Accounting (Basics) - Lecture 8

Revenue

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Measurement of revenue

- 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.
- 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.
- 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

Measurement of revenue

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 recognize the difference between the present value of all future receipts and the nominal amount of the consideration as interest revenue.
- An entity shall not recognize revenue:
  a) when goods or services are exchanged for goods or services that are of a similar nature and value, or

Measurement of revenue

b) when goods or services are exchanged for dissimilar goods or services but the transaction lacks commercial substance.

- An entity shall recognize 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.

Identification of the revenue transaction

- An entity usually applies the revenue recognition criteria 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.

Identification of the revenue transaction

- 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 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, i.e. the amount for which the award credits could be sold separately.

Sale of goods

- An entity shall recognize revenue from the sale of goods when all the following conditions are satisfied:
  a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods.
  b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.
  c) the amount of revenue can be measured reliably.
  d) it is probable that the economic benefits associated with the transaction will flow to the entity.
  e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.
- 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

Sale of goods

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.

- An entity does not recognize 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.
  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.
  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

Sale of goods

b) discretion without any reason, and the entity is uncertain about the probability of return.

- If an entity retains only an insignificant risk of ownership, the transaction is a sale and the entity recognizes the revenue. For example, a seller recognizes revenue when it retains the legal title to the goods solely to protect the collectibility of the amount due. Similarly an entity recognizes 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 recognizes a provision for returns.

Rendering of services

- When the outcome of a transaction involving the rendering of services can be estimated reliably, an entity shall recognize 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 “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.
- When services are performed by an indeterminate number of acts over a specified period of time, an entity recognizes revenue on a

Rendering of services

- 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.
- When the outcome of the transaction involving the rendering of services cannot be estimated reliably, an entity shall recognize revenue only to the extent of the expenses recognized that are recoverable.

Construction contracts

- When the outcome of a construction contract can be estimated reliably, an entity shall recognize 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 "percentage of completion method"). Reliable estimation of the outcome requires reliable estimates of the stage of completion, future costs and collectibility of billings.
- 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.

Construction contracts

- 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.

Percentage of completion method

- This method is used to recognize revenue from earlier mentioned rendering services and construction contracts.
- 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.
- An entity shall recognize costs that relate to future activity on the transaction or contract if it is probable that costs will be recovered.

Percentage of completion method

- An entity shall recognize as an expense immediately any costs whose recovery is not probable.
- When the outcome of a construction contract cannot be estimated reliably:
  a) an entity shall recognize revenue only to the extent of contract costs incurred that it is probable will be recoverable, and
  b) the entity shall recognize contract costs as an expense in the period in which they are incurred.
- When it is probable that total contract costs will exceed total contract revenue on a construction contract, the expected loss shall be recognized as an expense immediately, with a corresponding provision for an onerous contract.
- If the collectibility of an amount already recognized as contract revenue is no longer probable, the entity shall recognize the uncollectible amount as an expense rather than as an adjustment of the amount of contract revenue.

Interest, royalties and dividends

- An entity shall recognize revenue arising from the use by others of entity assets yielding interest, royalties and dividends 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.
- An entity shall recognize revenue on the following bases:
  a) interest shall be recognized using the effective interest method.
  b) royalties shall be recognized on an accrual basis in accordance with the substance of the relevant agreement.
  c) dividends shall be recognized when the shareholder's right to receive payment is established.

Disclosures

- 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 recognized 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.