Revenue from Contracts with Customers – Five steps to recognise revenue

Introduction

Hong Kong Financial Reporting Standard (HKFRS) 15 *Revenue from Contracts with Customers* is effective for annual reporting periods beginning on or after 1 January 2018. Under HKFRS 15, an entity recognises revenue when a "performance obligation" is satisfied, i.e. when control of the goods or services underlying the performance obligation is transferred to the customer. This new standard will have significant impact on how and when an entity recognises revenue with the principles in HKFRS 15 providing a structured approach for measuring and recognising revenue. However, HKFRS 15 does not apply to lease contract (which are covered by HKFRS 16), insurance contracts (HKFRS 4), financial instruments (HKFRS 9), contractual rights and obligations within the scope of HKFRS 10, HKFRS 11, Hong Kong Accounting Standard (HKAS) 27, HKAS 28, nor non-monetary exchanges.

(A) Five-step model

HKFRS 15 establishes a five-step model to account for revenue from contracts with customers:

(1) Identify the Contract(s) with a customer;

(2) Identify the Performance Obligations in the contract;

(3) Determine the Transaction Price;

(4) Allocate the transaction price to the performance obligations in the contract; and

(5) Recognise revenue when (or as) the entity Satisfies a performance obligation.

(Step 1) Identify the contract(s) with a customer

HKFRS 15 defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations." HKFRS 15 applies to a contract with a customer if ALL the five criteria set out in paragraph 9 of HKFRS 15 (HKFRS 15.9) are met:

1. The parties to the contract have approved the contract and are committed to perform their performance obligations;
2. The contract has commercial substance;
3. The entity can identify each party's rights regarding the goods or services to be transferred;
4. The entity can identify the payment terms for the goods or services to be transferred; and
5. It is probable that the entity will collect the consideration to which it will be entitled, taking into account of both the customer's ability and intention to pay.

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If a contract does not meet the above contract criteria, and an entity receives consideration from the customer, the entity shall recognise the consideration received as revenue only when either of the following events has occurred:

1. The entity has no remaining obligation to transfer goods or services to the customer and all, or substantially all, of the consideration has been received by the entity and is non-refundable; or
2. The contract has been terminated and the consideration received from the customer is non-refundable. (HKFRS 15.15)

(Step 2) Identify the performance obligations in the contract

Having identified that a contract is within the scope of HKFRS 15, an entity must consider the promises made to a customer. These promises may form one or more separate performance obligations.

Promises are separately identified and accounted for as seprate performance obligation if:

(a) the promised good or service (or bundle of goods or services) is distinct; or

(b) the promise is a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Goods or services are **distinct** if:

1. The good or service could benefit the customer on its own or with other resources that are readily available (i.e. the good or service is capable of being distinct); **and**
2. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises (i.e. not integrating, not significantly modifies/customise, not highly interdependent/interrelated).

(Step 3) Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. When determining transaction price, an entity should consider if there is:

1. **Variable consideration** – the variable element may include discounts, rebates, refunds, credits, price concessions, incentives, performance bonus or penalties. Variable consideration is included in transaction price based on either (i) its expected value (if large number of similar contracts) or (ii) single most likely amount (if only two possible outcomes). Variable consideration is included only to the extent that it is highly probable that a significant amount will not be reversed.
2. **Significant financing component** – consider (i) the difference between consideration and cash selling price and (ii) combined effect of length of time and prevailing interest rate; not require adjustment where payment will be one year or less.

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3. **Non-cash consideration** – measured at fair value, if cannot, then by reference to stand-alone selling price of the goods or services promised.
4. **Refund liabilities** – when seller expected products to be returned, recognise (i) a refund liability as well as (ii) an asset representing items to be returned,
5. **Consideration payable to a customer** – e.g. cash amounts, credit, coupons or vouchers. Consideration that is not in exchange for a distinct good/service is a reduction in transaction price, recognised at the later of the point at which (i) revenue is recognised or (ii) the entity pays/promises to pay the consideration.

