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IFRS Foundation: Training Material for the *IFRS® for SMEs*

Module 23 – Revenue

IFRS™

IFRS Foundation: Training Material for the *IFRS® for SMEs*

including the full text of
Section 23 *Revenue*
of the International Financial Reporting Standard (IFRS)
for Small and Medium-sized Entities (SMEs)
issued by the International Accounting Standards Board on 9 July 2009

with extensive explanations, self-assessment questions and case studies

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Module 23 – Revenue

This training material has been prepared by IFRS Foundation education staff and has not been approved by the International Accounting Standards Board (IASB).
The accounting requirements applicable to small and medium-sized entities (SMEs) are set out in the *International Financial Reporting Standard (IFRS) for SMEs*, which was issued by the IASB in July 2009.

INTRODUCTION

This module focuses on the accounting and reporting of revenue in accordance with Section 23 *Revenue* of the *IFRS for SMEs*. It introduces the learner to the subject, guides the learner through the official text, develops the learner's understanding of the requirements through the use of examples and indicates significant judgements that are required in accounting for revenue. Furthermore, the module includes questions designed to test the learner's knowledge of the requirements and case studies to develop the learner's ability to account for revenue in accordance with the *IFRS for SMEs*.

Learning objectives

Upon successful completion of this module you should know the financial reporting requirements for revenue in accordance with the *IFRS for SMEs*. Furthermore, through the completion of case studies that simulate aspects of the real world application of that knowledge, you should have enhanced your ability to account for revenue in accordance with the *IFRS for SMEs*. In particular you should, in the context of the *IFRS for SMEs*, be able:

- to identify when revenue arising from specific transactions and events qualifies for recognition in financial statements in accordance with Section 23
- to 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
- to account for revenues and costs associated with construction contracts
- to present and disclose revenue and construction contracts in financial statements
- to demonstrate an understanding of the significant judgements that are required in accounting for revenue and construction contracts.

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IFRS for SMEs

The *IFRS for SMEs* 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* includes mandatory requirements and other material (non-mandatory) that is published with it.

The material that is not mandatory includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* and explains its purpose, structure and authority.
- implementation guidance that includes illustrative financial statements and a disclosure checklist.
- the Basis for Conclusions, which summarises the IASB's main considerations in reaching its conclusions in the *IFRS for SMEs*.
- the dissenting opinion of an IASB member who did not agree with the publication of the *IFRS for SMEs*.

In the *IFRS for SMEs* the Glossary is part of the mandatory requirements.

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

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. The objective of Section 23 is to specify the financial reporting requirements for revenue and construction contracts.

Revenue is the gross inflow of economic benefits in 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. An exchange for goods or services of a similar nature and value is not regarded as a transaction that generates revenue. However, exchanges for dissimilar items are regarded as generating revenue.

The primary issue in accounting for revenue is determining when to recognise revenue. Revenue is recognised when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably. Section 23 identifies the circumstances in which these criteria will be met and, therefore, revenue will be recognised. It also provides practical guidance on the application of these criteria 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.

General principles for measurement of revenue

Revenue should be measured at the fair value of the consideration 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.

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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. Interest is recognised using the effective interest method.

General principles for recognition of revenue

Recognition means incorporating an item that meets the definition of revenue in the statement of comprehensive income (or income statement when the two statement approach is adopted) when it meets the following criteria:

- 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.

The *IFRS for SMEs* provides guidance for recognising the following specific categories of revenue:

Sale of goods

Revenue arising from the sale of goods should be recognised when, in addition to the general principles for recognition of revenue (see above), all of the following criteria have been satisfied:

- the seller has transferred to the buyer the significant risks and rewards of ownership of the goods;
- the seller retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold; and
- the costs incurred or to be incurred in respect of the transaction can be measured reliably.

Rendering of services

Revenue arising from the rendering of services is recognised by reference to the stage of completion of the transaction at the end of the reporting period (the percentage of completion method) provided that, in addition to the general principles for recognition of revenue, both of the following criteria are met:

- the stage of completion of the transaction at the end of the reporting period can be measured reliably; and
- the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue should be recognised only to the extent of the expenses recognised that are recoverable.

Construction contracts

Like revenue from services (see above), when the outcome of a construction contract can be estimated reliably, contract revenue is recognised 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).

Interest, royalties, and dividends

For interest, royalties and dividends, provided that the general principles for recognition of revenue are satisfied, revenue should be recognised as follows:

- interest: using the effective interest method.
- royalties: on an accruals basis in accordance with the substance of the relevant agreement.
- dividends: when the shareholder's right to receive payment is established.

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 in order 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. These sales are sometimes referred to as multiple element sales. 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).

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REQUIREMENTS AND EXAMPLES

The contents of Section 23 *Revenue* of the *IFRS for SMEs* are set out below and shaded grey. Terms defined in the Glossary of the *IFRS for SMEs* are also part of the requirements. Those terms are in **bold type** the first time they appear in the text of Section 23. The notes and examples inserted by the IFRS Foundation education staff are not shaded. Other annotations inserted by the IFRS Foundation staff are presented within square brackets in ***bold italics***. The insertions made by the staff do not form part of the *IFRS for SMEs* and have not been approved by the IASB.

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.

(d) the use by others of entity assets yielding interest, royalties or dividends.

Notes

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

Revenue is the gross inflow of economic benefits in 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 is income that arises in the course of ordinary activities of an entity and is referred to by a variety of different 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 (ie 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. This is because 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.

Example – revenue

Ex 1 **A chain of bicycle shops holds bicycles for short-term hire and for sale. The bicycles available for hire are used for two or three years and then sold by the shops as second-hand models.**

All shops sell both new and second-hand bicycles.

The shops have three sources of revenue: (i) the sale of new bicycles, (ii) the sale of second-hand bicycles and (iii) the rental of bicycles.

The sale of a second-hand bicycle is not a disposal of property, plant and equipment, even though the bicycle is held for use by the shops for a number of years in their hire business. The bicycle shops are in the business of selling both new and second-hand bicycles. Therefore selling second-hand bicycles is part of the shops' ordinary, recurring activities and hence such sales represent revenue.

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

(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*).

(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

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.

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 per cent discount on orders of 100 units or more. 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 per cent discount on orders of 100 units or more. 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 per cent 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).

The trade rebate is not intended as a financing transaction and it is unlikely that the time value of money is material. Therefore the manufacturer should recognise revenue at the amount paid net of the total volume rebate (ie 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 per cent early settlement discount provided that the customer settles within 30 days of buying the goods. Normal credit terms are 60 days.**

Customer 1 pays CU40,500, within 30 days of the date of purchase, to settle the amount owing for 90 units bought from the entity.

