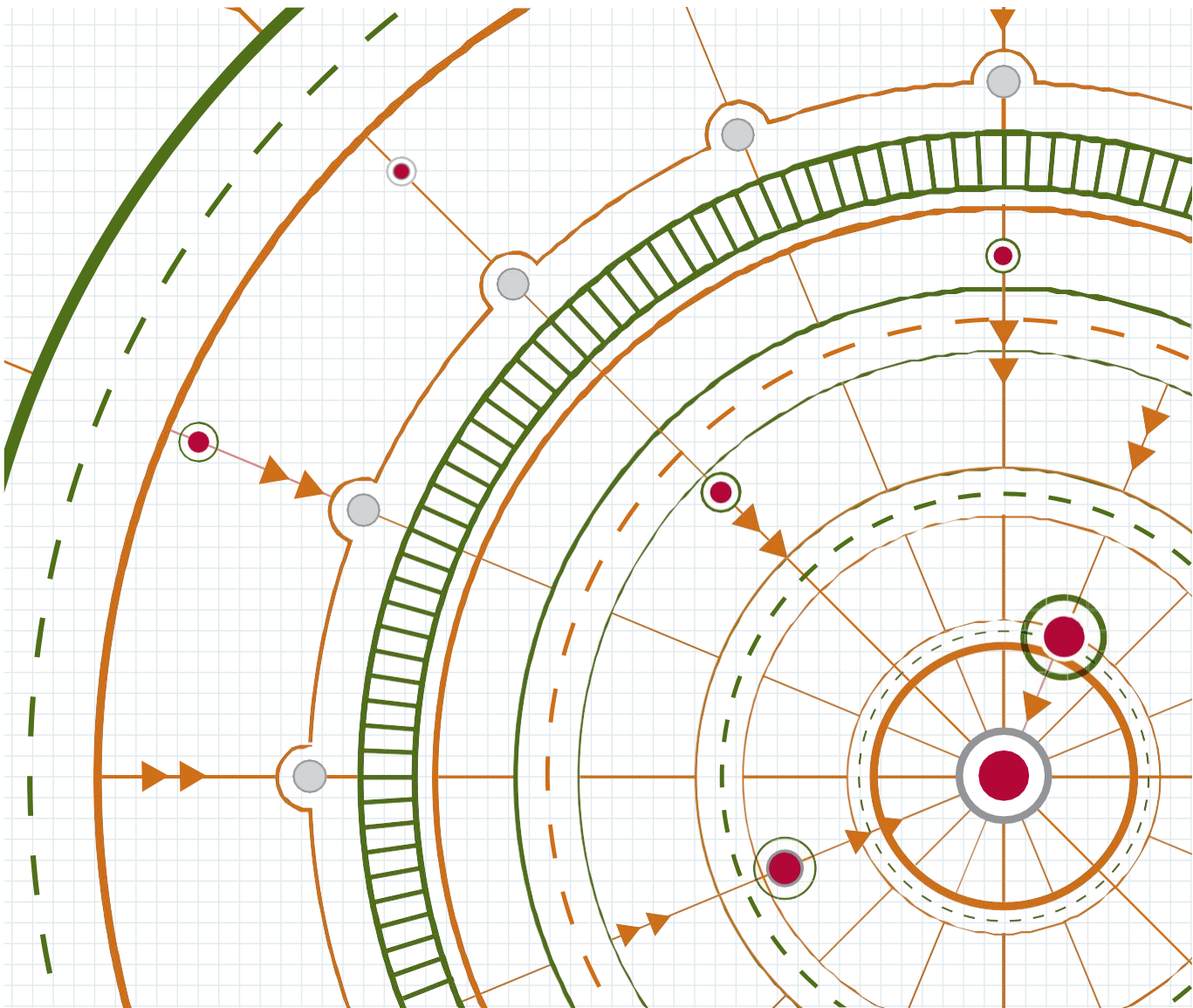


Module 23—Revenue



IFRS[®] Foundation

Supporting Material

for the *IFRS for SMEs*[®] Standard

including the full text of
Section 23 *Revenue*
of the *IFRS for SMEs* Standard
issued by the International Accounting Standards Board in October 2015

with extensive explanations, self-assessment questions and a case study

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Module 23—Revenue

The accounting requirements applicable to small and medium-sized entities (SMEs) discussed in this module are set out in the *IFRS for SMEs* Standard, issued by the International Accounting Standards Board (Board) in October 2015. This module has been prepared by IFRS Foundation education staff. The contents of Section 23 *Revenue* of the *IFRS for SMEs* Standard, including its accompanying Appendix, are set out in this module and shaded grey. The Glossary of terms of the *IFRS for SMEs* Standard (Glossary) is also part of the requirements. Terms defined in the Glossary are reproduced in bold type the first time they appear in the text of Section 23. The notes and examples inserted by the education staff are not shaded. These notes and examples do not form part of the *IFRS for SMEs* Standard and have not been approved by the Board.

INTRODUCTION

Which version of the *IFRS for SMEs*[®] Standard?

When the *IFRS for SMEs* Standard was first issued in July 2009, the Board said it would undertake an initial comprehensive review of the Standard to assess entities' experience of the first two years of its application and to consider the need for any amendments. To this end, in June 2012, the Board issued a Request for Information: *Comprehensive Review of the IFRS for SMEs*. An Exposure Draft proposing amendments to the *IFRS for SMEs* Standard was subsequently published in 2013, and in May 2015 the Board issued *2015 Amendments to the IFRS for SMEs* Standard.

The document published in May 2015 only included amended text, but in October 2015, the Board issued a fully revised edition of the Standard, which incorporated additional minor editorial amendments as well as the substantive May 2015 revisions. This module is based on that version.

The *IFRS for SMEs* Standard issued in October 2015 is effective for annual periods beginning on or after 1 January 2017. Earlier application was permitted, but an entity that did so was required to disclose the fact.

Any reference in this module to the *IFRS for SMEs* Standard refers to the version issued in October 2015.

This module

This module focuses on the general requirements for accounting and reporting of revenue in accordance with Section 23 *Revenue* of the *IFRS for SMEs* Standard. It introduces the subject and reproduces the official text along with explanatory notes and examples designed to enhance understanding of the requirements. The module identifies the significant judgements required in accounting for revenue. In addition, the module includes questions designed to test your understanding of the requirements and case studies that provide a practical opportunity to apply the requirements to account for revenue applying the *IFRS for SMEs* Standard.

Upon successful completion of this module, you should, within the context of the *IFRS for SMEs* Standard, be able to:

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- identify when revenue arising from specific transactions and events qualifies for recognition in financial statements in accordance with Section 23;
- measure revenue arising from the sale of goods, the rendering of services, the exchange of goods or services and the use by others of entity assets yielding interest, royalties or dividends;
- account for revenue and costs associated with construction contracts;
- present and disclose revenue and construction contracts in financial statements; and
- demonstrate an understanding of the significant judgements that are required in accounting for revenue and construction contracts.

IFRS for SMEs Standard

The *IFRS for SMEs* Standard is intended to apply to the general purpose financial statements of entities that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The *IFRS for SMEs* Standard is comprised of mandatory requirements and other non-mandatory material.

The non-mandatory material includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* Standard and explains its purpose, structure and authority;
- implementation guidance, which includes illustrative financial statements and a table of presentation and disclosure requirements;
- the Basis for Conclusions, which summarises the Board’s main considerations in reaching its conclusions in the *IFRS for SMEs* Standard issued in 2009 and, separately, in the 2015 Amendments; and
- the dissenting opinion of a Board member who did not agree with the issue of the *IFRS for SMEs* Standard in 2009 and the dissenting opinion of a Board member who did not agree with the 2015 Amendments.

In the *IFRS for SMEs* Standard, Appendix A: Effective date and transition, and Appendix B: Glossary of terms, are part of the mandatory requirements.

In the *IFRS for SMEs* Standard, there are appendices to Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue*. These appendices provide non-mandatory guidance.

The *IFRS for SMEs* Standard has been issued in two parts: Part A contains the preface, all the mandatory material and the appendices to Section 21, Section 22 and Section 23; and Part B contains the remainder of the material mentioned above.

Further, the SME Implementation Group (SMEIG), which assists the Board with supporting implementation of the *IFRS for SMEs* Standard, publishes implementation guidance as ‘questions and answers’ (Q&As). These Q&As provide non-mandatory, timely guidance on specific accounting questions raised with the SMEIG by entities implementing the *IFRS for SMEs* Standard and other interested parties. At the time of issue of this module (January 2019) the SMEIG has not issued any Q&As relevant to this module.

Module 23 – Revenue

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, performance and cash flows that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. Such users include, for example, owners who are not involved in managing the business, existing and potential creditors and credit rating agencies.

The objective of Section 23 is to prescribe how much revenue should be recognised, when it should be recognised, and what to disclose about revenue. In addition, it prescribes how costs arising on construction contracts should be recognised.

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

Revenue should be measured at the fair value of the consideration received or receivable considering the amount of any trade discounts, prompt settlement discounts and volume rebates the entity offers. When the inflow of cash or cash equivalents is deferred, and the arrangement constitutes, in effect, a financing transaction, the fair value of the consideration is the present value of all future receipts determined using an imputed rate of interest (using the effective interest method).

The primary issue in accounting for revenue is determining when it should be recognised. Paragraph 2.27 identifies two criteria that must be satisfied before an item is recognised in the financial statements, which, when applied to revenue, specify that it is recognised when:

- it is probable that any future economic benefit associated with the item of revenue will flow to the entity; and
- the amount of revenue can be measured with reliability.

Section 23 provides additional guidance on accounting for specific categories of revenue and includes additional requirements that must be met before revenue can be recognised. The categories identified are: the sale of goods; the rendering of services; construction contracts in which the entity is the contractor; and the receipt of interest, royalties or dividends arising from the use by others of entity assets.

Identification of the transaction

The recognition criteria are usually applied separately to each transaction. However, in some circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period in which the service is performed. Conversely, an entity applies the recognition criteria to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. The requirements for the identification of the transaction are consistent with the concept of accounting for the transactions in accordance with their economic reality rather than their legal form (see paragraph 2.8).

What has changed since the 2009 IFRS for SMEs Standard

This section of the *IFRS for SMEs* Standard was unchanged by the 2015 Amendments. However, this module reproduces other editorial changes.

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REQUIREMENTS AND EXAMPLES

Scope of this section

- 23.1 This section shall be applied in accounting for **revenue** arising from the following transactions and events:
- (a) the sale of goods (whether produced by the entity for the purpose of sale or purchased for resale);
 - (b) the rendering of services;
 - (c) **construction contracts** in which the entity is the contractor; and
 - (d) the use by others of entity **assets** yielding interest, royalties or dividends.

Notes

Income is an increase in economic benefits in the reporting period in the form of inflows or enhancements of assets or a decrease of liabilities that results in increases in equity, other than those relating to contributions from equity participants. Income encompasses both revenue and gains.

Paragraph 2.25 (a) states that revenue is income that arises in the course of ordinary activities of an entity and is referred to by a variety of names including sales, fees, interest, dividends, royalties and rent. Gains are other items that meet the definition of income but are not revenue (see paragraph 2.25(b)). Example 1 below provides useful guidance in differentiating revenue from gains. Proceeds from the disposal of property, plant and equipment shall not be classified as revenue (see paragraph 17.28). The sale of property, plant and equipment would be reported net in the statement of comprehensive income—as the gain or loss on disposal. The gain or loss would not be reported in revenue. It is important for users of financial statements to see such gains separately from revenue arising from an entity's sale of goods when evaluating an entity's past and future financial performance. Revenue from the sale of goods typically recurs on an ongoing basis in comparable amounts, whereas the disposal of an item of property, plant and equipment usually gives rise to one-off, non-recurring income.

Paragraph 23.1 supports paragraph 17.28, by specifying that revenue within the scope of Section 23 arising from the sale of goods is from the sale of goods produced by the entity for sale or goods purchased for resale. The sale of property, plant and equipment would not fall within this scope.

An entity may receive income from transactions that fall within a category of revenue identified by this Section, but because they do not form part of the ordinary activities of the entity, they are recognised as gains. A service rendered by the entity that is incidental to its core activities and by its nature unlikely to reoccur would be an example where recognising a gain may be required. Another example could be interest or dividends that are received from a temporary investment that does not represent the ordinary activities of the entity.

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Example—revenue

Ex 1 A chain of bicycle shops holds bicycles for rental and for sale. The bicycles available for rent are used for two or three years and then donated to local charities.

In 20X7, the entity sold a property which it had previously operated as a shop; the entity purchased a larger property nearby out of which it traded.

The financial statements of the entity recognise revenue from both bicycle sales and rentals.

The sale of the premises comprises a sale of property, plant and equipment. Consequently, the proceeds received on the sale are not recognised as revenue.

The donation of a second-hand bicycle is also a disposal of property, plant and equipment.

23.2 Revenue or other **income** arising from some transactions and events is dealt with in other sections of this Standard:

- (a) **lease** agreements (see Section 20 *Leases*);
- (b) dividends and other income arising from investments that are accounted for using the equity method (see Section 14 *Investments in Associates* and Section 15 *Investments in Joint Ventures*);
- (c) changes in the **fair value** of **financial assets** and **financial liabilities** or their disposal (see Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*);
- (d) changes in the fair value of **investment property** (see Section 16 *Investment Property*);
- (e) initial **recognition** and changes in the fair value of **biological assets** related to **agricultural activity** (see Section 34 *Specialised Activities*); and
- (f) initial recognition of **agricultural produce** (see Section 34).

Measurement of revenue

23.3 An entity shall measure revenue at the fair value of the consideration received or receivable. The fair value of the consideration received or receivable takes into account the amount of any trade discounts, prompt settlement discounts and volume rebates allowed by the entity.

Notes

Revenue is measured as the fair value of the consideration received or receivable. Fair value is the amount for which an asset could be exchanged, a liability settled or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction (see Glossary).

The fair value includes any trade discounts, early settlement discounts and volume rebates. Trade discounts and volume rebates will generally be known at the point of sale. Prompt settlement discounts will require the entity to make an estimate based on any outstanding receivables at the end of the period. Many entities will record revenue at the gross amount on sale and keep separate accounts for any discounts. It is important to close off such accounts against revenue when preparing the financial

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statements and to present only a net revenue figure.

Examples—measurement of revenue

- Ex 2** A manufacturer sells one of its products for CU500⁽¹⁾ per unit. However, the manufacturer gives customers a 20% discount on orders of 100 or more units. A customer buys 100 units in a single order.

The manufacturer must measure revenue from the sale of goods at CU40,000, ie 100 units × (CU500 list price less CU100 (ie 20% × CU500) volume discount).

- Ex 3** A manufacturer sells one of its products for CU500 per unit. However, the manufacturer gives customers a 20% discount on orders of 100 or more units. Furthermore, when the customer has purchased 1,000 or more units in a single annual financial reporting period, the retailer awards the customer a further volume discount of 10% of the list price for all units acquired by the customer in that financial year.

A customer buys 100 units of the product each month for one annual financial reporting period.

The manufacturer must measure the total revenue from the sale of goods to the customer in that annual period at CU420,000, ie 1,200 units × (CU500 list price less CU150 (ie 30% × CU500) volume discount). If the outcome of any further volume discounts are uncertain at report date a best estimate of the likely impact should be made, and revenue subsequently adjusted to reflect the actual discounts given.

The trade rebate is not intended to be a financing transaction and the time value of money is unlikely to be material. Therefore, the manufacturer should recognise revenue at the amount paid net of the total volume rebate (that is no discounting).

- Ex 4** A manufacturer sells one of its products for CU500 per unit on credit. To encourage early settlement, the retailer awards its customers a 10% early settlement discount provided that the customer settles within 30 days of buying the goods. The normal credit term is 60 days.

Customer 1 buys 90 units and settles within 30 days of purchase.

Customer 2 buys 90 units and settles 60 days after the date of purchase.

The retailer must measure revenue from the sale of goods as follows:

Customer 1 at CU40,500 (ie 90 units × (CU500 list price less 10% × CU500 early settlement discount)). This revenue will generally be recognised in two steps, first revenue of CU45,000 will be recorded, the early settlement will reduce the revenue (and the account receivable) by CU4,500, to give reported revenue of CU40,500. The reported revenue matches the fair value of the consideration (cash) received.

Revenue from the sale of goods to Customer 2 at CU45,000 (ie 90 units × CU500 list price).

⁽¹⁾ In this example, and in all other examples in this module, monetary amounts are denominated in 'currency units (CU)'.

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Ex 5 A retailer normally sells one of its products for CU550 per unit. On one occasion, the retailer exchanged 10 units of the product as payment for 10 hours of accounting services from a partner of an international accounting firm. The accounting services are available to the accounting firm's clients at CU500 per hour.

The retailer must measure revenue from the sale of goods at CU5,000 (ie 10 hours × CU500 per hour, as revenue is measured at the fair value of the consideration received (see also paragraphs 23.6 and 23.7)).

23.4 An entity shall include in revenue only the gross inflows of economic benefits received and receivable by the entity on its own account. An entity shall exclude from revenue all amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value added taxes. In an agency relationship, an entity (the agent) shall include in revenue only the amount of its commission. The amounts collected on behalf of the principal are not revenue of the entity.

Notes

Determining whether an entity is acting as a principal or as an agent depends on facts and circumstances and requires judgement. An entity is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services.

Features that, individually or in combination, indicate an entity is acting as a principal include:

- (a) The entity has the primary responsibility for providing the goods or services to the customer or for fulfilling the order, for example, by being responsible for the acceptability of the products or services the customer purchased;
- (b) the entity has inventory risk before or after the customer order, in shipping or on return;
- (c) the entity has discretion in establishing prices, either directly or indirectly, for example, by providing additional goods or services;
- (d) the entity bears the customer's credit risk for the amount receivable from the customer.

An entity is acting as an agent when it does not have exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. One feature indicating that an entity is acting as an agent is that the amount the entity earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer.

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Examples—transactions with third parties

Ex 6 A manufacturer sells goods to its customers through an intermediary. The intermediary holds the goods on consignment from the manufacturer. The intermediary may return any goods not sold to the manufacturer. The manufacturer instructs the intermediary to sell the goods at CU100 per unit. The intermediary deducts a fixed commission of CU10 for each unit sold and transfers the balance (CU90) to the manufacturer. If goods are found to be defective, the customers must return the goods to the manufacturer for repair or replacement.

