The Institute of Chartered Accountants of Pakistan

CA PAKISTAN

ACCOUNTING STANDARDS BOARD

IFRS 15
Revenue from contracts with customers

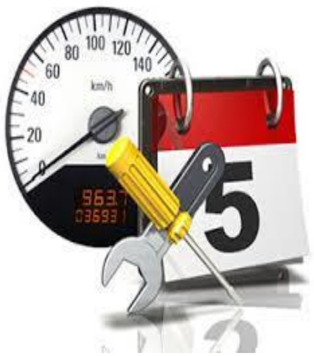
Contents

Introduction

- In 2014, IASB and FASB have issued a new global revenue recognition standard.
- New revenue standard is applicable from 01 January 2018.
- New global revenue recognition standard replaces all existing IFRS and US GAAP requirements on revenue recognition.
- Its effect on financial statements, business processes and internal controls will likely be significant for some entities.
- Its impact on the revenue and profit profiles will be significant, **as explained in the examples contained in this presentation.**

Automotive - Example

- PakChina (PC) Motors manufactures and sells vehicles.
- It sells a car to a customer for Rs. 2,000,000. With "free" maintenance after every 5000 kilometers for the first 50,000 kilometers of ownership (10 free maintenances).
- The maintenance is performed by the authorised dealers of the PC Motors and costs Rs. 5,000 to PC Motors.
- An individual can obtain a similar maintenance service contract from a 3rd party for Rs. 10,000 per service.



How PC Motors recognizes revenue from this sale under IAS 18 and IFRS 15?

Revenue under IAS 18

Under **IAS 18** PC Motors recognizes:

- Revenue of **Rs. 2 million** on the date of transfer of vehicle to the customer.

- **No revenue** in relation to the free maintenance services provided to the customer.

- Maintenance expense of **Rs. 5,000**, when customer obtains the maintenance services from the authorised dealers of PC Motors.

Revenue under IFRS 15

IFRS 15 requires revenue recognition using the **Five Step model.**

Step 1	Identify the **contract** 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 in the contract
Step 5	**Recognise revenue** when (or as) each performance obligation is satisfied

Revenue under IFRS 15

Use of Five Step model

Step 1	**Identify the contract with the customer**	**Contract with the customer** Car · Maintenance service · Rs. 2 million
Step 2	**Identify the performance obligation(s) in the contract**	**Two performance obligations** To provide a car · To provide free maintenance services
Step 3	**Determine the transaction price**	**Transaction price Rs. 2,000,000**

Revenue under IFRS 15 - *Contd ...*

Step 4

Allocate the transaction price to performance obligations

$$\frac{\text{Transaction price} \times \text{Standalone price of the deliverable}}{\text{Total selling price of the contracted deliverables}}$$

Car selling price
Rs. 2,000,000

Maintenance package
Rs. 100,000

Total selling price
Rs. 2,100,000
(Rs. 2,000,000
Plus
Rs. 10,000*10)

Allocated transaction price

Car Rs. 1,905,000
(2,000,000x 2,000,000 / 2,100,000)

Maintenance Rs. 95,000
(2,000,000x 100,000/ 2,100,000

Step 5

Recognise revenue as each performance obligation is performed

Rs. 1,905,000

Rs. 9,500
(Rs. 95,000/10 services)

Revenue under IFRS 15 - *Contd …*

In the above example the most important step in revenue recognition is the determination of performance obligations (identification of "distinct" goods and services)

IFRS 15 - Two-step model to identify which goods or services are distinct

Step 1 - Focus on whether the good or service is ***capable of being distinct***

Customer can benefit from the individual good or service on its own

OR

Customer can use good or service with other readily available resources

Step 2 - Focus on whether the good or service is ***distinct in the context of the contract***

The good or service is not integrated with,
highly dependent on,
highly interrelated with,
or significantly modifying
or customising other
promised goods or services
in the contract

Revenue under IFRS 15 - *Contd …*

	Step 1 – Capable of being distinct	Step 2 – Distinct in the context of the contract
Car	Car cannot be used without maintenance, but customer can obtain maintenance from another source. Car is distinct. Move to Step 2.	Car and its maintenance are not highly interrelated. No significant customization is required during the maintenance . Car is distinct on its own because customer could purchase it without opting for the maintenance services. Therefore second step is met.
Maintenance	The customer can benefit from the vehicle separately from the maintenance since they are sold separately in the marketplace; therefore, the first condition is met. Move to Step 2.	Maintenance services are not highly interrelated. No integration, modification or customization required. Services are individually distinct.

In the example, vehicle and maintenance are distinct performance obligations of PC Motors.

