Recognising revenue in mobile phone services
(Relevant to AAT Examination Paper 7 – Financial Accounting and PBE Paper I – Financial Accounting)

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Introduction

Elite Phone Limited ("Elite") provides mobile phone services to its customers. According to an agreement offered by Elite to a customer, Elite will provide a new-generation smart phone and maintenance support free of charge provided that the customer joins a specified plan and pays for mobile phone services for 60 months.

Mr. Mike Chung, the managing director of Elite, has raised the following questions:
(a) Do we need to recognise provision of the smart phone and mobile phone services, as well as maintenance support, as revenue?
(b) When should we recognise such goods and services as revenue in the financial statements of Elite?

To answer the above questions, we must follow the five-step model for recognising revenue from customer contracts in accordance with HKFRS 15 *Revenue from Contracts with Customers.*

Step 1: Identify the contract(s) with a customer

HKFRS 15 defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations". The requirements of HKFRS 15 apply to each contract that has been agreed upon with a customer and that meets the following specified criteria:
- The contract has been approved by the parties to the contract and such parties are committed to satisfying their perspective obligations.
- The contract has enforceable rights that can be identified regarding the goods or services to be transferred.
- The payment terms can be identified.
- The contract has commercial substance.
- It is probable that the entity will collect the consideration to which it will be entitled.

Example 1

In reference to the agreement made between Elite and a customer described above, all of the above five conditions can be met as follows:
- As the agreement has been signed by Elite and the customer, this shows that both parties have approved the contract and are committed to performing their relevant performance obligations.
- Both Elite and the customer have a present contractual right to receive service fees and mobile phone services respectively.

- As the agreement commits Elite to providing mobile phone services in exchange for a service fee for 60 months, the payment terms can be identified.
- The agreement between Elite and the customer has commercial substance because the risk, timing or amount of Elite's future cash flows is expected to change as a result of the contract.
- It is probable that Elite will receive a service fee for 60 months from the customer.

Therefore, a contract can be identified in the agreement between Elite and the customer, and the HKFRS 15 model is therefore applicable to that contract.

Step 2: Identify the performance obligations in the contract

After having identified a contract with a customer, the next step is to consider the promises made within that contract for the delivery of goods or services to that customer. Such promises are performance obligations. Examples of promises that may appear within a contract include selling goods, providing services, constructing assets, granting licences, etc.

A contract may contain one promise — for example, a promise to sell goods to the customer — in which case only a single performance obligation is clearly identified. However, there may be several promises within one contract, for example, a promise to provide a licence to use a software package together with installation services and technical support. These performance obligations are accounted for separately if the promised goods or services are "distinct". HKFRS 15 states that a good or service is "distinct" if both of the following criteria are met:

(a) The customer can benefit from the good or service on its own or together with other resources that are readily available to the customer (i.e. the good or service is capable of being distinct).

(b) The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e. the promise to transfer the good or service is distinct within the context of the contract).

For example, suppose that an entity has signed a contract with a customer to provide 3 years' free servicing as an incentive to the customer to buy a motor van from said entity rather than from another seller. In this case, the contract includes two performance obligations, which should be accounted for separately, as the promised good or service is distinct. Such good or service is "distinct" because both of the following criteria are fulfilled:

- The provision of the van and the servicing is ***capable of being distinct*** because the customer could obtain each from the entity or from another supplier.
- In the context of this contract, the entity is not integrating the van and the servicing, none of the goods or services modifies another and the goods or services are not highly interrelated. Thus, each promise is ***separately identifiable***.

Therefore, two performance obligations can be identified in this contract: One is the sale of a motor van and the other is the provision of 3 years' servicing.

Example 2

Referring again to the service agreement provided by Elite, the agreement includes three performance obligations as follows:

(a) the provision of a smart phone
(b) the provision of mobile phone services for 60 months
(c) the provision of maintenance support for 60 months.

Each of the promises in the contract to transfer goods or services is ***separately identifiable***, i.e. the smart phone, mobile phone services and maintenance support are not highly interdependent or highly interrelated, and each good or service provided (the provision of a smart phone, mobile phone services and maintenance support) is ***capable of being distinct*** because the customer could obtain a smart phone, contract for mobile phone service and maintenance support respectively from an alternative supplier.