The manufacturer is acting as a principal for the sale to the customers because it is exposed to the significant risks and rewards associated with the sale of goods (for example, inventory obsolescence, defective goods returned or setting of the sales price). The manufacturer is required to measure revenue from the sale of goods at CU100 for each unit of the goods sold by its agent (intermediary). The manufacturer should recognise revenue from the sale on the date the intermediary sells the goods because that is when the risks and rewards are transferred. The manufacturer must also recognise a warranty provision (liability) for the limited right of return (see Section 21 *Provisions and Contingencies*).

The intermediary is acting as an agent for the manufacturer. It must, therefore, measure revenue (sales commission) at CU10 for each unit of goods sold. The manufacturer must recognise a corresponding expense as commission paid.

Ex 7 A manufacturer sells goods to an intermediary at CU90. The intermediary purchases the goods for resale to others. Only the intermediary has the right to return any defective units to the manufacturer. The intermediary wishes to make a CU10 margin on its sales, so it sells the goods at CU100 per unit to customers. If goods are found to be defective, the customers must return the goods to the intermediary for repair or replacement.

The manufacturer must measure revenue from the sale of goods at CU90 for each unit of goods transferred to the intermediary. The manufacturer must also recognise a warranty provision (liability) for the limited right of return (see Section 21 *Provisions and Contingencies*).

The intermediary is acting as a principal for the sale to the customers as it has exposure to the significant risks and rewards associated with the sale of goods (for example, inventory obsolescence, defective goods returned, setting of the sales price). The intermediary must measure revenue from the sale of goods at CU100 for each unit of goods sold to the customers. For each unit sold, the intermediary must recognise an expense of CU90 for cost of goods sold.

Ex 8 A retailer sells goods for CU100 per unit, inclusive of VAT (sales tax) of CU10 that it collects on behalf of the national government.

The retailer must measure revenue at CU90 for each unit sold (that is, CU100 list price less CU10 collected on behalf of the government). The retailer is acting as an agent in the collection of VAT on behalf of the government and hence the VAT is not included in revenue.

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Ex 9 A tobacconist sells cigars for CU10 per unit, including the CU4 tobacco levy it collects on behalf of the national government. The tobacconist pays the government the levy by the end of the month after the month in which the cigar is sold. However, if the customer defaults, the tobacconist is entitled to reclaim the tobacco levy from the government.

The tobacconist must measure revenue at CU6 for each unit sold—the CU10 list price less CU4 collected on behalf of the government. In this example, the tobacco levy is a sales tax.

Ex 10 The facts are the same as in Example 9. However, in this example, the tobacconist is also the manufacturer of the cigars and the CU4 tobacco levy is based on the number of cigars the tobacconist produces in the month (the levy is payable by the tobacconist irrespective of whether the cigars are sold). Furthermore, when a customer defaults, the tobacconist cannot reclaim the tobacco levy from the government.

The tobacconist must measure revenue at CU10 for each unit sold because the levy is based on production and not sales. In this example, the tobacco levy is a production tax.

Deferred payment

23.5 When the inflow of **cash** or **cash equivalents** is deferred, and the arrangement constitutes in effect a financing transaction, the fair value of the consideration is the **present value** of all future receipts determined using an **imputed rate of interest**. A financing transaction arises when, for example, an entity provides interest-free credit to the buyer or accepts a note receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods. The imputed rate of interest is the more clearly determinable of either:

- (a) the prevailing rate for a similar instrument of an issuer with a similar credit rating; or
- (b) a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.

An entity shall recognise the difference between the present value of all future receipts and the nominal amount of the consideration as interest revenue in accordance with paragraphs 23.28 and 23.29 and Section 11.

Notes

The inflow of cash or cash equivalents will generally need to be discounted when it extends beyond the normally expected payment terms for that industry, often 30 days. The present value is the current estimate of the present discounted value of the future net cash flows in the normal course of business (see the Glossary).

If the imputed rate of interest is determined as a rate of interest that discounts the expected future payment amount of the instrument, that is, the receipts, to the current cash sales price of the goods or services (ie paragraph 23.5(b) is the more clearly determinable), the resulting interest rate should be assessed for reasonableness. An apparently unusually low rate (taking into account, for example, the time value of money and the credit worthiness of the buyer), could mean that the current cash sales

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price has not been properly determined for that customer.

Examples—deferred payment

Ex 11 An entity sells goods under conditions that allow the consideration to be paid by the customer in instalments.

The entity recognises revenue equal to the fair value of the consideration receivable, at the date of sale. The fair value of the consideration receivable is the present value of the instalments. The present value is determined by discounting the instalments receivable at the imputed rate of interest. The seller recognises the interest element as interest revenue using the effective interest method.

Ex 12 On the first day of its annual reporting period, an entity sold inventories for CU2,000,000 on two years' interest-free credit when the current cash sales price of the goods was CU1,652,893. CU2,000,000 is due to be settled at the end of the two-year interest-free period.

Since there is a CU347,107 difference between the cash price of CU1,652,893 and the amount due under the two years' interest-free credit arrangement, the arrangement is, in effect, both a financing transaction and a sale of goods. Assuming the imputed discount rate is reasonable (taking into account, for example, the time value of money and the credit standing of the customer), the entity must recognise revenue of CU1,652,893 from the sale of goods on the first day of its annual reporting period. Furthermore, the entity must recognise interest revenue from unwinding the discount. As a result, the entity recognises interest revenue of CU165,289 in the current and CU181,818 in the next annual reporting period, calculated using the effective interest method as illustrated below.

Using a spreadsheet or a financial calculator, the imputed rate of interest is calculated as 10% a year—the rate that discounts the nominal amount (CU2,000,000) payable in two years' time to the current cash sales price of the goods (CU1,652,893).

The revenue arising from the sale of goods is the current cash selling price CU1,652,893—the present value of the future payment.

Interest revenue for the year of the sale is CU165,289—calculation: CU1,652,893 present value \times 10% (the imputed rate of interest).

Interest revenue for the next year is CU181,818—calculation: (CU1,652,893 present value + CU165,289 interest accrued) \times 10%—the imputed rate of interest.

After recognising the interest revenue for both years, the trade receivable balance will total CU2,000,000, the amount of cash payable by the customer at that time.

Ex 13 On the first day of its annual reporting period, an entity sold inventories for CU2,000,000 on two years' interest-free credit. The entity and its competitors generally allow customers deferred payment with no interest and, hence, the entity has no recent cash transactions from which to make a reliable estimate of the cash sales price. The entity estimates that the customer would be able to obtain financing from other sources at an interest rate of 10% a year.

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The entity must recognise revenue of CU1,652,893 from the sale of goods on the first day of its annual reporting period. Furthermore, the entity must recognise interest revenue of CU165,289 in the current and CU181,818 in the next annual reporting period.

The imputed rate of interest is 10% a year—the prevailing rate for a similar instrument of an issuer with a similar credit rating.

The revenue arising from the sale of goods is measured at the present value of all future receipts determined using the imputed rate of interest (10%)— $CU2,000,000 \text{ future payment} \times 1 \div (1.1)^2 = CU1,652,893$.

Interest revenue for the year of the sale is CU165,289; calculation— $CU1,652,893 \text{ present value} \times 10\%$ (the imputed rate of interest).

Interest revenue for the next year is CU181,818; calculation— $(CU1,652,893 \text{ present value} + CU165,289 \text{ interest accrued}) \times 10\%$ (the imputed rate of interest).

After the entity recognises the interest revenue for both years, the trade receivable balance will total CU2,000,000, the amount of cash payable by the customer at that time.

Exchanges of goods or services

- 23.6 An entity shall not recognise revenue:
- (a) when goods or services are exchanged for goods or services that are of a similar nature and value; or
 - (b) when goods or services are exchanged for dissimilar goods or services but the transaction lacks commercial substance.

Notes

Common examples of goods that are exchanged or swapped for goods of a similar nature and value are commodities such as oil or milk, of which suppliers swap inventories in various locations to fulfil demand in another location on a timely basis.

- 23.7 An entity shall recognise revenue when goods are sold or services are exchanged for dissimilar goods or services in a transaction that has commercial substance. In that case, the entity shall measure the transaction:
- (a) at the fair value of the goods or services received adjusted by the amount of any cash or cash equivalents transferred;
 - (b) if the amount under (a) cannot be measured reliably, then at the fair value of the goods or services given up adjusted by the amount of any cash or cash equivalents transferred; or
 - (c) if the fair value of neither the goods or services received nor the goods or services given up can be measured reliably, then at the **carrying amount** of the asset given up adjusted by the amount of any cash or cash equivalents transferred.

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Example—revenue on exchange of goods and services

- Ex 14** On 2 January 20X1, a car dealership sold 100 new cars, each of which had a retail selling price of CU1,000. In lieu of cash payment, the purchasing entity offered land in a new retail park it was developing. The offer was accepted because the dealership was looking to expand its operations by opening an additional retail site and the land offered was in a suitable location. Because the retail park is still at an early stage of development and there have been no other land sales yet, it is difficult to estimate the fair value of the land.

The exchange of cars for land is an exchange of dissimilar goods. The car dealership must measure revenue from the sale of goods (cars) at the fair value of the goods or services received (paragraph 23.7(a)). However, if this amount cannot be measured reliably, the fair value of the goods given up should be used. In this case, the fair value of the goods given up in this transaction is most readily measurable by reference to the average selling price, assuming an active market for the cars. Therefore, the revenue recognised by the car dealership for the sale of cars in exchange for land is CU100,000.

Calculation: 100 cars × CU1,000 per car = CU100,000.

Examples—no revenue on the exchange of goods and services

- Ex 15** On 1 January 20X1, to fulfil an urgent order from a customer, fuel retailer X received 180,000 litres of motor fuel in City A from another fuel retailer Y in exchange for 180,000 litres of its motor fuel in City B. Motor fuel costs CU1 per litre.

Fuel retailer X does not recognise revenue arising from the exchange of motor fuel with fuel retailer Y—an exchange of similar goods or services.

Fuel retailer X will recognise revenue when it sells the fuel received in the exchange transaction to its customer.

- Ex 16** An entity operating in the telecommunications industry owns a network that transmits digital signals. The network comprises fibre optic cables. The entity commonly enters into capacity swap service contracts with third parties that own similar networks in other locations. Under one of these contracts, the entity is required to surrender capacity in its network of a value of CU1 million for a 10-year period to a third party that operates in the same line of business, in exchange for the use of a given capacity in the network of that third party.

On the facts, it appears that the capacity in the network is swapped for capacity in another network of a similar nature and value. Therefore, neither the entity nor the third party should recognise any revenue (or associated cost) for the transmission services provided (that is for the capacity given up (received)).

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Identification of the revenue transaction

23.8 An entity usually applies the revenue recognition criteria in this section separately to each transaction. However, an entity applies the recognition criteria to the separately identifiable components of a single transaction when necessary to reflect the substance of the transaction. For example, an entity applies the recognition criteria to the separately identifiable components of a single transaction when the selling price of a product includes an identifiable amount for subsequent servicing. Conversely, an entity applies the recognition criteria to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, an entity applies the recognition criteria to two or more transactions together when it sells goods and, at the same time, enters into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction.

Notes

See Example 8 in Appendix to Section 23.

Examples—identification of the revenue transaction

Ex 17 A car dealership sells new cars to customers. Furthermore, as a promotion for a limited time, the dealer offers free servicing for three years from the date of purchase. Normally, the dealership charges extra for the servicing and it is possible for a customer to purchase both the car and the servicing separately.

During the period of the promotional offer the dealership enters a sale with two separately identified elements. In a single transaction the dealership:

- sells a good—the new car; and
- undertakes to provide servicing for three years.

The dealership must allocate the fair value of the consideration received (the amount received from the customer) to the separately identified components of the transaction. Since the two elements are sold separately, it is possible to allocate the consideration pro rata based on the fair value of the individual elements when they are sold separately.

Furthermore, it must apply the recognition criteria to the separately identified components of the transaction (for the sale of the car see paragraphs 23.10–23.13 and for the servicing see paragraphs 23.14–23.16).

Ex 18 A security firm entered into a contract with a customer to supply a burglar alarm system (including installation), to service the system for three years from the date of installation and to provide an armed response to the customer if the alarm is triggered. The customer is contractually obliged to pay the security firm CU20,000 ‘interest-free’ three years after the burglar alarm has been installed.

The security firm installs all the burglar alarm systems that it sells, and only installs its own systems.

The security firm has entered a sale with multiple elements. The sale transaction has several components:

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- sale of a good, including installation—the burglar alarm system;
- providing alarm system maintenance services;
- providing armed response services; and
- a financing component related to the payment for the sale and servicing of the burglar alarm system and for the armed response services provided to the customer (see paragraph 23.5).

The security firm must allocate the fair value of the consideration receivable from the customer to the separately identified components of the transaction. Furthermore, it must apply the recognition criteria to the separately identified components of the transaction (for the sale of the good see paragraphs 23.10–23.13; for the rendering of services see paragraphs 23.14–23.16; and for the financing transaction see paragraphs 23.28–23.29 (a)).

In this case, installation is not treated as a separate component of a transaction because the customer would not purchase the system without installation and the entity does not offer installation services for systems it does not sell. A seller normally recognises revenue from the sale of goods when the buyer accepts delivery and installation and inspection are complete, because that is usually when the significant risks and rewards of ownership of the goods are transferred (see paragraph 23.10).

- Ex 19** A luxury yacht manufacturer sells a yacht to a bank for CU1,000,000 and simultaneously enters into an agreement to repurchase the yacht from the bank for CU1,080,000 a year later.

On the date of entering into the transaction, the fair value of the yacht was CU2,000,000 and the manufacturer’s incremental borrowing rate approximated 8% a year.

The bank does not have the right to sell the yacht to anyone else.

The yacht manufacturer must not recognise revenue from the sale of the yacht. The substance of the two transactions is that the manufacturer has borrowed CU1,000,000 from the bank and that borrowing is secured by the manufacturer’s yacht (inventory asset). Accordingly, the manufacturer must recognise the CU1,000,000 received from the bank as a secured liability and the yacht must remain in the manufacturer’s balance sheet.

Over the period of the loan, the CU80,000 (the excess of the CU1,080,000 repurchase price over the CU1,000,000 selling price) must be recognised as finance costs on the effective interest method, in accordance with Section 11 *Basic Financial Instruments*.

- Ex 20** The facts are the same as in Example 19. However, in this example, the manufacturer has an option (not an obligation) to repurchase the yacht from the bank for CU1,080,000 one year after the sale.

Because the fair value of the yacht is significantly higher than the strike price of the option to repurchase the yacht, the manufacturer is most unlikely to let the option lapse. Therefore, the substance of the two transactions taken as a whole is that the manufacturer has borrowed CU1,000,000 from the bank and that borrowing is secured by the manufacturer’s yacht (inventory asset). Accordingly, the manufacturer must

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recognise the CU1,000,000 received from the bank as a secured liability and the yacht must remain in the manufacturer's inventories.

Over the period of the loan, the CU80,000 (excess of the CU1,080,000 repurchase price over the CU1,000,000 selling price) must be recognised as finance costs on the effective interest method, in accordance with Section 11 *Basic Financial Instruments*.

If the strike price were instead close to the fair value of the yacht, judgment would need to be used to determine whether the transaction was genuinely a sale.

23.9 Sometimes, as part of a sales transaction, an entity grants its customer a loyalty award that the customer may redeem in the future for free or discounted goods or services. In this case, in accordance with paragraph 23.8, the entity shall account for the award credits as a separately identifiable component of the initial sales transaction. The entity shall allocate the fair value of the consideration received or receivable in respect of the initial sale between the award credits and the other components of the sale. The consideration allocated to the award credits shall be measured by reference to their fair value, ie the amount for which the award credits could be sold separately.

Notes

See Example 13 in Appendix to Section 23.

Examples—customer loyalty awards

Ex 21 A grocery retailer operates a customer loyalty programme. It grants programme members loyalty points for every CU1 spent on groceries. The loyalty points can be redeemed to purchase groceries and they have no expiry date.

By supplying award credits to its customers, the grocery retailer enters multiple element sales.

The grocery retailer must account for award credits as a separately identifiable component of the sales transaction in which they are granted (initial sale). The fair value of the consideration received or receivable in respect of the initial sale must be allocated between the award credits and the goods supplied to the customer in the initial sale. The consideration allocated to the award credits must be measured by reference to their fair value—the amount for which the award credits could be sold separately.

When award credits are redeemed and the grocery retailer fulfils its obligations by supplying goods in exchange for the awards, it must recognise the consideration allocated to award credits as revenue, applying the requirements of paragraphs 23.10–23.13. The amount of revenue recognised shall be based on the number of award credits redeemed relative to the total number expected to be redeemed.

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Ex 22 A grocery store has a customer loyalty programme that rewards a customer one customer loyalty point for every CU20 of purchases. Each point is redeemable for a CU1 discount on any future purchases of the entity’s products. In 20X9, customers purchase groceries for CU1,000,000 and earned 50,000 points. The entity expects 45,000 points to be redeemed for future purchases. Given the effective 10% chance that a point will not be redeemed, the entity estimates the fair value of each point is CU0.9—CU45,000 (the value of groceries expected to be bought) divided by 50,000 points issued. By the end of 20X9 (the first reporting period), 20,000 points have been redeemed.

In total, the grocery store allocates the transaction price (CU1,000,000) to the groceries and the points on at relative stand-alone selling price, as follows:

	CU	
Groceries	956,938	[CU1,000,000 × (CU1,000,000 stand-alone price ÷ CU1,045,000)]
Points	<u>43,062</u>	[CU1,000,000 × (CU45,000 stand-alone price ÷ CU1,045,000)]
Total	<u>1,000,000</u>	

At the end of 20X9 the grocery store will have recognised revenue for the loyalty points of CU19,138 [(20,000 points ÷ 45,000 points) × CU43,062] and has a remaining liability for deferred revenue of CU23,924 (CU43,062 – CU19,138) for the unredeemed points at the end of the first reporting period.