Customer 2 pays CU45,000, 60 days after the date of purchase, to settle the amount owing for 90 units bought from the entity.

The retailer must measure revenue from the sale of goods to customer 1 at CU40,500 (ie 90 units × (CU500 list price less 10% × CU500 early settlement discount)) and revenue from the sale of goods to customer 2 at CU45,000 (ie 90 units × CU500 list price).

Ex 5 **A retailer sells one of its products for CU500 per unit. On one occasion the retailer exchanged 10 units of the product as payment for 10 man-hours of accounting**

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

services from a partner of an international accounting firm. The accounting services received 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 man-hours × CU500 per hour (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 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

In an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal. However, only the part of the gross inflow that is commission for the agent is included in the revenue of the agent.

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 that 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 ordered or purchased by the customer;

(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.

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.

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 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 as it has exposure to the significant risks and rewards associated with the sale of goods (eg inventory obsolescence, defective goods returned, setting sales price etc). The manufacturer is required to measure revenue from the sale of goods at CU100 for each unit of the goods sold by its agent (the intermediary). The manufacturer should recognise revenue on the sale on the date the goods are sold to the customers by the intermediary as this 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 from the provision of services (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 and 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 (eg inventory obsolescence, defective goods returned, setting sales price etc). 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 CU10 sales tax (eg VAT) that it collects on behalf of the national government.**

The retailer must measure revenue at CU90 for each unit sold (ie 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.

Ex 9 **A tobacconist sells cigars for CU10 per unit, inclusive of CU4 tobacco levy that it collects on behalf of the national government. The tobacco levy is paid to the government by the end of the month following the month in which the cigarette 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 (ie CU10 list price less CU4 collected on behalf of the government).

Ex 10 **The facts are the same as in example 9. However, in this example, the CU4 tobacco levy is based on the number of cigars that the tobacconist produces in the month (ie 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 and recognise the levy in profit or loss of the period in which the cigar is produced. 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 present value is the current estimate of the present discounted value of the future net cash flows in the normal course of business.

If the imputed rate of interest is determined as a rate of interest that discounts the nominal amount of the instrument 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. If the rate appears unusually low (taking account of for example the time value of money and the credit worthiness of the buyer), this could mean that the current cash sales price has not been properly identified for that particular 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. This 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.**

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 a financing transaction as well as the sale of goods. Assuming that the implicit discount rate is reasonable (considering for example the time value of money and the credit standing of the customer), the entity must recognise revenue from the sale of goods on the first day of its annual reporting period of CU1,652,893. Furthermore, the entity must recognise interest revenue of respectively CU165,289 and CU181,818 in the current annual reporting period and the next calculated using the effective interest method as illustrated below.

Using a spreadsheet or a financial calculator, the imputed rate of interest is calculated at 10 per cent per year (ie 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 (ie the present value of the future payment).

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

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

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 there are no recent cash transactions from which the entity could 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 per cent per year.**

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

The imputed rate of interest is 10 per cent per year (ie 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%), ie CU2,000,000 future payment × 1 ÷ $(1.1)^2$ = CU1,652,893.

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

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

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 exchange or swap inventories in various locations to fulfil demand on a timely basis in a particular location.

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 at:

(a) 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 asset received nor the asset 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.

Example – revenue on exchange of goods and services

Ex 14 **On 1 January 20X1 a gold merchant that had recently acquired an executive jet received landing rights at a local airport in exchange for 100 ounces of gold, when gold was trading at CU1,000 per ounce.**

The exchange of gold for landing rights is an exchange of dissimilar goods. The gold merchant must measure revenue from the sale of goods (gold) at CU100,000 (ie this is considered to be the fair value of the landing rights (the consideration) received—see paragraph 23.3). In this case the fair value of the consideration received in the exchange transaction is most readily measurable by reference to the fair value of the gold—a commodity traded in an active market.

Calculation: 100 ounces of gold × CU1,000 per ounce = CU100,000.

Examples – no revenue on the exchange of goods and services

Ex 15 **On 1 January 20X1, in order 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 customers.

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 (ie for the capacity given up (received)).

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. *[Refer: Appendix to Section 23, example 8]*

Examples – identification of the revenue transaction

Ex 17 **A car dealership sells new cars to customers. Furthermore, as a limited period offer at no extra charge, the dealer undertakes to maintain the car for three years from the date of purchase. Normally the dealership charges extra for the maintenance services and it is possible for a customer to purchase both the car and the maintenance services separately.**

The dealership enters into a sale that has two separately identified elements. In a single transaction the dealership:

- sells a good—the new car; and
- undertakes to provide maintenance services 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 maintenance services 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 a three-year period from the date of installation and to provide an armed response to the customer in the event that the alarm is triggered. The customer is contractually obliged to pay the security firm CU20,000 three years after the burglar alarm has been installed, 'interest-free'.**

The security firm always installs burglar alarm systems that it sells. It never installs alarm systems sold by others.

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

- 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 if it does not also sell the system. When installation is incidental to the sale of goods, any fees related to installation are recognised when goods are sold (see Appendix to Section 23, examples 2 and 14). A seller normally recognises revenue from the sale of goods when the buyer accepts delivery, and installation and inspection are complete as 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 one 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 per cent per year.

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

The yacht manufacturer must not recognise revenue from the sale of the yacht. 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 recognise the CU1,000,000 received from the bank as a secured liability and the yacht must remain in the manufacturer's inventories.

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

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

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

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.

[Refer: Appendix to Section 23, example 13]

Examples – customer loyalty awards

Ex 21 **A grocery retailer operates a customer loyalty programme. It grants programme members loyalty points when they spend a specified amount on groceries. Programme members can redeem the points for further groceries. The points have no expiry date.**

By supplying award credits to its customers the grocery retailer enters into 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 (the '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 (ie the amount for which the award credits could be sold separately).

In accordance with the requirements of paragraphs 23.10–23.13 the grocery retailer must recognise the consideration allocated to award credits as revenue when award credits are redeemed and it fulfils its obligations to supply awards. The amount of revenue recognised shall be based on the number of award credits that have been redeemed in exchange for awards, relative to the total number expected to be redeemed.

Sale of goods

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.

The law in different countries may cause the recognition criteria in paragraph 23.10 to

be met at different times and so the timing of revenue recognition can differ between countries. However, this does not mean that different revenue recognition criteria are applied in different countries. In particular, the law may determine the point in time at which the entity transfers the significant risks and rewards of ownership.
For example, in some jurisdictions in mail order sales, the seller must give the customers a 'cooling-off period' in which they have an unconditional right to cancel the contract (eg 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 country in which the transaction takes place.

