

## **Educational material 5**

# **APPLICATION OF IFRS STANDARDS IN LIGHT OF THE CORONAVIRUS DISEASE (COVID-19) UNCERTAINTY IFRS 15 Revenue from Contracts with Customers**

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### *Disclaimer*

*Please note that every effort has been made to ensure that the advice given in this educational material is correct. Nevertheless, that advice is given purely as guidance to members of SAICA to assist them with particular problems relating to the subject matter of the educational material, and SAICA will have no responsibility to any person for any claim of any nature whatsoever that may arise out of, or relate to, the contents of this educational material.*

## 1. Introduction

This educational material issued by SAICA's Accounting Practices Committee (APC) is prepared for educational purposes, highlighting the requirements within IFRS that are relevant for entities considering how the pandemic affects their accounting, for financial periods ending on or after 31 December 2019 with a specific focus on IFRS 15 - *Revenue from Contracts with Customers*.

Entities are reminded to consider the impact of events related to COVID-19 on both interim and annual financial statements.

This guidance does not change, remove nor add to, the requirements in IFRS. It is intended to support the sound, consistent and robust application of requirements in IFRS. It is of importance that IFRS is applied consistently on the basis of the most robust reasonable and supportable assumptions in the current environment.

## 2. Revenue from contracts with customers – Application of IFRS 15

This educational material sets out the financial reporting considerations arising from COVID-19 for revenue measurement due to the impact of the existence of variable consideration in a contract with a customer, contract modifications and other IFRS 15 considerations.

### 2.1 Variable consideration

IFRS 15 paragraph 47 defines the transaction price as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both. Variability in the transaction price could exist in a variety of forms. An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event (IFRS 15 paragraph 51).

If the consideration promised in a contract includes a variable amount, an entity shall estimate, the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer (IFRS 15 paragraph 50).

An entity shall include in the transaction price some or all of an amount of variable consideration estimated only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved (IFRS 15 paragraph 56). This is what is referred to as the 'constraint' on estimation of variable consideration.

In addition to the above, IFRS 15 paragraph 59 requires the entity to reassess facts and circumstances at the end of each reporting period to ensure the estimation of variable

consideration, and the constraint thereon, depicts the conditions that exist at each reporting date.

IFRS 15 provides the following guidance for estimating, and applying the constraint, to variable consideration:

An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled, and apply this method consistently throughout the contract:

- (a) The expected value—the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
- (b) The most likely amount—the most likely amount is the single most likely amount in a range of possible consideration amounts (i.e. the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not) (IFRS 15 paragraph 53, 54).

In assessing whether it is highly probable that a significant reversal will not occur, an entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

- (a) the amount of consideration is highly susceptible to factors outside the entity's influence (including volatility in a market, the judgement or actions of third parties, weather conditions and a high risk of obsolescence of the promised good or service).
- (b) the uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- (c) the entity's experience with similar types of contracts is limited, or the experience has limited predictive value.
- (d) 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.
- (e) the contract has a large number and broad range of possible consideration amounts (IFRS 15 paragraph 57).

These factors may be particularly important in the current circumstances, due to the uncertainties around COVID-19 and effects of the lockdown and possible ongoing and changing regulations on social distancing.

Where there is a change in the measurement of the transaction price as a result of the above, an entity shall allocate to the performance obligations in the contract any

subsequent changes in the transaction price on the same basis as at contract inception (IFRS 15 paragraph 88).

There is, however, an exception to the above. An entity shall allocate a change in the transaction price entirely to one or more, but not all, performance obligations or distinct goods or services promised in a series that forms part of a single performance obligation only if the criteria in paragraph 85 on allocating variable consideration are met (IFRS 15 paragraph 89).

An entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation if both of the following criteria are met:

- (a) the terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service); and
- (b) allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 73 when considering all of the performance obligations and payment terms in the contract (IFRS 15 paragraph 85).

As noted above, IFRS 15 paragraph 59 requires management to reassess facts and circumstances at the end of each reporting period to ensure the estimation of variable consideration, and the constraints thereon, depicts the conditions that exist at the reporting date<sup>1</sup>. COVID-19 and the Government-imposed lockdown may evidence a change in facts and circumstances which requires management to reassess its estimates of variable consideration in contracts with customers. The lockdown regulations may negatively impact an entity's ability to perform, while the consequent deterioration in economic conditions arising more broadly from COVID-19 may impact customer behaviour resulting in a change in expectations and estimates of the amount of consideration the entity expects to be entitled to.