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Sale of goods

- 23.10 An entity shall recognise revenue from the sale of goods when all the following conditions are satisfied:
- (a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
 - (b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
 - (c) the amount of revenue can be measured reliably;
 - (d) it is **probable** that the economic benefits associated with the transaction will flow to the entity; and
 - (e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.
- 23.11 The assessment of when an entity has transferred the significant risks and rewards of ownership to the buyer requires an examination of the circumstances of the transaction. In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer. This is the case for most retail sales. In other cases, the transfer of risks and rewards of ownership occurs at a time different from the transfer of legal title or the passing of possession.
- 23.12 An entity does not recognise revenue if it retains significant risks and rewards of ownership. Examples of situations in which the entity may retain the significant risks and rewards of ownership are:
- (a) when the entity retains an obligation for unsatisfactory performance not covered by normal warranties;
 - (b) when the receipt of the revenue from a particular sale is contingent on the buyer selling the goods;
 - (c) when the goods are shipped subject to installation and the installation is a significant part of the contract that has not yet been completed; and
 - (d) when the buyer has the right to rescind the purchase for a reason specified in the sales contract, or at the buyer's sole discretion without any reason, and the entity is uncertain about the probability of return.

Notes

The primary issue in accounting for revenue from the sale of goods is determining when to recognise revenue. Paragraph 23.10 specifies conditions that must be satisfied for revenue from the sale of goods to be recognised. Paragraphs 23.11–23.13 provide mandatory guidance for the application of the specified conditions.

In some jurisdictions, laws may affect the timing of when the recognition criteria in paragraph 23.10 are met. The law may, for example, determine the point in time at which the entity transfers the significant risks and rewards of ownership. For example, in some jurisdictions, for mail order sales, the seller must give the customers a 'cooling-off period' in which they have an unconditional right to cancel the contract (for example, on sale of goods by mail order the cooling-off period may end seven working days after the day the goods are received). Therefore, the examples in this module need to be read in the context of the laws relating to the sale of goods in the

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jurisdiction in which the transaction takes place.

Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity (see paragraph 23.10(d)). In some cases, this may not be probable until the consideration is received or until an uncertainty is removed. For example, it may be uncertain that a foreign governmental authority will grant permission to remit the consideration from a sale in a foreign country.

When an uncertainty arises about the collectability of an amount already recognised as revenue, the uncollectable amount or the amount for which recovery has ceased to be probable is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

Section 11 *Basic Financial Instruments* specifies requirements for the impairment of financial instruments such as trade receivables which are measured at cost or amortised cost.

Examples 1, 6 and 7 in the Appendix to Section 23 relate to paragraph 23.10, Examples 5–8 and 10 relate to paragraph 23.11 and Examples 9, 2 and 3 relate to paragraphs 23.12(b), 23.12(c) and 23.12(d) respectively.

Examples—revenue from the sale of goods

Ex 23 An entity manufactures customised equipment for the plastic manufacturing industry (customers). The equipment is manufactured in parts. The parts are assembled and installed at the customers' factories. Legal title passes to the customer after it accepts delivery, upon completion of installation and inspection. Customers pay for the equipment upon accepting delivery.

The entity provides its customers a standard two-year warranty against manufacturing defects.

In this example, the customer inspected the equipment and accepted delivery.

The entity recognises revenue when the customer accepts the delivery (ie after inspection) when the risks and rewards of ownership pass to the customer, and the other factors listed in paragraph 23.10 are satisfied.

Note: In accordance with Section 21 *Provisions and Contingencies*, the entity would recognise a provision (liability) for its warranty obligation.

Ex 24 The facts are the same as in Example 23.

In the year after the sale, the customer discovers a manufacturing defect in the equipment acquired from the entity. In accordance with the warranty, the entity fulfils its contractual obligation by replacing the defective part of the customer's equipment.

Revenue is not adjusted for the expenditures made in fulfilling the warranty obligation. The warranty obligation is accounted for in accordance with Section 21 *Provisions and Contingencies*.

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- Ex 25** The facts are the same as in Example 23. However, in this example, the customer was not satisfied with the equipment installed and accordingly did not accept delivery.

The entity cannot recognise revenue because the risks and rewards of ownership have not passed to the customer—the factors listed in paragraph 23.10 are not satisfied. The equipment remains the inventory (asset) of the entity and would be assessed for impairment in accordance with paragraphs 27.2 and 27.3.

Note: At this time, the entity has not sold the equipment, and, therefore, would not recognise a warranty provision (liability) unless it has an onerous contract.

- Ex 26** The facts are the same as in Example 23. However, in this example, the sale was on normal credit terms, 60 days.

When the customer accepted the delivery, the customer was in a sound financial position. However, a month after delivery, the customer’s business was destroyed by a natural disaster and the entity realistically expects to receive only 20% of the selling price on liquidation of the customer.

The entity recognised revenue (and a trade receivable) when the customer accepted the delivery when the risks and rewards of ownership pass to the customer and the other factors listed in paragraph 23.10 are satisfied.

The trade receivable is tested for impairment in accordance with Section 11 *Basic Financial Instruments* (see paragraphs 11.21–11.25). Revenue is unaffected by the impairment.

Example—seller retains significant risks of ownership

- Ex 27** An entity accepts an order from a customer for the manufacture of a product that has never been manufactured, for example, a spaceship that significantly surpasses current technologies. The entity guarantees a specified level of performance from the product, for example, the spaceship is capable of landing on Mars and returning to Earth. It will only be known if the guaranteed level of performance will be achieved after the product has operated as intended by the customer—after the spaceship returns from its first voyage to Mars. If the spaceship does not successfully complete its maiden voyage, the entity is required to refund the purchase price to its customer.

Legal title passes to the customer on delivery.

Because of uncertainties about whether the product can attain the guaranteed level of performance, the risks and rewards of ownership do not pass to the customer until the successful completion of the maiden voyage—the entity retains substantial risks of ownership because there is a significant possibility that the guaranteed level of performance will not be achieved.

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23.13 If an entity retains only an insignificant risk of ownership, the transaction is a sale and the entity recognises the revenue. For example, a seller recognises revenue when it retains the legal title to the goods solely to protect the collectability of the amount due. Similarly an entity recognises revenue when it offers a refund if the customer finds the goods faulty or is not satisfied for other reasons and the entity can estimate the returns reliably. In such cases, the entity recognises a **provision** for returns in accordance with Section 21 *Provisions and Contingencies*.

Examples—seller does not retain significant risks of ownership

Ex 28 A manufacturer of vending machines sells 10 vending machines to an amusement park on credit. Payment is due within three months of delivery. For all sales on credit, the manufacturer writes into the contract a clause that legal title passes to the customer only when consideration is received—not on delivery.

Retention of title may indicate that the risks and rewards of ownership have not passed to the buyer, although the passing of title is not a required condition for revenue recognition. Assuming the other revenue recognition criteria in paragraph 23.10 are met and there is no reason to believe that the amusement park will fail to pay, revenue can be recognised, provided that, along with the title, the only rights that the manufacturer retains are those allowing repossession of the vending machines if the customer fails to pay. In other words, substantially all the risks and rewards of ownership pass from the manufacturer to the amusement park on delivery of the vending machines. The temporary retention of legal title in this circumstance is insignificant.

Ex 29 A retailer offers its customers a lifetime right of return on sales of torches. Customers may return their torches for any reason, at any time, on presentation of a valid receipt and have their money refunded. Consistent historical data show that approximately 5 % of sales are refunded. The retailer expects this refund rate to continue in the future.

The retailer retains only an insignificant and measurable level of the risks and rewards of ownership. Provided that the other recognition criteria in paragraph 23.10 are met, revenue should be recognised on sale. The possibility of returns affects the measurement of the amount of revenue to be recognised for the sale of each torch (in this example revenue must be recorded at 95% of the cash selling price, with the other 5% set aside as a provision for returns).

If, in a later reporting period, actual returns are found to be greater than or less than 5%—the original estimate—the revision of the estimate is accounted for prospectively (as a change in estimate in accordance with Section 10 *Accounting Policies, Estimates and Errors*).

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Rendering of services

Notes

The primary issue in accounting for revenue from rendering services is determining when to recognise revenue. Paragraph 23.14 specifies that revenue from the rendering of services is recognised using the percentage of completion method when the outcome of the transaction can be estimated reliably. Paragraph 23.14 specifies conditions that must be satisfied to determine that the outcome of a transaction can be estimated reliably. Paragraphs 23.15 and 23.21–23.27 provide mandatory guidance for applying the percentage of completion method. Paragraph 23.16 specifies how revenue from the rendering of services is recognised when the outcome of the transaction cannot be estimated reliably.

23.14 When the outcome of a transaction involving the rendering of services can be estimated reliably, an entity shall recognise revenue associated with the transaction by reference to the stage of completion of the transaction at the end of the **reporting period** (sometimes referred to as the percentage of completion method). The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

- (a) the amount of revenue can be measured reliably;
- (b) it is probable that the economic benefits associated with the transaction will flow to the entity;
- (c) the stage of completion of the transaction at the end of the reporting period can be measured reliably; and
- (d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

Paragraphs 23.21–23.27 provide guidance for applying the percentage of completion method.

Notes

Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity (see paragraph 23.14(b)). However, when an uncertainty arises about the collectability of an amount already included in revenue, the uncollectable amount, or the amount for which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

An entity is generally able to make reliable estimates after it has agreed on:

- (a) each party's enforceable rights regarding the service to be provided and received by the parties;
- (b) the consideration to be exchanged; and
- (c) the manner and terms of settlement.

It is also usually necessary for the entity to have an effective internal financial budgeting and reporting system. The entity reviews and, when necessary, revises the estimates of revenue as the service is performed. The need for such revisions does not necessarily indicate that the outcome of the transaction cannot be estimated reliably.

See paragraph 23.A1 and Examples 14–20 in Appendix to Section 23.

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Examples—rendering of services

Ex 30 A calibration engineer entered into a contract to calibrate a manufacturer's machine at six-month intervals over a two-year period ending 31 December 20X2 for a fixed upfront fee of CU10,000.

On 1 January 20X1, the manufacturer paid the calibration engineer CU10,000. The cost to the calibration engineer of performing each calibration is approximately CU1,000.

Service revenue can only be recognised when the four conditions in paragraph 23.14 are met. In this example:

- (a) Can the amount of revenue be measured reliably? Yes—the contract is fixed price.
- (b) Is it probable that the economic benefits associated with the transaction will flow to the entity? Yes—cash has already been received.
- (c) Can the stage of completion of the transaction at the end of the reporting period be measured reliably? Yes—because four specific events appear to be of equal amounts of effort, it would be reasonable to assume that each event represents a completion of 25% of the contract.
- (d) Can the costs incurred for the transaction and the costs to complete the transaction be measured reliably? Yes—because each servicing has approximately the same specified cost a reliable measurement would seem possible.
- (e) After meeting all the recognition criteria, the manufacturer would recognise revenue, applying the percentage of completion method outlined in paragraphs 23.21–23.72

Ex 31 A consulting firm, SME A, provides leadership training to the senior executives in companies around the world. The contract with Company X provides for an agreed number of hours a month with each executive for one year. SME A is remunerated based on formulas that scale relative to improvements in an agreed set of independently measured key performance indicators, such as sales growth, share price or customer satisfaction, measured at the end of the year after training has been provided. The final fee can range from CU0 to a very large figure depending on the level of improvement.

Service revenue can only be recognised when the four conditions in paragraph 23.14 are met. In this example:

- (a) Can the amount of revenue be measured reliably? No—the contracts are structured so that until the end of the year following service provision, it is almost impossible to know what the actual amount of revenue on any given engagement will be.
- (b) Is it probable that the economic benefits associated with the transaction will flow to the entity? Yes—the firm would need to assess the probability of payment, but with good contracts and well selected clients it may be reasonable to assume that benefits will flow if earned.
- (c) Can the stage of completion of the transaction at the end of the reporting period be measured reliably? Yes—because the hours are fixed, it would be possible over the year that services are provided to assess the stage of completion.
- (d) Can the costs incurred for the transaction and the costs to complete the transaction be measured reliably? Yes—because consultants' salaries are known and hours are fixed, costs could be reliably measured.

As revenue can only be recognised when all four criteria are met. In this case, this is only likely to occur at the end of the second year as the amount of revenue can only be measured reliably at the end of the year following service provision when the remuneration is calculated.

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- 23.15 When services are performed by an indeterminate number of acts over a specified period of time, an entity recognises revenue on a straight-line basis over the specified period unless there is evidence that some other method better represents the stage of completion. When a specific act is much more significant than any other act, the entity postpones recognition of revenue until the significant act is executed.

Examples—services performed by an indeterminate number of acts

- Ex 32 A security firm enters into contracts to provide armed responses to homeowners when their alarm systems are triggered. The security firm has a 30 June year-end. On 1 January 20X1, one homeowner paid the security firm CU10,000. In return for the fixed fee, the security firm is contractually obliged to provide its armed response services to the homeowner for a two-year period.**

The security firm must recognise revenue from the provision of the armed response service on a straight-line basis over the two-year period (ie CU417 a month = CU10,000 revenue ÷ 24 months). Call-outs take place only when the alarm is triggered in the two-year contract period. The frequency and timing of these events cannot be determined.

Therefore, revenue will be recognised as follows:

Year ended June 20X1: CU10,000 × 6 ÷ 24 months = CU2,500.

Year ended June 20X2: CU10,000 × 12 ÷ 24 months = CU5,000

Year ended June 20X3: CU10,000 × 6 ÷ 24 months = CU2,500.

- Ex 33 A vehicle dealer enters into contracts to maintain its customer's new vehicle for a three-year period.**

On 1 January 20X1, a customer paid the dealer CU10,000. Experience has shown that the costs to the dealer of maintaining new vehicles of the model owned by the customer are on average CU1,000 in the first year of ownership, CU1,000 in the second year and CU3,000 in the third year.

The mechanic must recognise revenue from the provision of the vehicle maintenance services to the customer as follows: CU2,000 in 20X1, CU2,000 in 20X2 and CU6,000 in 20X3. Although the vehicle maintenance services are performed by an indeterminate number of acts over a specified time, experience provides evidence that 20% of the work will be performed in each of Year 1 and Year 2, while 60% of the work will be performed in Year 3. This division of work better represents the stage of completion and it reflects the expectation of a constant gross margin over the period of the contract.

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Ex 34 Two research firms (A and B) are competing to develop a new chemical compound for a pharmaceutical manufacturer. In accordance with the contract, A and B will simultaneously attempt to develop the compound. The manufacturer will pay CU1,000,000 to the research firm that first delivers the completed compound that meets predetermined specifications. The other research firm will receive nothing. When the pharmaceutical manufacturer accepted the compound developed by A, B abandoned its development in progress.

The manufacturer's acceptance of either research firm's newly developed compound is an act more significant than any other. Accordingly, both research firms must postpone recognition of revenue until the pharmaceutical manufacturer accepts one of their submissions.

When the pharmaceutical manufacturer accepts A's submission, A recognises CU1,000,000 revenue.

B does not recognise any revenue—no economic benefits will flow to B from the services it provided to the pharmaceutical manufacturer.

23.16 When the outcome of the transaction involving the rendering of services cannot be estimated reliably, an entity shall recognise revenue only to the extent of the **expenses** recognised that are recoverable.

Notes

Often, in the early stages of a transaction, the outcome cannot be estimated reliably. Nevertheless, it may be probable that the entity will recover its transaction costs. Revenue is recognised only to the extent of costs incurred that are expected to be recoverable (see paragraph 23.25(a)). As the outcome of the transaction cannot be estimated reliably, no profit is recognised.

Examples—outcome of a services transaction that cannot be estimated reliably

Ex 35 A law firm is contracted to represent a group of past employees in a class action lawsuit against a mining company. The law firm will receive a fee for legal services provided; the fee will be equal to 20% of the total damages awarded by the court (or 20% of any out of court settlement). However, if the lawsuit fails, the law firm will receive nothing.

When the outcome of the lawsuit cannot be estimated reliably, the law firm cannot recognise any revenue—the expenses recognised may not be recoverable.

When the outcome of the lawsuit can be estimated reliably, the law firm must recognise revenue based on the percentage of completion method.

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Ex 36 The facts are the same as in Example 35. However, in this example, regardless of the outcome of the lawsuit, the law firm will be remunerated for the time spent in pleading the case (ie X hours spent × CU100 per hour). In the current reporting period, the law firm spent 120 hours on the lawsuit.

In this example, the outcome of the transaction is independent of the outcome of the lawsuit (the client pays regardless of the outcome of the lawsuit); therefore, the conditions of reliable measurement and probable flow of economic benefits are met.

The law firm must recognise revenue based on the actual hours worked (ie 120 hours × CU100 per hour = CU12,000) because this represents the appropriate stage of the contract completion.

Ex 37 Two consultancy firms (A and B) are competing to assist a gaming firm in its bid for a casino licence to be granted by Government X in a competitive bidding process. In accordance with the contractual arrangements, both A and B will each prepare an independent bid proposal for submission to Government X, out of which the gaming firm will make its selection.

The consultancy firm whose proposal is selected will receive a fee for its services based on a predetermined hourly rate. The consultancy firm whose proposal is not submitted will receive nothing.

Consultancy firms usually bill their clients based on an hourly rate that is payable regardless of whether their clients act on their advice.

The gaming firm selects A's proposal and submits it to Government X as its bid for the casino licence.

When the outcome of the selection cannot be estimated reliably, the consultancy firms cannot recognise any revenue. Paragraph 23.16 specifies that when the outcome of the transaction cannot be estimated reliably revenue should be recognised only to the extent of the recoverable expenses. In this instance, recovery of the expenses is uncertain, so no revenue can be recognised by either consultancy firm.

When the outcome of the selection can be estimated reliably, the consultancy firm whose bid is reliably expected to be selected must recognise revenue based on the percentage of completion method. The other consultancy firm would continue to postpone recognition of revenue.

In this case, it is probable that the outcome of the transaction can be estimated with sufficient reliability only when the gaming firm announces which bid proposal it has selected (when the gaming firm selects A's proposal).

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Construction contracts

Notes

A construction contract is defined in the glossary as a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use. Frequently, the construction contract term will be longer than a year. However, some contracts lasting less than a year may also fall within the definition.

This section specifies the accounting for construction contracts in the financial statements of contractors. The requirements in this section cover the accounting treatment of both revenue and costs associated with construction contracts.

Because of the nature of construction-contract activity, the commencement and completion dates usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. Paragraph 23.17 focuses on determining when the outcome of the contract can be estimated reliably and determining the stage of completion of the contract activity.

Paragraphs 23.18–23.20 provide guidance on segmenting contracts into multiple construction contracts and combining contracts into a single construction contract.