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. *[Refer: paragraphs 23.11—23.13]*

(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.

(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

[Refer: Appendix to Section 23, examples 1, 6 and 7]

Notes

Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity (see paragraph 23.10(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 collectibility of an amount already recognised as revenue, the uncollectible amount or the amount in respect of 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 measured at cost or amortised cost.

Examples – revenue from the sale of goods

Ex 22 **An entity manufactures bespoke (ie customised) equipment for the plastic manufacturing industry (the customers). The equipment is manufactured in parts. The parts are assembled and installed at the customers' factories. Legal title passes**

when a customer accepts delivery and installation and inspection are complete. Customers pay for the equipment upon accepting delivery.

The entity provides to 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 accepted the delivery (ie after inspection) when the risks and rewards of ownership pass 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 23 **The facts are the same as in example 22.**

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*.

Ex 24 **The facts are the same as in example 22. 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 (ie 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 there is no sale and therefore the entity would not recognise a warranty provision (liability) unless it has an onerous contract.

Ex 25 **The facts are the same as in example 22. 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 per cent of the selling price on liquidation of the customer.

The entity recognised revenue (and a trade receivable) when the customer accepted the delivery (ie after inspection) when the risks and rewards of ownership pass 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.

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. *[Refer: Appendix to Section 23, examples 5–8 and 10]*

23.12 An entity does not recognise revenue if it retains significant risks 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.

[Refer: Appendix to Section 23, example 9]

(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.

[Refer: Appendix to Section 23, example 2]

(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.

[Refer: Appendix to Section 23, example 3]

Example – seller retains significant risks of ownership

Ex 26 **An entity accepts an order from a customer for the manufacture of a product that has never been manufactured (eg a spaceship that significantly surpasses current technologies). The entity guarantees a specified level of performance from the product (eg 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 (ie 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 on delivery.

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

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 collectibility 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 27 **A manufacturer of vending machines sells ten 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 only when consideration is received and not on delivery.**

Retention of title may indicate that the risks and rewards of ownership have not passed to the buyer, although passing of title is not a required condition for revenue recognition. Provided that 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 the only rights that the manufacturer retains together with the title are those allowing repossession of the vending machines in the event of non-payment by the amusement park. In other words, substantially all the risks and reward 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 28 **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 1 per cent 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 (ie in this example revenue must be recorded at 99 per cent of the cash selling price).

Notes: If, in a later reporting period, actual returns are found to be greater than or less than 1 per cent (the original estimate), the revision of the estimate is accounted for prospectively (ie a change in estimate in accordance with Section 10 *Accounting Policies, Estimates and Errors*).

Module 23 – Revenue

Rendering of services

Notes

The primary issue in accounting for revenue from rendering services is determining when to recognise revenue. Paragraph 23.14 specifies conditions that must be satisfied for revenue from the rendering of services to be recognised using the percentage of completion method when the outcome of the 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.

(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.

[Refer: Appendix to Section 23, paragraph 23.A1 and examples 14–20]

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 collectibility of an amount already included in revenue, the uncollectible amount, or the amount in respect of 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 to the following:

(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.

Examples – rendering of services

Ex 29 **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.**

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.

The calibration engineer must recognise CU2,500 revenue from the provision of the calibration services when it performs the calibration services in each of June 20X1, December 20X1, June 20X2 and December 20X2. The calibration services are performed by a predetermined number of acts (four calibrations) at specified times (six-month intervals from 1 January 20X1). Hence the amount received on 1 January 20X1 (CU10,000) is initially recognised by the calibration engineer as a liability.

Ex 30 **An entity provides maintenance services to a third party under a contract for a fixed price of CU100,000. The entity initially estimated that its total costs under the contract will be CU60,000. At the end of the reporting period (20X1) the entity has incurred CU50,000 costs and it expects to incur a further CU15,000 costs to complete the maintenance services.**

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

At the end of 20X1 the contract is 76.923 per cent complete—calculation: CU50,000 costs incurred ÷ CU65,000 estimated total contract costs. Accordingly, in 20X1 the entity must recognise revenue of CU76,923—calculation: 76.923% × CU100,000 total expected revenue. Furthermore, the entity must recognise costs of CU50,000.

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 31 **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 per 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 32 **The facts are the same as in example 29.**

(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.

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.)

The calibration services are performed by a predetermined number of acts (four calibrations) at specified times (six-month intervals from 1 January 20X1), ie the requirements in paragraph 23.15 do not apply to this transaction.

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 period of time, experience provides evidence that 20 per cent of the work will be performed in each of years 1 and 2 and 60 per cent of the work will be performed in year 3. This ratio better represents the stage of completion and it reflects the expectation of a constant gross margin over the period of the contract).

Ex 34 **Two research firms (A and B) are competing to develop a compound for a pharmaceutical manufacturer. In accordance with the contractual arrangements, A and B will simultaneously attempt to develop the compound. The manufacturer will pay CU1,000,000 to the research firm that first delivers to it 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 submission of the compound developed to the predetermined specifications in advance of the competing research firm is a specific act that is more significant than any other act. Accordingly, the research firms postpone recognition of revenue until the pharmaceutical manufacturer accepts its compound.

When the pharmaceutical manufacturer accepts the compound A recognises CU1,000,000 revenue.

B does not record any revenue—no economic benefits will flow to B as a result of 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 the transaction costs incurred. Therefore, revenue is recognised only to the extent of costs incurred that are expected to be recoverable. As the outcome of the transaction cannot be estimated reliably, no profit is recognised.

Examples – Outcome of a services transaction 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 equal to 20 per cent of the total damages awarded by the court (or 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.

Ex 36 **The facts are the same as in example 35. However, in this example irrespective of the outcome of the lawsuit the law firm will be remunerated on the basis of 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 not dependent upon the outcome of the lawsuit (ie the client pays irrespective of the outcome of the lawsuit).

The law firm must recognise revenue based on the actual hours worked (ie 120 hours × CU100 per hour = CU12,000).

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 prepare independent bid proposals for the gaming firm to consider. The gaming firm will select one of the proposals developed by A and B for submission as its bid in the competitive bidding process.**

The consultancy firm whose proposal is selected to be submitted by the gaming firm to Government X, 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 an hourly rate that is payable irrespective 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 selection of either bid proposal by the gaming firm cannot be estimated reliably, the consultancy firms cannot recognise any revenue—the expenses recognised are not recoverable.

