



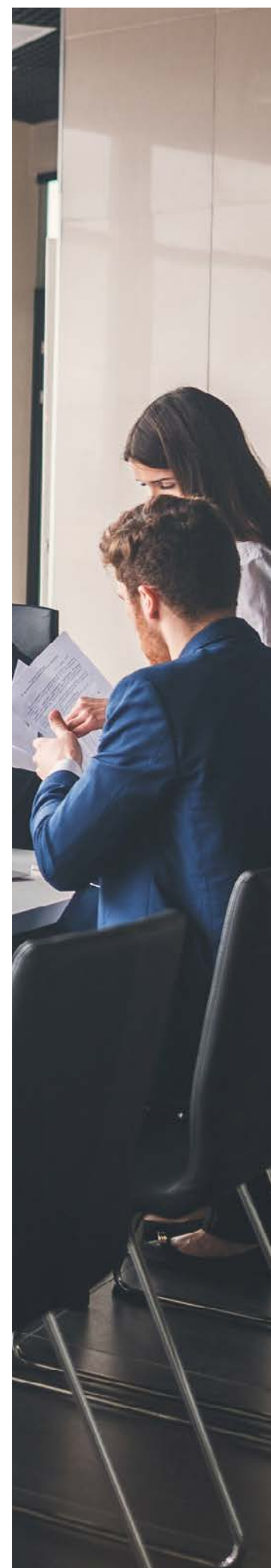
IFRS IN PRACTICE

IFRS 15 Revenue from Contracts
with Customers

2022/2023

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1. Introduction

Background

IFRS 15 *Revenue from Contracts with Customers* sets out a single and comprehensive framework for revenue recognition. In common with other recently issued IFRSs, IFRS 15 includes comprehensive application guidance and illustrative examples, together with a detailed section which sets out how the IASB reached its decisions about the requirements (the Basis for Conclusions).

The standard also includes an overall disclosure objective together with significantly enhanced disclosure requirements for revenue recognition. These are accompanied by an explicit statement that immaterial information does not need to be disclosed and that the disclosure requirements should not be used as a checklist.

In this publication we update our previous guidance to discuss issues that companies have encountered in implementing IFRS 15 and include a number of new examples to demonstrate how the standard should be applied.

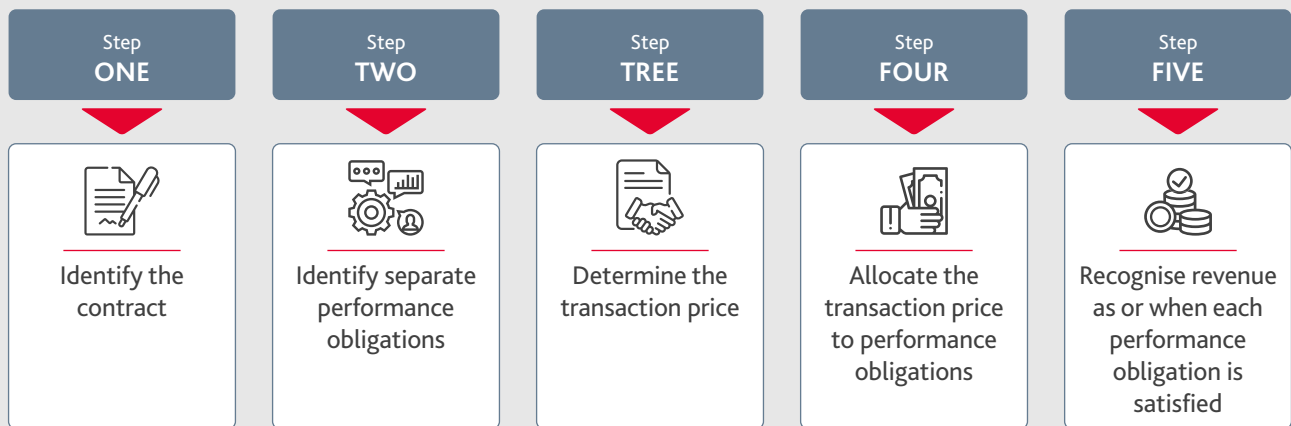


2. Overview of IFRS 15's Requirements

IFRS 15 establishes a single and comprehensive framework which sets out how much revenue is to be recognised, and when. The core principle is that a vendor should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the vendor expects to be entitled in exchange for those goods or services.