Paragraphs 23.21–23.27 provide guidance for applying the percentage of completion method in accounting for a construction contract in the financial statements of a contractor. If the entire contract falls into a single accounting period, the entity will not need to allocate revenue and costs to different accounting periods. Since the contract commences and terminates in the same period, all revenue and costs will be recognised in the same accounting period (see Example 38).

The guidance provided for recognising revenue from the rendering of services (for example, paragraph 23.14 is also useful in accounting for construction contracts).

Example—identification of construction contracts

Ex 38 A manufacturer enters into a long-term contract to supply a wholesaler with 10,000 kettles over the term of the contract to the wholesaler's predetermined specification.

The contract between a supplier and a customer for producing goods over time does not meet the definition of a construction contract. It is simply a contract for producing goods.

This contract could not be considered a construction contract for the construction of a combination of assets since the kettles are not closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use (see paragraph 23.19).

The manufacture and sale of a single kettle could not be considered an individual construction contract since there is no significant specific negotiation for its construction—the supplier sells 10,000 kettles to the wholesaler. In addition, the entire production and delivery of a kettle will generally fall into a single accounting period.

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23.17 When the outcome of a construction contract can be estimated reliably, an entity shall recognise contract revenue and contract costs associated with the construction contract as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period (often referred to as the percentage of completion method). Reliable estimation of the outcome requires reliable estimates of the stage of completion, future costs and collectability of billings. Paragraphs 23.21–23.27 provide guidance for applying the percentage of completion method.

Notes

Paragraph 23.25 sets out what to do when the outcome of the contract cannot be estimated reliably and paragraph 23.26 sets out what to do when it is probable that total contract costs will exceed total contract revenue.

Contract revenue

Contract revenue includes the initial amount of revenue agreed in the contract, as well as variations in any contract work, claims and incentive payments that can be reliably measured to the extent it is probable that they will result in revenue.

A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract.

A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from delays caused by the customer, errors in specifications or design, and disputed variations in contract work, for example.

Incentive payments are additional amounts paid to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when the contract is sufficiently advanced for it to be probable that the specified performance standards will be met or exceeded and the amount of the incentive payment can be measured reliably.

It is probable that revenue will result from:

- a variation when it is probable that the customer will approve the variation;
- a claim when negotiations have reached such an advanced stage that it is probable the customer will accept the claim; or
- an incentive payment when the contract is sufficiently advanced for it to be probable that the specified performance standards will be met or exceeded.

Contract costs

Contract costs include costs that relate directly to the specific contract, costs that are attributable to contract activity in general and can be allocated to the contract and other costs that are chargeable to the customer under the terms of the contract.

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Costs that relate directly to a specific contract include:

- (a) site labour costs, including site supervision;
- (b) costs of materials used in construction;
- (c) depreciation of plant and equipment used on the contract;
- (d) costs of moving plant, equipment and materials to and from the contract site;
- (e) costs of hiring plant and equipment;
- (f) costs of design and technical assistance that is directly related to the contract;
- (g) estimated costs of rectification and guarantee work, including expected warranty costs; and
- (h) claims from third parties.

Some costs may be attributable to contract activity in general, for example, construction overheads, and can be allocated to specific contracts.

Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such excluded costs include:

- (a) general administration costs for which reimbursement is not specified in the contract;
- (b) selling costs;
- (c) research and development costs for which reimbursement is not specified in the contract; and
- (d) depreciation of idle plant and equipment that is not used to fulfil a contract.

The estimates of contract costs and contract revenue often need to be revised as events occur and uncertainties are resolved (see paragraph 23.21). The need for such revisions does not necessarily indicate that the outcome of the contract cannot be estimated reliably. Changes in accounting estimates are accounted for in accordance with Section 10 *Accounting Policies, Estimates and Errors*.

Notes

The examples below illustrate paragraph 23.17, including illustrating the basic stage of completion calculations. For guidance in applying the percentage of completion method and the related examples in this training material as well as for an understanding of the pertinent calculations, refer to paragraphs 23.21–23.27.

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Examples—construction contracts

Ex 39 Under a construction contract, a contractor agrees to a fixed contract price of CU2,000 to refurbish the kitchen of a residential flat. The contractor's initial estimate of contract costs at 1 February 20X1, the date the contract is agreed, is CU1,200.

The contractor has a 31 December year-end. The contract price will be paid to the contractor on completion of the refurbishment.

The refurbishment was completed on 31 July 20X1 at a cost of CU1,250 (that is, actual costs incurred under the contract as at 31 July 20X1 are CU1,250).

Although this contract meets the definition of a construction contract, construction falls into a single accounting period (assuming the entity does not prepare interim financial statements). Therefore, the contractor need not allocate contract revenue and contract costs to different accounting periods as the stage of completion is nil at the start of the accounting period and 100% at the end of the accounting period.

Contract revenue of CU2,000 and contract costs of CU1,250 are recorded in 20X1.

Ex 40 The facts are the same as in Example 39. However, in this example, the contractor's year ends 30 June.

As at 30 June 20X1, contract costs incurred for work performed to date are CU800 and the contractor estimates that costs to complete the contract will be CU400 (total contract costs will be CU1,200).

The contractor determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed to date bear to the latest estimated total contract costs (see paragraph 23.22).

Since construction falls into two accounting periods, stage of completion calculations must be performed to allocate contract revenue between the two accounting periods.

The contractor calculates the stage of completion as: Stage of completion = costs incurred relating to work performed to date ÷ estimated total costs × 100%.

Stage of completion at 30 June 20X1 = 66.67% (ie $CU800 \div CU1,200 \times 100\% = 66.67\%$).

For the year ended 30 June 20X1 the contractor must recognise revenue of CU1,333 (= $CU2,000 \times 66.67\%$) and costs of CU800 for this contract.

For the year ended 30 June 20X2 the contractor must recognise revenue of CU667 (ie $CU2,000$ less $CU1,333$ recognised in prior periods) and costs of CU450 (ie $CU1,250$ less $CU800$ recognised in prior periods) for this contract.

Ex 41 Under a construction contract, a contractor agrees to receive a fee from the customer equal to direct contract costs plus a 40% fixed return on those direct contract costs. The contractor's initial estimate of contract costs at 1 January 20X1, the date the contract is agreed, is CU2,000 (all of which are considered direct costs). Therefore, expected revenue under the contract is CU2,800. The contract is expected to last two years.

The contractor has a 31 December year-end.

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At 31 December 20X1, the contractor incurs contract costs of CU1,045 and expects total contract costs to be CU1,900 (all considered direct costs).

At 31 December 20X2, actual costs are CU2,000. However, only CU1,800 meet the contract criteria for direct costs when determining the 40% fixed return.

The contractor determines the stage of contract completion by calculating the proportion of contract costs incurred for work performed to date as compared to the latest estimated total contract costs.

Stage of completion at 31 December 20X1 = 55% (ie $\text{CU1,045} \div \text{CU1,900} \times 100\% = 55\%$).

In the year ended 31 December 20X1 the contractor should recognise revenue of CU1,463 (ie $\text{CU1,900} \times (100\% + 40\%) \times 55\%$) and costs of CU1,045 for this contract.

In the year ended 31 December 20X2 the contractor should recognise revenue of CU1,057 (ie $\text{CU1,800} \times (100\% + 40\%)$ less CU1,463 previously recognised) and costs of CU955 (ie CU2,000 less CU1,045) for this contract.

Ex 42 On 1 January 20X1, a contractor enters into a construction contract to build a bridge. The contractor agrees to a fixed contract price of CU9,000. The contractor's initial estimate of contract costs is CU8,000. The contractor expects it will take three years to build the bridge.

The contractor has a 31 December year-end.

By the end of the first year of the contract, 31 December 20X1, the contractor's estimate of total contract costs has increased to CU8,050.

In 20X2, the customer and contractor agree to a variation resulting in an increase in contract revenue of CU200 and estimated additional contract costs of CU150. At the end of 20X2, costs incurred include CU100 paid for standard materials stored at the site to be used in 20X3 to complete the project.

The contractor determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed to date bear to the latest estimated total contract costs. A summary of the financial data in the construction period is as follows:

	20X3	20X2	20X1
	CU	CU	CU
Initial amount of revenue agreed in contract	9,000	9,000	9,000
Variation	200	200	–
Total revenue	9,200	9,200	9,000
Costs incurred to date	8,200	6,168	2,093
Estimated costs to complete	–	2,032	5,957
Total estimated costs	8,200	8,200	8,050

The contractor calculates the stage of completion as follows:

	20X3	20X2	20X1
	CU	CU	CU
Costs incurred relating to work performed to date	8,200	6,068 ^(a)	2,093
Stage of completion	100%	74% ^(b)	26% ^(c)

(a) CU6,168 costs incurred less CU100 costs that relate to 20X3 = CU6,068.

(b) $\text{CU6,068} \div \text{CU8,200} \times 100\% = 74\%$ complete.

(c) $\text{CU2,093} \div \text{CU8,050} \times 100\% = 26\%$ complete.

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Revenue and expenses are recognised in profit or loss as follows:

	To date CU	Recognised in prior years CU	Recognised in current year CU
20X1			
Revenue (to date: 26% of CU9,000)	2,340	–	2,340
Expenses (to date: 26% of CU8,050)	2,093	–	2,093
Profit	247	–	247
20X2			
Revenue (to date: 74% of CU9,200)	6,808	2,340	4,468
Expenses (to date: 74% of CU8,200)	6,068	2,093	3,975
Profit	740	247	493
20X3			
Revenue (to date: 100% of CU9,200)	9,200	6,808	2,392
Expenses (to date: 100% of CU8,200)	8,200	6,068	2,132
Profit	1,000	740	260

- 23.18 The requirements of this section are usually applied separately to each construction contract. However, in some circumstances, it is necessary to apply this section to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.
- 23.19 When a contract covers a number of assets, the construction of each asset shall be treated as a separate construction contract when:
- separate proposals have been submitted for each asset;
 - each asset has been subject to separate negotiation, and the contractor and customer are able to accept or reject that part of the contract relating to each asset; and
 - the costs and revenues of each asset can be identified.

Notes

Sometimes it is necessary to break a single contract into its separately identifiable components and apply the requirements in this section to each component. Conversely, in some situations, a group of separate contracts should be treated as one contract because, in substance, they represent a single contract. To assess whether to combine or segregate contracts, an entity should assess whether a contract (or a component of a contract) was negotiated independently of other related contracts (or components), or whether all the contracts (or components) were negotiated together as a package. To make this assessment, the criteria in paragraphs 23.19–23.20 must be applied. The requirements are designed so that the accounting reflects the substance of the arrangement, rather than its legal or contractual form.

When the contract meets the criteria in paragraph 23.19, the segregation of a single contract is required (this is not optional). Similarly, the combination of a group of contracts is required when the contract meets the criteria in 23.20.

It is important to combine or segregate contracts appropriately since combining or segmenting will have a significant effect on the allocation of revenue and profit between accounting periods.

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Example—construction contracts covering multiple assets

Ex 43 An entity was awarded a CU5,000,000 (fixed price) contract by a transport authority to construct a 1,000 kilometre road and to build a sports stadium. The entity submitted separate tenders for the construction of the road and the stadium. The tenders were considered in separate competitive bidding processes.

The construction of each asset must be treated as a separate construction contract since the contract includes the criteria in paragraph 23.19:

- (a) separate proposals were submitted for the road and the stadium.
- (b) the road and the stadium were subject to separate negotiation and the entity and the transport authority were able to accept one tender and reject the other one—evidenced by separate tenders awarded independently.
- (c) to prepare its separate tenders, the entity must have segregated the costs of each job and include a price in each tender. Therefore, the costs and revenue of each asset can be identified.

23.20 A group of contracts, whether with a single customer or with several customers, shall be treated as a single construction contract when:

- (a) the group of contracts is negotiated as a single package;
- (b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
- (c) the contracts are performed concurrently or in a continuous sequence.

Examples—group of construction contracts

Ex 44 An entity is contracted to design and construct a railroad that will wind through five timber farmers' plantations and link to the nearby national railroad network (project). The design specification is to optimise the efficiency of transporting the timber from the farmers' lands to the national railroad system. The length of the track on each farmer's land may vary and is not necessarily proportional to the size of the farmers' plantations.

In securing the project, the entity negotiated with the farmers collectively. However, once the farmers agreed to contract with the entity to undertake the project, the entity entered into separate contracts with each farmer. Each farmer is contractually bound to pay the entity CU100,000 for the design and construction of the portion of the railroad to be built on its land.

The entity must treat the group of contracts with the five farmers as a single construction contract because the criteria in paragraph 23.20 for combining individual contracts are met:

- (a) the group of five contracts was negotiated as a single package for the design and construction of a railroad that efficiently winds through the five farmers' plantations.
- (b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin—the railroad is designed and constructed for overall efficiency across the five farmers' plantations. The costs to be incurred on each farmer's land have no bearing on the CU100,000 (fixed amount) that each farmer is required to pay the entity.

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- (c) the contracts are performed concurrently or in a continuous sequence—the construction of a railroad that winds across five farmers' lands would necessarily be constructed concurrently or in a continuous sequence.

Ex 45 An entity was awarded a CU5,000,000 fixed price contract by a transport authority to construct a 1,000 kilometre road including the construction of a bridge on that stretch of road. As required by the transport authority, the entity submitted a single tender for the construction of the road and the bridge. The transport authority considered the tenders received in a single competitive bidding process and awarded the entity the project for the construction of the road and the bridge.

The construction of the road and the bridge cannot be treated as separate construction contracts since the criteria in paragraph 23.19 are not met. Separate proposals were not submitted for construction of the road and the bridge. Furthermore, tenders for the construction of the road and the bridge were considered as a single project. The construction of the road and the bridge were not subject to separate negotiation; nor was the entity or the transport authority able to accept or reject the tender for one part (the road or the bridge) without the other.

Furthermore, the construction of the road and the bridge must be treated as a single contract because the criteria in paragraph 23.20 for combining individual contracts are met:

- (a) the two components—construction of the road and construction of the bridge—are negotiated as a single package.
- (b) the components are very closely interrelated since they are negotiated together, the bridge is built on the stretch of road, and one component will not be awarded to the contractor without the other.
- (c) it is expected that the contracts will be performed concurrently or in a continuous sequence because the bridge cannot be utilised to its full extent without the road and vice versa. Because the bridge is part of the road, the road cannot be completed unless the bridge is completed.

Therefore, even if these two assets had been contractually separate agreements, they would still need to be combined.

Percentage of completion method

23.21 This method is used to recognise revenue from rendering services (see paragraphs 23.14–23.16) and from construction contracts (see paragraphs 23.17–23.20). An entity shall review and, when necessary, revise the estimates of revenue and costs as the service transaction or construction contract progresses.

Notes

The measurement of revenue and costs may be affected by a variety of uncertainties that depend on the outcome of future events. Under a construction contract, the estimates of contract revenue and contract costs often need to be revised as events occur and uncertainties are resolved. For example, the contract revenue may increase

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or decrease from one period to the next if a contractor and a customer agree on variations or claims; the revenue may change or due to penalties arising from delays caused by the contractor in the completion of the contract. Similarly, projected costs may increase or decrease as circumstances change. The need for such revisions does not necessarily indicate that the outcome of the contract cannot be estimated reliably.

At the end of each reporting period, an entity must review its estimates of contract revenue and contract costs and revise them if they have changed. The percentage of completion method is applied cumulatively; revisions are treated as changes in estimates and prior periods are not adjusted (see Section 10 *Accounting Policies, Estimates and Errors*).

The revised estimates are used to determine the percentage of completion and the amount of revenue and expenses to recognise in profit or loss in the period in which the change is made as well as in subsequent periods. For example, if contract revenue and contract costs are revised in Year 2 of a four-year project, no adjustment is made to the revenue or expenses recognised in Year 1. The change will be reflected in years 2, 3 and 4.

- 23.22 An entity shall determine the stage of completion of a transaction or contract using the method that measures most reliably the work performed. Possible methods include:
- (a) the proportion that costs incurred for work performed to date bear to the estimated total costs. Costs incurred for work performed to date do not include costs relating to future activity, such as for materials or prepayments.
 - (b) surveys of work performed.
 - (c) completion of a physical proportion of the service transaction or contract work.
- Progress payments and advances received from customers often do not reflect the work performed.

Notes

The examples 43–45 discuss the impact on profit or loss of construction contracts. This note discusses the impact on the statement of financial position (balance sheet).

For each construction contract in progress at the reporting date, the gross amount due from customers is shown as an asset in the statement of financial position calculated as:

- (a) total costs incurred on the contract plus the cumulative recognised profit (or less the cumulative recognised loss); less
- (b) progress billings (that is amounts invoiced to customers for work performed on a contract regardless of whether they have been paid by the customer).

The gross amount due from customers is disclosed separately from inventories to which Section 13 applies.

Where progress billings exceed total costs incurred plus cumulative recognised profit (or less cumulative recognised loss), the balance will be a net credit balance shown as a liability in the statement of financial position known as the 'gross amount due to customers'. This negative balance must not be offset against positive balances on other contracts.

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The section does not specify the classification of either the asset or the liability for amounts due from or to customers.

Many construction contracts will contain ‘milestones’ to trigger progress payments. These milestones and the related payment may or may not be consistent with the amount of work performed, and it should not be assumed that the payment is automatically recognised as revenue.

Examples—stage of completion

Ex 46 A construction contractor has a fixed price contract for CU100,000 to construct a building (project).

It will take two years to construct the project.

At the end of the first year of the project (31 December 20X1), the contractor determines that the stage of completion of the construction contract is measured most reliably by reference to independent surveys of work performed.⁽²⁾ An independent surveyor certified that 28% of the contract work is completed. The contract has not become onerous.

At 31 December 20X1, the stage of completion of the contract is 28%—determined by the independent surveyor.

Consequently, the entity would recognise revenue of CU28,000 ($\text{CU}100,000 \times 28\%$) during the year ended 31 December 20X1.

Ex 47 The facts are the same as in Example 46. However, in this example, the contractor determines that the stage of construction-contract completion is measured most reliably by reference to completion of a physical proportion of the contract work. During the first year, the site was cleared (the contract stipulates as 10% of the total project), the foundations laid (stipulated as 5% of the total project) and the walls of the building erected (stipulated as 14% of the total project). The amounts payable for each phase are irrevocably payable. The contract has not become onerous.

