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# IFRS 15

# Revenue from Contracts with Customers

WAG ACADEMY

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# Scope

The guidance applies to most **contracts with customers** with only a few exceptions. It does not apply to other transactions or activities.

A **customer** is “a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities.”

# Overview

The principle behind revenue recognition under this standard is that an entity should recognize revenue in an amount that reflects the consideration that the entity expects to be entitled to in exchange for goods or services.

# Overview

In order to determine when to recognize revenue, the entity applies **five** steps:

| | |
|---|---|
| **Step 1:** | Identify the contract(s) with the customer |
| **Step 2:** | Identify the performance obligations in the contract |
| **Step 3:** | Determine the transaction price |
| **Step 4:** | Allocate the transaction price to the performance obligations |
| **Step 5:** | Recognize revenue when (or as) each performance obligation is satisfied |

# Identify the contract(s) with the customer

A contract is defined as "… an agreement between two or more parties that creates enforceable rights and obligations." (ASC 606-10-25-2)

Both written and oral agreements are considered contracts. Contracts can also be implied based on the seller's normal business practices.

# Identify the contract(s) with the customer

- The following criteria must all be met for a contract to be identified under ASC 606:
  - The contract must be approved by all parties to the contract.
  - Each party’s rights regarding the goods and services to be transferred must be identifiable.
  - The payment terms must be identifiable.
  - The contract must have commercial substance.
- It must be probable that a vendor will collect the consideration to which it is entitled.

# Identify the contract(s) with the customer

- Contracts can be combined if:
  - Under the guidance in ASC 60 6-10-25-9a, they are negotiated “as a package with a single commercial objective.”
  - The amount of consideration in one contract depends on the price or performance in the other contract.
- The goods or services identified in the contracts are a single performance obligation.

# Identify the separate performance obligations

A performance obligation is defined as a contractual promise with a customer to transfer a service or good to the customer.

- Each separate performance obligation must be identified by the entity by evaluating the goods or services promised in the contract and determining which of these (or which bundles of goods and services) is distinct.
- If goods or services are not distinct, then they should be bundled together and considered as one performance obligation.

# Identify the separate performance obligations

- A good or service is considered distinct if it meets the following criteria per ASC 606-10-25-19:
  - The customer can benefit from the good or service either on a stand-alone basis or along with another resource that is readily available to the customer (capable of being distinct).
  - The entity’s promise to transfer the good or service is separately identifiable from other promises in the contract (distinct within the context of the contract).

# Identify the separate performance obligations

- Factors that indicate goods/services are not distinct include the following:
  - The goods or services are highly interrelated and the entity must provide a significant service to integrate the goods or services into the combined item(s) for the customer
  - The goods or services are significantly modified or customized in order to fulfill the contract.

# Identify the separate performance obligations

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  - The goods or services are significantly modified or customized in order to fulfill the contract.

# Determination of separate performance obligations

An entity licenses customer relationship management software to a customer. In addition, the entity promises to provide consulting services to significantly customize the software to the customer's information technology environment for total consideration of $600,000.

- Are the software and consulting services one performance obligation or two?

# Determination of separate performance obligations

## Example 1 solution

See guidance in ASC 606-10-25-19.

The entity is providing a significant service of integrating the goods and services (the license and the consulting services) into the combined item for which the customer has contracted. The software is significantly customized by the entity in accordance with the specifications negotiated with the customer. Thus, the goods and services are not distinct as the criterion that the customer can benefit from the customer management software on a stand-alone basis has not been met.  Therefore, the entity would account for the license and consulting services together as one performance obligation.

# Determine the transaction price

The transaction price is the amount that the entity expects to be entitled to as a result of transferring goods or services to the customer.

In determining the transaction price, there are several things to consider, including:

- Variable consideration
- The time value of money
- Noncash considerations
- Considerations payable to a customer

# Determine the transaction price – variable consideration

- Contract consideration could be variable due to the existence of discounts, incentives, refunds, rebates, contingencies, price concessions, etc.
- If the consideration specified in the contract is variable and it is **probable that a significant revenue reversal will not occur**, then the entity should include an estimate of the variable consideration to which the entity will be entitled in order to determine the transaction price.

# Determine the transaction price – variable consideration

- The entity may use one of two estimation methods as described below based on the guidance in ASC 606-10-32-8.  The chosen method should be applied consistently throughout the contract.
  - **The expected value method:**  the estimate is measured as "the sum of the probability-weighted amounts in a range of possible consideration amounts."
  - **The most likely amount method:** the estimate is measured as "the  single most likely amount in a range of possible consideration amounts."