Management would need to estimate the variable consideration in accordance with paragraph 53 above, depending on the appropriate estimation method (expected value or most likely amount). If current estimates differ from previous estimates, the transaction price should be amended, subject to the constraint in paragraph 56 i.e. only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty is subsequently resolved. If the result is a reduction in the transaction price, the change in estimate may give rise to a reversal of revenue recognised cumulatively. Guidance in paragraph 85 (included above) should also be considered, as it may indicate that the effects of the change in estimate need only be allocated to a single performance obligation or part thereof as opposed to affecting the transaction price allocated to all performance obligations.

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<sup>1</sup> Reporting date refers to both interim and year end reporting.

Given the uncertainty inherent in this situation, the assessments of variability, and estimation thereof, may be challenging and will require the application of management judgement. This would give rise to additional disclosures in the respective financial statements.

### **2.1.1 Disclosure requirements**

An entity shall disclose the judgements, and changes in the judgements, made in applying IFRS 15 that significantly affect the determination of the amount and timing of revenue from contracts with customers. In particular, an entity shall explain the judgements, and changes in the judgements, used in determining both of the following:

- the transaction price; and
- the amounts allocated to performance obligations (IFRS 15 paragraph 123).

An entity shall disclose information about the methods, inputs and assumptions used for determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money and measuring non-cash consideration; and assessing whether an estimate of variable consideration is constrained. (IFRS 15 paragraph 126)

### **2.1.2 Examples**

#### **Example 1 - Volume discount incentive**

An entity enters into a contract with a customer on 1 October 2019 to sell wine at R100 per bottle. If the customer purchases more than 1,000 bottles within the next 12 months, the contract specifies that the price per unit is retrospectively reduced to R90 per bottle. Consequently, the consideration in the contract is variable. The entity has a 30 September financial reporting year end.

For the first quarter ended 31 December 2019, the entity sells 500 bottles to the customer. The entity estimates that the customer's purchases will exceed the 1,000-unit threshold required for the volume discount in the 12-month period. The entity determines that it has significant experience with this product and with the purchasing pattern of the customer. Thus, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (i.e. R100 per unit) will occur when the uncertainty is resolved (i.e. when the total amount of purchases is known). Consequently, the entity recognises revenue of R45,000 (500 units × R90 per unit) for the quarter ended 31 December 2019.

During the second quarter ending March 2020, as a result of COVID-19 the entity only sold an additional 75 bottles of wine to the customer. In the light of the new facts, the entity now estimates that the customer's purchases will not exceed the 1,000-unit threshold for the calendar year and therefore it will be required to do a cumulative catch up adjustment and retrospectively increase the price per unit to R100.

Consequently, the entity recognises revenue of R12,500 for the quarter ended 31 March 2020. That amount is calculated from R7,500 for the sale of 75 units (75 units × R100 per unit) plus the change in transaction price of R5,000 (500 units × R10 price increase) for the increase of revenue relating to units sold for the quarter ended 31 December 2019.

Cumulative revenue recognised to date at 31 March 2020 is therefore R57,500 (575 units × R100).

### **Example 2 - Penalty gives rise to variable consideration**

An entity enters into a contract with a customer to build an asset for R1 million. In addition, the terms of the contract include a penalty of R100,000 if the construction is not completed within three months of a date specified in the contract. The construction is identified as a single performance obligation in step 2, and over time revenue recognition is appropriate in terms of step 5.

At contract inception, 1 January 2020, the entity's assessment was that it believed it would complete the construction on time.

As a result of COVID-19 and the lockdown, the entity was not able to continue with the construction. At 31 March 2020, the interim reporting date of the entity, management believes as a result of the lockdown and the downturn in the economy which impacts its ability to pay suppliers, that there is a 95% probability that the construction would be completed 4 months late, and a 5% probability it would be 5 months late. Management determines that the most likely outcome is the appropriate method to estimate the variable consideration in this contract.

Consequently, as revenue is recognised over time, based on the measure of progress achieved at 31 March 2020, the transaction price utilised in measuring revenue to be recognised at that date would be based on the contract price of R1 million less R100,000. Management calculates the measure of progress to be 25%, therefore revenue recognised at 31 March 2020 is R225,000 ((R1 million – R100,000) × 25%).

## **2.2 Contract modifications**

A contract modification is a change in scope or price of a contract that is approved by the parties to the contract (IFRS 15 paragraph 18). The existence of COVID-19 and the lockdown, and any consequential restrictions to trade, does not automatically result in a contract modification in terms of IFRS 15.

A contract modification would only arise from a renegotiation of the contract that either creates new enforceable rights and obligations or changes existing enforceable rights and obligations of the parties to the contract and is approved in writing, or by oral agreement or implied by customary business practices. If the parties have not approved a contract modification, an entity shall continue to apply IFRS 15 to the existing contract until the contract modification is approved (IFRS 15 paragraph 18).