Revenue is recognised by a vendor when control over the goods or services is transferred to the customer. In contrast, IAS 18 based revenue recognition around an analysis of the transfer of risks and rewards. An assessment of risks and rewards now forms one of a number of criteria that are assessed in determining whether control has been transferred.

The application of the core principle in IFRS 15 is carried out in five steps:



The first step is to identify the contract(s) with the customer for accounting purposes, which may not be the same as the contract(s) for legal purposes. Whatever the form (written, oral or implied by an entity's customary business practices), a contract for IFRS 15 purposes must create enforceable rights and obligations between a vendor and its customer.

After identifying the contract(s) with the customer for accounting purposes, in step 2 a vendor identifies its separate 'performance obligations'. A performance obligation is a vendor's promise to transfer a good or service that is 'distinct' from other goods and services identified in the contract. Goods and services (either individually, or in combination with each other) are distinct from one another if the customer can benefit from one or more goods or services on their own (or in combination with resources readily available to the customer). Two or more promises (such as a promise to supply materials (such as bricks and mortar) for the construction of an asset (such as a wall) and a promise to supply labour to construct the asset are combined if they represent one overall performance obligation.

In step 3 a vendor determines the transaction price of each contract identified for accounting purposes in step 1, and then in step 4 allocates that transaction price to each of the performance obligations identified in step 2.

In step 5, a vendor assesses when it satisfies each performance obligation identified in step 2, which is determined by reference to when the customer obtains control of each good or service. This could be at a point in time or over time, with the revenue allocated to each performance obligation in step 4 recognised accordingly.

The five-step model is applied to individual contracts. However, as a practical expedient, IFRS 15 permits an entity to apply the model to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects would not differ materially from applying it to individual contracts. This practical expedient will often be applied to situations involving measurement estimates where an entity may have many contracts which are affected by a particular issue and an estimate is more appropriately made on the population of contracts rather than on each contract individually. For example, in a retail sale which gives the customer a right of return, it may be more appropriate to estimate the aggregate level of returns on all such retail transactions, rather than at the contract level (which is each individual retail sale on which a right of return is granted).



3. Scope

IFRS 15 applies to all contracts with customers, except for:

- Lease contracts within the scope of IAS IFRS 16 *Leases*;
- Insurance contracts within the scope of IFRS 17 *Insurance Contracts*. However, an entity may choose to apply IFRS 15 to insurance contracts that have as their primary purpose the provision of services for a fixed fee in accordance with paragraph 8 of IFRS 17.
- Financial instruments and other contractual rights and obligations within the scope of IFRS 9 *Financial Instruments*, IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IAS 27 *Separate Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*.
- Non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers (such as a contract between two oil customers to exchange oil to fulfil demand from their customers in different specified locations).



BDO Comment

The example in the standard of two oil companies agreeing to exchange oil avoids revenue being accounted for twice in what is essentially a single supply of oil. Each oil company has sold oil to its respective end customer (or potential end customer) and therefore revenue is recognised on that ultimate sale of oil. The scope exclusion prevents both oil companies from also recognising additional revenue (and equivalent cost) from the initial exchange of oil between them.

However, barter transactions are in the scope of IFRS 15 for situations in which the two entities concerned are not in the same line of business, or when the exchange is not for the purposes of facilitating sales to customers or potential customers. Therefore, an exchange of oil between a manufacturing company and an oil refiner would potentially be in scope as long as the contract to exchange oil had commercial substance (see section 4.1 below on identification of a contract). In contrast, a contract between a rail freight company and a road freight company to exchange diesel fuel would not be within the scope of IFRS 15, because those companies sell freight services to their customers, not diesel fuel.

IFRS 15 does not give any further guidance on what is meant by a 'line of business' when assessing exchange transactions, and therefore judgement may be needed. For example:

- Is an entity involved in oil exploration in the same line of business as an entity engaged in mining gold because they both operate in the extractive industry, or are they in different lines of business because they mine very different raw materials?
- Is an entity involved in mining rubies in the same line of business as an entity mining diamonds because they both operate in the same industry sub-sector (i.e. mining of precious stones), or are they in different lines of business because they both mine different gem stones?
- Is an entity involved only in mining diamonds in the same industry as an entity engaged in both mining and cutting diamonds?