At 31 December 20X1, the stage of completion of the contract is 29%—calculation: 10% (clearing the site) + 5% (laying the foundations) + 14% (building the walls).

Consequently, the entity would recognise revenue of CU29,000 ($\text{CU}100,000 \times 29\%$) during the year ended 31 December 20X1.

Ex 48 The facts are the same as in Example 46. However, in this example the contractor determines that the stage of completion of the construction contract is measured most reliably by reference to the proportion that costs incurred for work performed to date bear to the estimated total costs. At the end of the first year of the project the contractor has incurred costs of CU20,000 on the contract,

⁽²⁾ Examples 47 and 48 illustrate other methods of determining the stage of completion. The entity is required to use the method that measures most reliably the work performed (see paragraph 23.22).

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including CU2,000 on roof tiles and timber held offsite. At 31 December 20X1, the contractor's estimate of total contract costs is CU60,000.

At 31 December 20X1 the stage of completion of the contract is 30%—calculation: $(\text{CU}20,000 \text{ costs incurred less CU}2,000 \text{ costs relating to future activity}) \div \text{CU}60,000 \text{ estimated total contract costs} \times 100\% = 30\%$.

Consequently, the entity would recognise revenue of CU30,000 ($\text{CU}100,000 \times 30\%$) during the year ended 31 December 20X1.

23.23 An entity shall recognise costs that relate to future activity on the transaction or contract, such as for materials or prepayments, as an asset if it is probable that the costs will be recovered.

Notes

When a contractor determines the stage of completion of the contract by calculating the proportion of contract costs incurred for work performed to date compared to the latest estimated total contract costs, this results in all contract costs being expensed in profit or loss during the period incurred, unless such costs relate to future activity on the contract (for example, raw materials purchased for future use or payments made to subcontractors in advance of work to be performed under a subcontract). Costs that relate to future activity on a contract (for example, raw materials purchased for future use or payments made to subcontractors in advance of work to be performed under the subcontract) are carried forward as a separate asset (for example, raw materials) in the statement of financial position, provided it is probable they will be recovered under the contract.

Examples of circumstances in which the contractor's ability to recover the cost is not probable and in which contract costs may need to be recognised immediately as an expense include contracts:

- (a) that are not fully enforceable (that is, their validity is in question);
- (b) for which the completion is subject to the outcome of pending litigation or legislation;
- (c) that relate to properties that are likely to be condemned or expropriated;
- (d) for which the customer is unable to meet its obligations; or
- (e) that the contractor is unable to complete or otherwise meet the obligations thereof.

Examples—recognition of costs on a construction contract

Ex 49 A construction contractor has a fixed price contract for CU100,000 to construct a building (project).

It will take two years to construct the project.

At the end of the first year of the project (31 December 20X1) the contractor has incurred costs of CU20,000 on the contract, including, for CU2,000, the purchase of roof tiles and timber held offsite.

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The contractor determines the stage of completion of the construction contract by reference to independent surveys of work performed. At the end of 20X1 the project was certified as 28% complete.

The contract has not become onerous.

In 20X1, the contractor must recognise revenue of CU28,000 (28% × CU100,000 total expected contract revenue). One way of accounting for contract costs is to recognise them as an expense in profit or loss in the accounting periods in which the work to which they relate is performed. Paragraph 23.23 requires that costs that relate to future activity should be recognised as assets if it is probable the costs will be recovered. Consequently, using this method, in 20X1, the contractor would recognise contract expenses of CU18,000 in profit or loss (CU20,000 less CU2,000 roof tiles and timber inventory).

This means profit in 20X1 is CU10,000 (CU28,000 contract revenue less CU18,000 contract expenses).

Assuming no progress billings have been made, an amount of CU28,000 will be included in the ‘gross amount due from customers for contract work’ for this contract.

Ex 50 The facts are the same as in Example 49. However, in this example, at the end of 20X1, the project was certified as 32% complete, progress billings of CU29,000 had been made, and the customer had paid CU19,000 of these progress billings.

In 20X1, the contractor must recognise revenue of CU32,000 (ie 32% of CU100,000 total expected contract revenue) and expenses of CU18,000 (ie CU20,000 less CU2,000 roof tiles and timber inventory). This means that profit in 20X1 is CU14,000 (ie CU32,000 less CU18,000).

In the entity’s statement of financial position, an amount of CU2,000 (the roof tiles and timber that is held offsite) is included in inventories and ‘the gross amount due from customers for contract work’ of CU3,000 for this contract is calculated as follows:

- (a) revenue (CU32,000); less
- (b) progress billings (CU29,000).

In addition, CU10,000 will be shown in trade receivables (a separate asset) for the progress billings not yet settled by the customer (ie CU29,000 progress billings less CU19,000 received from the customer).

Ex 51 The facts are the same as in Example 49. However, in this example, the contractor determines the stage of completion of the construction contract by reference to the proportion of contract costs incurred for work performed to date compared to the latest estimated total contract costs. The contractor’s initial estimate of total contract costs was CU60,000 and at the end of 20X1, its estimate of total contract costs remained CU60,000.

At 31 December 20X1, the contract is 30% complete—calculation: (CU20,000 costs incurred less CU2,000 costs relating to future activity) ÷ CU60,000 estimated total contract costs × 100% = 30%.

In 20X1, the contractor must recognise revenue of CU30,000 (ie 30% × CU100,000 total expected contract revenue) and expenses of CU18,000 (ie CU20,000 less CU2,000). This means that profit in 20X1 is CU12,000 (ie CU30,000 contract revenue less CU18,000 contract expenses).

The CU2,000 of roof tiles and timber would be included in the statement of financial position as an asset (inventories) and assuming no progress billings have been made, an

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amount of CU30,000 would be included in ‘the gross amount due from customers for contract work’ for this contract, calculated as follows:

- (a) revenue (ie CU30,000); less
- (b) progress billings (nil).

23.24 An entity shall recognise as an expense immediately any costs whose recovery is not probable.

23.25 When the outcome of a contract cannot be estimated reliably:

- (a) an entity shall recognise revenue only to the extent of contract costs incurred that it is probable will be recoverable; and
- (b) the entity shall recognise contract costs as an expense in the period in which they are incurred.

Example—outcome cannot be estimated reliably

Ex 52 A construction contractor has a fixed price contract for CU100,000 to construct a building according to a design that has never been applied and using materials that have never been used in the construction of a building (project).

The contractor began construction of the project in 20X1 and expects that construction will take at least five years. In 20X1, the contractor incurred CU5,000 recoverable contract costs on the project.

Because of the uncertainties arising from the new design and materials, at the end of 20X1, the entity cannot reliably estimate total expected contract costs. Consequently, at the end of 20X1, the contractor cannot estimate the outcome of the contract with sufficient reliability to estimate the percentage completion of the project. It is highly likely that the customer will pay the contract price.

At the end of 20X1, the contractor must recognise revenue only to the extent of recoverable contract costs incurred (that is, CU5,000 contract revenue and CU5,000 expenses).

23.26 When it is probable that total contract costs will exceed total contract revenue on a contract, the expected loss shall be recognised as an expense immediately, with a corresponding provision for an **onerous contract** (see Section 21).

Notes

The Appendix to Section 21 *Provisions and Contingencies* provides guidance on accounting for onerous contracts. The value of the provision reflects the expected least net cost of exiting from the contract, whether this means fulfilling it or paying compensation or penalties for failing to fulfil it.

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Example—expected loss on a construction contract

Ex 53 A construction contractor has a fixed price contract for CU100,000 to construct a building (project).

The contractor determines the stage of completion of this construction contract by reference to the proportion that costs incurred for work performed to date bear to the estimated total costs.

The contractor's initial estimate of total contract costs was CU60,000, but by the end of the first year of the project, 20X1, the contractor has incurred CU90,000 contract costs and expects to incur a further CU30,000 to complete the project.

At the end of 20X1, the contract is 75% complete—calculation: CU90,000 costs incurred ÷ CU120,000 estimated total contract costs × 100%. Accordingly, in 20X1, the contractor must recognise revenue of CU75,000 (that is 75% of CU100,000 total expected contract revenue). Furthermore, the contractor must recognise contract costs of CU90,000 (which are the contract costs incurred during the year) plus CU5,000 (a further expense equal to the provision for the expected additional loss to complete the contract, ie the amount by which estimated costs to complete the contract (CU30,000) exceed expected future contract revenue (CU25,000)).

Consequently, in 20X1, revenue of CU75,000 and costs of CU95,000 are recognised in respect of this contract, resulting in a loss of CU20,000. The loss equals the total expected loss on the onerous contract (CU100,000 less CU120,000) and, applying paragraph 23.26, must be accounted for in 20X1 when the contract became onerous.

In 20X2, assuming that the estimates were correct, and a further CU30,000 of costs were incurred to complete the project, revenue of CU25,000 and expense of CU25,000 would be recognised. The remaining CU5,000 of costs would be recognised as a reduction in the provision recorded in 20X1 as a result of the onerous contract.

23.27 If the collectability of an amount already recognised as contract revenue is no longer probable, the entity shall recognise the uncollectable amount as an expense instead of as an adjustment of the amount of contract revenue.

Example—collectability of recognised amounts

Ex 54 In 20X1, a contractor completed the construction of a building as per the two-year CU100,000 fixed price contract with a customer. The contractor recognised revenue of CU100,000 over the two-year construction period using the percentage of completion method.

In 20X2, shortly before the customer was due to settle the liability of CU100,000 for the newly constructed building, a tsunami destroyed the customer's business. At the end of 20X2, the liquidator of the customer informed the customer's creditors that, in full and final settlement of the debt, they would receive a liquidation dividend of 10% of the amount the customer owed them.

The contractor recognised revenue of CU100,000 over the two-year construction period using the percentage of completion method. In 20X2, when the collectability of the amount becomes improbable, the contractor must recognise an expense of CU90,000 (ie 90% of CU100,000 debt). The expense must not be presented as a reversal of contract revenue. See paragraphs 11.21 and 11.22 for further details about impairment of trade receivables.

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Examples—accounting for construction contracts from start to finish

Ex 55 On 1 January 20X1, a contractor enters into a construction contract which includes a fixed contract price of CU12,000 to build a bridge.

The contractor has a 31 December year-end.

In 20X2, the customer and the contractor agree to a variation resulting in an increase in contract revenue of CU200 and estimated additional contract costs of CU150.

Actual cumulative costs incurred to the end of 20X1, 20X2 and 20X3 (the end of the contract), including the costs of the variation are CU3,000, CU7,105 and CU10,050 respectively.

At the end of 20X1, 20X2 and 20X3, the customer paid the contractor progress billings of CU5,000, CU3,000 and CU4,200 respectively.

The contractor determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed to date bear to the latest estimated total contract costs.

The contractor’s initial estimate of contract costs is CU8,000 over a three-year construction period and at 31 December 20X1, the contractor’s estimate of total contract costs is still CU8,000. However, by the end of 20X2 the contractor’s estimate of contract costs increased to CU10,000, excluding the variation above.

A summary of the financial data in the construction period is as follows:

	20X3	20X2	20X1
	CU	CU	CU
Initial amount of revenue agreed in contract	12,000	12,000	12,000
Variation	200	200	–
Total revenue	12,200	12,200	12,000
Costs incurred to date	10,050	7,105	3,000
Estimated costs to complete	–	3,045	5,000
Total estimated costs	10,050	10,150	8,000
Total estimated profit	2,150	2,050	4,000

The contractor calculates the stage of completion as follows:

	20X3	20X2	20X1
	CU	CU	CU
Costs incurred relating to work performed to date	10,050	7,105	3,000
Stage of completion	100%	70% (b)	37.5% (a)

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Revenue, expenses and profit are recognised in the determination of profit or loss as follows:

	20X3	20X2	20X1
	CU	CU	CU
Revenue	3,660 (e)	4,040 (d)	4,500 (c)
Expenses	(2,945) (g)	(4,105) (f)	(3,000)
Profit (loss)	715	(65)	1,500

- (a) $CU3,000 \div CU8,000 \times 100\% = 37.5\%$
 (b) $CU7,105 \div CU10,150 \times 100\% = 70\%$
 (c) $37.5\% \times CU12,000 = CU4,500$
 (d) $70\% \times CU12,200 \text{ less } CU4,500 = CU4,040$
 (e) $CU12,200 \text{ less } (CU4,500 + CU4,040) = CU3,660$
 (f) $CU7,105 \text{ less } CU3,000 = CU4,105$
 (g) $CU10,050 \text{ less } (CU4,105 + CU3,000) = CU2,945$

The asset or (liability) to be presented in the contractor's statement of financial position at the end of each year is:

	20X3	20X2	20X1
	CU	CU	CU
Total costs incurred to date	10,050	7,105	3,000
Cumulative profits to date	2,150	1,435	1,500
Cumulative revenue recognised to date	12,200	8,540	4,500
Total progress billings to date	(12,200)	(8,000)	(5,000)
Gross amount due from (to) the customer for contract work	0	540	(500)

Ex 56 The facts are the same as in Example 55. However, in this example the contractor determines the stage of completion of the construction contract by reference to independent surveys of work performed.

At the end of 20X1, the project was certified as 40% complete and at the end of 20X2 the project was certified as 65% complete.

	20X3	20X2	20X1
	CU	CU	CU
Stage of completion (as certified)	100%	65%	40%

Revenue, expenses and profit are recognised in profit or loss as follows:

	20X3	20X2	20X1
	CU	CU	CU
Revenue	4,270 (c)	3,130 (b)	4,800 (a)
Expenses	(2,945) (e)	(4,105) (d)	(3,000)
Profit (loss)	1,325	(975)	1,800

- (a) $40\% \times CU12,000 = CU4,800$
 (b) $65\% \times CU12,200 \text{ less } CU4,800 = CU3,130$
 (c) $CU12,200 \text{ less } (CU4,800 + CU3,130) = CU4,270$
 (d) $CU7,105 \text{ less } CU3,000 = CU4,105$
 (e) $CU10,050 \text{ less } (CU7,105) = CU2,945$

The asset or (liability) to be presented in the contractor's statement of financial position at the end of each year is:

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	20X3 CU	20X2 CU	20X1 CU
Total costs incurred to date	10,050	7,105	3,000
Cumulative profits to date	2,150	825	1,800
Cumulative revenue recognised to date	12,200	7,930	4,800
Total progress billings to date	(12,200)	(8,000)	(5,000)
Gross amount due from (to) the customer for contract work	0	(70)	(200)

Interest, royalties and dividends

- 23.28 An entity shall recognise revenue arising from the use by others of entity assets yielding interest, royalties and dividends on the bases set out in paragraph 23.29 when:
- (a) it is probable that the economic benefits associated with the transaction will flow to the entity; and
 - (b) the amount of the revenue can be measured reliably.
- 23.29 An entity shall recognise revenue on the following bases:
- (a) interest shall be recognised using the **effective interest method** as described in paragraphs 11.15–11.20;
 - (b) royalties shall be recognised on an accrual basis in accordance with the substance of the relevant agreement; and
 - (c) dividends shall be recognised when the shareholder’s right to receive payment is established.

Notes

See Example 26 in Appendix to Section 23.

Examples—interest, royalties and dividends

Ex 57 An entity (investor) invests CU100,000 in a debenture issued by a major local corporation (issuer). The debenture contract requires the issuer, on the sixth anniversary of the loan, to pay the investor CU134,010 to redeem the debenture (that is, CU100,000 repayment of capital and a CU34,010 ‘premium’). The debenture has a coupon of zero (that is, it is nominally ‘interest-free’).

In substance, the redemption premium is the interest return to the investor for six years, paid entirely at maturity. The amortisation of the redemption premium is income. The investor must recognise interest income of CU5,000 in Year 1, CU5,250 in Year 2, CU5,513 in Year 3, CU5,788 in Year 4, CU6,078 in Year 5 and CU6,381 in Year 6.

The effective interest method (see Section 11 *Basic Financial Instruments*) requires accrual of the CU34,010 premium to be recognised over the life of the debenture.

Using a spreadsheet or financial calculator, the effective interest rate on this debenture is 5.00% a year (ie the present value of a single payment of CU134,010 at the end of six years at 5% is CU100,000).

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The premium of CU34,010 would be recognised as follows:

	Accretion of premium (5% x Asset balance at start of year)	Asset
		100,000
Year 1	5,000	105,000
Year 2	5,250	110,250
Year 3	5,513	115,763
Year 4	5,788	121,551
Year 5	6,078	127,629
Year 6	6,381	134,010
Total	34,010	

Ex 58 Entity A owns 2% of the ordinary share capital of Entity B.

On 18 December 20X4, the management of Entity B proposed a dividend of CU1,000,000 for the year ended 31 December 20X4. Entity A is not entitled to receive its share of the dividend of CU20,000 until the shareholders have approved it, which will not be until 28 February 20X5.

On 28 February 20X5, the dividend was ratified by the shareholders of Entity B at the annual general meeting. The dividend will be paid on 20 May 20X5 to shareholders registered on 28 February 20X5 as owners of Entity B’s ordinary shares.

Both Entity A and Entity B have December year ends.

In the year ended 31 December 20X4, Entity A should not recognise dividend revenue for the dividend proposed on 18 December 20X4. Entity A is not entitled to receive the dividend of CU20,000 until the shareholders approve it on 28 February 20X5. Note also that Entity B would not recognise a dividend payable until the dividend is approved.

Ex 59 The facts are the same as in Example 58 except that Entity A has a March year-end.

In the year ended 31 March 20X5, Entity A should recognise dividend revenue of CU20,000 for the dividend proposed on 18 December 20X4. Entity A is entitled to receive the final dividend when the shareholders approve it on 28 February 20X5. In its statement of financial position as at 31 March 20X5, Entity A should recognise a receivable for the dividend which will be paid on 20 May 20X5.

Ex 60 An IT company produces tax software. Customers purchase a one-year licence which allows the software to be used for one tax year and then renewed if desired. If the license is renewed, the customer will receive updated software revised for any changes in tax legislation for the next tax year. The IT company does not have any further obligations after sale of the licence. Without upgrades, the software is useful for only one tax year because of annual changes in tax legislation.

Since the IT company does not have any further obligations after sale, the annual licence fee may be recognised as revenue immediately on sale of the licence (even if this date is earlier than the start of the licence period), provided conditions in paragraph 23.10 for recognising revenue from the sale of goods are satisfied.

