Fiji Institute of Accountants: Technical Workshop 2017

IFRS 15 *Revenue from Contracts with Customers*

Case Study Solutions

Case study 1: Performance obligations

This case study was based on IFRS 15 Illustrative Example 11 which is reproduced below (with minor amendments)

Go Fast Computing (GFC), a software developer, enters into a contract with Emirates Team New Zealand (ETNZ) to transfer a software licence, perform an installation service and provide unspecified software updates and technical support (online and telephone) for a two-year period. GFC sells the licence, installation service and technical support separately. The contract specifies that, as part of the installation service, the software is to be substantially customised to add significant new functionality to enable the software to interface with other customised software applications used by the customer. The customised installation service can be provided by other entities. The software remains functional without the updates and the technical support.

Question

What are the performance obligations under this contract?

Solution

GFC assesses the goods and services promised to ETNZ to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. GFC observes that the terms of the contract result in a promise to provide a significant service of integrating the licenced software into the existing software system by performing a customised installation service as specified in the contract. In other words, GFC is using the licence and the customised installation service as inputs to produce the combined output (ie a functional and integrated software system) specified in the contract (see paragraph 29(a) of IFRS 15). In addition, the software is significantly modified and customised by the service (see paragraph 29(b) of IFRS 15). Although the customised installation service can be provided by other entities, GFC determines that within the context of the contract, the promise to transfer the licence is not separately identifiable from the customised installation service and, therefore, the criterion in paragraph 27(b) of IFRS 15 (on the basis of the factors in paragraph 29 of IFRS 15) is not met. Thus, the software licence and the customised installation service are not distinct.

GFC concludes that the software updates and technical support are distinct from the other promises in the contract. This is because the customer can benefit from the updates and technical support either on their own or together with the other goods and services that are readily available and because the promise to transfer the software updates and the technical support to ETNZ are separately identifiable from each of the other promises. On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

(a) customised installation service (that includes the software licence);

(b) software updates; and

(c) technical support.

GFC applies paragraphs 31–38 of IFRS 15 to determine whether each performance obligation is satisfied at a point in time or over time.

Case study 2: Consideration payable to a customer

This case study was based on IFRS 15 Illustrative Example 32 which is reproduced below (with minor amendments)

Good Looking Inc (GLI) manufactures branded sports gear enters into a one-year contract to sell goods to Yachting New Zealand (YNZ). YNZ commits to buy at least $15 million of products during the year after TNZ with the America's Cup. The contract also requires GLI to make a non-refundable payment of $1.5 million to YNZ at the inception of the contract. The $1.5 million payment will compensate YNZ for the changes it needs to make to its shelving to accommodate the GLI's products.

Question

How does the GLI account for the upfront payment to YNZ?

Solution

GLI has to consider the requirements in paragraphs 70–72 of IFRS 15 and concludes that the payment to the customer is not in exchange for a distinct good or service that transfers to the entity. This is because the entity does not obtain control of any rights to the YNZ's shelves. Consequently, GLI determines that, in accordance with paragraph 70 of IFRS 15, the $1.5 million payment is a reduction of the transaction price.

GLI applies the requirements in paragraph 72 of IFRS 15 and concludes that the consideration payable is accounted for as a reduction in the transaction price when the entity recognises revenue for the transfer of the goods. Consequently, as GLI transfers goods to YNZ, GLI reduces the transaction price for each good by 10 per cent ($1.5 million ÷ $15 million). Therefore, in the first month in which GLI transfers goods to YNZ, GLI recognises revenue of $1.8 million ($2.0 million invoiced amount less $0.2 million of consideration payable to YNZ).

Case study 3: Option that provides the customer with a material right (discount voucher)

This case study was based on IFRS 15 Illustrative Example 49 which is reproduced below (with minor amendments)

Smart Pens Limited (SPL) enters into a contract with the ETNZ supporters club for the sale of fountain pens for $100. As part of the contract, SPL will give the ETNZ supporters club a 40 per cent discount voucher for any future purchases of branded ETNZ pens up to $100 in the next 30 days. But SPL intends to offer a 10 per cent discount on all sales during the next 30 days as part of a seasonal promotion. The 10 per cent discount cannot be used in addition to the 40 per cent discount voucher.

SPL estimates an 80 per cent likelihood that members of the ETNZ Supporters club will redeem the voucher and that ETNZ supporters club members will, on average, purchase $50 of additional products.

