AFA 300: Revenue Recognition - IFRS

Revenue recognition is one of the most important concepts in accounting because it impacts the amount of revenue reported on the income statement or the statement of comprehensive income.

Revenue recognition is covered under **IFRS 15** and **Section 3400**, under ASPE. Under ASPE, revenue is measured under the **earnings-approach,** which recognizes revenue as earned.

However, under IFRS, we use the **contract-based approach** which recognizes and measures revenue based on changes in assets and liabilities.

In this tipsheet we will only cover revenue recognition under IFRS.

Five-Step Criteria

An entity will recognize revenue once the 5 conditions mentioned below have been met.

1. **<u>Identify the contract with a customer.</u>**
   - To ensure the contract is valid, the collectability of the payment needs to be determined. This refers to the customer's ability and intention to pay the amount agreed upon in the contract.
   - If collection is not probable, the contract is seen to be not valid and revenue is not recognized until consideration is received.
   - Make sure to check if the business transaction has **commercial substance,** this means that the expected future cash flows of a business will change as a result of the transaction.
   - At this step, there is **no journal entry required.**

2. **<u>Identify the performance obligations in the contract.</u>**
   - A performance obligation is a promise in a contract to provide a product/service to a customer. This will determine when revenue is recognized.

3. **<u>Determine the transaction price.</u>**
   - This refers to the amount of the consideration the entity expects to receive for transferring the promised goods or services.

- If there is a non-cash consideration, you must recognize the revenue on the basis of the fair value of what is received.

4. **<u>Allocate the transaction price to the performance obligations in the contract.</u>**
    - When there are multiple performance obligations included in the contract, the price of the contract should be allocated based on the stand-alone prices of each component.

5. **<u>Recognize revenue when (or as) the entity satisfies a performance obligation.</u>**
    - Revenue should be recognized when the performance obligation has been satisfied. This occurs when the control of assets has been transferred to the other party.
    - The question of control is answered by looking at the risks (i.e. goods could be damaged, stolen, or destroyed) and the rewards (i.e. goods can be sold) available to the vendor.
    - When a service is to be delivered over a period of time, one of the three criteria need to be satisfied to determine in which period the revenue will be recognized.
        - The customer simultaneously receives and consumes benefits as the business performs it;
        - The business' performance creates or enhances an asset that the customer controls; or
        - The entity's performance does not create an asset with an alternative use to the entity and entity has an enforceable right to payment.

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Contract costs

Any costs incurred to obtain and fulfill a contract are capitalized and amortized over the life of the contract. However, this is only applicable if the costs relate directly to the contract, generate or enhance resources to satisfy performance obligations, and the costs are expected to be recovered.

Some examples of such costs are:

- Insurance
- Depreciation
- Supervision
- Commission costs

Recognizing Sale with Warranty

Warranty is a form of assurance that the company provides to the customer that guarantees that the product will work as intended. Warranty may be provided at an additional cost to the customer or it may be included within the initial purchase price and is of no cost.

There are two methods to recognize warranty.

Method	Use when	Description
Cost Deferral	The warranty is not sold separately and is included in the initial purchase price of the product. There is no additional performance obligation.	A separate provision* needs to be set up for the amount that can be reliably estimated. When the warranty repair happens, the expense causes a decrease in the provision account. The warranty provision is then adjusted at the end of the period to reflect actual warranty cost.

Revenue Deferral	Warranty provides the customer with future services (e.g. repairs) in addition to the product purchased. This warranty is purchased separately. In this case, there are two performance obligations.	A part of the sales revenue is deferred as contract liability. The unearned revenue. The unearned revenue is recognized over time until the warranty expires. Warranty costs are expensed are they occur. There is no adjustment of deferred revenue other than through the passage of time until the warranty expires.

*provision = an account that records a present liability