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 might be that the outcome of the transaction can be estimated with sufficient reliability only when the gaming firm announces which bid proposal it has selected (ie when the gaming firm selects A's proposal).

Construction contracts

Notes

A construction contract is 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. Normally construction contracts will be for a period 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. Furthermore, the requirements in this section cover both the accounting treatment of revenue and costs associated with construction contracts.

Because of the nature of the activity undertaken in construction contracts the date at

which the contract activity is entered into and the date when the activity is completed 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. In particular, determining when the outcome of the contract can be estimated reliably (see paragraph 23.17) and determining the stage of completion of the contract activity.

Paragraphs 23.18–23.20 provide guidance on segmenting contracts into a number of 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 then 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 (eg paragraph 23.14 is also useful in accounting for construction contracts).

Illustration

A contract between a supplier and a customer for the production of a number of goods over a period of time does not meet the definition of a construction contract. For example, a long-term contract between a manufacturer and a wholesaler where the manufacturer supplies the wholesaler with 10,000 kettles over the term of the contract to the wholesaler's predetermined specification would not be a construction contract. It is simply a contract for the production of goods.

The 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.

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 as the supplier sells 10,000 kettles to the wholesaler. In addition, the entire production and delivery of an individual kettle will generally fall into a single accounting period.

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

[Refer: paragraph 23.25 (outcome of the contract cannot be estimated reliably)]
[Refer: paragraph 23.26 (it is probable that total contract costs will exceed total contract revenue)]

Notes

Contract revenue

Contract revenue includes the initial amount of revenue agreed in the contract, as well as variations in contract work, claims and incentive payments, to the extent that it is probable that they will result in revenue and they are capable of being reliably measured. 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 that the customer will accept the claim.
- an incentive payment when the contract is sufficiently advanced for it to be probable that the specified performance standards will be met or exceeded.

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, for example, delays caused by the customer, errors in specifications or design, and disputed variations in contract work.

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.

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 such other costs as are specifically chargeable to the customer under the terms of the contract.

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) the 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 (eg 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 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 on a particular contract.

The estimates of contract costs and contract revenues 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*.

[The examples below illustrate paragraph 23.17. This necessitates illustrating basic stage of completion calculations within the examples. Paragraphs 23.21–23.27 provide guidance for applying the percentage of completion method and reference should be made to these paragraphs and the related examples in this training material for an understanding of the calculations involved.]

Examples – construction contracts

Ex 38 **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 (ie 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 that the entity does not prepare interim financial statements). Therefore there is no need to allocate contract revenue and contract costs to different accounting periods as the stage of completion is nil per cent at the start of the accounting period and 100 per cent at the end of the accounting period.

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

Ex 39 **The facts are the same as in example 38. However, in this example the contractor has a 30 June year-end.**

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 (ie 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 follows:

Stage of completion = costs incurred relating to work performed to date ÷ estimated total costs.

Stage of completion at 30 June 20X1 = 66.67% (ie CU800 ÷ CU1,200 = 66.67%).

For the year ended 30 June 20X1 the contractor must recognise revenue of CU1,333 (= CU2,000 × 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 40 **Under a construction contract, a contractor agrees to receive a 40 per cent fixed return on its direct contract costs from the customer. 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.

At 31 December 20X1 contract costs of CU1,045 have been incurred and the contractor 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 criteria in the contract to be considered direct costs when determining the 40 per cent fixed return.

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.

Stage of completion at 31 December 20X1 = 55% (ie CU1,045 ÷ CU1,900 = 55%).

In the year ended 31 December 20X1 the contractor should recognise revenue of CU1,463 (ie CU1,900 × (100% + 40%) × 55%) and costs of CU1,045 for this contract. A short cut to measuring revenue in a cost plus contract—add the agreed margin to the specified costs, (ie in this example, CU1,045 + 40% × CU1,045 = CU1,463).

In the year ended 31 December 20X2 the contractor should recognise revenue of CU1,057 (ie CU1,800 × (100% + 40%) less CU1,463) and costs of CU955 (ie CU2,000 less CU1,045) for

this contract. Shortcut—CU1,800 + 40% × CU1,800 less CU1,463 recognised in 20X1 = CU1,057.

Ex 41 **A contractor enters into a construction contract on 1 January 20X1. The contractor agrees to a fixed contract price of CU9,000 to build a bridge. The contractor's initial estimate of contract costs is CU8,000. The contractor expects that 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) CU6,068 contract costs ÷ CU8,200 estimated total contract costs = 74% complete.

(c) CU2,093 contract costs ÷ CU8,050 estimated total contract costs = 26% complete.

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

	To date	*Recognised in prior years*	*Recognised in current year*
	CU	*CU*	*CU*
20X1			
Revenue (26% of CU9,000)	2,340	–	2,340
Expenses (26% of CU8,050)	2,093	–	2,093
Profit	**247**	**–**	**247**
20X2			
Revenue (74% of CU9,200)	6,808	2,340	4,468
Expenses (74% of CU8,200)	6,068	2,093	3,975
Profit	**740**	**247**	**493**
20X3			
Revenue (100% of CU9,200)	9,200	6,808	2,392
Expenses	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 *[Refer: paragraph 23.19]* or to a group of contracts together *[Refer: paragraph 23.20]* in order to reflect the substance of a contract or a group of contracts.

Notes

The requirements in paragraphs 23.18―23.20 regarding combining and segmenting contracts aim to reflect the substance of the arrangement, rather than its legal or contractual form. When the criteria in paragraph 23.19 are met, the segregation of a single contract is required (this is not optional). Similarly the combination of a group of contracts is required when the criteria in 23.20 are met.

Sometimes it is necessary to break a single contract into its separately identifiable components and apply the requirements in this section to each of those components separately. Conversely, there may be situations where 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 and 23.20 must be applied.

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.

23.19 When a contract covers a number of assets, the construction of each asset shall be treated as a separate construction contract when:

(a) separate proposals have been submitted for each asset;

(b) 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

(c) the costs and revenues of each asset can be identified.

Example – construction contracts covering a number of assets

Ex 42 **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 criteria in paragraph 23.19 are met:

(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 of each other; and

(c) in order to prepare its separate tenders, the entity must have been able to segregate the costs and therefore the costs and revenues of each asset can be identified. The CU5,000,000 fixed price contract is the sum of those prices.

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 43 **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 system (the 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, separate contracts were entered into with each of the farmers. 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:

(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 has no bearing on the CU100,000 (fixed amount) that each farmer is required to pay the entity; and

(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 designed concurrently and it would be constructed concurrently or in a continuous sequence.