Step 3: Determine the transaction price

After identifying the performance obligations in the contract, step 3 is to determine the transaction price. The transaction price is the amount of consideration in a contract that the seller expects to be entitled to in exchange for transferring the promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration.

If the consideration is variable, this may be the result of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, etc. In estimating the amount of variable consideration, there are two possible methods that can be used:

- "Expected value": the sum of probability weighted amounts in a range of possible outcomes
- "Single most likely amount": the single most likely amount among a range of possible consideration amounts.

An entity should select the method that is expected to provide a better prediction of the consideration to which it will be entitled.

Example 3

Referring to the agreement entered into by Elite and a customer, Elite will charge the customer $500 per month for 60 months of service. The agreement also states that if the customer pays all 60 months' service fee at the inception of the agreement, a 10% discount becomes payable to the customer. Elite expects that there is an 80% chance of the customer choosing to pay for all service fees at the inception of the agreement.

The consideration is variable due to the discount, i.e. the fact that Elite will receive an amount that is less than the price stated in the contract if the customer pays all service fees at the inception of the agreement.

Elite could have chosen to use either the expected value method or the single most likely outcome method to estimate the variable consideration. In this case, it is apparent that the determination of the transaction price could be based on the single most likely outcome method, as the agreement has only two possible outcomes.

Therefore, the transaction price is \$27,000 (\$500 × 60 × 90%), which is the single most likely outcome.

Step 4: Allocate the transaction price to the performance obligations

The transaction price determined in step 3 must be allocated to the performance obligations identified in step 2. The allocation should be made in proportion to the individual stand-alone selling price attached to each performance obligation. The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer.

Example 4

The agreement between Elite and a customer (see Example 3) is priced at \$27,000. The stand-alone selling prices of each element are as follows:

	$
• Provision of a smart phone	5,000
• Mobile phone service	18,000
• Provision of maintenance support	10,000
	33,000

In this case, the transaction price is allocated in proportion to the individual stand-alone selling prices of the goods or services as follows:

	$	
• Provision of a smart phone	4,091	\$27,000 × (\$5,000/\$33,000)
• Mobile phone service	14,727	\$27,000 × (\$18,000/\$33,000)
• Provision of maintenance support	8,182	\$27,000 × (\$10,000/\$33,000)
	27,000	

Step 5: Recognise revenue when performance obligations are satisfied

The final step is to recognise revenue when each performance obligation is satisfied. A performance obligation is satisfied when a good or service is transferred to the customer, i.e. when the customer obtains control of the asset. Control is the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset.

A performance obligation may be satisfied “at a point in time” (typically for promises to transfer goods to a customer) or “over time” (typically for promises to transfer services to a customer). A performance obligation is satisfied over time if any of the following criteria is met:

(a) The customer simultaneously receives and consumes the benefits as the entity performs (e.g. routine service such as cleaning).
(b) The entity’s performance creates or enhances an asset controlled by the customer.
(c) The entity’s performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

When a performance obligation is satisfied at a single point in time, the entity should consider the following indicators of transfer of control of the asset:

(a) The entity has a present right to payment for the asset.
(b) The entity has transferred legal title of the asset to the customer.
(c) The entity has transferred physical possession of the asset to the customer.
(d) The entity has transferred the significant risks and rewards of ownership of the asset to the customer.
(e) The customer has accepted the asset.

Example 5

Referring to the agreement entered into by Elite (see Example 4), Elite should recognise the revenue for each performance obligation as follows:

- Provision of a smart phone: This performance obligation is satisfied ***at a point in time***, as Elite has transferred physical possession of the smart phone to the customer. Therefore, Elite should recognise the revenue of $4,091 at the inception of the agreement.
- Mobile phone service: This performance obligation is satisfied ***over time***, as the customer simultaneously receives and consumes the benefits over 60 months as Elite performs its obligation. Therefore, Elite should recognise revenue of $245 ($14,727/60) for each month.
- Provision of maintenance support: This performance obligation is treated the same as the mobile phone service above. Therefore, Elite should recognise revenue of $136 ($8,182/60) for each month.

Conclusion

Students sitting for PBE Paper I and AAT Examination Paper 7: Financial Accounting must understand the HKFRS 15 five-step model for recognising revenue from customer contracts. In this article, we have explained the definition of customer contracts, as well as the processes of identification of performance obligations, determination and allocation of the transaction price, and recognition of revenue for each performance obligation.