Note: if customers can renew the licence at below market price for a further period or periods (at a price lower than that paid in Year 1), then a portion of the Year 1 revenue may need to be deferred over the expected period of renewal at below market rates (see paragraph 23.9).

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Ex 61 An IT company produces tax software. Customers purchase a licence which allows the software to be used for 10 years from the date of purchase. Under the licence, a customer is entitled to receive all software upgrades free of charge over the licence period. The software is updated annually for any changes in tax legislation and at other times, whenever the IT company releases an improved version of the software. The IT company also provides free support to any customers having difficulty using the software.

Since the IT company has an ongoing obligation to perform upgrades and provide support after sale, some or all the revenue should be spread over the 10-year licence period to recognise it in the period in which the upgrades and customer support services are provided to the licensees.

The extent to which revenue is deferred will depend on the terms of the licence (for example, how significant the upgrades and support are compared with the software provided on the first day of the licence arrangement).

Note: the arrangement is a multiple-element sale—a sale of goods (software) and services (upgrade services and customer support services). Paragraph 23.8 has guidance on determining the separately identifiable components of a single transaction.

Disclosures

General disclosures about revenue

23.30 An entity shall disclose:

- (a) the **accounting policies** adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services; and
- (b) the amount of each category of revenue recognised during the period, showing separately, at a minimum, revenue arising from:
 - (i) the sale of goods;
 - (ii) the rendering of services;
 - (iii) interest;
 - (iv) royalties;
 - (v) dividends;
 - (vi) commissions;
 - (vii) **government grants**; and
 - (viii) any other significant types of revenue.

Notes

The policy for each of an entity's material type of transactions should be disclosed.

Module 23 – Revenue

Example—general disclosures

Ex 62 An entity could make general disclosures about revenue as follows:

Note 1 Accounting policies (extract)

Revenue recognition

Revenue is measured at the fair value of the consideration received or receivable, net of discounts and sales-related taxes.

Revenue from sales of furniture is recognised when the goods are delivered to the customer and any related installation has been completed.

Revenue from building design contracts is recognised under the percentage of completion method. The stage of completion is measured by the labour cost incurred to date as a percentage of the total estimated labour cost for each contract.

Revenue from construction contracts is recognised under the percentage of completion method. The stage of completion is measured by the contract costs incurred to date as a percentage of the total estimated contract costs for each contract.

If the outcome of a construction contract cannot be estimated reliably, contract revenue is recognised to the extent of contract costs incurred that it is probable will be recoverable.

When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised as an expense immediately.

Note 5 Revenue

Revenue recognised during the year:

	20X2	20X1
	CU	CU
Sale of furniture	700,000	500,000
Rendering of building design services	100,000	80,000
Construction contracts	3,000,000	2,900,000
	3,800,000	3,480,000

Revenue from construction contracts includes CU300,000 (20X1:CU0) recognised in exchange for 1,000 hours of legal services.

Disclosures relating to revenue from construction contracts

- 23.31 An entity shall disclose the following:
 - (a) the amount of contract revenue recognised as revenue in the period;
 - (b) the methods used to determine the contract revenue recognised in the period; and
 - (c) the methods used to determine the stage of completion of contracts in progress.

- 23.32 An entity shall present:
 - (a) the gross amount due from customers for contract work, as an asset; and
 - (b) the gross amount due to customers for contract work, as a **liability**.

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Example—disclosures about construction contracts

Ex 63 SME X, a contractor, has reached the end of its first year of operations. The contract costs incurred have been paid for in cash and all payments for its progress billings and advances have been received in cash. Contract costs incurred for contracts B, C and E include the cost of materials purchased for the contract, but which have not been used to fulfil the contract to date. For contracts B, C and E, the customers have made advances to the contractor for work not yet performed. Contract D has run significantly over budget, and while SME X will recover the cost of some future activities, it also expects to incur some additional losses. Contract E currently includes contract costs that relate to future activity recognised as an asset in accordance with paragraph 23.23, however the expected losses relate to an impairment of this asset. The status of its five contracts in progress at the end of the reporting period is as follows:

	<i>A</i>	<i>B</i>	<i>C</i>	<i>D</i>	<i>E</i>	<i>Total</i>
	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
Contract revenue recognised in accordance with paragraph 23.17	145	520	380	200	55	1,300
Contract expenses recognised in accordance with paragraph 23.17	(110)	(450)	(350)	(250)	(55)	(1,215)
Expected losses recognised in accordance with paragraph 23.26	-	-	-	(40)	(30)	(70)
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
Contract costs incurred in the period	110	510	450	250	100	1,420
Contract costs incurred recognised as contract expenses in the period in accordance with paragraph 23.17	(110)	(450)	(350)	(250)	(55)	(1,215)
Contract costs that relate to future activity recognised as an asset in accordance with paragraph 23.23	-	60	100	-	45	205
Contract revenue (see above)	145	520	380	200	55	1,300
Billings to date	100	600	400	180	80	1360
Unbilled contract revenue	45	-	-	20	-	65
Advances	-	80	20	-	25	125

Module 23 – Revenue

Extract from SME X’s statement of financial position at 31 December 20X1:

	<i>Notes</i>	<i>20X1</i>
		<i>CU</i>
Assets		
Accounts Receivable		0
Unbilled revenue ^(a) [paragraph 4.11(b)]	4	45
Prepaid expenses ^(b)	4	175
Liabilities		
Advances from customers		125
Provision for onerous contract ^(c)	4	20

- (a) Unbilled Revenue of CU65, less CU20 due from customer D, which is offset against the amount expected to be expended to satisfy the onerous contract.
- (b) Prepaid expenses of CU205, less CU30 that is not expected to be recovered from customer E.
- (c) Expected loss of CU40 recognised as an expense, less CU20 due from customer D to give net expected cash outflow from the contract.

Extracts from the notes to the financial statements for the year ended 31 December 20X1

Note 1 Accounting policies (extract)

Revenue arising from construction contracts

Revenue from construction contracts is recognised on the percentage of completion method, measured by reference to the ratio of contract costs incurred to date to the total estimated contract cost for each contract.

If the outcome of a construction contract cannot be estimated reliably, contract revenue is recognised to the extent of contract costs incurred that it is probable will be recoverable.

When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised immediately as an expense.

Note 2 Revenue

	<i>20X1</i>
	<i>CU</i>
Revenue comprises:	
Contract revenue [paragraph 23.31(a)]	1,300
...	

Note 4 Amount due from (to) customers

	<i>20X1</i>
	<i>CU</i>
Gross amount due from customers for contract work – presented as an asset [paragraph 23.32(a)]	220
Gross amount due to customers for contract work – presented as a liability [paragraph 23.32(b)]	(20)
...	

Module 23 – Revenue

Calculations that do not form part of the disclosures:

Note: the calculations below prove the gross amount due from and to customers reconciles with the individual contracts only and would not constitute part of the disclosures in the financial statements.

Contract	A	B	C	D	E	Total
Contract costs incurred	110	510	450	250	100	1,420
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
	145	580	480	160	70	1,435
Billings to date	100	600	400	180	80	1360
Advances		(80)	(20)		(25)	
Progress billings	(100)	(520)	(380)	(180)	(55)	(1,235)
Due from customers	45	60	100	–	15	220
Due to customers	–	–	–	(20)	–	(20)

Module 23 – Revenue

Appendix to Section 23

Examples of revenue recognition under the principles in Section 23

This Appendix accompanies, but is not part of, Section 23. It provides guidance for applying the requirements of Section 23 in recognising revenue.

23A.1 The following examples focus on particular aspects of a transaction and are not a comprehensive discussion of all the relevant factors that might influence the recognition of revenue. The examples generally assume that the amount of revenue can be measured reliably; it is probable that the economic benefits will flow to the entity and the costs incurred or to be incurred can be measured reliably.

Sale of goods

23A.2 The law in different countries may cause the recognition criteria in Section 23 to be met at different times. In particular, the law may determine the point in time at which the entity transfers the significant risks and rewards of ownership. Consequently, the examples in this appendix need to be read in the context of the laws relating to the sale of goods in the country in which the transaction takes place.

Example 1 ‘Bill and hold’ sales, in which delivery is delayed at the buyer’s request but the buyer takes title and accepts billing

23A.3 The seller recognises revenue when the buyer takes title, provided:

- (a) it is probable that delivery will be made;
- (b) the item is on hand, identified and ready for delivery to the buyer at the time the sale is recognised;
- (c) the buyer specifically acknowledges the deferred delivery instructions; and
- (d) the usual payment terms apply.

Revenue is not recognised when there is simply an intention to acquire or manufacture the goods in time for delivery.

Example 2 Goods shipped subject to conditions: installation and inspection

23A.4 The seller normally recognises revenue when the buyer accepts delivery, and installation and inspection are complete. However, revenue is recognised immediately upon the buyer’s acceptance of delivery when:

- (a) the installation process is simple, for example the installation of a factory-tested television receiver that requires only unpacking and connection of power and antennae; or
- (b) the inspection is performed only for the purposes of final determination of contract prices, for example, shipments of iron ore, sugar or soya beans.

Module 23 – Revenue

Example 3 Goods shipped subject to conditions: on approval when the buyer has negotiated a limited right of return

23A.5 If there is uncertainty about the possibility of return, the seller recognises revenue when the shipment has been formally accepted by the buyer or the goods have been delivered and the time period for rejection has elapsed.

Example 4 Goods shipped subject to conditions: consignment sales under which the recipient (buyer) undertakes to sell the goods on behalf of the shipper (seller)

23A.6 The shipper recognises revenue when the goods are sold by the recipient to a third party.

Example 5 Goods shipped subject to conditions: cash on delivery sales

23A.7 The seller recognises revenue when delivery is made and cash is received by the seller or its agent.

Example 6 Layaway sales under which the goods are delivered only when the buyer makes the final payment in a series of instalments

23A.8 The seller recognises revenue from such sales when the goods are delivered. However, when experience indicates that most such sales are consummated, revenue may be recognised when a significant deposit is received, provided the goods are on hand, identified and ready for delivery to the buyer.

Example 7 Orders when payment (or partial payment) is received in advance of delivery for goods not currently held in inventory, for example, the goods are still to be manufactured or will be delivered direct to the buyer from a third party

23A.9 The seller recognises revenue when the goods are delivered to the buyer.

Example 8 Sale and repurchase agreements (other than swap transactions) under which the seller concurrently agrees to repurchase the same goods at a later date, or when the seller has a call option to repurchase or the buyer has a put option to require the repurchase, by the seller, of the goods

23A.10 For a sale and repurchase agreement on an asset other than a financial asset, the seller must analyse the terms of the agreement to ascertain whether, in substance, the risks and rewards of ownership have been transferred to the buyer. If they have been transferred, the seller recognises revenue. When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to revenue. For a sale and repurchase agreement on a financial asset, the derecognition provisions of Section 11 apply.

Module 23 – Revenue

Example 9 Sales to intermediate parties, such as distributors, dealers or others for resale

23A.11 The seller generally recognises revenue from such sales when the risks and rewards of ownership have been transferred. However, when the buyer is acting, in substance, as an agent, the sale is treated as a consignment sale.

Example 10 Subscriptions to publications and similar items

23A.12 When the items involved are of similar value in each time period, the seller recognises revenue on a straight-line basis over the period in which the items are dispatched. When the items vary in value from period to period, the seller recognises revenue on the basis of the sales value of the item dispatched in relation to the total estimated sales value of all items covered by the subscription.

Example 11 Instalment sales, under which the consideration is receivable in instalments

23A.13 The seller recognises revenue attributable to the sales price, exclusive of interest, at the date of sale. The sale price is the present value of the consideration, determined by discounting the instalments receivable at the imputed rate of interest. The seller recognises the interest element as revenue using the effective interest method.

Example 12 Agreements for the construction of real estate

23A.14 An entity that undertakes the construction of real estate, directly or through subcontractors, and enters into an agreement with one or more buyers before construction is complete, shall account for the agreement as a sale of services, using the percentage of completion method, only if:

- (a) the buyer is able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether it exercises that ability or not), or
- (b) the buyer acquires and supplies construction materials and the entity provides only construction services.

23A.15 If the entity is required to provide services together with construction materials in order to perform its contractual obligation to deliver real estate to the buyer, the agreement shall be accounted for as the sale of goods. In this case, the buyer does not obtain control or the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. Instead, the transfer occurs only on delivery of the completed real estate to the buyer.

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Example 13 Sale with customer loyalty award

23A.16 An entity sells product A for CU100. Purchasers of product A get an award credit enabling them to buy product B for CU10. The normal selling price of product B is CU18. The entity estimates that 40 per cent of the purchasers of product A will use their award to buy product B at CU10. The normal selling price of product A, after taking into account discounts that are usually offered but that are not available during this promotion, is CU95.

23A.17 The fair value of the award credit is 40 per cent \times [CU18 – CU10] = CU3.20. The entity allocates the total revenue of CU100 between product A and the award credit by reference to their relative fair values of CU95 and CU3.20 respectively. Consequently:

- (a) revenue for product A is $CU100 \times [CU95 \div (CU95 + CU3.20)] = CU96.74$; and
- (b) revenue for product B is $CU100 \times [CU3.20 \div (CU95 + CU3.20)] = CU3.26$

Rendering of services

Example 14 Installation fees

23A.18 The seller recognises installation fees as revenue by reference to the stage of completion of the installation, unless they are incidental to the sale of a product, in which case they are recognised when the goods are sold.

Example 15 Servicing fees included in the price of the product

23A.19 When the selling price of a product includes an identifiable amount for subsequent servicing (for example, after sales support and product enhancement on the sale of software), the seller defers that amount and recognises it as revenue over the period during which the service is performed. The amount deferred is that which will cover the expected costs of the services under the agreement, together with a reasonable profit on those services.

Example 16 Advertising commissions

23A.20 Media commissions are recognised when the related advertisement or commercial appears before the public. Production commissions are recognised by reference to the stage of completion of the project.

Example 17 Insurance agency commissions

23A.21 Insurance agency commissions received or receivable that do not require the agent to render further service are recognised as revenue by the agent on the effective commencement or renewal dates of the related policies. However, when it is probable that the agent will be required to render further services during the life of the policy, the agent defers the commission, or part of it, and recognises it as revenue over the period during which the policy is in force.

Module 23 – Revenue

Example 18 Admission fees

23A.22 The seller recognises revenue from artistic performances, banquets and other special events when the event takes place. When a subscription to a number of events is sold, the seller allocates the fee to each event on a basis that reflects the extent to which services are performed at each event.

Example 19 Tuition fees

23A.23 The seller recognises revenue over the period of instruction.

Example 20 Initiation, entrance and membership fees

23A.24 Revenue recognition depends on the nature of the services provided. If the fee permits only membership, and all other services or products are paid for separately, or if there is a separate annual subscription, the fee is recognised as revenue when no significant uncertainty about its collectability exists. If the fee entitles the member to services or publications to be provided during the membership period, or to purchase goods or services at prices lower than those charged to non-members, it is recognised on a basis that reflects the timing, nature and value of the benefits provided.

Franchise fees

23A.25 Franchise fees may cover the supply of initial and subsequent services, equipment and other tangible assets, and know how. Accordingly, franchise fees are recognised as revenue on a basis that reflects the purpose for which the fees were charged. The following methods of franchise fee recognition are appropriate.

Example 21 Franchise fees: Supplies of equipment and other tangible assets

23A.26 The franchisor recognises the fair value of the assets sold as revenue when the items are delivered or title passes.

Example 22 Franchise fees: Supplies of initial and subsequent services

23A.27 The franchisor recognises fees for the provision of continuing services, whether part of the initial fee or a separate fee, as revenue as the services are rendered. When the separate fee does not cover the cost of continuing services together with a reasonable profit, part of the initial fee, sufficient to cover the costs of continuing services and to provide a reasonable profit on those services, is deferred and recognised as revenue as the services are rendered.

23A.28 The franchise agreement may provide for the franchisor to supply equipment, inventories or other tangible assets at a price lower than that charged to others or a price that does not provide a reasonable profit on those sales. In these circumstances, part of the initial fee, sufficient to cover estimated costs in excess of that price and to provide a reasonable profit on those sales, is deferred and recognised over the period the goods are likely to be sold to the franchisee. The balance of an initial fee is recognised as revenue when performance of all the initial services and other obligations required of the franchisor (such as assistance with site selection, staff training, financing and advertising) has been

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substantially accomplished.

23A.29 The initial services and other obligations under an area franchise agreement may depend on the number of individual outlets established in the area. In this case, the fees attributable to the initial services are recognised as revenue in proportion to the number of outlets for which the initial services have been substantially completed.

23A.30 If the initial fee is collectable over an extended period and there is a significant uncertainty that it will be collected in full, the fee is recognised as cash instalments are received.

Example 23 Franchise fees: Continuing franchise fees

23A.31 Fees charged for the use of continuing rights granted by the agreement, or for other services provided during the period of the agreement, are recognised as revenue as the services are provided or the rights used.

Example 24 Franchise fees: Agency transactions

23A.32 Transactions may take place between the franchisor and the franchisee that, in substance, involve the franchisor acting as agent for the franchisee. For example, the franchisor may order supplies and arrange for their delivery to the franchisee at no profit. Such transactions do not give rise to revenue.

Example 25 Fees from the development of customised software

23A.33 The software developer recognises fees from the development of customised software as revenue by reference to the stage of completion of the development, including completion of services provided for post-delivery service support.

Interest, royalties and dividends

Example 26 Licence fees and royalties

23A.34 The licensor recognises fees and royalties paid for the use of an entity's assets (such as trademarks, patents, software, music copyright, record masters and motion picture films) in accordance with the substance of the agreement. As a practical matter, this may be on a straight-line basis over the life of the agreement, for example, when a licensee has the right to use specified technology for a specified period of time.

23A.35 An assignment of rights for a fixed fee or non-refundable guarantee under a non-cancellable contract that permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform is, in substance, a sale. An example is a licensing agreement for the use of software when the licensor has no obligations after delivery. Another example is the granting of rights to exhibit a motion picture film in markets in which the licensor has no control over the distributor and expects to receive no further revenue from the box office receipts. In such cases, revenue is recognised at the time of sale.

23A.36 In some cases, whether or not a licence fee or royalty will be received is contingent on the occurrence of a future event. In such cases, revenue is recognised only when it is probable that the fee or royalty will be received, which is normally when the event has occurred.