Question

How would the transaction price be allocated?

Solution

Because all SPL's customers will receive a 10 per cent discount on purchases during the next 30 days, the only discount that provides the ETNZ supporters club with a material right is the discount that is incremental to that 10 per cent (ie the additional 30 per cent discount). SPL accounts for the promise to provide the incremental discount as a performance obligation in the contract for the sale of the branded fountain pens.

To estimate the stand-alone selling price of the discount voucher in accordance with paragraph B42 of IFRS 15, SPL estimates an 80 per cent likelihood that an ETNZ supporter club member will redeem the voucher and that ETNZ supporter will, on average, purchase $50 of additional products. Consequently, SPL's estimated stand-alone selling price of the discount voucher is $12 ($50 average purchase price of additional products × 30 per cent incremental discount × 80 per cent likelihood of exercising the option). The stand-alone selling prices of the fountain pens and the discount voucher and the resulting allocation of the $100 transaction price are as follows:

Performance obligation	Stand-alone selling price ($)	
Fountain pen	100	
Discount Voucher	12	
Total	112	
	Allocated transaction price ($)	
Fountain pen	89	(100/112)*100
Discount Voucher	11	(12/112)*100
Total	100	

SPL allocates $89 to the sale of each fountain pen and recognises revenue for the fountain pens when control transfers. SPL the allocates $11 to the discount voucher and recognises revenue for the vouchers when the ETNZ supporters club member redeems it for goods or services or when it expires.

Case study 4: Assessing whether a performance obligation is satisfied at a point in time or over time

This case study was based on IFRS 15 Illustrative Example 17B which is reproduced below (with minor amendments)

Great Views Limited (GVL) is developing a multi-unit residential complex in Auckland, right beside the ETNZ compound. A customer enters into a binding sales contract with GVL for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).

The customer pays a non-refundable deposit upon entering into the contract and will make progress payments during construction of the unit. The contract has substantive terms that preclude the entity from being able to direct the unit to another customer. In addition, the customer does not have the right to terminate the contract unless the entity fails to perform as promised. If the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, GVL would have a right to all of the consideration promised in the contract if it completes the construction of the unit. The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

Question

How should revenue be recognised?

Solution

At contract inception, GVL applies paragraph 35(c) of IFRS 15 to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. GVL determines that the asset (unit) created by its performance does not have an alternative use to GVL because the contract precludes the entity from transferring the specified unit to another customer. GVL does not consider the possibility of a contract termination in assessing whether the entity is able to direct the asset to another customer.

GVL also has a right to payment for performance completed to date in accordance with paragraphs 37 and B9–B13 of IFRS 15. This is because if the customer were to default on its obligations, GVL would have an enforceable right to all of the consideration promised under the contract if it continues to perform as promised.

Therefore, the terms of the contract and the practices in the legal jurisdiction (ie New Zealand) indicate that there is a right to payment for performance completed to date. Consequently, the criteria in paragraph 35(c) of IFRS 15 are met and GVL has a performance obligation that it satisfies over time. To recognise revenue for that performance obligation satisfied over time, GVL measures its progress towards complete satisfaction of its performance obligation in accordance with paragraphs 39–45 and B14–B19 of IFRS 15.

In the construction of a multi-unit residential complex, GVL may have many contracts with individual customers for the construction of individual units within the complex. GVL would account for each contract separately. However, depending on the nature of the construction, GVL's performance in undertaking the initial construction works (ie the foundation and the basic structure), as well as the construction of common areas, may need to be reflected when measuring its progress towards complete satisfaction of its performance obligations in each contract.

Case study 5: Non-refundable upfront fee

This case study was based on IFRS 15 Illustrative Example 53 which is reproduced below (with minor amendments)

A payroll processing company enters into a contract with ETNZ for one year of transaction processing services. The payroll processing company contracts have standard terms that are the same for all customers (no matter who they are!). The contract requires ETNZ to pay an upfront fee to set up the ETNZ on the payroll processing company's systems and processes. The fee is a nominal amount and is non-refundable. ETNZ can renew the contract each year without paying an additional fee.

Question

How should the payroll processing company recognise the non-refundable upfront fee?

Solution

The payroll processing company's setup activities do not transfer a good or service to ETNZ and, therefore, do not give rise to a performance obligation.

