



Revenue from Contracts with Customers – IFRS 15

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This article is designed to assist students in preparing for questions on the topic of Revenue on the P1 Corporate Reporting paper. It is also likely to be of benefit to students of P2 Advanced Corporate Reporting.

Introduction

IFRS 15 Revenue from Contracts with Customers was issued in May 2014. It is mandatory for all accounting periods beginning on or after 1 January 2018, with earlier adoption permitted. IFRS 15 replaces two standards, namely IAS 11 *Construction Contracts*, and IAS 18 *Revenue*, as well as several IFRIC interpretations (13, 15 and 18) and SIC 31. (Note: The SIC was the pre-2003 title of what are now called IFRICs, and all deal with interpreting standards in issue. IFRICs are not on the P1 syllabus.)

Definition of revenue

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity.

Recognition of revenue – core principle

The primary issue in accounting for revenue is determining when to recognise revenue. Revenue is recognised when an entity satisfies a performance obligation by transferring a promised good or service to a customer. However, a good or service is only considered transferred when the customer obtains control of that good or service.

Usually the following criteria will be met:

- A contract has been agreed between the parties. This may be orally, in writing or otherwise;
- The value of the goods or services has been established;
- The product or service has been provided to the buyer (control has transferred);
- The buyer has indicated willingness to hand over cash or other assets in settlement.

Five step approach

IFRS 15 uses a five step model for the recognition of revenue. A discussion of these steps follows.

(1) Identify the contract with the customer.

A contract is an agreement between the parties. It need not be in writing, as a valid contract can be oral or implied. The key requirements are that the contract has commercial substance, identifies each party's rights and makes clear the payment terms. It must be probable that the consideration (payment) will be collected.

(2) Identify the performance obligation(s).

This refers to whatever the seller is obliged to do under the contract. The performance obligation may be single or multiple depending on the situation. A straightforward retail sale of goods is an example of a single obligation. Once the seller provides the goods to the buyer, it has satisfied its performance obligation.

Sometimes a contract may have multiple performance obligations. An example here is a seller that agrees to supply and install a heating system for a customer. The supply of the goods is one deliverable, and the installation of the system is another. Each portion capable of being sold separately must be identified.

(3) Determine the transaction price.

Normally the agreed price is clear from the agreement. It should be taken to be the fair value (at the transaction date) of the consideration expected to be received. If there are uncertainties, the transaction price should be estimated using probabilities. The price should be considered net of VAT, trade discounts and rebates (but is not net of settlement discounts). If there are delayed payment terms agreed to one year or more, the provision of credit is considered an additional deliverable, and separated from the supply of goods (see example 3) by discounting the amount receivable to present value.

(4) Allocate transaction price to performance obligations.

This step is only relevant if multiple deliverables exist in the contract. If there is only one deliverable, the entire price is allocated to that. If there are multiple deliverables, the transaction price is allocated to the deliverables in the ratio of the standalone selling prices of each individual deliverable as at the contract date.

(5) Recognise revenue when the performance obligation is satisfied.

A performance obligation is normally deemed to be satisfied when control of the goods or services is transferred to the customer. Control may be transferred at one point in time, or over a period of time. If a performance obligation is delivered over time, revenue is only recognised if at least ONE OF the following criteria is met:

- The customer consumes the service as it is supplied;
- The customer controls the asset as it is created in stages;
- The entity's performance does not create an asset with alternative uses to the entity, and the entity has an enforceable right to payment for work completed.

Measurement of revenue

Revenue shall be measured at the fair value of the consideration received or receivable. Fair value is **the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price) per IFRS 13.**

Further issues

- Selling costs directly incurred in earning a sales contract are capitalised and recognised over the period revenue from that contract is recognised. Example – sales commission paid to an agent by a phone company for securing a 12-month phone service contract.
- Goods expected to be returned are not to be recognised as revenue. An estimate should be made of the amount expected to be returned.
- A warranty is often a separate deliverable in a sales contract. As such it is treated as a component of the deal. The revenue is separated, and the portion relating to the warranty is recognised over the warranty period. If the warranty is inseparable from the goods supplied (i.e. if cost information is not separately available), then a provision should be made under IAS 37, as was the previous practice for all warranties.

- If goods are sold as agent rather than as principal, only the commission receivable is recognised as revenue. For example, if an estate agent sells a house on behalf of a client for €300,000, earning 1.5% commission. The revenue of the agent is €4,500, not €300,000.
- If cash is received in advance of supply, the amount is credited to a deferred revenue account, and carried as a liability in the statement of financial position. The liability is transferred to revenue when the performance obligation is met. This is the case even if the cash received is non-refundable (see example 1).

Example 1: Simple transaction

Merlton Ltd, a motor dealer, sold a vehicle to a customer on 14 November 2017. The contract showed an agreed price of €30,000 and a delivery date of 3 January 2018. The customer paid a 20% non-refundable deposit on 14 November 2017. The vehicle was delivered on 10 January 2018 and the balance due of €24,000 was paid by the customer on that date.