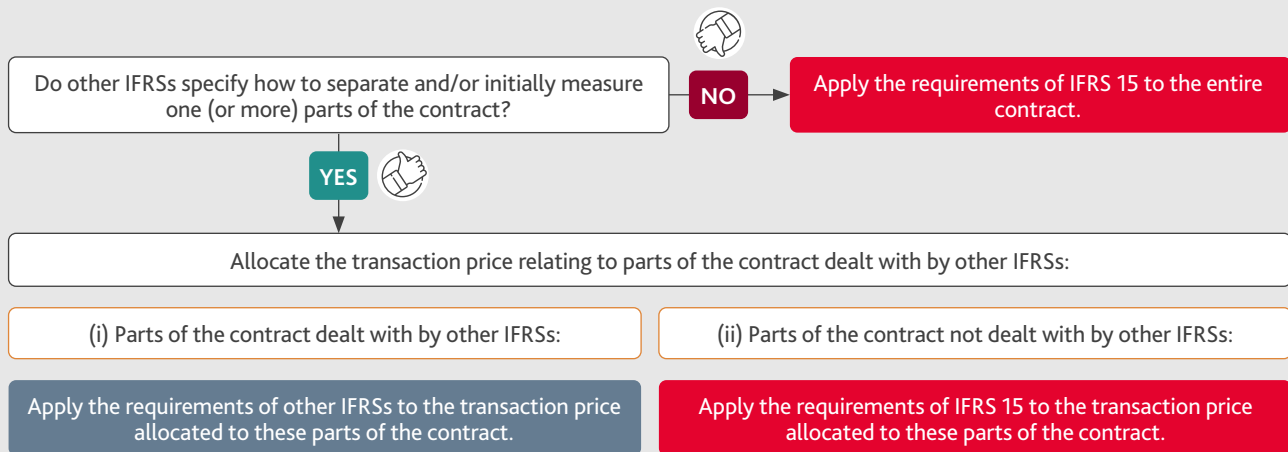
In our view, the scope exception is quite tightly drawn. In each of the above situations, the entities are not in the same line of business. However, it would be necessary to understand what the commercial substance of the transaction is for the exchange in question before concluding that the exchanges give rise to revenue. Further, even if there is commercial substance to the exchanges, each entity might be acting as an agent for the other in the ultimate sale to the other entity's end customer, meaning that they are providing agency services to each other. This would impact the measurement of revenue, which would then be based on the provision of the agency services, not the gross value of the exchanged goods or services.

As noted above, under IFRS 15, revenue is derived from contracts entered into by a vendor for the sale of goods or services, arising from its ordinary activities, to a customer. Its recognition is linked to changes in a vendor's assets and liabilities. This can be in the form of cash inflows or increases in receivable balances, or decreases in a liability that represents deferred revenue. All changes in those assets and liabilities are recognised in profit or loss, other

than those relating to transactions with owners (for example, shareholders) of the vendor if the owners enter into transactions with the vendor in their capacity as such.

The requirements of other IFRSs for the recognition of a gain or loss on the transfer of some non-financial assets that are not an output of a vendor's ordinary activities (such as property, plant and equipment, investment property and intangible assets) are consistent with the requirements in IFRS 15. Therefore, sales of such assets should only be recognised by the seller when control has passed to the purchaser.

A contract may be partially within the scope of IFRS 15 and partially within the scope of other IFRSs. In this situation a vendor takes the approach summarised in the following diagram:



Therefore, if one or more other IFRSs specify how to separate and/or measure certain parts of a contract, those other IFRSs are applied first. Those other IFRSs take precedence in accounting for the overall contract, with any residual amount of consideration being allocated to those part(s) of the contract that fall within the scope of IFRS 15.



Example 1

A car manufacturer leases a fleet of cars to a customer for 3 years. As part of the contract it also deals with various administrative matters for the customer such as arranging insurance, providing breakdown cover and annual servicing.

IFRS 16 Leases require contracts to be separated into their lease and non-lease components. A vendor applies IFRS 15 to the amounts received from the customer that relate to the non-lease components of the contract.

A vendor is also required to assess whether, instead of a transaction being a sale, the counterparty to a contract shares the risks and benefits that result from an activity or process (such as developing an asset). If so, the counterparty is not a customer, and the transaction falls outside of the scope of IFRS 15. Judgement will be required, as the IASB decided that it would not be feasible to develop application guidance that would apply to all circumstances. This is because the nature of the relationship (supplier-customer or collaborative arrangement) will depend on the specific contractual terms and conditions. Care may also be needed in assessing transactions with related parties, as their relationship with the vendor may be more complex than those with third parties.