Ex 44 **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 neither 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 (ie 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; and

(c) it is expected that the contracts will be performed concurrently or in a continuous sequence as the bridge cannot be utilised to its full extent without the road and vice versa. Also since 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 is affected by a variety of uncertainties that depend on the outcome of future events. In particular, 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 amount of contract revenue may increase or decrease from one period to the next if a contractor and a customer agree variations or claims, or as a result of 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 on a cumulative basis and so revisions are treated as changes in estimates meaning that prior periods are not adjusted (see Section 10 *Accounting Policies, Estimates and Errors*).

The revised estimates are used when determining 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 and in future periods. For example, in a four-year project, if contract revenue and contract costs are revised in year 2 of the 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 above examples consider the impact on profit or loss of construction contracts. This note considers 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 at the net amount of:

(a) total costs incurred on the contract plus the cumulative recognised profit (or less the cumulative recognised loss); less

(b) progress billings (ie amounts actually invoiced to customers for work performed on a contract whether or not 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 and hence this is 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.

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

Any progress billings which have not been paid by the customer at the reporting date are included in trade receivables (separate from amount due from/to customers).

Examples – stage of completion

Ex 45 **A construction contractor has a fixed price contract for CU100,000 to construct a building (the project).**

The contractor's estimate of total contract costs is CU60,000. It will take two years to construct the building.

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 CU2,000 on cement that is held offsite**
- **an independent surveyor certified that 28 per cent of the contract work is completed**
- **the site was cleared (stipulated in the contract to constitute 10 per cent of the total project), the foundations laid (stipulated as 5 per cent of the total project) and the walls of the building erected (stipulated as 14 per cent of the total project).**

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.[2]

At 31 December 20X1 the stage of completion of the contract is 30 per cent—calculation: (CU20,000 costs incurred less CU2,000 costs relating to future activity) ÷ CU60,000 estimated total contract costs = 30 per cent.

Ex 46 **The facts are the same as in example 45. However, in this example the contractor determines that the stage of completion of the construction contract is measured most reliably by reference to independent surveys of work performed.**

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

Ex 47 **The facts are the same as in example 45 above. However, in this example the contractor determines that the stage of completion of the construction contract is measured most reliably by reference to completion of a physical proportion of the contract work.**

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

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 that contract costs incurred for work performed to date bear to the latest estimated total contract costs, this results in all contract costs being charged to expense in the period incurred, unless such costs relate to future activity on the contract (eg raw materials purchased for future use or payments made to subcontractors in advance of work to be performed under the subcontract). Such costs that relate to future activity may be carried forward as a separate asset (eg raw materials) in the statement of financial position provided that it is probable that they will be recovered under the contract.

Examples of circumstances in which the recoverability of contract costs incurred may not be probable and in which contract costs may need to be recognised as an expense immediately include contracts:

(a) that are not fully enforceable (ie their validity is seriously in question);

(b) the completion of which is subject to the outcome of pending litigation or legislation;

[2] Examples 46 and 47 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).

(c) relating to properties that are likely to be condemned or expropriated;

(d) where the customer is unable to meet its obligations; or

(e) where the contractor is unable to complete the contract or otherwise meet its obligations under the contract.

Examples – recognition of costs on a construction contract

Ex 48 **A construction contractor has a fixed price contract for CU100,000 to construct a building (the project).**

The contractor's initial estimate of total contract costs is CU60,000. It will take two years to construct the building.

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 CU2,000 on cement that is held offsite. The entity's estimate of total contract costs has stayed the same.

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.

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

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

The CU2,000 of cement that is held offsite would be included in the statement of financial position as an asset (inventories) and assuming no progress billings have been made, an amount of CU30,000 would be included in 'the gross amount due from customers for contract work' for this contract, determined as follows:

(a) total costs incurred plus cumulative recognised profits (ie CU18,000 (ie excluding cement inventory) + CU12,000); less

(b) progress billings (nil).

Ex 49 **The facts are the same as in example 48. 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 to be 28 per cent complete.**

In 20X1 the contractor must recognise revenue of CU28,000 (ie 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.[3] Using this method, in 20X1 the contractor would

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[3] The method used in this example (and in all other examples in this module in which the stage of completion is determined other than by reference to the proportion that costs incurred for work performed to date bear to the estimated

recognise contract expenses of CU18,000 in profit or loss (ie CU20,000 less CU2,000 cement inventory). This means profit in 20X1 is CU10,000 (ie 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, determined as follows:

(a) total costs incurred plus cumulative recognised profit (ie CU18,000 + CU10,000); less

(b) progress billings (nil)

Ex 50 **The facts are the same as in example 48. 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 to be 32 per cent complete. Also in this example progress billings of CU30,000 have been made as at the end of 20X1 and the customer has paid CU20,000 of these progress billings.**

In 20X1 the contractor must recognise revenue and expenses of respectively CU32,000 (ie 32% of CU100,000 total expected contract revenue) and CU18,000 (ie CU20,000 less CU2,000 cement inventory). This means 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 cement that is held offsite) is included in inventories and 'the gross amount due from customers for contract work' of CU2,000 for this contract is determined as follows:

(a) total costs incurred plus cumulative recognised profit (ie CU18,000 + CU14,000); less

(b) progress billings (CU30,000).

CU10,000 will be shown in trade receivables (a separate asset) for the progress billings not yet settled by the customer (ie CU30,000 progress billings less CU20,000 received from the customer).

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

23.25 When the outcome of a construction 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.

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total costs) is consistent with the requirements of paragraph 26 of IAS 11 *Construction Contracts* of full IFRSs as issued at 9 July 2009.

Example – outcome cannot be estimated reliably

Ex 51 **A construction contractor has a fixed price contract for CU100,000 to construct a building of a design that has never before been constructed and using materials that have never before been used in the construction of a building (the project).**

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

At the end of 20X1 the contractor cannot estimate the outcome of the contract with sufficient reliability to estimate the project's percentage of completion (ie because of the uncertainties arising from the new design and new materials the entity cannot estimate total expected contract costs with sufficient reliability). It is highly likely that the contract price will be received from the customer.

At the end of 20X1 the contractor must recognise revenue only to the extent of recoverable contract costs incurred (ie 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 construction contract, the expected loss shall be recognised as an expense immediately, with a corresponding provision for an onerous contract (see Section 21).

Example – expected loss on a construction contract

Ex 52 **A construction contractor has a fixed price contract for CU100,000 to construct a building (the project).**

The contractor's initial estimate of total contract costs was CU60,000.