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SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* Standard to transactions and events often requires judgement. Information about significant judgements and key sources of estimation uncertainty are useful in assessing an entity's financial position, performance and cash flows. Consequently, in accordance with paragraph 8.6, an entity must disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Furthermore, in accordance with paragraph 8.7, an entity must disclose information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Other sections of the *IFRS for SMEs* Standard require disclosure of information about particular judgements and estimation uncertainties.

Recognition

Sometimes significant judgement is required in identifying the revenue transaction to which the revenue recognition criteria must be applied. For example:

- When a single sales transaction contains multiple elements, judgement may be needed to identify each element so that the recognition criteria can be applied independently to each separately identifiable component of the multiple-element sale to reflect the substance of the transaction (for example, in substance, the entity is selling several goods and services). See Examples 17–20 of this module, which illustrate the requirements of paragraph 23.8.
- Sometimes significant judgement is required to determine whether two or more transactions are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole (see paragraph 23.8. For example, an entity uses judgement to decide whether the sale of goods subject to a repurchase agreement is the sale of goods with a subsequent repurchase of goods, or a financing transaction with the goods used as collateral for the loan (see Appendix to Section 23 Example 8).
- Sometimes when a construction contract covers multiple assets, significant judgement is required to determine whether each asset is treated as a separate construction contract (see paragraphs 23.18 and 23.19).
- Sometimes significant judgement is required to determine whether a group of contracts, with either a single customer or with several customers, must be treated as a single construction contract (see paragraphs 23.18 and 23.20).
- Sometimes significant judgement is required to determine whether an entity is acting as agent or principal, in particular where the entity has exposure to some but not all of the significant risks and rewards associated with the sale of goods or the rendering of services (see Example 24 in the Appendix to Section 23 and Examples 6–10 of this module, which illustrate the requirements of paragraph 23.4).
- Sometimes significant judgement is required to determine whether sales of assets are part of the entity's ordinary activities and hence give rise to revenue as opposed to other income (see Example 1 of this module, which illustrates the requirements of paragraph 23.1).

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- Sometimes significant judgement is required to determine whether interest and dividends received by the entity are part of the entity's ordinary activities and hence give rise to revenue as opposed to other income.

In some cases significant judgement is required in determining when the revenue recognition criteria are met. For example:

- Significant judgement may be required in determining whether a sale of goods has taken place when some but not all of the risks and rewards of ownership are passed to the customer. For example, the transfer of risks and rewards of ownership may take place at a different time from the transfer of legal title or possession. Furthermore, the law in different countries may cause the recognition criteria to be met at different times. In particular, the law may determine the point in time at which the entity transfers the significant risks and rewards of ownership.
- Significant judgement may be required in determining whether it is probable that the economic benefits associated with the sales transaction will flow to the entity. In some cases, this may not be probable until the consideration is received or until an uncertainty is removed. For example, it may be uncertain that a foreign government authority will grant permission to remit the consideration from a sale in a foreign country. When the permission is granted, the uncertainty is removed and revenue is recognised.
- Significant judgement may be required in assessing whether the outcome of a transaction involving the rendering of services (including construction services) can be estimated reliably.
- Significant judgement may need to be applied in determining whether, having regard to the substance of the agreement, it is more appropriate to recognise royalty revenue on some other systematic and rational basis rather than accruing royalties in accordance with the terms of the relevant agreement.

Measurement

An entity shall measure revenue at the fair value of the consideration received or receivable. The fair value of the consideration received or receivable takes into account the amount of any trade discounts and volume rebates allowed by the entity.

In many cases, little difficulty is encountered in measuring revenue—the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received. However, in some cases significant judgement is required. For example:

- When the inflow of cash or cash equivalents is deferred, the consideration will need to be discounted if the effect of discounting is material. Judgement will need to be applied in determining the imputed rate of interest.
- When multiple element sale transactions take place, the recognition criteria may need to be applied separately to each component of the multiple element sale. Judgement may need to be exercised in allocating the fair value of the consideration received or receivable to the components of the multiple element sale.
- When goods are sold or services rendered in exchange for dissimilar goods, judgement may need to be applied in determining the fair value of the assets exchanged.
- For contracts for services and construction contracts spanning several accounting periods, determining the future costs to be incurred in the transaction often involves significant estimation and judgement.

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COMPARISON WITH FULL IFRS Standards

When the *IFRS for SMEs* Standard was issued in July 2009 and revised in 2015, Section 23 was based on IAS 18 *Revenue* and IAS 11 *Construction Contracts*. IFRS 15 *Revenue from Contracts with Customers* has been issued to replace IAS 18 and IAS 11 with effect for annual periods beginning on or after 1 January 2018. Consequently, in addition to the comparison with IAS 18 and IAS 11, a comparison with IFRS 15 is provided.

IAS 18 Revenue and IAS 11 Construction Contracts

IAS 18 deals with the sale of goods, rendering of services, interest, dividends and royalties. Section 23 shares the same principles for accounting and reporting revenue as IAS 18. IAS 11 deals with construction Contracts and Section 23 shares the same principles for accounting and reporting revenue as IAS 11. Section 23 provides less guidance on how to apply the principles than is in full IFRS Standards. Furthermore, the disclosure requirements of Section 23 are less detailed than those specified in IAS 11.

IFRS 15 Revenue from Contracts with Customers

In May 2014 the Board issued IFRS 15 *Revenue from Contracts with Customers* to replace IAS 18 and IAS 11. The effective date of the new Standard is annual reporting periods beginning on or after 1 January 2018.

IFRS 15 introduces a single comprehensive model for recognising revenue that applies consistently to all contracts for goods or services, including construction contracts. Some of the more significant changes that are relevant to this Module include:

- Section 23 differentiates between goods and services and accounting requirements are specified for each. IFRS 15 differentiates between the performance obligations in a contract (which might be individual components in a multiple element sale transaction) that are satisfied at a point in time or over time;
- IFRS 15 generally contains more guidance, including more guidance on multiple element sales and variable consideration, than is contained in Section 23.
- Contracts that meet the definition of a construction contract under Section 23 would not be accounted for on a percentage of completion basis unless their enforceable contractual rights and obligations satisfy specified criteria in IFRS 15; and

Provisions, Contingent Liabilities and Contingent Assets;

- IFRS 15 contains more comprehensive disclosure requirements than does Section 23.

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TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for accounting and reporting revenue in accordance with the *IFRS for SMEs* Standard by answering the questions below.

Once you have completed the test check your answers against those set out below this test.

Assume all amounts are material.

Mark the box next to the most correct statement.

Question 1

Section 23 is applied in accounting for revenue arising from the sale of goods, the rendering of services, construction contracts in which the entity is the contractor and the use by others of entity assets yielding interest, royalties or dividends. However, Section 23 does not apply to revenue arising from:

- (a) lease agreements.
- (b) changes in the fair value of financial assets and financial liabilities or their disposal.
- (c) the initial recognition and changes in the fair value of biological assets related to agricultural activity.
- (d) all of the above.

Question 2

An entity sold a good with a list price (advertised price) of CU1,000 to a customer on normal credit terms (ie 30 days interest-free credit).

Ten days after the sale, the customer paid the entity CU690 in full and final settlement of a debt that arose from the sale of the goods. CU50 of the amount received from the customer is sales tax collected by the entity on behalf of the national government.

The difference between the list price and the settlement amount are as follows: CU1,000 list price less CU200 trade discount less CU100 volume rebate less CU10 prompt settlement discount.

At what amount should the entity measure revenue from the sale of the good:

- (a) CU640
- (b) CU1,000
- (c) CU700
- (d) CU690

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Question 3

An entity (the seller) bills a customer for goods that are yet to be delivered to the customer. The buyer takes title and accepts the billing, but delivery is delayed in accordance with an instruction from the customer. The seller recognises revenue when the customer takes title, provided:

- (a) it is probable that delivery will be made.
- (b) the item is on hand, identified and ready for delivery to the customer at the time the sale is recognised.
- (c) the customer specifically acknowledges the deferred delivery instructions.
- (d) the usual payment terms apply.
- (e) all of the above.

Question 4

An entity must not:

- (a) recognise revenue from the sale of goods if it retains significant risks and rewards of ownership of goods sold.
- (b) recognise revenue from the rendering of services using the percentage of completion method if it cannot estimate the outcome of the transaction reliably.
- (c) recognise revenue from a construction contract using the percentage of completion method if it cannot estimate the outcome of a contract reliably.
- (d) recognise revenue from any of (a) to (c) above.

Question 5

The percentage of completion method is applied to recognise revenue from:

- (a) the rendering of services and construction contracts.
- (b) the rendering of services only when the outcome of the revenue transaction can be estimated reliably.
- (c) construction contracts only when the outcome of the contract can be estimated reliably.
- (d) both (b) and (c).

Question 6

In a promotion, a car dealer undertakes to service and maintain cars sold in the promotion period free of charge for two years from the date of sale. Furthermore, promotion sales are made on two-year interest-free credit.

The car dealer enters into a sale which has the following separately identified elements to which the entity must apply the recognition criteria separately:

- (a) the sale of goods.
- (b) the sale of goods and the rendering of maintenance services.
- (c) the sale of goods, the rendering of services and a financing element (interest) related to the deferred payment for the sale.

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Question 7

On 1 January 20X1, an entity incurred CU2,000 selling costs to sell a good for CU95,000. The sale agreement provided that the customer pay the CU95,000 selling price in full on 31 December 20X1.

The prevailing rate for one-year credit granted to trade customers in the industry is 10% a year. This is the more clearly determinable way of determining the imputed rate of interest in accordance with paragraph 23.5.

The entity must measure revenue from the sale of the good at:

- (a) CU95,000
- (b) CU86,364
- (c) CU97,000
- (d) CU93,000

Question 8

A construction contractor builds a house under a contract with a fixed price of CU1,000,000. The contractor incurred contract costs of CU10,000, CU890,000 and CU200,000 in 20X1, 20X2 and 20X3 respectively. At the end of 20X1, the outcome of the transaction cannot be estimated reliably however it is probable that the costs incurred in 20X1 will be recoverable. At the end of 20X2, the contractor can estimate the outcome of the contract reliably and estimates costs to complete the contract at CU200,000. The contract was completed in 20X3.

The contractor determines the stage of completion of the construction contract by reference to the proportion that costs incurred for work performed to date bear to the estimated total costs.

In 20X2, the contractor must:

- (a) recognise contract revenue of CU818,182 and contract costs of CU900,000.
- (b) recognise contract revenue of CU808,182 and contract costs of CU890,000.
- (c) recognise contract revenue of CU808,182 and contract costs of CU908,182.
- (d) recognise contract revenue of CU808,182 and contract costs of CU900,000.

Question 9

A construction contractor builds a house under a contract with a fixed price of CU1,000,000. The contractor incurred contract costs of CU200,000, CU400,000 and CU100,000 in 20X1, 20X2 and 20X3 respectively. At the end of 20X1 the contractor estimated (with sufficient reliability) the future costs to complete the contract as CU400,000. At the end of 20X2 the contractor estimated (with sufficient reliability) the future costs to complete the contract as CU150,000. The contract was completed in 20X3.

The contractor determines the stage of completion of the construction contract by reference to the proportion that costs incurred for work performed to date bear to the estimated total costs.

The contractor must recognise contract revenue at:

- (a) CU333,333 in 20X1, CU466,667 in 20X2 and CU200,000 in 20X3.
- (b) CU1,000,000 in 20X1, CU0 in both 20X2 and 20X3.
- (c) CU0 in both 20X1 and 20X2 and CU1,000,000 in 20X3.
- (d) CU333,333 in 20X1, CU333,333 in 20X2 and CU333,333 in 20X3.

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Question 10

Consider the information in Question 9. However, in this example, contract costs incurred at the end of 20X2 included CU50,000 prepaid wages.

The contractor must recognise contract revenue at:

- (a) CU333,333 in 20X1, CU466,667 in 20X2 and CU200,000 in 20X3.
- (b) CU333,333 in 20X1, CU400,000 in 20X2 and CU266,667 in 20X3.
- (c) CU0 in 20X1 and 20X2 and CU1,000,000 in 20X3.
- (d) CU333,333 in 20X1, CU333,333 in 20X2 and CU333,333 in 20X3.

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Answers

Q1 (d) see paragraph 23.2

Q2 (a) see paragraph 23.3

Calculation: CU1,000 list price less CU200 trade discount less CU100 volume rebate less CU10 prompt-settlement discount less CU50 sales tax collected on behalf of the government = CU640.

Q3 (e) see paragraph 23A.3

Q4 (d) see paragraphs 23.10(a), 23.14, 23.16, 23.17 and 23.25

Q5 (d) see paragraphs 23.14 and 23.17

Q6 (c) see paragraph 23.8

Q7 (b) calculation: $\text{CU}95,000 \div 1.1 = \text{CU}86,364$. see paragraph 23.5

Q8 (c) Calculations:

Revenue = $\text{CU}900,000$ costs incurred to relating to work performed date \div $\text{CU}1,100,000$ total expected contract costs $\times 100\% = 81.82\%$ stage of completion. $81.82\% \times \text{CU}1,000,000$ contract price = $\text{CU}818,182$ contract revenue recognised up to the end of 20X2. $\text{CU}818,182$ less $\text{CU}10,000$ revenue recognised in 20X1—limited to recoverable contract costs = $\text{CU}808,182$ recognised in 20X2.

Cost = $81.82\% \times \text{CU}1,100,000$ total expected contract costs = $\text{CU}900,000$ contract costs recognised up to the end of 20X2. $\text{CU}900,000$ less $\text{CU}10,000$ costs recognised in 20X1 = $\text{CU}890,000$ recognised in 20X2. However, total contract costs are expected to exceed total expected contract revenue, therefore an additional loss must be recognised in respect of the onerous contract, ie the loss that would otherwise be recognised in 20X3 if costs in 20X3 are as expected at the end of 20X2: revenue of $\text{CU}181,818$ less costs of $\text{CU}200,000 = \text{CU}18,182$.

Expense = $\text{CU}908,182$ (ie $\text{CU}890,000$ incurred to date + $\text{CU}18,182$ in respect of the onerous contract).

By recognising the additional provision in 20X2, costs recognised in 20X3 will be $\text{CU}181,818$, the same as revenue in 20X3.

Q9 (a) Calculations:

20X1: $\text{CU}200,000$ costs incurred relating to work performed to date \div $\text{CU}600,000$ total expected contract costs $\times 100\% = 33.33\%$ stage of completion. $33.33\% \times \text{CU}1,000,000$ contract price = $\text{CU}333,333$ contract revenue recognised in 20X1.

20X2: $\text{CU}600,000$ costs incurred relating to work performed to date \div $\text{CU}750,000$ total expected contract costs $\times 100\% = 80\%$ stage of completion. $80\% \times \text{CU}1,000,000$ contract price (contract revenue recognised up to the end of 20X2) less $\text{CU}333,333$ (contract revenue recognised in 20X1) = $\text{CU}466,667$ contract revenue recognised in 20X2.

20X3: $\text{CU}1,000,000$ contract price less $\text{CU}800,000$ (contract revenue recognised up to the end of 20X2) = $\text{CU}200,000$ contract revenue recognised in 20X3.

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Q10 (b) Calculations:

20X1: $\text{CU}200,000$ costs incurred relating to work performed to date \div $\text{CU}600,000$ total expected contract costs $\times 100\% = 33.33\%$ stage of completion. $33.33\% \times \text{CU}1,000,000$ contract price = $\text{CU}333,333$ contract revenue recognised in 20X1.

20X2: $(\text{CU}600,000 - \text{CU}50,000 \text{ prepayment}) = \text{CU}550,000$ costs incurred relating to work performed to date. $\text{CU}550,000 + \text{CU}50,000 \text{ prepayment} + \text{CU}150,000$ expected future contract costs = $\text{CU}750,000$ total expected contract costs.

$\text{CU}550,000$ contract costs incurred relating to work performed to date \div $\text{CU}750,000$ total expected contract costs $\times 100\% = 73.33\%$ stage of completion. $73.33\% \times \text{CU}1,000,000$ contract price (contract revenue recognised up to the end of 20X2) less $\text{CU}333,333$ (contract revenue recognised in 20X1) = $\text{CU} 400,000$ contract revenue recognised in 20X2.

20X3: $\text{CU}1,000,000$ contract price – less $\text{CU}733,333$ (contract revenue recognised up to the end of 20X2) = $\text{CU} 266,667$ contract revenue recognised in 20X3.

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APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements for accounting for and reporting of revenue in accordance with the *IFRS for SMEs* Standard by solving the case studies below.

Once you have completed the test check your answers against those set out beneath it.

Case study 1

SME A entered into a contract with a customer to supply and install a machine on 1 January 20X1 and to service the machine on 1 July 20X1 and 1 January 20X2. The cost of the machine to entity A is CU80,000. It is possible for a customer to purchase both the machine and the maintenance services separately.

The customer is contractually obliged to pay SME A CU200,000 on 1 January 20X2. Normal credit terms in the industry are 30 days for the sale of the machine and cash on delivery for the provision of servicing.

The prevailing rate for one-year credit granted to trade customers in the industry is 5% per six-month period. This is the more clearly determinable way of establishing the imputed rate of interest under paragraph 23.5.

Experience has shown that the servicing of a machine of the model sold to the customer is expected to cost SME A CU15,000 to perform the first service and CU25,000 to perform the second service. Assume actual costs equal expected costs. When SME A provides machine services to customers in a separate transaction it earns a margin of 50% on cost.

On 1 January 20X1, the cash selling price of a machine of the model sold to the customer is CU125,964.

SME A is not required to collect any sales taxes.

Part A:

Identify the components of the transaction that SME A must apply the revenue recognition criteria to separately.

Part B:

Calculate the amount of revenue SME A must allocate to each component of the transaction.

Part C:

Prepare accounting entries to record the information set out above in the accounting records of SME A for the years ended 31 December 20X1 and 20X2.

Part D:

Draft an extract showing how revenue could be presented and disclosed in the financial statements of SME A for the year ended 31 December 20X2.

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Answer to case study 1

Part A:

On 1 January 20X1, SME A entered into a single transaction with three identifiable separate components:

- sale (and installation) of a good (the machine);
- rendering of services (machine maintenance services on 1 July 20X1 and 1 January 20X2); and
- providing finance (sale of the machine and rendering of services on extended period credit).