Example 2

Entity A and Entity B enter into an agreement whereby:

- A newly formed special purpose entity, Company X, is owned 50:50 by entities A and B, which operate in the real estate sector
- Entities A and B have joint control over Company X
- Entity A contributes land to Company X
- Entity B constructs an office block on the land

- The office block will be leased to tenants by Company X

In this fact pattern, Entity A and Entity B might not treat Company X as their customer and, consequently, would not recognise revenue or a receivable from X for their respective land contribution and construction work undertaken. Instead, depending on precise facts and circumstances, appropriate accounting approaches might include the following:

- If the contractual arrangements give entities A and B rights over Company X's net assets, the arrangement would be classified as a joint venture. Revenue would not be recognised, with entities A and B accounting for their interests in Company X using the equity method.
- If the contractual arrangements give Entity A and Entity B rights to the assets and obligations for the liabilities of Company X, then the arrangement would be classified as a joint operation. Entity A and Entity B would recognise revenue as Company X earns rental income based on their respective contractual share.

However, it would be necessary to consider whether any elements of the arrangement gave rise to a supplier-customer relationship. The IASB also noted that in some collaborative arrangements, an entity might consider applying the principles of IFRS 15 as an accounting policy developed in accordance with IAS 8.

TRG discussions

Credit card fees (Agenda Paper 36; July 2015)

The TRG discussed whether arrangements between financial institutions and credit cardholders are within the scope of the new revenue standard. Although contracts within the scope of IFRS 9 mean that some income streams, such as interest charges on late payments, are not within the scope of IFRS 15, questions had been raised in respect of periodic or annual fees which are not dependent on the amount of credit available or the level of use of a credit card. Ancillary services such as access to airport lounges and rewards programmes are also often included. While U.S. GAAP includes specific guidance on credit card fees, IFRS does not have specific guidance on this topic.

The TRG members observed that IFRS 15 did not change the requirements for determining whether fees received by a card issuing bank are within the scope of IFRS 9 or IFRS 15. The card issuing bank would first determine whether any fees (or part of the fees) are within the scope of IFRS 9. If the bank concludes that the fees are not within the scope of IFRS 9 then they would be accounted for in accordance with IFRS 15. This could include cardholder reward programmes because IFRS 15 does not explicitly exclude them from its scope.



4. The 'Five Step' approach

4.1. STEP ONE – IDENTIFY THE CONTRACT

IFRS 15 is applied to contracts with customers that meet all of the following five criteria:

- The contract has been approved in writing, orally, or in accordance with other customary business practices and the parties are committed to perform their obligations in the contract
- Each party's rights regarding the goods or services to be transferred can be identified
- The payment terms for the goods or services to be transferred can be identified
- The contract has commercial substance (i.e. the risk, timing or amount of the vendor's future cash flows is expected to change as a result of the contract)
- It is probable that the consideration for the exchange of the goods or services that the vendor is entitled to will be collected. For the purposes of this criterion, only the customer's ability and intention to pay amounts when they become due are considered.

The last point above includes a collectability threshold for revenue recognition, which goes beyond the contractual terms of an arrangement with a customer.

The focus will often be on the price included in the contract between a vendor and its customer. However, it is possible that the amount of consideration that the vendor ultimately expects to be entitled to will be less, because it may offer a price concession or discount. In these cases, the assessment of the customer's ability and intention to pay is made against the lower amount, which will be determined in accordance with the guidance in IFRS 15 for variable consideration.

In some cases, an entity may consider it probable that it will receive only some of the stated consideration in an otherwise fixed price contract. In these cases, although it can be concluded the probability of collection condition is met, it is also necessary to apply the guidance in IFRS 15 on variable consideration. The accounting for variable consideration is discussed in more detail in section 4.3 below.



Example 3

A vendor sells a product to a customer in return for a contractually agreed amount of CU 1 million. This is the vendor's first sale to a customer in the geographic region, and the region is experiencing significant economic difficulty. The vendor therefore expects that it will not be able to collect the full amount of the contract price. Despite the fact that it may not collect the full amount, the vendor believes that economic conditions in the region will improve in future. It also considers that establishing a trading relationship with this customer could help it to open up a new market with other potential customers in the region.