(Step 4) Allocate the transaction price to the performance obligations in the contract

The transaction price must be allocated to the performance obligations in proportion to the individual "stand-alone selling price" attached to each performance obligation. If a stand-alone selling price is not directly observable, an entity should estimate using a suitable method, e.g.:

1. **Adjusted market approach** – estimate the price that a customer is willing to pay, with reference to competitors' pricing, adjusted for entity's cost and margin
2. **Expected cost plus margin approach** – forecasting expected costs and adding a margin
3. **Residual approach** – reference to total transaction price less sum of observable price of other goods/services. This is appropriate only if the entity (i) sells the same good/service to different customers for a broad range of amounts (representative price is not discernible), or (ii) has not yet established a price/not previous sold on stand-alone basis.

A customer may receive a discount for purchasing a bundle of goods or services. The discount is allocated proportionately to all performance obligation based on their single-alone selling prices. it is allocated only to certain performance obligations if ALL of following conditions are met: (i) the entity regularly sells each distinct goods or services on a stand-alone basis, (i) the entity regularly sells a bundle at discount, and (iii) the discount attributable to each bundle is substantially the same as the discount in the contract which provides observable evidence of the performance obligation to which the entire discount belongs.

(Step 5) Recognise revenue when (or as) the entity satisfies a performance obligation

A performance obligation is **satisfied** when a good or service is transferred to the customer, i.e. the customer obtains **control** of the good or service. Control is the ability to direct the use of and obtain substantially all of the remaining benefits from the asset). Performance obligation may be satisfied (i) at a single point in time or (ii) over a period of time. If a performance obligation is not satisfied over time, it is assumed to be satisfied at a point in time. (HKFRS 15.38).

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An entity recognises revenue over time, if one of the following criteria is met:

1. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs, e.g. cleaning service;
2. The entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhance, e.g. customised software in customer's existing information system; or
3. The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date (HKFRS 15.35).

Revenue is recognised only when an entity can reasonably measure the outcome. In the early stages of a contact when this is not possible, revenue is recognised only to the extent of costs incurred that are expected to be recovered. Where an entity can reasonably measure the outcome, revenue is recognised based on progress towards satisfaction of the performance obligation, measured by input method or output method.

(B) Other issues

Modifications to contracts - A contract modification is accounted for as a separate contract if (i) the scope changes because additional distinct goods or services are promised, **and** (ii) the increase in contract price reflects the stand-alone selling price of the additional goods or services promised. If the contract modification is not accounted for as a separate contract, then either: (i) if the remaining promised goods or services are distinct, the existing contract will be treated as being terminated and a new contract deemed to exist; or (ii) if the remaining promised goods or services is not distinct, i.e. only a single performance obligation, the modification will be treated as part of the original contract.

Changes in transaction price after modification – either (i) allocate to performance obligations identified in original contract if variable consideration was promised **before** modification; or (ii) allocated to performance obligations in modified contract if variable consideration was promised **after** modification and modification was **not** accounted for as a separate contract.

Costs of obtaining a contract – non-incremental costs of obtaining a contract are recognised immediately in profit or loss unless they can be charged to customer regardless of whether the contract is obtained. Incremental costs of obtaining a contract are recognised as an asset if the costs are expected to be recovered (amortised to reflect the transfer of goods or services to customer, expensed if amortisation period is one year or less).

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Costs of fulfilling a contract – expensed for (i) general and administrative, (ii) abnormal costs (wasted), (iii) costs relating to performance obligations that have already been satisfied, (iv) costs that cannot distinguish whether relating to satisfied or unsatisfied. Other costs that do not fall within scope of another standard (e.g. HKAS 2, HKAS 16, HKAS 38) are recognised as an asset if ALL 3 conditions are met: the costs (i) relate directly to a contract/anticipated contract (direct labour, direct materials, directly allocated costs, explicitly chargeable, incurred only because of the contract); (i) generate or enhance resources that will be used to satisfy performance obligations in future; and (ii) are expected to be recovered.