At the end of the first year of the project (20X1) the contractor has incurred CU90,000 contract costs and it expects to incur a further CU30,000 to complete the project.

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.

At the end of 20X1 the contract is 75 per cent complete—calculation: CU90,000 costs incurred ÷ CU120,000 estimated total contract costs. Accordingly, in 20X1 the contractor must recognise revenue of CU75,000 (ie 75 per cent of CU100,000 total expected contract revenue). Furthermore, the contractor must recognise contract costs of CU90,000 and a further expense, provision for the additional expected loss on completing the contract of CU5,000 (ie the amount by which estimated costs to complete the contract (CU30,000) exceed expected future contract revenue (CU25,000)).

In other words, the total expected loss (CU20,000) on the onerous contract must be accounted for in 20X1 (when the contract became onerous).

Note: Assuming no progress billings have been made, an amount of CU70,000 will be included in 'the gross amount due from customers' (an asset in the contractor's statement of financial position) for this contract, determined as follows:

(a) total costs incurred less cumulative recognised loss (ie CU90,000 less CU20,000); less

(b) progress billings (nil).

23.27 If the collectibility of an amount already recognised as contract revenue is no longer probable, the entity shall recognise the uncollectible amount as an expense rather than as an adjustment of the amount of contract revenue.

Example – collectibility of recognised amounts

Ex 53 **In 20X1 a contractor completed the construction of a building for a customer. The contractor recognised the CU100,000 fixed price contract in revenue in the two year construction period using the percentage of completion method.**

In 20X2 when the customer owed the contractor CU100,000 for constructing the building, a tsunami destroyed the customer's business. At the end of 20X2 the liquidator of the customer had informed the customer's creditors that they would receive a liquidation dividend of 10 per cent of the amount owed to them by the customer in full and final settlement of the debt.

The contractor recognised CU100,000 in revenue in the two-year construction period using the percentage of completion method. In 20X2 when the collectibility of the amount was no longer probable, 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.

Examples – accounting for construction contracts from start to finish

The examples below illustrate the accounting for a construction contract from its inception to its completion.

Ex 54 **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's initial estimate of contract costs is CU8,000 over a three-year construction period.

The contractor has a 31 December year-end.

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 below.

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.

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%** [(a)]	**37,5%** [(b)]

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

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

[(a)] CU7,105 ÷ CU10,150 = 0.7

[(b)] CU3,000 ÷ CU8,000 = 0.375

[(c)] CU12,200 less (CU4,500 + CU4,040) = CU3,660

[(d)] 70% × CU12,200 less CU4,500 = CU4,040

[(e)] 37.5% × CU12,000 = CU4,500

[(f)] CU10,050 less CU7,105 = CU2,945

[(g)] CU7,105 less CU3,000 = CU4,105

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
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 55 The facts are the same as in example 54. 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 to be 40 per cent complete and at the end of 20X2 the project was certified to be 65 per cent 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 [(a)]	3,130 [(b)]	4,800 [(c)]
Expenses	(2,945) [(d)]	(4,105) [(e)]	(3,000)
Profit (loss)	**1,325**	**(975)**	**1,800**

(a) CU12,200 less (CU4,800 + CU3,130) = CU4,270

(b) 65% × CU12,200 less CU4,800 = CU3,130

(c) 40% × CU12,000 = CU4,800

(d) CU10,050 less (CU7,105) = CU2,945

(e) CU7,105 less CU3,000 = CU4,105

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	825	1,800
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. *[Refer: Appendix to Section 23, example 26]*

(c) dividends shall be recognised when the shareholder's right to receive payment is established.

Examples – interest, royalties and dividends

Ex 56 **See examples 12 and 13 for examples relating to goods sold on credit.**

In such transactions, revenue is allocated between revenue from the sale of goods and interest revenue for the financing element.

Ex 57 **An entity [Investor] invests CU100,000 in a debenture issued by a major local corporation [Issuer]. The debenture contract requires Issuer, on the sixth anniversary of the loan, to pay Investor CU134,010 to redeem the debenture (ie CU100,000 repayment of capital and CU34,010 'premium'). The debenture has a coupon of zero (ie it is '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. 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.

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

Using a spreadsheet or financial calculator, the effective interest rate on this debenture is 5.00 per cent per year (ie the present value of a single payment of CU134,010 at the end of six years at 5 per cent is CU100,000). The premium of CU34,010 would be amortised as follows:

	Amortisation of premium (5% x Asset)	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 per cent 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 the dividend of CU20,000 until the shareholders approve it on 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 as owners of entity B's ordinary shares on 28 February 20X5.

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.

Ex 59 **The facts are the same as in example 58 above except 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 renewed, the customer will receive updated software that is 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 in revenue immediately on sale of the licence (even if this date is earlier than the start of the licence period) provided the conditions in paragraph 23.10 for recognising revenue from the sale of goods are satisfied.

Note: if customers are able to renew the licence at below market price for a further period or periods (ie at a price lower than that paid in year one), 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).

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 also 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 after sale to perform upgrades and provide support, some or all of the revenue should be spread over the 10-year licence period in order 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 (eg how significant the upgrades and support are compared to the software provided on day 1 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.

(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.

(viii) any other significant types of revenue.

Notes

If an entity has different policies for different types of revenue transactions, the policy for each material type of transaction should be disclosed.

Example – general disclosures

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

Note 1 Accounting policies

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 complete.

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

(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.

(b) the gross amount due to customers for contract work, as a liability.

Example – disclosures about construction contracts

Ex 63 A contractor has reached the end of its first year of operations. All its contract costs incurred have been paid for in cash and all its progress billings and advances have been received in cash. Contract costs incurred for contracts B, C and E include the cost of materials that have been purchased for the contract but which have not been used in contract performance to date. For contracts B, C and E, the customers have made advances to the contractor for work not yet performed.