This means that instead of the contract price being fixed at CU1 million, the amount of promised consideration is variable. The vendor assesses the customer's intention and ability to pay and, based on the facts and circumstances and taking into account the poor economic conditions, it is concluded that it is probable that it will be entitled to an estimated amount of CU500,000 and that the customer will pay this amount.

Assuming that the other four criteria set out above are met, the vendor concludes that it has entered into a contract for the sale of the product in return for variable consideration of CU500,000.

TRG discussions

Collectability criteria (Agenda Paper 13; January 2015)

The TRG discussed several questions arising from the collectability criteria. It was agreed that if an entity considers collectability of the transaction price to be probable for a portfolio of contracts, then the entity should recognise the transaction price as revenue when (or as) each of the separate performance obligations are satisfied.



Example 4

An entity has a large volume of homogenous revenue generating customer contracts for which invoices are sent in arrears on a monthly basis. Before accepting a customer, the entity performs procedures designed to ensure that it is probable that the customer will pay the amounts owed. If these procedures result in the entity concluding that it is not probable that the customer will pay the amounts owed, the entity does not accept them as a customer. Because these procedures are only designed to determine whether collection is probable (and thus not a certainty), the entity anticipates that it will have some customers that will not pay all amounts. While the entity collects the entire amount due from the vast majority of its customers, on average, the entity's historical evidence (which is representative of its expectations for the future) indicates that the entity will only collect 98% of the amounts billed.

The issue could be viewed as being whether a contract exists for 100% of the amounts invoiced, or for 98%. Based on the TRG discussions, 100% would be recorded as revenue, as the criterion is that it is 'probable' that the entity will collect the consideration for each of the sales on an individual contract basis (which is the unit of account for the purposes of IFRS 15). This is because the entity concluded that, as a result of its customer acceptance procedures, it is probable that each customer will pay the amount owed. The fact that only 98% of amounts invoiced are expected to be collected will instead be relevant to the expected credit loss (bad debt) provision recognised for the purposes of IFRS 9.

In addition to determining whether collectability of the transaction price is probable at contract inception, collectability also needs to be reassessed when there is an indication of a significant change in facts and circumstances. Therefore, if a contract is initially assessed as meeting the probability of collection criterion and the customer's ability to pay the consideration subsequently deteriorates, there might no longer be a contract for accounting purposes. For this to happen, the change in the customer's financial condition would need to be so significant that it indicates that the contract is no longer valid. Changes of a more minor nature that might reasonably occur (particularly during a long term contract) would not result in that conclusion.

If it is concluded that a contract is no longer valid, although any revenue recognised to date would not be reversed (instead the receivable or contract asset would be subject to the impairment provisions of IFRS 9), no further revenue could be recognised until the vendor could once again conclude that the probability of receipt criterion is met, or when one of the following applies:

- The vendor has no remaining contractual obligations to transfer goods or services and all, or substantially all, of the consideration has been received and is non-refundable; or
- The contract has been terminated and the consideration received is non-refundable.

The above two bullet points would also apply if an entity receives payment before all of the five criteria set out above are met.

A linked point is that the criteria above mean that when collectability for a contract as a whole is not probable, recognising revenue on the basis of cash collected is prohibited by IFRS 15. This is the case even if some non-refundable consideration has been received from the customer, with any such non-refundable consideration instead giving rise to a liability. This may result in a significant change in practice for some entities.

Some members of the TRG considered that the accounting might not reflect the economics in some circumstances because the vendor may be unable to terminate a contract and be required to continue to provide goods or services. It was also considered possible that, for a contract such as a three year contract with a customer with a poor credit rating, under which services are carried out monthly and non-refundable cash is collected monthly, IFRS 15 could be interpreted to require full deferral of revenue until either the contract is terminated (the end of three years, or earlier depending on the termination provisions), or until collection of the entire transaction price becomes probable. Some TRG members felt that a prohibition on the recognition of revenue when a distinct good or service has been provided and payment has been received would not reflect economic substance. However, Board members at the TRG meeting noted that the inclusion of the collectability criterion in step 1 was deliberate, because revenue recognition is prohibited when a valid contract does not exist.

