Allocation of the Transaction Price to Performance Obligations and the Effect of Financing

Standard required:

115 Revenue from Contracts with Customers

CASE STUDY

Ind AS 115 – Allocation of the Transaction Price to Performance Obligations and the Effect of Financing

Learning outcome

This case study discusses how to allocate the transaction price to performance obligations when a customer receives a discount for purchasing a bundle of products. Secondly, this case study also shows how to adjust the transaction price when the contract contains a significant financing component because of the length of the time between when the customer pays for the products and when the entity transfers the products to the customer, considering the prevailing interest rates in the market. Lastly, how an entity should present the effects of financing (interest expense and interest revenue) separately from revenue from contracts with customer in the Statement of Profit and Loss has also been discussed.

Introduction

A customer receives a discount for purchasing a bundle of products if the sum of the stand-alone selling price of those promised products in the contract exceeds the promised consideration in a contract. Except when an entity has observable evidence that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity should allocate a discount proportionally to all performance obligations in the contract.

Since the transaction price is received in advance and the entity will satisfy the performance obligations for each of the products at different points in time, the entity needs to adjust the transaction price (ie, consideration which is received in advance) and accretes the contract liability (which is recognised at contract inception) by recognising interest at the rate, which is the entity's incremental borrowing rate.

Case Study

The reporting period of Delta Ltd ends on 31 March each year. On 1 April 20x2, Delta Ltd enters into a contract to sell products A and B against an upfront payment of CU 150,000. Delta Ltd regularly sells products A and B individually, thereby establishing the following *stand-alone selling prices* [1] –

Product	Stand-alone selling price (CU)
A	40,000
B	120,000
Total	160,000

Delta Ltd will satisfy the *performance obligations* [2] for each of the products at different points in time, as under –

Product	Delivery date
A	31 March 20x4
B	31 March 20x5

To determine the point in time at which the customer will obtain control of the promised products and Delta Ltd will satisfy performance obligations, Delta Ltd will consider the following indicators of the transfer of control –

- Delta Ltd will transfer physical possession of the products which will indicate that the customer will have the ability to direct the use of, and obtain substantially all of the remaining benefits from the products or to restrict the access of other entities to those benefits.
- The customer will accept the products which will indicate that it will obtain the ability to direct the use of, and obtain substantially all of the remaining benefits from the products.
- The customer will have the significant risks and rewards of ownership of the products which will indicate that the customer will obtain the ability to direct the use of, and obtain substantially all of the remaining benefits from, the products.

Delta Ltd's incremental borrowing rate (ie, the rate of interest that an entity would have to pay to borrow over a similar term, and with a similar security, the funds necessary to purchase a similar asset) is 6%.

The following costs were incurred to complete the contract (figures in CU) –

Year	Materials		Labour		Overheads		Total (product wise)		Total (year wise)
Mar 31	A	B	A	B	A	B	A	B	
20x3	4,000	22,000	5,000	12,000	8,000	11,000	17,000	45,000	62,000
20x4	6,000	18,000	4,000	8,000	3,000	8,000	13,000	34,000	47,000
20x5	–	5,000	–	2,000	–	4,000	–	11,000	11,000
							30,000	90,000	

Paragraph 73 of Ind AS 115 states that the objective when allocating the *transaction price* [3] is for an entity to allocate the transaction price to each distinct product in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised products to the customer.

The customer receives a discount of CU 10,000 (CU 160,000 – CU 150,000) for purchasing two products A and B, because the sum of the stand-alone prices (CU 160,000) exceeds the paid consideration (CU 150,000).

As per **paragraph 76 and 77 of Ind AS 115**, to allocate the transaction price to each performance obligation on a relative stand-alone selling price basis, an entity shall determine the stand-alone selling price at contract inception of the distinct product underlying each performance obligation in the contract and allocate the transaction price in proportion to those stand-alone selling prices. The best evidence of a stand-alone selling price is the observable price of a product when the entity sells that product separately in similar circumstances and to similar customers.

[1] **Stand-alone selling price** of a good or service is the price at which an entity would sell a promised good or service separately to a customer.

[2] **Performance obligation** is a promise in a contract with a customer to transfer to the customer either –

- a good or service (or a bundle of goods or services) that is distinct; or
- a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

[3] **Transaction price** for a contract with a customer is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (eg, sales taxes).