Comparative analysis

IAS 18

	Month											
	0	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Revenue	2,000,000	-	-	-	-	-	-	-	-	-	-	**2,000,000**
Cost of revenue												
Vehicle cost	1,000,000	-	-	-	-	-	-	-	-	-	-	**1,000,000**
Gross profit	1,000,000	-	-	-	-	-	-	-	-	-	-	**1,000,000**
Vehicle maintenance cost	-	5,000	5,000	5,000	5,000	-	5,000	5,000	5,000	5,000	5,000	**45,000**
Net Profit	1,000,000	(5,000)	(5,000)	(5,000)	(5,000)	-	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	**955,000**

At 25,000 KM, customer did not come for the maintenance

IFRS 15

	Month											
	0	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Revenue	1,905,000	9,500	9,500	9,500	9,500	9,500	9,500	9,500	9,500	9,500	9,500	**2,000,000**
Cost of revenue												
Vehicle cost	1,000,000	-	-	-	-	-	-	-	-	-	-	**1,000,000**
Vehicle maintenance cost	-	5,000	5,000	5,000	5,000	-	5,000	5,000	5,000	5,000	5,000	**45,000**
Gross profit	905,000	4,500	4,500	4,500	4,500	9,500	4,500	4,500	4,500	4,500	4,500	**955,000**

At 25,000 KM, customer did not come for the maintenance

REVENUE RECOGNITION PATTERN HAS CHANGED.

TOTAL REVENUE AND PROFIT REMAIN THE SAME.

Warranties

Two types of warranties: **assurance-type warranties** and **service-type warranties**

Warranties

Service type

Customer has option to purchase warranty separately?

→ **Treat as a separate performance obligation (Account for in accordance with IFRS 15)**

No

Does the warranty provide customer with a service in addition to 'assurance'?

→ **Treat as a separate performance obligation (Account for in accordance with IFRS 15)**

No

Assurance type

Account in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

Warranties - *Contd …*

Example:

- Considering the earlier example of car sale of Rs. 2,000,000, assume that Pak Motors provides the particular customer with a five-year guarantee that the car will continue to perform to specifications.
- Pak Motors, normally provides one year guarantee to its customers.
- The normal one-year warranty cost is Rs. 100,000 per car.
- There is no free maintenance service under the contract.

How to account for revenue and warranty in the above scenario?

Warranties - *Contd …*

Step 1	**Identify the contract with the customer**

Car + 5 years warranty for Rs. 2,000,000

Step 2	**Identify the performance obligation(s) in the contract**

5 years warranty offered to a particular customer

Assurance warranty - 1st year of car sale

Represents warranty offered to every customer. The warranty would be accounted for under IAS 37 as a "Warranty provision".

Service warranty - 2 to 5 years of car sale

The warranty offered during year 2-5 represents a separate performance obligation (as its above the normal period of one year generally offered to every customer). Pak motors is committing to provide warranty and ensure car performs as per specifications beyond the "assurance" period.

This would be accounted for under IFRS 15 as "Contract liability" (Deferred Revenue)

Warranties - *Contd …*

Step 3	Determine the transaction price

Rs. 2,000,000

Step 4	Allocate the transaction price to performance obligations

Pak Motors determines that:

1. **Rs. 1.7 million** of the Rs. 2 million transaction price should be allocated **to the car**; and
2. **Rs. 0.3 million** to the **service warranty**

(based on estimated stand-alone selling prices and a relative selling price allocation)

Warranties - *Contd …*

Step 5 **Recognise revenue**

Revenue recognition under IFRS 15

Upon delivery of the car, Pak Motors records the following entries:

Dr. Bank	2,000,000	
Cr. Revenue		1,700,000
Cr. **Contract liability** (service warranty year 2-5)		300,000

Warranty accounting under IAS 37

Dr. Warranty expense	100,000	
Cr. Accrued warranty costs (assurance warranty)		100,000

Revenue recognition under IAS 18

Dr. Bank	2,000,000	
Cr. Revenue		2,000,000

Warranty accounting under IAS 37

Dr. Warranty Expense	100,000	
Cr. Accrued warranty cost		100,000

The contract liability on account of service warranty is recognised as revenue over the service warranty period (years two through five). The costs of providing the service warranty are recognised as incurred.

The accrued warranty cost representing the assurance warranty obligation is used/derecognised as car's defective units are replaced/repaired during the first year of the warranty. Upon expiration of the assurance warranty period, any remaining assurance warranty obligation is reversed.

Telecommunication - Example

- Subscriber enters into a **1 year post paid plan** with the Telco.
- The terms of post paid plan are:

  Free handset

  Data and voice services

  Monthly post paid billing of Rs. 2,000

- Telco sells the same handset for Rs. 10,000 (costs Rs. 8,000 to Telco), and the standalone billing of the similar data and voice services plan is Rs. 1400 / month.
- Telco's cost of data and voice services is Rs. 500 per month.

How Telco recognizes the revenue from this plan under IAS 18 and IFRS 15?