Combination of contracts

Two or more contracts that are entered into at (or near) the same time, and with the same customer or related parties of the customer, are accounted for as if they were a single contract for accounting purposes, if one of the following criteria are met:

- The contracts are negotiated as a package with a single commercial objective;
- The amount of consideration in one contract depends on the price or performance of the other contract(s); or
- The goods or services that are promised in the contracts (or some of the goods or services) represent a single performance obligation (see discussion on step 2 in section 4.2 below).



BDO comment

The requirement to consider contracts which are entered into with two or more separate parties that are related to each other has been included because there may be interdependencies between or among those contracts. This is because the amount and timing of revenue to be recognised might differ depending on whether the contracts are accounted for as separate

contracts as opposed to a single contract. /The term 'related parties' has the same meaning as the definition in IAS 24 Related Party Disclosures, which encompasses a wide range of entities and individuals, and careful analysis may be required to ensure that all of these are considered.

Contract modifications

A contract modification is a change in the scope and/or price of a contract that is approved by the parties to that contract. This might be referred to as change order, variation, and/or an amendment. Consistent with the provisions of IFRS 15, adjustments are only made for a contract modification when either new enforceable rights and obligations are created, or existing ones are changed.

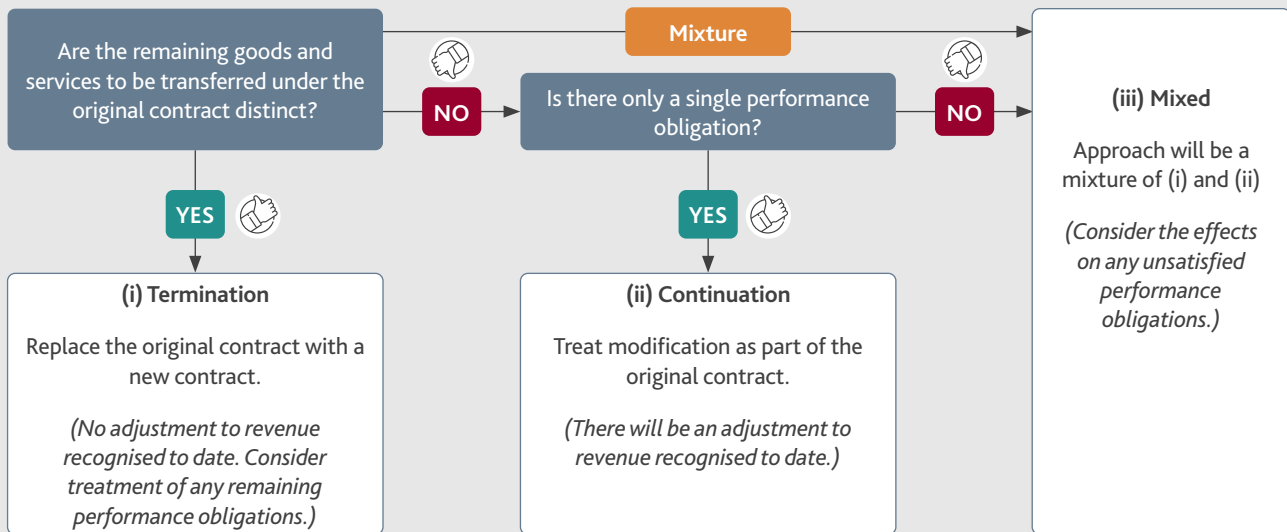
A vendor accounts for a contract modification as a separate contract to the original one, such that the accounting for the original contract remains unchanged, only if:

- the scope of the contract changes due to the addition of promised goods or services that are distinct for the purposes of step 2 of the five-step model (see section 4.2 below); and
- the price of the contract increases by an amount of consideration that reflects the vendor's stand-alone selling price of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract (e.g. a discount to reflect that the vendor did not incur the same costs as it would do for a new customer).

If both of these criteria are met, then the contract modification is, for accounting purposes, a separate contract which is subject to the same five-step model as any other contract.



When a contract modification is not accounted for as a separate contract (i.e. one or both of the above two criteria are not met), the vendor identifies the total goods or services that have not yet been transferred. This will be comprised of the remaining goods or services from the original contract, and any new goods or services arising from the contract modification. The approach which is then followed is illustrated by the following diagram:



If the modification results in the original contract being accounted for as if it were terminated, then no adjustment is made on modification date to the cumulative revenue previously recognised on the original contract. Instead, the remaining goods and services and the remaining contractual consideration (i.e. the total consideration as modified less revenue recognised prior to modification) form the new contract for accounting purposes.