IFRS 15 provides guidance as to how an entity should account for contract modifications. Therefore, if as a result of COVID-19 the parties agree to modify the contract in accordance with paragraph 18 above, the following guidance applies:

An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

- (a) the scope of the contract increases because of the addition of promised goods or services that are distinct performance obligations; and
- (b) the price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract (IFRS 15 paragraph 20).

If a contract modification is not accounted for as a separate contract in accordance with paragraph 20, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (i.e. the remaining promised goods or services) in whichever of the following ways is applicable:

- (a) An entity shall account for the contract modification as if it were a termination of the existing contract and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 22(b)) is the sum of:
  - i) the consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognised as revenue; and
  - ii) the consideration promised as part of the contract modification.
- (b) An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress towards complete satisfaction of the performance obligation, is recognised as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (i.e. the adjustment to revenue is made on a cumulative catch-up basis).
- (c) If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph. (IFRS 15 paragraph 21)



### 2.3 Other considerations in terms of IFRS 15

COVID-19 may have an impact on other areas of the entity's contracts with its customers that would require the entity to reconsider certain judgements already made in its application of IFRS 15.

Highlighted below are further areas that may require consideration:

- 1) Criteria for a contract. Paragraph 9(e) requires that, for a contract to exist, it must be probable that the entity will collect the consideration to which it is entitled in exchange for the goods or services that will be transferred to the customer. Paragraph 13 states that if a contract with a customer meets the criteria in paragraph 9 at contract inception, an entity shall not reassess those criteria unless there is an indication of a significant change in facts and circumstances. For example, if a customer's ability to pay the consideration deteriorates significantly, an entity would reassess whether it is probable that the entity will collect the consideration to which the entity will be entitled in exchange for the remaining goods or services that will be transferred to the customer. COVID-19 may significantly affect the customer's ability and/intention to pay the consideration when it is due. Should the entity conclude that the criteria in paragraph 9 are no longer met, and the entity chooses to continue to perform under the contract, the entity does not recognise any further revenue associated with the contract. Any previously recognised revenue up until this point is not reversed. The entity accounts for any impairment of the existing receivable in accordance with IFRS 9 - *Financial Instruments*. The entity should also consider the onerous contract requirements mentioned below.
- 2) Effects on contract balances
  - (a) Where the entity has already received advance consideration from the customer prior to satisfying its performance obligation(s), IFRS 15 requires a contract liability to be recognised. COVID-19 may result in delays in the entity performing in terms of the contract. In such instances, the entity continues to recognise a contract liability until such time that the entity is able to perform in terms of the contract. This will necessitate the entity updating its contract liability disclosures as required by paragraphs 116 - 118. It may also be necessary to revise estimates regarding any significant financing component (refer to the guidance on variable consideration above) if the contract is a long-term contract.
  - (b) Where the entity has partially performed under the contract by transferring goods or services promised, but has not yet invoiced the customer, the entity recognises a contract asset. Delays arising from COVID-19 may delay further performance. The entity should continue to recognise a contract asset until such time that it is able to complete its performance and invoice under the contract. The extent of revenue recognised would depend on the method of measuring progress applied in recognising revenue over time. The requirements of paragraphs 116 -118 insofar as they relate to contract asset disclosures should also be updated

accordingly. Contract assets are assessed for impairment in accordance with IFRS 9.

- 3) Onerous contracts. Revised estimates of penalties on a contract (refer to the guidance on variable consideration above) due to delayed or incomplete performance under a contract, may reduce the transaction price to the point where the unavoidable costs to fulfil the contract exceed the transaction price, i.e. the contract becomes loss-making, or onerous. SAICA's Educational Material on *Application of IFRS Standards in Light of the Coronavirus Disease (COVID-19) Uncertainty - Onerous contracts* IAS 37 sets out the financial reporting considerations arising from COVID-19 for onerous contracts.
- 4) To determine whether the events linked to COVID-19 are adjusting or non-adjusting events, refer to SAICA's Educational Material 1 - *Application of IFRS Standards in Light of the Coronavirus Disease (COVID-19) Uncertainty - Events after the Reporting Period and Going Concern*. Where the events are identified as adjusting, the guidance above should be applied. Where the events are non-adjusting, in terms of IAS 10 - *Events after the Reporting Period* paragraph 10 an entity shall not adjust the amounts recognised in its financial statements to reflect these events. If non-adjusting events after the reporting period are material, an entity shall disclose the nature of the event, and an estimate of its financial effect (which would involve the application of the above guidance) or a statement that such an estimate cannot be made.