ACCOUNTING FOR DISCOUNTS UNDER IFRS 15 REVENUE FROM CONTRACTS WITH CUSTOMERS

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Abstract*: Revenue is an important indicator to users of financial statements in assessing an entity's financial performance. In May 2014, the International Accounting Standards Board issued IFRS 15 Revenue from Contracts with Customers which supersedes IAS 18 Revenue and IAS 11 Construction contracts. It applies to all businesses reporting under IFRS for periods beginning on or after 1 January 2018. IFRS 15 specifies the requirements an entity must apply to measure and recognise revenue and the related cash flows. This article considers the application of IFRS 15 and the impact it has on determining the transaction price, especially in case of variable consideration.*

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1. Introduction

Discounts are probably the most popular selling tool in business. Many companies reduce the price for their goods or services in various forms, for example: 'buy 1, get 1 free', bonuses for early payment or for cash payment, gift vouchers, 'get 10% off for purchases over a certain amount', and many others.

When a seller provides a discount to a customer, this directly affects measurement of various items in the financial statements and potentially the accounting treatment for the revenue.

IFRS 15 specifies the accounting treatment for all revenue arising from contracts with customers. It affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other IFRS requirements).

The core principle of IFRS 15 is that an entity will recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This core principle is based on a five-step model framework:

- Step 1: Identify the contract with the customer

IFRS 15 defines a contract as an agreement between two or more parties that creates enforceable rights and obligations. It also sets out specified criteria for every contract that must be met.

- Step 2: Identify the performance obligations in the contract

A performance obligation is a promise in a contract with a customer to transfer a goods or services to the customer. If the goods or services are distinct, the promises are performance obligations and are accounted for separately.

- Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.

- Step 4: Allocate the transaction price to the performance obligations in the contract

For a contract that has more than one performance obligation, an entity should allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation.

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

An entity recognises revenue by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service).

The revenue recognition model has changed from being focused on the transfer of the risks and rewards of ownership (in IAS 18) to being based on the transfer of control (in IFRS 15).

IFRS 15 is an objective-based standard, meaning that reporting entities have the flexibility to choose various methods based on the standard's principles and objectives. The reporting entity shall determine which methods provide the most relevant and useful information for its business and the external users of their financial statements.

2. The transaction price

The transaction price is the amount of consideration that an entity expects to be entitled to in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties.

The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash.

The transaction price includes the effects of two factors: (1) *variable consideration*, which can be either explicit or implicit price concessions (i.e., discounts, rebates, refunds, credits, etc.), and (2) *the consideration of a constraint*. For the purpose of determining the transaction price, an entity assumes that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled or modified.

2.1. Variable consideration

Entities often offer price concessions to their customers, which are items that cause variable consideration under IFRS 15.

Variable consideration is considered to be a component of the transaction price. The transaction price can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items.

Variability in consideration may be explicitly stated in a contract or may be implied. If either of the following situations exists, in addition to the terms of the contract, the consideration promised is variable:

- customary business practices, published policies or specific statements have created a valid expectation that the entity will offer a price concession,
- other facts and circumstances indicate that it is the entity's intent to offer a price concession when entering into the contract with the customer.

Under IFRS 15, an entity is required to estimate variable consideration using either the 'expected value' method or the 'most likely amount' method, based on whichever better predicts the amount of consideration to which the entity is entitled. The entity applies the selected method consistently throughout the contract and for similar types of contracts.

Expected value method – that is the sum of probability weighted amounts in a range of possible outcomes. This may be an appropriate approach if the vendor has a large number of contracts with similar characteristics.

Example 1 - Estimating variable consideration based on the expected value

Entity A enters into a contract with a customer to build an asset for CU 500,000 with a performance bonus of CU 50,000 based on the timing of completion. The amount of the performance bonus decreases by 20% per month for every month beyond the agreed-upon completion date. The contract requirements are similar to contracts Entity A has performed previously, and it concludes that the expected value method is most predictive in this case. Entity A estimates there is a 70% probability of completion by the agreed date, a 20% probability that it will be delayed by a month, and a 10% probability that it will be delayed by two months.

The transaction price is the estimate of the consideration entitled for the work performed. Probability-weighted consideration under the expected value method:

CU 550,000 (fixed fee plus full performance bonus) x 70% = CU 385,000

CU 540,000 (fixed fee plus 80% of performance bonus) x 20% = CU 108,000

CU 520,000 (fixed fee plus 60% of performance bonus) x 10% = CU 52,000

Total probability-weighted consideration is CU 545,000.

The total transaction price of CU 545,000 is based on the probability-weighted estimate. Entity A should update its estimate at each reporting date.

The expected value approach is applicable to the portfolio method of aggregating customer contracts. If management makes reasonable estimates and applies them to a large number of similar contracts, the aggregate amount of revenue should reflect the sum of all of the expected amounts of the individual contracts. The expected value approach is also appropriate in situations where there is a spectrum of amounts possible, as in the example above where there is a bonus for each period prior to a deadline that an entity completes a performance obligation (or a penalty for each period late).

Most likely amount method – that is the most likely outcome from the contract. This may be an appropriate approach if a contract has two possible outcomes, such as a performance bonus which will or will not be allowed (BDO, 2017, pp. 26).

Example 2 - Estimating variable consideration based on the most likely amount

Entity B enters into a contract with a customer to design the interior of an office building for CU 100,000. The terms of the contract include a penalty of CU 10,000 if the service is not provided by a specified date. In determining the transaction price, entity B considers that the most likely amount method is the appropriate approach.

This approach will better predict the amount of consideration that it will ultimately be entitled to. This is because there are only two possible outcomes; either the penalty will be applied or it will not.