# Variable consideration

Catherine’s Costumes sells 1,000 Halloween costumes to a wholesaler for total consideration of $20 per costume.  The contract provides the customer with the right to return all unsold costumes after Halloween.  Due to its extensive experience in this industry, Catherine’s Costumes can reliably provide the following range of probability of returns based on this sales volume.

| Costumes returned | Probability |
|---|---|
| **50** | 40% |
| **75** | 45% |
| **100** | 15% |

- What is the estimated transaction price for the contract if Catherine’s Costumes uses the expected value method?
- The most likely amount method?

# Variable consideration

## Example 2 solution

See guidance in ASC 606-10-32-8.

**Expected value method:** the estimated contract price is measured using the sum of the probability-weighted amounts in the range of possible consideration amounts. Therefore, the calculation is as follows:

Estimated contract price = (950 x 40% x $20) + (925 x 45% x $20) + (900 x 15% x $20)

= $7,600 + $8,325 + $2,700

= $18,625

**Most likely amount method:** based on the highest probability of 45% for 75 costumes being returned, this would be considered the most likely amount. Therefore, Catherine's Costumes will calculate using 925 costumes multiplied by $20 per costume for a total estimated contract price of $18,500.

# Determine the transaction price – the time value of money

- If the time between (1) when the entity provides the goods or services and (2) the customer makes the payment for these goods or services is more than one year, the entity may need to adjust the amount of the consideration to reflect the time value of money.
- Per ASC 660-10-32-16, if the contract has a financing component that is significant to the contract, then the entity should only recognize revenue at an amount that reflects what the cash selling price would be at the point that the goods or services were transferred. The impact on net income of this financing component should be presented separately on the statement of comprehensive income as interest income or expense.

# Determine the transaction price – the time value of money

The following factors should be considered by the entity when determining whether the financing component is significant:

- The expected length of time between payment and transfer of the goods or services
- Whether the amount of consideration would differ substantially if the customer paid cash promptly in accordance with typical credit terms in the industry
- The differences between the interest rate in the contract and the prevailing interest rates in the market

# The time value of money

Madison Wholesalers enters into a contract with a customer to sell a product for $200,000. The product will be delivered in two years, but the customer pays for it today. Typical credit rates in the industry are 5% annually.

- Would you assess that the financing component of the contract is significant? Explain.
- What are the journal entries that Madison Wholesalers will record over the two-year period?

# The time value of money
## Example 3 solution

See guidance in ASC 606-10-32-16.

**Is the financing component significant to the contract?**

In evaluating whether the financing component is significant, one could argue that a two-year period of time between the payment and the transfer of the goods is significant.  One could also argue that the amount of consideration would differ significantly based on typical credit terms in the industry of 5%.  Therefore, given the significance of the financing component, this should be recognized in the revenue amount.

Example 3 solution (continued)

# The time value of money

**What are the journal entries that Madison Wholesalers will record over the two-year period?**

At the date that Madison Wholesalers receives the cash, Madison Wholesalers should make the following entry:

Cash $200,000

Deferred revenue $200,000

During the two-year period, Madison Wholesalers will recognize interest expense of $20,500 (200,000 x ($1.05^2$-1)).

Interest expense $20,500

Deferred revenue $20,500

When the product is transferred in two years, Madison Wholesalers will recognize revenue based on the balance of the deferred revenue account.

Deferred revenue $220,500

Revenue $220,500

# Determine the transaction price – noncash consideration

- Per ASC 660-10-32-21, if the consideration that the entity receives is noncash, **<u>the transaction price is measured as the fair value of the noncash consideration.</u>**
- Per ASC 660-10-32-22, if the fair value of the noncash consideration cannot be reliably measured, then the transaction price is measured as the standalone selling price of the goods or services promised to the customer in the contract.

# Determine the transaction price – noncash consideration

- Per ASC 660-10-32-21, if the consideration that the entity receives is noncash, **<u>the transaction price is measured as the fair value of the noncash consideration.</u>**
- Per ASC 660-10-32-22, if the fair value of the noncash consideration cannot be reliably measured, then the transaction price is measured as the standalone selling price of the goods or services promised to the customer in the contract.

# Noncash consideration

ABC Computing provides computer installation services to a customer. The standalone value of these services is $4,300. In exchange, the customer gave ABC Computing several used computers. These used computers have a fair value of $4,500.

- What is the journal entry that ABC Computing will make to record the sale?
- What would the journal entry be if the fair value of the used computers was not available?

# Noncash consideration
## Example 4 solution

See guidance in ASC 606-10-32-21 and 22.