The status of its five contracts in progress at the end of the reporting period is as follows:

	A	*B*	*C*	*D*	*E*	*Total*
	CU	*CU*	*CU*	*CU*	*CU*	*CU*
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
Progress billings	100	520	380	180	55	1,235
Unbilled contract revenue	45	-	-	20	-	65
Advances	-	80	20	-	25	125

Extract from SME group consolidated statement of financial position at 31 December 20X1:

	Notes	*20X1*	*20X0*
		CU	*CU*
Assets			
Gross amount due from customers for contract work	4	45	–
Prepaid expenses		205	
Liabilities			
Advances from customers		125	–
Gross amount due to customers for contract work	4	50	–

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

Note 1 Accounting policies

Revenue arising from construction contracts

Revenue from construction contracts is recognised on the percentage of completion method, measured by reference to the percentage of contract costs incurred to date to 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 as an expense immediately

Note 2 Revenue

	20X1	*20X0*
	CU	*CU*
Revenue comprises:		
Contract revenue	1,300	–
…		

Extract from the notes to the financial statements at 31 December 20X1

Note 4 Amount due from (to) customers

	20X1			*20X0*
	Asset	*Liability*		
	CU	*CU*	*CU*	*CU*
Aggregate of contract costs incurred and recognised profits and losses	1,045	185	1,230	–
Progress billings	(1,000)	(135)	(1,235)	–
Amount due from (to) customers	**45**	**(50)**		**–**

Calculations that do not form part of the disclosures:

Note: the calculations below illustrate the workings only and would not constitute part of the actual disclosures in the financial statements.

Contract	*A*	*B*	*C*	*D*	*E*	*Total*
Contract costs incurred	110	510	450	250	100	1,420
Less recognised as a separate asset	–	(60)	(100)	–	(45)	(205)
	110	**450**	**350**	**250**	**55**	**1,215**
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
	145	**520**	**380**	**160**	**25**	**1,230**
Progress billings	(100)	(520)	(380)	(180)	(55)	(1,235)
Due from customers	**45**	**–**	**–**	**–**	**–**	**45**
Due to customers	**–**	**–**	**–**	**(20)**	**(30)**	**(50)**

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. Therefore, 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.

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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.

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. Rather, the transfer occurs only on delivery of the completed real estate to the buyer.

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 × [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. Therefore:

(a) Revenue for product A is CU100 × [CU95 / (CU95 + CU3.20)] = CU96.74

(b) Revenue for product B is CU100 × [CU3.20 / (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 (eg 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.

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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 collectibility 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 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 collectible 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 revenues 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.

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* 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* 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 multiple element sales occur, the revenue transaction must be identified 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 (eg in substance the entity is selling several goods and services). See examples 1—3, 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), eg 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 a number of 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, whether with 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 1—4, 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, which illustrates the requirements of paragraph 23.1).

Module 23 – Revenue

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Revenue is recognised when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably. 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 must 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.

COMPARISON WITH FULL IFRSs

Sale of goods, rendering of services, interest, dividends and royalties

Full IFRSs (see IAS 18 *Revenue*) and the *IFRS for SMEs* (see Section 23 *Revenue*) as issued at 9 July 2009 share the same principles for accounting and reporting revenue. However, the *IFRS for SMEs* is drafted in simple language and provides less guidance on how to apply the principles. Furthermore, the disclosure requirements of Section 23 are less detailed than those specified in IAS 18.

Construction contracts

Full IFRSs (see IAS 11 *Construction Contracts*) and the *IFRS for SMEs* (see Section 23 *Revenue*) as issued at 9 July 2009 share the same principles for accounting and reporting construction contracts. However, the *IFRS for SMEs* is drafted in simple language and provides less guidance on how to apply the principles. Furthermore, the disclosure requirements of Section 23 are less detailed than those specified in IAS 11.

Module 23 – Revenue

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for accounting and reporting revenue in accordance with the *IFRS for SMEs* 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

Module 23 – Revenue

Question 3

An entity (the seller) bills a customer for goods that are yet to be delivered to the customer. 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) above.

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.

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% per 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 home 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.

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Question 9

A construction contractor builds a home 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.

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.

Module 23 – Revenue

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: CU95,000 ÷ 1.1 = CU86,364. see paragraph 23.5

Q8 (c) Calculations:
Revenue = CU900,000 costs incurred to relating to work performed date ÷ CU1,100,000 total expected contract costs = 81.82% stage of completion. 81.82% × CU1,000,000 contract price = CU818,182 contract revenue recognised up to the end of 20X2. CU818,182 less CU10,000 revenue recognised in 20X1—limited to recoverable contract costs = CU808,182 recognised in 20X2.

Cost = 81.82% × CU1,100,000 total expected contract costs = CU900,000 contract costs recognised up to the end of 20X2. CU900,000 less CU10,000 costs recognised in 20X1 = CU890,000 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 18.18% (the percentage of future activity on the contract) × CU100,000 the excess of total expected contract costs over total expected contract revenue = CU18,182.

Expense = CU908,182 (ie CU890,000 incurred to date + CU18,182 in respect of the onerous contract).

Q9 (a) Calculations:

20X1: CU200,000 costs incurred relating to work performed to date ÷ CU600,000 total expected contract costs = 33.33% stage of completion. 33.33% × CU1,000,000 contract price = CU333,333 contract revenue recognised in 20X1.

20X2: CU600,000 costs incurred relating to work performed to date ÷ CU750,000 total expected contract costs = 80% stage of completion. 80% × CU1,000,000 contract price (contract revenue recognised up to the end of 20X2) less CU333,333 (contract revenue recognised in 20X1) = CU466,667 contract revenue recognised in 20X2.

20X3: CU1,000,000 contract price less CU800,000 (contract revenue recognised up to the end of 20X2) = CU200,000 contract revenue recognised in 20X3.

Q10 (b) Calculations:

20X1: CU200,000 costs incurred relating to work performed to date ÷ CU600,000 total expected contract costs = 33.33% stage of completion. 33.33% × CU1,000,000 contract price = CU333,333 contract revenue recognised in 20X1.

20X2: (CU600,000 − CU50,000 prepayment) = CU550,000 costs incurred relating to work performed to date. CU550,000 + CU50,000 prepayment + CU150,000 expected future contract costs = CU750,000 total expected contract costs.
CU550,000 contract costs incurred relating to work performed to date ÷ CU750,000 total expected contract costs = 73.33% stage of completion. 73.33% × CU1,000,000 contract price (contract revenue recognised up to the end of 20X2) less CU333,333 (contract revenue recognised in 20X1) = CU 400,000 contract revenue recognised in 20X2.

20X3: CU1,000,000 contract price − less CU733,333 (contract revenue recognised up to the end of 20X2) = CU 266,667 contract revenue recognised in 20X3.

APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements for accounting and reporting events after the end of the reporting period in accordance with the *IFRS for SMEs* by solving the case studies below.

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

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 entity A CU200,000 on 1 January 20X2.

The prevailing rate for one-year credit granted to trade customers in the industry is 5 per cent 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 entity SME A CU15,000 to perform the first service and CU25,000 to perform the second service. Assume actual costs equal expected costs. When entity A provides machine services to customers in a separate transaction it earns a margin of 50 per cent on cost.