Presentation of contracts with customers –

1. **Contract asset** – entity's right to consideration that is conditional on something other than the passage of time.
2. **Receivable** – entity's right to consideration that is unconditional, i.e. only the passage of time is required.
3. **Contract liability** – entity's obligation to transfer the goods or services to the customer for which the entity has received consideration (or the amount is due), i.e. if customer pays consideration before the entity transfer goods or services.

Disclosure – HKFRS 15 requires an entity to provide both qualitative and quantitative information about (i) its contracts with customers; (i) significant judgements and changes in judgements; (iii) any assets recognised from costs to obtain or fulfil a contract.

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Application guidance – HKFRS 15 includes application guidance on:

1. **sales with a right of return** – Debit (Dr) Bank, Credit (Cr) Revenue only to the extent expects to entitle, Cr Refund Liability for consideration received but not expect to entitle; Dr Asset/Inventory expected to be recovered, Cr Cost of Sales that are not expected to be returned, Cr Inventory;

2. **extended warranties** (additional to standard warranty) - as a separate performance obligation and allocated a portion of transaction price;

3. **acting as an agent** (not primary responsible for fulfilling promises, no inventory risk, no discretion in setting prices) – revenue measured at the fee/commission

4. **royalties** – recognise revenue when the later of subsequent sales or usage/performance obligation to which royalty allocated has been satisfied

5. **licensing** – when the promise to grant a licence is distinct from the promised goods and services, it is a separate performance obligation. If the licence allows customer access as it exists at any given time (continue to support and update), it is a performance obligation satisfied over time. If it allows only at the date the licence is granted, it is a performance obligation satisfied at a point in time.

6. **repurchase agreement** – seller has obligation/right (call option) to repurchase – sale and leaseback/lease/financing arrangement; customer has right to make seller repurchase (put option) – sale with a right of return/lease/sale and leaseback/financing arrangement,

7. **consignment** – product is controlled by the seller (manufacturer), seller can require the return, customer (dealer) does not have unconditional obligation to pay,

8. **bill and hold arrangements** – billed, but product is physically retained by seller. Recognise revenue when control of the goods has passed, i.e. all 4 criteria met: reason for bill and hold is substantive (requested by customer), product identified as belonging to customer, product is ready for physically transfer, entity cannot use the product or transfer to another customer,

9. **options for additional goods and services –** (a) for free/discounted price (award credits, points, loyalty scheme) – separate performance obligation if it provides a material right, proportion of consideration received that relates to future is deferred and recognise as revenue at the earlier of (1) the date the future goods and services are provided, or (2) the date the option to additional goods and services expires, (b) for an option to additional good or service at stand-alone selling price, it does not provide the customer a material right, thus only a marketing offer.

(10) **non-refundable upfront fees** – if upfront fee is not related to the transfer of a promised good or service, it is a prepayment over the length of the contract (and optional extension period if the option to extend provides the customer a material right that would not otherwise be available).

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Application example: Copas Limited
(Copas – Contract, Obligations, Price, Allocate, Satisfied)

Copas Limited (Copas) has developed a new equipment, Beta. Beta will not function or be sold without the operating software. Upon purchase of Beta, customers are offered a separately priced five-year maintenance agreement and there is no right of return.

Copas places emphasis on product innovations and software upgrades is developing for Beta. To encourage customers to opt for the maintenance agreement, any software upgrades during the maintenance agreement period will be installed at no cost to customers who purchased the maintenance agreement.

On 1 January 2018, Copas signed a contract with Omega. Omega agreed to purchase Beta for $3,000,000 and paid an additional $500,000 for a five-year maintenance agreement. The maintenance agreement covers parts, labour, and software repairs. The full amount of $3,500,000 is payable upon delivery of Beta. Based on Omega's credit history and current financial condition, Copas determined that collection of the consideration is probable.