Telecommunication - Example

- Under the current practice i.e. IAS 18, the revenue that Telco recognizes upon the delivery of the handset is limited to the amount of consideration received upfront; that is nil (Handset is provided for free).

- Conversely, under the new revenue standard i.e. IFRS 15, the total transaction consideration would be allocated to the identified deliverables/ performance obligations (handset and monthly data services) based on their relative standalone selling prices, and revenue would be recognised as each performance obligation is satisfied.

- The result would be that under IFRS 15, Telco would:

- Consider provision of free hand set as a performance obligation under the contract;
- Allocate more transaction consideration to the handset than under the current practice;
- Recognise the above allocated revenue to hand set sale and data services under the package.

- The biggest impact of the new standard is that the companies will report revenue in a different pattern, resultantly the period profit patterns will also change.

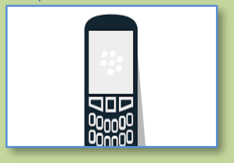
Lets demonstrate this with the application of IAS 18 and IFRS 15.

Revenue under IAS 18

- Under IAS 18, Telco should apply the recognition criteria to the separately identifiable components of a single transaction (here: handset + monthly plan).
- However, **IAS 18 does not give any guidance** on how to identify these components and how to allocate selling price and as a result, there are different practices applied.

Revenue recognition IAS 18

Revenue of Rs 2,000 recognised from the sale of plan as the service is provided *i.e. on a monthly basis*



No revenue for handset – Telco treats the cost of handset as the ***cost of acquiring the customer***

Profit and Loss Account under IAS 18

	Rs.
Revenue (Time 1- Time 12)	
Data and voice revenue	2,000
Expense	
Customer acquisition cost (Time 0)	8,000
Data and voice cost (Time 1- Time 12)	500

Revenue under IFRS 15 – *Contd …*

Step 1 | Identify the contract with the customer

One year (12 months) contract

Handset for free

Data, calls and texts services

Rs. 2000 per month

Step 2 | Identify the performance obligation(s) in the contract

Two performance obligations

To provide Handset

To provide data and voice service

Step 3 | Determine the transaction price

Transaction price Rs. 24,000

- Contract term 12 months
- Package Rs. 2,000 per month

Revenue under IFRS 15 - *Contd …*

Step 4

Allocate the transaction price to performance obligations

$$\frac{\text{Transaction price} \times \text{Standalone price of the deliverable}}{\text{Total selling price of the contracted deliverables}}$$

Phone selling price
Rs. 10,000

Monthly rate of package
Rs. 1500

Total selling price
Rs. 28,000
(Rs. 10,000
Plus
Rs. 1500*12)

Allocated transaction price

Rs. 8,570
(24000 x 10,000 / 28000)

Rs. 15,430
(24000x 18000/ 28000

Step 5

Recognise revenue

Rs. 8,570

Time 0

Rs. 1,285
(Rs 15430 / 12)

Time 1 to
Time 12

Comparative analysis

IAS 18

Telco reported loss in the beginning of the contract and then earned steady profits, because it recognized revenue in line with the invoicing to customer i.e. (Rs. 2,000)

	Month													
	0	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**Total**
Revenue - Data services	-	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	**24,000**
Cost of revenue														
Data services	-	500	500	500	500	500	500	500	500	500	500	500	500	**6,000**
Gross profit	-	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	**18,000**
Customer acquisition cost	8,000	-	-	-	-	-	-	-	-	-	-	-	-	**8,000**
Net profit	(8,000)	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	**10,000**

IFRS 15

The reported revenue and profits are the same in total, compared to IAS 18. However, the revenue recognition pattern over time is different. Further, monthly recognition of revenue , is not based on monthly invoicing of Rs. 2,000.

	Month													
	0	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**Total**
Revenue														
Hand set sale	8,570	-	-	-	-	-	-	-	-	-	-	-	-	**8,570**
Data services	-	1,286	1,286	1,286	1,286	1,286	1,286	1,286	1,286	1,286	1,286	1,286	1,286	**15,430**
	8,570	1,286	1,286	1,286	1,286	1,286	1,286	1,286	1,286	1,286	1,286	1,286	1,286	**24,000**
Cost of revenue														
Handset cost	8,000	-	-	-	-	-	-	-	-		-	-	-	**8,000**
Data services	-	500	500	500	500	500	500	500	500	500	500	500	500	**6,000**
														14,000
Gross profit	570	786	786	786	786	786	786	786	786	786	786	786	786	**10,000**

Comparative analysis - *Contd …*

Implications

- The timing of revenue recognition has changed
- The period to period gross profit has changed
- Revenue recognition does not correspond with monthly billing to the customers, as there will be some deferral accounts involved
- Total Gross profit and revenue over the contract terms is same

The impact of IFRS 15 is challenging for Telecommunication companies. Its implementation will require significant changes in the IT systems, enabling the companies to automatically calculate and record the amount of revenue for each subscriber.