If, in contrast, the modification results in the original contract continuing, then the amount of revenue recognised prior to the modification will need to be adjusted to reflect the extent to which the performance obligation affected in the modified contract has been completed. This might apply to a construction contract for a building where revenue is being recognised over time, and there is a change to the building specification which increases the scope of work and affects the stage of completion. In some cases, the remaining goods and services to be delivered under the modified contract are not distinct from those that have already been delivered, and may be comprised of more than one performance obligation. In those cases, the entity will need to apply judgement to determine which elements of the original contract are being terminated and which elements are being continued.



Example 5 – sale of a product

A vendor enters into a contract with a customer to sell 200 units of a product for CU 16,000 (CU 80 per unit). These are to be supplied evenly to the customer over a four month period (50 units per month) and control over each unit passes to the customer on delivery.

After 150 units have been delivered, the contract is modified to require the delivery of an additional 50 units (i.e. at the point of contract modification, the vendor is now required to supply a total of 100 units, being the 50 units not delivered under the original contract plus a further 50 units). At the point at which the contract is modified, the stand-alone selling price of one unit of the product has declined to CU 75.

Assuming the additional units to be delivered are distinct (considered under step 2 in Section 4.2 below), the accounting for the contract modification will depend on whether the sales price for the additional units reflects the stand-alone selling price at the date of contract modification (CU 75).

Scenario A – the price of each of the additional units is CU 75

The selling price of the additional units is the stand-alone price at the date of contract modification. Consequently, the additional units are accounted for as being sold under a new and separate contract from the units to be delivered under the terms of the original contract.

The vendor recognises revenue of CU 80 per unit for the remaining 50 units specified in the original contract, and CU 75 per unit for the 50 units that are added as a result of the contract modification.



BDO Comment

In our view, if the units are fungible, revenue should be recognised on a FIFO basis. That is, the first 50 units delivered to the customer after the modification satisfy the remainder of the original promise to deliver 200 units in the original contract, and which will result in revenue of CU 80 being recognised as each of the first 50 units of the remaining 100 units are delivered. The second tranche of 50 units delivered relate to the contract modification (which, for accounting purposes, is a separate contract) on which revenue of CU 75 is recognised as each unit is delivered. To permit a

different approach could result in structuring of the amount of revenue to be recognised, by 'specifying' whether deliveries of the remaining 100 units following the contract modification relate to the original contract or the contract modification.

The FIFO approach is consistent with the approach which is implied in IFRS 15, Example 5A, with the obligations in the original contract being satisfied first, before the additional items arising from the contract modification.

Scenario B – the price of each of the additional units is CU 65, reflecting a CU 10 discount as compensation for past poor service

When the contract modification for the additional 50 units was being negotiated, the vendor agreed to a price reduction of CU 10 for each of the additional units, to compensate the customer for poor service. Some of the first 50 units that had been delivered were faulty and the vendor had been slow in rectifying the position.

At the point of contract modification, the vendor recognises the CU 10 per unit discount as an immediate reduction in revenue of CU 500. This is because the discount relates to units that have already been delivered to the customer; the allocation of the discount to the price charged for units that are to be sold in future does not mean that the discount is attributed to them.

The selling price of the additional units is therefore the stand-alone selling price (CU 75) at the date of contract modification. Consequently, the additional units are accounted for as being sold under a new and separate contract from the units to be delivered under the terms of the original contract.

This means that, as in scenario A, the vendor recognises revenue of CU 80 per unit for the remaining 50 units specified in the original contract, and then CU 75 per unit for the 50 units that are delivered as a result of the contract modification

Scenario C – the price of each of the additional units is CU 60, solely reflecting a special discount given to the customer

The selling price of the additional units is not the stand-alone price at the date of contract modification. The 100 units still to be delivered after the contract modification are distinct from the 150 already delivered. Consequently, for accounting purposes, the original contract is considered to be terminated at the point of contract modification. The remaining units to be sold that were covered by the original contract, together with the additional units from the contract modification, are accounted for together as being sold under a new contract.

The amount of revenue recognised for each of the units is a weighted average price of CU 70. This is calculated as $((50 * CU 80) + (50 * CU 60)) / 100$.