Since Delta Ltd regularly sells products A and B separately, the stand-alone selling prices of the products are directly observable. The discount, and therefore, the transaction price, is allocated as follows –

Product	Stand-alone selling price (CU)	Allocated transaction price (CU)
A	40,000	37,500 (40,000 ÷ 160,000 x 150,000)
B	120,000	112,500 (120,000 ÷ 160,000 x 150,000)
Total	160,000	150,000

An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The nature, timing and amount of consideration promised by a customer affect the estimate of the transaction price. As per **paragraph 60 of Ind AS 115**, in determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of products to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

According to **paragraph 61 of Ind AS 115** the objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognise revenue at an amount that reflects the price that a customer would have paid for the promised products if the customer had paid cash for those products when (or as) they transfer to the customer (ie, the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

- the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods; and
- the combined effect of both the following –
  - the expected length of time between when the entity transfers the promised goods to the customer and when the customer pays for those goods; and
  - the prevailing interest rates in the relevant market.

In accordance with **paragraph 65 of Ind AS 115**, an entity shall present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the Statement of Profit and Loss. Interest revenue or interest expense is recognised only to the extent that a contract asset (or receivable) or a contract liability is recognised in accounting for a contract with a customer.

An entity should recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised product (ie, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

In this example, Delta Ltd satisfies each performance obligation separately at a point in time. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfied a performance obligation, Delta Ltd should consider the requirements for control, which is as under –

Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

Therefore, in respect of product A, the performance obligation is satisfied on 31 March 20x4; and in respect of product B, the performance obligation is satisfied on 31 March 20x5.
In this case, Delta Ltd should –

- recognise a *contract liability* [4] for receipt of the upfront payment; and
- recognise a *contract asset* [5] from the costs incurred to fulfil a contract only if those costs meet the following criteria:
    - the costs relate directly to a contract; and
    - the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.

[4] **Contract liability** is an entity's obligations to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

[5] **Contract asset** is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (eg, the entity's future performance).

Journal

20x2

Apr 1	1.	Cash	CU 150,000
		Contract liability	CU 150,000

Balance Sheet as at 31 March 20x3 (Extract)

	CU
Liabilities	
Non-current liabilities	
Contract liability	112,500
Current liabilities	
Contract liability	37,500

20x4

Mar 31	1.	Interest expense	CU 4,635 [37,500 x $(1.06)^2$ – 37,500]
		Contract liability	CU 4,635
	2.	Contract liability	CU 42,135 (37,500 + 4,635)
		Revenue	CU 37,500
		Interest income	CU 4,635

Balance Sheet as at 31 March 20x4 (Extract)

	CU
Equity	
Retained earnings	4,500
Liabilities	
Current liabilities	
Contract liability	112,500

Statement of Profit and Loss for the year ended 31 March 20x4 (Extract)

	CU
Revenue	37,500
Cost of sales (CU 17,000 + CU 13,000)	30,000
Gross profit	7,500
Interest expense	(4,635)
Interest income	4,635
Accounting profit	7,500
Tax expense –	
Current tax @ 40%	3,000
Profit for the period	4,500

20x5

Mar 31	1.	Interest expense	CU 21,490 [112,500 x $(1.06)^3$ – 112,500]
		Contract liability	CU 21,490
	2.	Contract liability	CU 133,990 (112,500 + 21,490)
		Revenue	CU 112,500
		Interest income	CU 21,490

Balance Sheet as at 31 March 20x5 (Extract)

	CU
Equity	
Retained earnings	13,500

Statement of Profit and Loss for the year ended 31 March 20x5 (Extract)

	CU
Revenue	112,500
Cost of sales (CU 79,000 + CU 11,000)	90,000
Gross profit	22,500
Interest expense	(21,490)
Interest income	21,490
Accounting profit	22,500
Tax expense –	
Current tax @ 40%	9,000
Profit for the period	13,500

Conclusion

At contract inception, an entity should allocate the transaction price in proportion to the stand-alone selling prices of the distinct products underlying each performance obligation in the contract.

Though the customer has made an upfront payment, the entity does not have a right to consideration that is unconditional (a receivable) until the products are transferred to the customer. If a customer pays consideration before the entity transfers a product to the customer, the entity should present the contract as a contract liability when the payment is made. Likewise, if an entity performs by creating or enhancing an asset (eg, work-in-progress) that the customer controls as the asset is created or enhanced and the entity does not have a right to consideration that is unconditional (a receivable) until the product is transferred to the customer, the entity should present the contract as a contract asset.

In determining the transaction price, an entity should adjust the amount of consideration (that has been received) to reflect the time value of money if the contract has a financing component that is significant to the contract. An entity should present the effects of financing separately from revenue (as interest expense and interest income) in Statement of Profit and Loss.