The payroll processing company concludes that the renewal option does not provide a material right to ETNZ that it would not receive without entering into that contract (see paragraph B40 of IFRS 15). The upfront fee is, in effect, an advance payment for the future transaction processing services. Consequently, the payroll processing company determines the transaction price, which includes the non-refundable upfront fee, and recognises revenue for the transaction processing services as those services are provided in accordance with paragraph B49 of IFRS 15.

Case study 6: Identifying a distinct licence

This case study was based on IFRS 15 Illustrative Example 56B which is reproduced below (with minor amendments)

ETNZ, licenses to a customer called Fast Boats Limited (FBL) its patent rights to n keel design for 10 years and also promises make the keels for the customer. Following the racing in Bermuda, the keel technology is a mature product; therefore the ETNZ will not undertake any activities to support use of the keel, which is consistent with its customary business practices. The manufacturing process used to produce the keelis not unique or specialised and several other entities can also manufacture the keel for the customer.

Question

1. How many performance obligations exist?
2. How should revenue be recognised?

Solution

ETNZ must assess the goods and services promised to FBL to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. Because the manufacturing process can be provided by other entities, ETNZ concludes that FBL can benefit from the licence on its own (ie without the manufacturing service) and that the licence is separately identifiable from the manufacturing process (ie the criteria in paragraph 27 of IFRS 15 are met). Consequently, ETNZ concludes that the licence and the manufacturing service are distinct and the entity has two performance obligations:

(a) licence of patent rights; and

(b) manufacturing service.

ETNZ must then assess, in accordance with paragraph B58 of IFRS 15, the nature of it's promise to grant the licence. The keel is a mature product (ie it is proven, is currently being manufactured and has been sold commercially). For these types of mature products, ETNZ customary business practice is not to undertake any activities to support the keel. Consequently, ETNZ concludes that the criteria set out in paragraph B58 of IFRS 15 are not met because the contract does not require, and FBL does not reasonably expect, ETNZ to undertake activities that significantly affect the intellectual property to which the customer has rights. In its assessment of the criteria in paragraph B58 of IFRS 15, ETNZ does not take into consideration the separate performance obligation of promising to provide a manufacturing service. Consequently, the nature of the ETNZ's promise in transferring the licence is to provide a right to use ETNZ's intellectual property in the form and the functionality with which it exists at the point in time that it is granted to the customer. Consequently, ETNZ need to account for the licence as a performance obligation satisfied at a point in time.

The entity applies paragraphs 31–38 of IFRS 15 to determine whether the manufacturing service is a performance obligation satisfied at a point in time or over time.

Case study 7: Costs that give rise to an asset

This case study was based on IFRS 15 Illustrative Example 37 which is reproduced below (with minor amendments)

Quick Computers Limited (QCL) enters into a service contract to manage ETNZ's information technology data centre for five years. The contract is renewable for subsequent one-year periods. The average customer term is seven years. QCL pays an employee a $10,000 sales commission upon the customer signing the contract with ETNZ. Before providing the services, QCL designs and builds a technology platform for ETNZ's internal use that interfaces with other TNZ systems. That platform isnot transferred to ETNZ, but will be used to deliver services to the ETNZ.

The initial costs incurred to set up the technology platform are as follows:

	$
Design services	40,000
Hardware	120,000
Software	90,000
Migration and testing of data centre	100,000
Total costs	350,000

Question

How should the costs shown be treated?

Solution

Incremental costs of obtaining a contract

In accordance with paragraph 91 of IFRS 15, QCL recognises an asset for the $10,000 incremental costs of obtaining the contract for the sales commission because QCL expects to recover those costs through future fees for the services to be provided. QCL amortises the asset over seven years in accordance with paragraph 99 of IFRS 15, because the asset relates to the services transferred to ETNZ during the contract term of five years and QCL anticipates that the contract will be renewed by ETNZ for two subsequent one-year periods.

Costs to fulfil a contract

The initial setup costs relate primarily to activities to fulfil the contract but do not transfer goods or services to the customer. The entity accounts for the initial setup costs as follows:

(a) hardware costs—accounted for in accordance with IAS 16 *Property, Plant and Equipment*.

(b) software costs—accounted for in accordance with IAS 38 *Intangible Assets*.

(c) costs of the design, migration and testing of the data centre—assessed in accordance with paragraph 95 of IFRS 15 to determine whether an asset can be recognised for the costs to fulfil the contract. Any resulting asset would be amortised on a systematic basis over the seven-year period (ie the five-year contract term and two anticipated one-year renewal periods) that the entity expects to provide services related to the data centre.