Copas: suggested solution

Step 1: Identify the contract(s) with a customer. The contract between Copas and Omega complies with the five conditions indicated in HKFRS 15: (1) Both parties have approved the contract and are committed to perform their performance obligations; (2) The contract has commercial substance; (3) Copas can identify each party's rights regarding the goods or services to be transferred; (4) Copas can identify the payment terms for the goods or services to be transferred; and (5) It is probable that Copas will collect the consideration to which it will be entitled, taking into account of both Omega's ability and intention to pay.

Step 2: Identify the performance obligations in the contract. Having identified that the contract is within the scope of HKFRS 15, Copas must consider the promises made to Omega. These promises may form one or more separate performance obligations. If those goods or services are distinct, then the promises are performance obligations and are accounted for separately. In this contract, Copas promises to deliver the following four items to Omega:

1. Beta;
2. operating software for Beta;
3. maintenance for the next five years (parts, labour, and software repairs); and
4. software upgrades if and when available during the five-year maintenance agreement.

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After the promises in the contract have been identified, Copas should evaluate each of these promised goods and services to determine if they are distinct. Goods or services are distinct if: (i) the good or service could benefit Omega on its own or with other resource that are readily available (i.e. the good or service is capable of being distinct); and (ii) Copas' promise to transfer the good or service to Omega is separately identifiable from other promises (i.e. not integrating, not significantly modifies/customise, not highly interdependent/interrelated).

Therefore, there are three performance obligations in this contract:

1. Beta does not have stand-alone value without the operating software. Omega would not be able to directly benefit or resell Beta without the operating software. However, "Beta with the operating software" has stand-alone value to Omega because Omega can benefit from the good or service on its own or could resell Beta with its operating software.
2. The "maintenance agreement" has stand-alone value because Omega can benefit from the good or service on its own or can resell the maintenance agreement.
3. "Potential software upgrades" have stand-alone value as Omega can separately benefit from the good or service on its own or can resell the software upgrades.

Step 3: Determine the transaction price. The transaction price is the amount of consideration to which Copas expects to be entitled in exchange for transferring promised goods or services to Omega. The full transaction price of $3,500,000 is payable upon delivery of Beta with its operating software.

Step 4: Allocate the transaction price to the performance obligations in the contract. This contract has three performance obligations. Therefore, Copas should allocate the transaction price to each performance obligation based on the relative stand-alone selling prices of each distinct good or service promised in the contract. Therefore, the transaction price of $3,500,000 should be allocated among the (i) Beta with its operating software; (ii) maintenance agreement and (iii) potential software upgrades based on their relative stand-alone selling prices.

Beta with its operating software has stand-alone value to the customer, but neither Beta nor the operating software separately has stand-alone value. The allocation of the $3,500,000 transaction price is necessary because the three performance obligations (Beta with its operating software, maintenance agreement and potential software upgrades) are distinct as they have stand-alone value to Omega. Copas has promised to install any software upgrades during the maintenance agreement period at no cost to Omega. There may be no observable stand-alone selling prices for the maintenance agreement and the potential software upgrades. Therefore, Copas is required to make a reasonable estimate of the relative stand-alone selling price using a suitable method (e.g. adjusted market approach or expected cost plus margin approach) and allocate the $3,500,000 accordingly to each of these three performance obligations.

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Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation.

For the three performance obligations, revenue should be recognised as Copa satisfies the performance obligations:

1. Copas should recognise the portion of the contract price allocated to Beta with its operating software upon delivery of Beta to Omega. Since the contract states that there is no right of return, no provision for refund liability is necessary.

2. Copas should recognise the "portion of the contract price allocated to the maintenance agreement" over the five-year period that the service is provided. Copas should evaluate whether maintenance costs would most likely be evenly incurred over the maintenance period. If not, these costs should be allocated in different percentages over the five-year maintenance period.

3. Copas should recognise the "portion of the contract price allocated to any potential software upgrades" over the five-year period.

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