The estimated amount of variable consideration is updated at each reporting date to reflect the position at that date, and any changes in circumstances since the last reporting date.

An entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. In addition, an entity shall consider all the information (historical, current and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. (IFRS 15 par. 54)

These two approaches should not be applied simultaneously to the same source of variable consideration within a contract (or aggregate group of similar contracts). However they may be applied separately to different sources of variable consideration within the same contract. For example, if a contract included both a bonus for early completion of a

project, which scaled with the number of days ahead of schedule, and a quality bonus if a project exceeds certain specifications, an entity might choose to use the expected value approach for the early completion bonus, and the best estimate approach for the quality bonus, within the same contract (Riley, 2015).

2.2. Constraining estimates of variable consideration

Companies must adjust the estimated amount of variable consideration downward by excluding any amount that is probably subject to reversal in the future. Specifically, IFRS 15 requires the transaction price to include an amount to the extent that it is highly probable that a significant reversal will not occur. The determination of "highly probable" for IFRS purposes requires a careful evaluation of the uncertainty surrounding variable consideration.

An entity should include in the transaction price some or all of an amount of variable consideration only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved subsequently.

The magnitude and possibility of the reversal in revenue should be determined in order to assess such probability. The risk of revenue reversal increases if the following factors exist:

- The entity has limited experience with similar contracts;
- The estimate is sensitive and can be impacted greatly by different factors outside of the entity's control like as market volatility, legal and regulatory changes, internal factors, etc.;
- The contract has a large number and broad range of possible consideration amounts;
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances (Solanki, 2016).

These estimates should be revised at the end of each reporting period and any changes to the transaction price as a result of the change in estimate should be made in the reporting period.

The recognition of variable consideration is a significant change from prior accounting standard. In the past, entities were required to determine whether the amount of consideration was fixed or determinable, and only recognize the fixed or determinable portion. Under the new standard, the recognition of variable revenue is limited to the amount that is not expected to reverse, instead of being precluded entirely. This may lead to earlier revenue recognition for many entities.

Example 3 – Estimating the amount of variable consideration in case of additional services at discount

Entity C is a provider of digital cable TV and the price for 1-month service is CU 100. In order to increase the number of clients, it offers to each customer who enters in a 1-year contract one month of free service after 1-year period of paid services is over.

The performance obligations in this specific contract are as following:

- digital cable TV services, and
- 1-month of free service, that is the material right at the end of the 1-year period of paid services.

Entity C has to determine the transaction price and to allocate the transaction price to both of the performance obligations.

The transaction price is CU 1,200, as 12 months x CU 100 per month.

The transaction price has to be allocated to both performance obligations based on their relative stand-alone selling prices.

The stand-alone selling price of network services is CU 100 per month.

The stand-alone selling price of the 1-month of free service needs to be estimated based on the probability that the client will use the additional free service for one month. Assuming that the client would like to use services for 1 extra month at no cost, the probability is 100%.

This means that the stand-alone selling price of the 1-month of free service is CU 100, estimated as follows: 100% x the discount of CU 100 (equals the price of 1-month service).

The allocation of the transaction price of CU 1,200 to individual performance obligations under the contract based on their relative stand-alone selling prices (or their estimates) is presented in table no. 1.

Table no. 1. The allocation of the transaction price to individual performance obligations

Performance obligation	**Stand-alone selling price** (CU)	**% on total**	**Revenue** (CU)
Digital cable TV services	1,200	92.3%	1,108*
1-month of free service	100	7.7%	92*
Total	**1,300**	**100%**	**1,200**

* Revenue = CU 1,200 x % on total

The revenue is recognised as services are provided. The client pays CU 100 per month and Entity C recognises only CU 92 that is 1,108/12 as the revenue from digital cable TV services per month.

The journal entry that is recorded every month is as follows:

Debit Accounts receivables: CU 100

Credit Revenues from cable services: CU 92.33

Credit Contract liability: CU 7.67

Entity C makes the same entry each month during 12 months if nothing changes.

After 1 year, the revenue from digital cable services is CU 1,108 (as shown in the above table), but there is also a contract liability of CU 92 (CU 7.67 x 12 months).

The journal entry that is recorded for the 1-month of free service is as follows:

Debit Contract liability: CU 92

Credit Revenues from cable services: CU 92

Under IFRS 15, the reported profits are the same in total, but their pattern over time is different, as it can be seen in table no. 2.

Table no. 2. The revenue measurement under IAS 18 and IFRS 15

Performance obligation	**Under IAS 18** (CU)	**Under IFRS 15** (CU)
Digital cable TV services	1,200	1,108
1-month of free service	0	92
Total	**1,200**	**1,200**

The conclusion is that instead of recognising the revenue from 12 month services at 100 per month and then 0 for the free month, Entity C recognises the revenue from both 12 months of paid service and the material right.

3. Conclusions

The new provisions of IFRS 15 have impact on all entities, but the extent of the impact can vary significantly. The application of the prescriptive and detailed implementation guidance contained within the standard may change, considering the timing and/or the amount of revenue recognition, primarily arising from:

- the number of goods or services in a contractual arrangement over which revenue needs to be allocated;
- the manner in which revenue is allocated to these goods and services; and
- the timing when an entity provides the goods or services to the customer.

Option for additional goods or services at a discount is one area that is likely to require more judgment in the application of the additional guidance and possibly result in accounting changes (Delloitte, 2014, pp. 2).

However, all entities have to reassess their revenue recognition policies and consider whether revisions are needed, as well as to look carefully at the new requirements regarding the revenue measurement.

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