Part B:

Working for receivable—calculate using a spreadsheet or a financial calculator

Date	Opening balance	Interest	Goods	Services	Payment	Closing balance
01/01/20X1	–	–	125,964	–	–	125,964
01/07/20X1	125,964	6,298 ^(a)	–	22,500	–	154,762
31/12/20X1	154,762	7,738 ^(b)	–	–	–	162,500
01/01/20X2	162,500	–	–	37,500	(200,000)	–

(a) $5\% \times \text{CU}125,964 = \text{CU}6,298$

(b) $5\% \times \text{CU}154,762 = \text{CU}7,738$

SME A must allocate the fair value of the consideration receivable from the customer to the three separately identified components of the transaction. As a first step, it must use the discount rate of 5% per six-month period to determine the interest revenue component. Furthermore, one method of determining the amount of revenue attributable to machine maintenance services is using the margin the entity applies to separate machine maintenance services. In this case the selling price of the machine is the residual (ie CU125,964). The basis of allocation between the sale of goods and the rendering of services is reasonable as the residual equals the cash selling price of the machine.

SME A must apply the recognition criteria to the separately identified components of the transaction (for the sale of the good see paragraphs 23.10–23.13, for the rendering of services see paragraphs 23.14–23.16 and for the financing transaction see paragraphs 23.28–23.29(a)).

Part C:

1 January 20X1

Dr Other receivable* CU125,964^(a)
 Cr Profit or loss—revenue from the sale of goods CU125,964

To recognise revenue from the sale of the machine on credit.

* The transaction effectively comprises a loan to the customer rather than a normal trade transaction and is therefore not simply recorded as an account receivable.

Dr Profit or loss—cost of sales CU80,000
 Cr Inventories CU80,000

To recognise the cost of the goods sold.

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1 January 20X1 to 30 June 20X1

Dr	Other receivable	CU6,298 ^(a)	
	Cr Profit or loss—interest revenue		CU6,298

To recognise, as revenue, interest on the outstanding receivable.

1 July 20X1

Dr	Other receivable	CU22,500 ^(a)	
	Cr Profit or loss—revenue from the rendering of services		CU22,500

To recognise revenue from the rendering of maintenance services.

Dr	Profit or loss—cost of services	CU15,000	
	Cr Cash or payables		CU15,000

To recognise the cost of performing maintenance services.

1 July 20X1 to 31 December 20X1

Dr	Other receivable	CU7,738 ^(a)	
	Cr Profit or loss—interest revenue		CU7,738

To recognise, as revenue, interest on the outstanding receivable.

1 January 20X2

Dr	Other receivable	CU37,500 ^(a)	
	Cr Profit or loss—revenue from the rendering of services		CU37,500

To recognise revenue from the rendering of maintenance services.

Dr	Profit or loss—cost of services	CU25,000	
	Cr Cash or payables		CU25,000

To recognise the cost of performing maintenance services.

Dr	Cash	CU200,000	
	Cr Other receivable		CU200,000

To recognise the receipt of cash from the customer.

(a) See the working in Part B above.

Part D:

SME A

Notes to the financial statements for the year ended 31 December 20X2

Note 1 Accounting policies (extract)

Revenue recognition

Revenue is measured at the fair value of the consideration received or receivable, net of discounts and sales related taxes. When consideration is deferred beyond normal business terms it is discounted to present value using an appropriate discount rate.

Revenue from the sale of machinery is recognised when the customer has accepted delivery of the machinery and inspected its installation.

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Revenue from the rendering of machine maintenance services is recognised over the period in which the service is provided based on the ratio of costs incurred to date to estimated total costs.

Interest revenue is recognised using the effective interest method when it is probable that the economic benefits associated with the transaction will flow to the entity and the amount of the revenue can be measured reliably.

Note 5 Revenue

	20X2	20X1
	CU	CU
Sale of goods	–	125,964
Rendering of machine-maintenance services	37,500	22,500
Interest	-	14,036
	<u>37,500</u>	<u>162,500</u>

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Case study 2

In December 20X1, SME B entered into a contract to construct a luxury yacht for a customer for a fixed price of CU2,000,000. In accordance with the agreement for the construction of the yacht, the customer is able to specify the major structural elements of the design of the yacht before construction begins and can specify major structural changes once construction is in progress.

In 20X3, the customer requested, and SME B accepted a variation to the contract. The variation requires SME B to include additional fixtures in the yacht in exchange for CU500,000 additional consideration.

In 20X4, the price of the material used to construct and fit the yacht increased significantly.

SME B bills the customer amounts determined periodically by independent surveys of work completed on the yacht. SME B billed the customer and received payment from the customer as follows:

(amounts in CU)	Years ending				
	31/12/20X1	31/12/20X2	31/12/20X3	31/12/20X4	31/12/20X5
Progress billings in the year	55,000	245,000	955,000	945,000	300,000
Paid in the year	–	300,000	955,000	545,000	700,000
Outstanding at the year end	55,000	–	–	400,000	–

However, SME B determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed to date bear to the latest estimated total contract costs. SME B believes that this method provides the best estimate of the stage of completion.

Cost information:

(amounts in CU)	Years ending				
	31/12/20X1	31/12/20X2	31/12/20X3	31/12/20X4	31/12/20X5
Cumulative costs incurred to date	50,000	250,000	1,000,000	1,900,000	2,550,000
Expected costs to complete	1,450,000	1,350,000	1,200,000	700,000	–
Total expected costs	1,500,000	1,600,000	2,200,000	2,600,000	2,550,000

Part A

Prepare accounting entries to record the information set out above in the accounting records of SME B for the years ended 31 December 20X1–20X5.

Part B

The facts are the same as part A. However, in this part, the agreement for the construction of the yacht provides the customer with only limited ability to influence the design of the yacht (for example, to select a design from a range of options specified by the yacht constructor and to specify only minor variations to the basic design, but the customer cannot specify or alter major structural elements of the yacht). In the jurisdiction, no rights to the underlying yacht are transferred to the buyer otherwise than through the agreement. Consequently, the construction takes place regardless of whether sale agreements exist.

Prepare accounting entries to record the information set out above in the accounting records of SME B for the years ended 31 December 20X1–20X5.

Module 23 – Revenue

Answer to case study 2—Part A

In 20X1

Dr	Contract account – yacht ^(a)	CU50,000 ^(b)	
	Cr Cash		CU50,000

To recognise cost incurred in 20X1 for contract work.

Dr	Trade receivable	CU55,000	
	Cr Contract account—yacht		CU55,000

To recognise a receivable for contract work performed (as certified) in 20X1.

31 December 20X1

Dr	Profit or loss—contract expenses	CU50,000 ^(b)	
Dr	Contract account—yacht	CU16,667	
	Cr Profit or loss—contract revenue		CU66,667 ^(c)

To recognise revenue and expenses from providing construction services in 20X1.

In 20X2

Dr	Contract account – yacht	CU200,000 ^(d)	
	Cr Cash		CU200,000

To recognise cost incurred in 20X2 for contract work.

Dr	Trade receivable	CU245,000	
	Cr Contract account—yacht		CU245,000

To recognise a receivable for contract work performed (as certified) in 20X2.

Dr	Cash	CU300,000	
	Cr Trade receivable		CU300,000

To recognise payments received from the customer in 20X2.

31 December 20X2

Dr	Profit or loss—contract expenses	CU200,000 ^(d)	
Dr	Contract account—yacht	CU45,833	
	Cr Profit or loss—contract revenue		CU245,833 ^(e)

To recognise revenue and expenses from providing construction services in 20X2.

Module 23 – Revenue

In 20X3

Dr	Contract account – yacht	CU750,000 ^(f)	
	Cr Cash		CU750,000

To recognise cost incurred in 20X3 for contract work.

Dr	Trade receivable	CU955,000	
	Cr Contract account—yacht		CU955,000

To recognise a receivable for contract work performed (as certified) in 20X3.

Dr	Cash	CU955,000	
	Cr Trade receivable		CU955,000

To recognise payments received from the customer in 20X3.

31 December 20X3

Dr	Profit or loss—contract expenses	CU750,000 ^(f)	
Dr	Contract account—yacht	CU73,864	
	Cr Profit or loss—contract revenue		CU823,864 ^(g)

To recognise revenue and expenses from providing construction services in 20X3.

In 20X4

Dr	Contract account – yacht	CU900,000 ^(h)	
	Cr Cash		CU900,000

To recognise a receivable for contract work performed (as certified) in 20X4.

Dr	Trade receivable	CU945,000	
	Cr Contract account—yacht		CU945,000

To recognise a receivable for contract work performed (as certified) in 20X4.

Dr	Cash	CU545,000	
	Cr Trade receivable		CU545,000

To recognise payments received from the customer in 20X4.

31 December 20X4

Dr	Profit or loss—contract expenses	CU900,000 ^(h)	
	Cr Contract account—yacht		CU209,441
	Cr Profit or loss—contract revenue		CU690,559 ⁽ⁱ⁾

To recognise revenue and expenses from providing construction services in 20X4.

Dr	Profit or loss—provision for expected loss	CU26,923 ⁽ⁱ⁾	
	Cr Provision for expected loss (liability)		CU26,923

Module 23 – Revenue

In 20X5

Dr	Contract account – yacht	CU650,000	
	Cr Cash		CU650,000

To recognise cost incurred in 20X5 for contract work.

Dr	Trade receivable	CU300,000	
	Cr Contract account—yacht		CU300,000

To recognise a receivable for contract work performed (as certified) in 20X5.

Dr	Cash	CU700,000	
	Cr Trade receivable		CU700,000

To recognise payments received from the customer in 20X5.

31 December 20X5

Dr	Profit or loss—contract expenses	CU650,000 ^(k)	
Dr	Contract account—yacht	CU23,077	
	Cr Profit or loss—contract revenue		CU673,077 ^(l)

To recognise revenue and expenses from providing construction services in 20X5.

Dr	Provision for expected loss (liability)	CU26,923 ⁽ⁱ⁾	
	Cr Profit or loss—provision for expected loss		CU26,923

To recognise the reversal of the prior period provision for expected loss for providing future construction services on onerous contracts.

The calculations and explanatory notes below do not form part of the answer to this case study:

Summary of financial performance:

	Years ending				
	31/12/20X1	31/12/20X2	31/12/20X3	31/12/20X4	31/12/20X5
	CU	CU	CU	CU	CU
Revenue	66,667 ^(c)	245,833 ^(e)	823,864 ^(g)	690,559 ⁽ⁱ⁾	673,077 ^(l)
Expenses	(50,000) ^(b)	(200,000) ^(d)	(750,000) ^(f)	(926,923) ^{(h)+(j)}	(623,077) ^{(k)-(l)}
Profit/(loss)	16,667	45,833	73,864	(236,364)	50,000

Summary of financial position:

	31/12/20X1	31/12/20X2	31/12/20X3	31/12/20X4	31/12/20X5
	CU	CU	CU	CU	CU
Cumulative costs incurred to date	50,000	250,000	1,000,000	1,900,000	2,550,000
Cumulative profit(loss) to date	16,667	62,500	136,364	(100,000)	(50,000)
Cumulative progress billings to date	(55,000)	(300,000)	(1,255,000)	(2,200,000)	(2,500,000)
Gross amount due from (to) the customer for contract work^(a)	11,667	12,500	(118,636)	(400,000)	-

(a) The balance on this account at the end of a reporting period is presented as the amount due from the customer if the account is in debit (an asset) or the amount due to the customer if the account is in credit (a liability).

(b) Contract expense 20X1 = CU50,000 (cost incurred in 20X1).

Module 23 – Revenue

- (c) Contract revenue 20X1 = contract price x percentage of completion.
 $\text{CU2,000,000 (contract price)} \times [\text{CU50,000 (cumulative costs incurred to date)} \div \text{CU1,500,000 (total expected costs)}] \text{ (percentage of completion)} = \text{CU66,667 contract revenue recognised in 20X1.}$
- (d) Contract expense 20X2 = CU250,000 (cumulative costs incurred to date) less CU50,000 (cost incurred in 20X1) = CU200,000 (cost incurred in 20X2).
- (e) Contract revenue 20X2 = (contract price x percentage of completion) less contract revenue 20X1.
 $\text{CU2,000,000 (contract price)} \times [\text{CU250,000 (cumulative costs incurred to date)} \div \text{CU1,600,000 (total expected costs)}] \text{ (percentage of completion)} \text{ less CU66,667}^{(c)} = \text{CU245,833}$
- (f) Contract expense 20X3 = CU1,000,000 (cumulative costs incurred to date) less CU50,000 (cost incurred in 20X1) less CU200,000 (cost incurred in 20X2) = CU750,000 (cost incurred in 20X3).
- (g) Contract revenue 20X3 = (contract price x percentage of completion) less contract revenue 20X1 less contract revenue 20X2.
 $\text{CU2,500,000 (contract price)} \times [\text{CU1,000,000 (cumulative costs incurred to date)} \div \text{CU2,200,000 (total expected costs)}] \text{ (percentage of completion)} \text{ less CU66,667}^{(c)} \text{ less CU245,833}^{(e)} = \text{CU823,864}$
- (h) Contract expense 20X4 = CU1,900,000 (cumulative costs incurred to date) less CU50,000 (cost incurred in 20X1) less CU200,000 (cost incurred in 20X2) less CU750,000 (cost incurred in 20X3) = CU900,000 (cost incurred in 20X4).
- (i) Contract revenue 20X4 = (contract price x percentage of completion) less contract revenue 20X1 less contract revenue 20X2 less contract revenue 20X3.
 $\text{CU2,500,000 (contract price)} \times [\text{CU1,900,000 (cumulative costs incurred to date)} \div \text{CU2,600,000 (total expected costs)}] \text{ (percentage of completion)} \text{ less CU66,667}^{(c)} \text{ less CU245,833}^{(e)} \text{ less CU823,864}^{(g)} = \text{CU690,559}$
- (j) Total expected loss on the contract as at 31.12.X4 = CU100,000 (CU2,500,000 revenue less CU2,600,000 total expected costs)
Total loss booked to date (before any provision) = CU209,441 (loss for X4) less CU73,864 (profit for X3) less CU45,833 (profit for X2) less CU16,667 (profit for X1) = CU73,077.
Provision required at 31 December 20X4 for further expected loss = CU100,000 less CU73,077 = CU26,923.
This is equal to the loss that would otherwise be recognised in 20X5 if costs in 20X5 are as expected at the end of 20X4 (ie revenue of CU673,077^(l) less costs of CU700,000).
- (k) Contract expense 20X5 = CU2,550,000 (cumulative costs incurred to date) less CU50,000 (cost incurred in 20X1) less CU200,000 (cost incurred in 20X2) less CU750,000 (cost incurred in 20X3) less CU900,000 (cost incurred in 20X4) = CU650,000 (cost incurred in 20X5).
- (l) Contract revenue 20X5 = (contract price x percentage of completion) less contract revenue 20X1 less contract revenue 20X2 less contract revenue 20X3 less contract revenue 20X4.
 $\text{CU2,500,000 (contract price)} \times [\text{CU2,550,000 (cumulative costs incurred to date)} \div \text{CU2,550,000 (total expected costs)}] \text{ (percentage of completion)} \text{ less CU66,667}^{(c)} \text{ less CU245,833}^{(e)} \text{ less CU823,864}^{(g)} \text{ less CU690,559}^{(i)} = \text{CU673,077}$

Module 23 – Revenue

Answer to case study 2—Part B

Notes:

In part B the terms of the agreement and all the surrounding facts and circumstances indicate that the agreement is not a construction contract. The agreement is a forward contract that gives the buyer an asset in the form of a right to acquire, use and sell the completed yacht at a later date and an obligation to pay the purchase price in accordance with its terms. Although the buyer might be able to transfer its interest in the forward contract to another party, the entity retains control and the significant risks and rewards of ownership of the work in progress in its current state until the completed yacht is transferred. Therefore, revenue should be recognised only when all the criteria in paragraph 23.10 are met (at completion in this example).

Answer:

In 20X1

Dr Inventories – yacht	CU50,000	
Cr Cash		CU50,000

To recognise cost incurred in construction of inventory—yacht.

In 20X2

Dr Cash	CU300,000	
Cr liability—advance from customer		CU300,000

To recognise payments received from the customer in 20X2.

Dr Inventories – yacht	CU200,000	
Cr Cash		CU200,000

To recognise cost incurred in construction of inventory—yacht.

In 20X3

Dr Cash	CU955,000	
Cr liability—advance from customer		CU955,000

To recognise payments received from the customer in 20X3.

Dr Inventories – yacht	CU750,000	
Cr Cash		CU750,000

To recognise cost incurred in construction of inventory—yacht.

Module 23 – Revenue

In 20X4

Dr	Cash	CU545,000	
	Cr liability—advance from customer		CU545,000

To recognise payments received from the customer in 20X4.

Dr	Inventories – yacht	CU900,000	
	Cr Cash		CU900,000

To recognise cost incurred in construction of inventory—yacht.

31 December 20X4

Dr	Profit or loss—impairment of inventory	CU100,000 ^(a)	
	Cr Inventories – yacht		CU100,000

To recognise the impairment loss in respect of the inventory item.

In 20X5

Dr	Cash	CU700,000	
	Cr liability—advance from customer		CU700,000

To recognise payments received from the customer in 20X5.

Dr	Inventories – yacht	CU650,000	
	Cr Cash		CU650,000

To recognise cost incurred in construction of inventory—yacht.

Dr	Inventories – yacht	CU50,000	
	Cr Profit or loss—reversal of prior period impairment of inventories		CU50,000

To recognise the reversal of the prior period impairment of inventory—yacht.

Dr	Liability—advance from customer	CU2,500,000 ^(b)	
	Cr Profit or loss—revenue		CU2,500,000

To recognise revenue from the sale of the yacht and the extinguishment of the liability to the customer in 20X5.

Dr	Profit or loss—cost of goods sold	CU2,500,000	
	Cr Inventories—yacht		CU2,500,000

To derecognise the inventory sold.

The calculations and explanatory notes below do not form part of the answer to this case study:

(a) CU2,500,000 selling price less CU700,000 expected costs to complete = CU1,800,000 selling price less costs to complete. CU1,900,000 carrying amount less CU1,800,000 selling price less costs to complete = CU100,000 loss.

(b) CU2,000,000 original contract price + CU500,000 variation = CU2,500,000.