**What is the journal entry that ABC Computing will make to record the sale?**

ABC Computing will record the transaction price as the fair value of the noncash consideration received.

| | |
|---|---|
| Computer inventory | $4,500 |
| Service revenue | $4,500 |

**What would the journal entry be if the fair value of the used computers was not available?**

If the fair value of the computers is not available, ABC Computing will record the transaction at the standalone selling price of the services.

| | |
|---|---|
| Computer inventory | $4,300 |
| Service revenue | $4,300 |

# Determine the transaction price – consideration payable (ASC 606-10-32-25)

- If an entity expects to pay a customer an amount in the form of cash, "… credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity …," this is referred to as a consideration payable.
- Consideration payable to a customer should be treated as a reduction of the transaction price unless the payment is in exchange for a distinct service or good.

# Consideration payable

Example 5

MMR Wholesalers sells 500 machine-embroidered tote bags to a customer for $25 per bag in the first quarter of the year.  MMR Wholesalers has a contract with the customer that if they purchase more than 3,000 tote bags during the year, they will receive a retroactive, $5-per-bag discount.  In the first quarter, MMR Wholesalers does not anticipate that the customer will earn the volume discount.  However, during the second quarter, the customer purchases 3,000 bags

- What is the amount of revenue that MMR Wholesalers will record in the first quarter?  The second quarter?

# Consideration payable
## Example 5 solution

See guidance in ASC 606-10-32-25.

**What is the amount of revenue that MMR Wholesalers will record in the first quarter?**

MMR Wholesalers records the transaction price of $25 per bag in the first quarter because it does not anticipate that the customer will earn the discount. Consequently, MMR Wholesalers will record total revenue of $12,500 in the first quarter (500 bags x $25 per bag).

**What is the amount of revenue that MMR Wholesalers will record in the second quarter?**

As the customer has earned the volume discount, MMR Wholesalers will report revenue of $57,500. This amount is calculated as follows:

| Amount | Calculation |
|---|---|
| $60,000 | 3,000 bags sold in second quarter x $20 ($25 per bag less $5-per-bag volume discount) |
| (2,500) | 500 bags sold in first quarter x $5-per-bag volume discount |
| $57,500 | Revenue to recognize |

# Allocate the transaction price to the separate performance obligations in the contract

- If the contract has multiple performance obligations, then the transaction price should be allocated across the performance obligations.
- The entity first determines the standalone selling price of each good or service underlying each performance obligation at the inception of the contract.
  - Per ASC 606-10-32-31, the standalone selling price is the amount that the seller would charge if it were to sell the good or service separately.
- The best way to determine the standalone selling price is to use the price the seller would actually charge when it sells the same good or service to similar customers under similar circumstance.

# Allocation of the transaction price

LEDD Company enters into a contract with a customer to sell three products for a total transaction price of $50,000. Each product is appropriately classified as a separate performance obligation. LEDD Company typically sells these three products on a standalone basis for the following prices:

| Product | Standalone selling price |
|---|---|
| A | $10,000 |
| B | 22,000 |
| C | 20,000 |
| Total | $52,000 |

- How should LEDD Company allocate the transaction price to the three products?

# Allocation of the transaction price

Example 6 solution

See guidance in ASC 606-10-32-31.

LEDD Company should allocate the $50,000 transaction price based on the products' relative, standalone selling prices as follows:

| Product | Standalone selling price | Percentage | Allocated transaction price |
|---|---|---|---|
| A | $10,000 | 19.2% | $ 9,600 |
| B | 22,000 | 42.3% | 21,150 |
| C | 20,000 | 38.5% | 19,250 |
| Total | $52,000 | 100.0% | $50,000 |

- Per ASC 606-10-32-34, if the seller cannot directly observe a standalone selling price, the seller must **estimate a standalone selling price**. (Note: vendor-specific objective evidence is not required.)
- The following methods are suitable:
  - Adjusted market assessment approach: the entity estimates the price that customers in the market in which it sells the goods or services would be willing to pay. This approach might include referring to prices charged by competitors.
  - Expected cost plus a margin approach: the entity forecasts the costs associated with providing the good or service and adds an appropriate margin.
  - Residual approach: the entity estimates the standalone selling price by subtracting the standalone selling prices of the goods or services that underlie the other performance obligations from the total transaction price.

# Allocate the transaction price to the separate performance obligations in the contract

- If the sum of the standalone selling prices is greater than the transaction price, then the entity typically should allocate the discount to the separate performance obligations on a relative, standalone-selling-price basis.  There are exceptions to this rule, which are not covered in this lecture.
- If the transaction price includes an amount that is contingent on a future event or circumstance, it generally should be allocated to the separate performance obligations.

# Estimation of standalone selling price

Example 7

Hammond Industries enters into a contract with a customer to sell three products for a total transaction price of $430,000. Each product is appropriately classified as a separate performance obligation. Hammond Industries only sells products A and B on an individual basis so it must estimate the standalone selling prices.