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

Part A:
Identify the components of the transaction that entity 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.

Answer to case study 1

Part A:

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

- sale 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% × CU125,964 = CU6,298

[(b)] 5% × CU154,762 = CU7,738

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 cent 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 Trade 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.

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

To recognise the cost of the goods sold.

1 January 20X1 to 30 June 20X1

Dr	Trade receivable	CU6,298[a]	
	Cr Profit or loss—interest revenue		CU6,298

To recognise revenue from the use by others of entity asset (outstanding trade receivable) yielding interest.

1 July 20X1

Dr	Trade 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	Trade receivable	CU7,738[a]	
	Cr Profit or loss—interest revenue		CU7,738

To recognise revenue form the use by others of entity asset (outstanding trade receivable) yielding interest.

1 January 20X2

Dr	Trade 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 Trade receivable		CU200,000

To recognise the receipt of cash from the customer.

[a] See the working in Part B above.

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Part D:

SME A

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

Note 1 Accounting policies

Revenue recognition

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

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

Revenue from the rendering of machine maintenance services is recognised when the outcome can be measured reliably by reference to the stage of completion of the transaction using the proportion that costs incurred for work performed to date bear 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	7,738	6,298
	45,238	154,762

Module 23 – Revenue

Case study 2

In December 20X1 entity 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 entity B accepted a variation to the contract. The variation requires entity 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.

Cost information:

(amounts in CU)	*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**

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. However, entity SME B bills the customer amounts determined periodically by independent surveys of work stage of completion of the yacht. Entity SME B billed the customer and received payment from the customer, as follows:

(amounts in CU)	*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**	**–**

Part A

Prepare accounting entries to record the information set out above in the accounting records of entity 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 (eg 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.

Answer to case study 2—Part A

In 20X1

Dr	Trade receivable	CU55,000	
	Cr Contract account—yacht[a]		CU55,000

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

Dr	Contract account – yacht	CU50,000	
	Cr Cash		CU50,000

To recognise cost incurred in 20X1 for contract work.

31 December 20X1

Dr	Profit or loss—contract expenses	CU50,000[b]	
Dr	Contract account—yacht[a]	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	Trade receivable	CU245,000	
	Cr Contract account—yacht[a]		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.

Dr	Contract account – yacht[a]	CU200,000	
	Cr Cash		CU200,000

To recognise cost incurred in 20X2 for contract work.

31 December 20X2

Dr	Profit or loss—contract expenses	CU200,000[d]	
Dr	Contract account—yacht[a]	CU45,833	
	Cr Profit or loss—contract revenue		CU245,833[e]

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

In 20X3

Dr	Trade receivable	CU955,000	
	Cr Contract account—yacht[a]		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.

Dr	Contract account – yacht[a]	CU750,000	
	Cr Cash		CU750,000

To recognise cost incurred in 20X3 for contract work.

31 December 20X3

Dr	Profit or loss—contract expenses	CU750,000[f]	
Dr	Contract account—yacht[a]	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	Trade receivable	CU945,000	
	Cr Contract account—yacht[a]		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.

Dr	Contract account – yacht[a]	CU900,000	
	Cr Cash		CU900,000

To recognise cost incurred in 20X4 for contract work.

31 December 20X4

Dr	Profit or loss—contract expenses	CU900,000[h]	
	Cr Contract account—yacht[a]		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[j]	
	Cr Provision for expected loss (liability)		CU26,923

To recognise the expected loss for providing future construction services on onerous contracts.

In 20X5

		Dr	Cr
Dr	Trade receivable	CU300,000	
	Cr Contract account—yacht[a]		CU300,000

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

		Dr	Cr
Dr	Cash	CU700,000	
	Cr Trade receivable		CU700,000

To recognise payments received from the customer in 20X5.

		Dr	Cr
Dr	Contract account – yacht[a]	CU650,000	
	Cr Cash		CU650,000

To recognise cost incurred in 20X5 for contract work.

31 December 20X5

		Dr	Cr
Dr	Profit or loss—contract expenses	CU650,000[k]	
Dr	Contract account—yacht[a]	CU23,077	
	Cr Profit or loss—contract revenue		CU673,077[l]

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

		Dr	Cr
Dr	Provision for expected loss (liability)	CU26,923[j]	
	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:

	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)-(j)
Profit	**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).

[c] Contract revenue 20X1 = contract price x percentage of completion. CU2,000,000 (contract price) × [CU50,000 (cumulative costs incurred to date) ÷ CU1,500,000 (total expected costs)] (percentage of completion) = 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. CU2,000,000 (contract price) × [CU250,000 (cumulative costs incurred to date) ÷ CU1,600,000 (total expected costs)] (percentage of completion) less CU66,667[c] = 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 × percentage of completion less contract revenue 20X1 less contract revenue 20X2. CU2,500,000 (contract price) × [CU1,000,000 (cumulative costs incurred to date) ÷ CU2,200,000 (total expected costs)] (percentage of completion) less CU66,667[c] less CU245,833[e] = 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. CU2,500,000 (contract price) × [CU1,900,000 (cumulative costs incurred to date) ÷ CU2,600,000 (total expected costs)] (percentage of completion) less CU66,667[c] less CU245,833[e] less CU823,864[g] = CU690,559

[j] (100% less 73.077%[m] percentage of completion already recognised) = 26.923%. 26.923% × (CU2,600,000 total expected contract costs less CU2,500,000 contract price (including variation)) = CU26,923 expected loss relating to future contract activity accrued for in 20X4.

[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. CU2,500,000 (contract price) × [CU2,550,000 (cumulative costs incurred to date) ÷ CU2,550,000 (total expected costs)] (percentage of completion) less CU66,667[c] less CU245,833[e] less CU823,864[g] less CU690,559[i] = CU673,077

[m] CU1,900,000 cumulative costs incurred to date ÷ CU2,600,000 total expected costs = 73.077% complete at 31 December 20X4.

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Answer to case study 2—Part B

Notes:

In this example (part 2) 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	Cr
Dr	Inventories – yacht	CU50,000	
	Cr Cash		CU50,000

To recognise cost incurred in construction of inventory—yacht.

In 20X2

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

To recognise payments received from the customer in 20X2.

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

To recognise cost incurred in construction of inventory—yacht.

In 20X3

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

To recognise payments received from the customer in 20X3.

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

To recognise cost incurred in construction of inventory—yacht.

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 an onerous contract for the forward sale of a yacht.

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	CU2,550,000	
	Cr Inventories—yacht		CU2,550,000

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.