled – goods were sold and transported. Revenue was recognized in accordance with the identification of obligation and the allocation of price. Revenue amount was CU12,940 calculated: *Goods sold 110 units x CU120 = CU13,200* *Discount CU13,200 x 5% = CU660* *Transportation CU200 x 2 order = CU400* *Total revenue: CU13,200 – CU660 + CU400 = CU12,940* **In July**, both obligations were fulfilled – goods sold and transported. Revenue was recognized in accordance with the identification of obligation and the allocation of price. Revenue amount was CU14,050 calculated: *Sold goods 120 units x CU120 = CU14,400* *Discount CU14,400 x 5% = CU720* *Transportation CU200 x 2 order = CU400* *Fine delivery untimely CU200 x 5% x 3 days = CU30* *Total revenue: CU14,400 – CU720 + CU400 – CU30 = CU14,050* **In August**, both obligations were fulfilled – goods sold and transported. Revenue was recognized in accordance with the identification of obligation and the allocation of price. Revenue amount was CU12,856 calculated: *Sold goods 110 units x CU120 = CU13,200* *Discount CU13,200 x 6% = CU792* *Fine for payment delay 40 units x CU120 x 0.2% x 5 days = CU48* *Transportation CU200 x 2 order = CU400* *Total revenue: CU13,200 – CU792 + CU48 + CU400 = CU12,856*

Conclusion:

The example introduced shows that several contracts may be related, and the variable price element specified in the contract may affect the revenue recognition, and the amount may be different in different periods. Therefore, it is important to follow the steps recommended by IFRS 15 for identification of the contract, the obligations defined in it, the established price elements and properly assigning the price to the respective obligations. Then the revenue recorded in the accounts will show the correct performance of the entity.