Information related to these three products is provided in the following table.

| Product | Standalone selling price | Market competitor prices | Forecasted cost |
|---|---|---|---|
| A | $100,000 | $ 99,000 | $ 79,000 |
| B | 250,000 | 255,000 | 200,000 |
| C | Not available | 85,000 | 65,000 |
| Total | | $439,000 | $344,000 |

- How should Hammond Industries allocate the transaction price to the three products using the adjusted market assessment approach? The cost plus margin approach? The residual approach?

# Estimation of standalone selling price

Example 7 solution

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See guidance in ASC 606-10-32-34.

**Adjusted market assessment approach**: Hammond Industries should allocate on a relative basis as follows:

| Product | Market competitor prices | Percentage of total | Allocated transaction price |
|---|---|---|---|
| A | $ 99,000 | 22.55% | $ 96,965 |
| B | 255,000 | 58.09% | 249,787 |
| C | 85,000 | 19.36% | 83,248 |
| Total | $439,000 | 100.00% | $430,000 |

# Estimation of standalone selling price
Example 7 solution (continued)

## Expected cost plus margin approach

Given a total cost of $344,000 and a total transaction price of $430,000, an appropriate margin would be 25% ($430,000/$344,000). Thus, to get the allocated transaction price for each product, we multiply the forecasted cost of each product by 1.25.

| Product | Forecasted cost | Allocated transaction price |
|---|---|---|
| A | $ 79,000 | $ 98,750 |
| B | 200,000 | 250,000 |
| C | 65,000 | 81,250 |
| Total | $344,000 | $430,000 |

# Estimation of standalone selling price

Example 7 solution (continued)

## Residual approach

Using the residual approach, the standalone selling prices that are available for products A and B are reduced from the total transaction price to arrive at the standalone selling price for product C, which is $80,000.

| Product | Standalone selling price |
|---|---|
| Total | $430,000 |
| A | (100,000) |
| B | (250,000) |
| C | $ 80,000 |

# Recognize revenue when (or as) each performance obligation is satisfied

- The entity should recognize as revenue the amount of the transaction price allocated to a performance obligation when it satisfies that performance obligation by transferring a good or service to a customer.
- Transfer occurs when the customer obtains control of the asset.
  - ASC 606-10-25-25 defines control as “the ability to direct the use of and obtain substantially all of the remaining benefits from the asset.”

Performance obligations may be satisfied at a point in time or over time.

- At a point in time: per ASC 660-10-25-30, if satisfied at a point in time, then revenue is recognized when control is transferred. Some indications of change in control are as follows:
  - The seller has a present right to payment.
  - The customer has a legal title to the asset.
  - The seller has transferred physical possession of the asset to the customer.
  - The customer has significant risks and rewards of ownership of the asset.
  - The customer has accepted the asset.

Over time, per ASC 606-10-25-27:

- An entity "satisfies a performance obligation and recognizes revenue over time if one of the following criteria is met":
  - The customer is receiving and consuming the benefits of the seller's performance as the seller performs.
  - The seller creates or enhances an asset that the customer controls as it is created or enhanced.
  - The asset created by the seller does not have an alternative use and the seller has a right to payment for performance completed to date.

- If a performance obligation is satisfied over time, then revenue should be recognized in accordance with the progress toward completion of the performance obligation, if the entity can reasonably measure its progress toward completing the obligation.  In measuring progress, either input ***or*** output methods may be used.  The *method* an entity chooses *should be used for all similar performance obligations and in similar circumstances*.
  - Input method: per ASC 606-10-55-20, revenue is recognized based on the seller's efforts or inputs toward completion of the performance obligation.
  - Output method: per ASC 606-10-55-17, revenue is recognized based on the value (to the customer) of the goods or services that have been transferred.

# Recognition over a period of time

Example 9 solution

**Input method:**

ASC 606-10-55-20 indicates revenue using the input method should be based on the seller's efforts to satisfy its performance obligation. PJG has incurred 50% of the road material costs ($15 million/$30 million) and 50% of the construction hours (200,000 hours/400,000 hours). Therefore, $25 million should be recognized as revenue at the end of year one, calculated as 50% of the $50 million.

**Output method:**

ASC 606-10-55-17 indicates revenue using the output method should be based on the value of the goods transferred to the customer. PJG has completed 10 miles of road and turned them over to the toll road operator. The remaining 15 miles are not currently available to the toll road operator. Therefore, $20 million should be recognized as revenue at the end of year one, calculated as 40% (10 miles/25 miles) of the $50 million.

# Disclosures

- The key principle is to help users of financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.
- There are three broad disclosure requirements that will present both qualitative and quantitative information about:
  - Contracts with customers
  - Significant judgments and changes in judgments made in applying the guidance to those contracts.
  - Assets recognized from costs to obtain or fulfill a contract.
- There are more disclosure requirements for public companies than for nonpublic companies.
- There is some divergence between US GAAP and IFRS as it relates to interim disclosure requirements.