Required: Advise, showing relevant journal entries, how the above transaction should be recognised in Merlton's financial statements for the year ended 31 December 2017 and 2018?

Solution:

Applying the 5-step approach:

1. The contract is clear.
2. The performance obligation is clear. Merlton must deliver a vehicle on 3 January 2018.
3. The transaction price is clear: €30,000.
4. There is only one performance obligation. Hence the entire transaction price is allocated to that.
5. The performance obligation is satisfied on 10 January 2018. Hence Merlton will recognise revenue on that date.

No revenue is recognised for year ended 31 December 2017 in respect of this transaction. The €6,000 received in November 2017 is debited to cash, and credited to deferred revenue. It is carried as a current liability in the statement of financial position as at 31 December 2017.

Journal entries 2017:

Dr Cash	€6,000	
Cr Deferred revenue		€6,000

For year ended 31 December 2018, revenue of €30,000 should be recognised. The journal entry would be as follows:

Dr Cash	€24,000	
Dr Deferred revenue	€6,000	
Cr Revenue		€30,000

Example 2: Multiple deliverables

Carltown Ltd, a technology equipment supply company, entered into a contract with a customer on 1 December 2017 to supply, install and service a system of computers. The agreed price was €200,000, to include a two-year service contract. Payment was made in total following installation in January 2018.

At 31 December 2017, Carltown had supplied all the machines, but had not yet installed any. Installation happened in January 2018. The directors of Carltown estimated that the computers would be sold for €150,000 on a stand-alone basis. Installation would cost €20,000, and the two-year service contract would cost €50,000 if purchased separately.

Required: Advise, showing relevant journal entries, how the above transaction should be recognised in Carltown's financial statements for years ended 31 December 2017 and 2018?

Solution:

Applying the 5-step approach:

1. The contract is clear.
2. The performance obligations are three. Carltown must deliver machines, install them and service them for 2 years.
3. The transaction price is clear. €200,000.
4. The transaction price is allocated to each performance obligation in the ratio of their standalone fair values. The total of the individual deliverables would be €220,000. Hence the transaction price is divided as follows: Machines $200,000 \times (150/220) = €136,364$; Installation $200,000 \times (20/220) = €18,182$; Servicing $200,000 \times (50/220) = €45,454$.
5. Only the first performance obligation is satisfied during 2017. Hence Carltown will recognise €136,364 in revenue (and trade receivables) on that date. The installation is completed in January 2018. Hence €18,182 is recognised on that date. The servicing will happen over 2 years. Hence half the revenue related to the servicing (€22,727) will be recognised in 2018. The balance will be carried forward as deferred revenue and recognised in 2019.

Journal entries 2017:

Dr Trade receivables	€136,364	
Cr Revenue		€136,364

Journal entries 2018:

Dr Cash	€200,000	
Cr Trade receivables		€136,364
Cr Revenue - installation		€18,182
Cr Revenue – servicing (€45,454 * 1/2)		€22,727
Cr Deferred revenue (2019 servicing)		€22,727

Example 3: Deferred payment

Shipton Ltd, a professional services company, provided estate management services for a customer, completed on 30 September 2017. The agreed price was €50,000. The customer paid €10,000 on completion on 30 September 2017. It was agreed that the customer would pay the remainder 12 months later, on 30 September 2018. Shipton's cost of capital is 7%.

Required: Advise, showing relevant journal entries, how the above transaction should be recognised in Shipton's financial statements for the year ended 31 December 2017 and 2018?

Solution:

Applying the 5-step approach:

1. The contract is clear.
2. The performance obligations are two. First, provide the services, secondly, provide 12 months' credit on €40,000 of the agreed fee. As the credit period is 12 months, we must separate this out as a separate performance obligation.
3. The transaction price is clear: €50,000.
4. The fair value of the consideration at the transaction date is calculated. This is €10,000 plus the present value of the remaining €40,000 at the transaction date. ($40,000 \times 1/1.07 = €37,383$). Hence the fair value of the consideration receivable is €47,383, and the fair value of the credit allowed is $(50,000 - 47,383) €2,617$.
5. The first performance obligation is satisfied on 30 September 2017. Hence Merlton will recognise revenue of €47,383 on that date. The second performance obligation is satisfied as time passes over the following 12 months. Hence this portion of revenue is recognised as finance income on a time-apportioned basis over the year from 30 September 2017 to 30 September 2018.

Journal entries 2017:

Dr Cash	€10,000	
Dr Trade receivables	€37,383	
Cr Revenue		€47,383
Dr Trade receivables ($€2,617 \times 3/12$)	€654	
Cr Profit or loss - Finance income		€654

Journal entries 2018:

Dr Cash	€40,000	
Cr Trade receivables ($47,383 + 654$)		€38,037
Cr Profit or loss - Finance income ($€2,617 \times 9/12$)		€1,963