BDO comment

Care will be needed when determining the appropriate accounting approach in circumstances in which a contract is modified, and the selling price of remaining performance obligations reflects both compensation for poor past performance, and a revised price that does not represent the stand-alone selling price at

the date of contract modification. This is to ensure that the adjustment to revenue previously recognised on contract modification (reflecting compensation payable to the customer for poor past performance) and the revenue to be reflected for the remaining goods to be delivered is appropriate.

Contract Enforceability and termination clauses

Under IFRS 15, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties). A contract is 'wholly unperformed' if:

- The entity has not yet transferred any promised goods or services to the customer; and
- The entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

An entity only applies IFRS 15 to the term of the contract in which the parties to the contract have enforceable rights and obligations.



TRG discussions

Contract enforceability and termination clauses (Agenda Paper 10; October 2014)

Although IFRS 15 contains guidance on when a contract exists, questions were raised about how to assess whether a contract exists for accounting purposes (and, if so, the contract duration) if the contract between a vendor and its customer contains termination clauses. The TRG considered the following examples in deliberating how such clauses should be taken into account by a vendor and generally agreed with the staffs' conclusions.

Example A

An entity enters into a service contract with a customer under which the entity continues to provide services until the contract is terminated. Each party can terminate the contract without compensating the other party for the termination (that is, there is no termination penalty).

The duration of the contract does not extend beyond the services already provided.

Example B

An entity enters into a contract with a customer to supply services for two years. Each party can terminate the contract at any time after fifteen months from the start of the contract without compensating the other party for the termination.

The duration of the contract is fifteen months.

Example C

An entity enters into a contract with a customer to provide services for two years. Either party can terminate the contract by compensating the other party.

The duration of the contract is the specified contractual period of two years.

Example D

An entity enters into a contract to provide services for 24 months. Either party can terminate the contract by compensating the other party. The entity has a past practice of allowing customers to terminate the contract at the end of 12 months without enforcing collection of the termination penalty.

In this case, whether the contractual period is 24 months or 12 months depends on whether the past practice is considered by law (which may vary by jurisdiction) to restrict the parties' enforceable rights and obligations. The entity's past practice of allowing customers to terminate the contract at the end of month 12 without enforcing collection of the termination penalty affects the contract term only if that practice changes the parties' legally enforceable rights and obligations. If that past practice does not change the parties' legally enforceable rights and obligations, then the contract term is the stated period of 24 months.



4.2. STEP TWO - IDENTIFY SEPARATE PERFORMANCE OBLIGATIONS IN THE CONTRACT

Having identified the contract for accounting purposes in step one, a vendor is then required to identify the performance obligations(s) contained in that contract. A performance obligation is a promise to a customer to transfer:

- 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.

A single contract can have more than one performance obligation. For example, the purchase of a mobile handset and connection to a mobile network for 2 years, in return for 24 monthly fixed payments, is likely to be set out in a single contract. However, the contract will typically be analysed as containing two performance obligations for accounting purposes - the sale of the mobile handset on credit, and the provision of network services for 2 years.

Further, although two contracts between a vendor and its customer may be identified as a single contract for accounting purposes in step 1 (because, for example, they were negotiated at or near the same time, with interdependency in the amount of consideration allocated to each), the good(s) or service(s) specified in each of the two legal contracts could be separate performance obligations for accounting purposes. As a result, an entity is not able to obtain a particular accounting result by structuring obligations in different contracts with its customer. Continuing the example of a mobile handset and provision of network services above, a vendor might structure this as a contract for the purchase of a mobile phone and a separate contract for the connection of that phone to a mobile network rather than as a single contract. However, the two contracts would still have the same two performance obligations for accounting purposes as the more typical situation of both deliverables being set out in a single legal contract.

This has important consequences for the consistency of revenue recognition for similar arrangements that are structured differently. If the two separate contracts were priced on the basis of the relative fair values of the mobile handset and the network services, there would be no difference in the accounting compared to a single contract for both performance obligations. However, if the vendor structured the arrangement as being a contract (at overvalue) for the mobile handset and a contract (at undervalue) for the network services, the two contracts would be combined into one contract for accounting purposes in step 1, with the total consideration allocated to each performance obligation (the mobile handset and the network services) on the basis of their relative fair values.

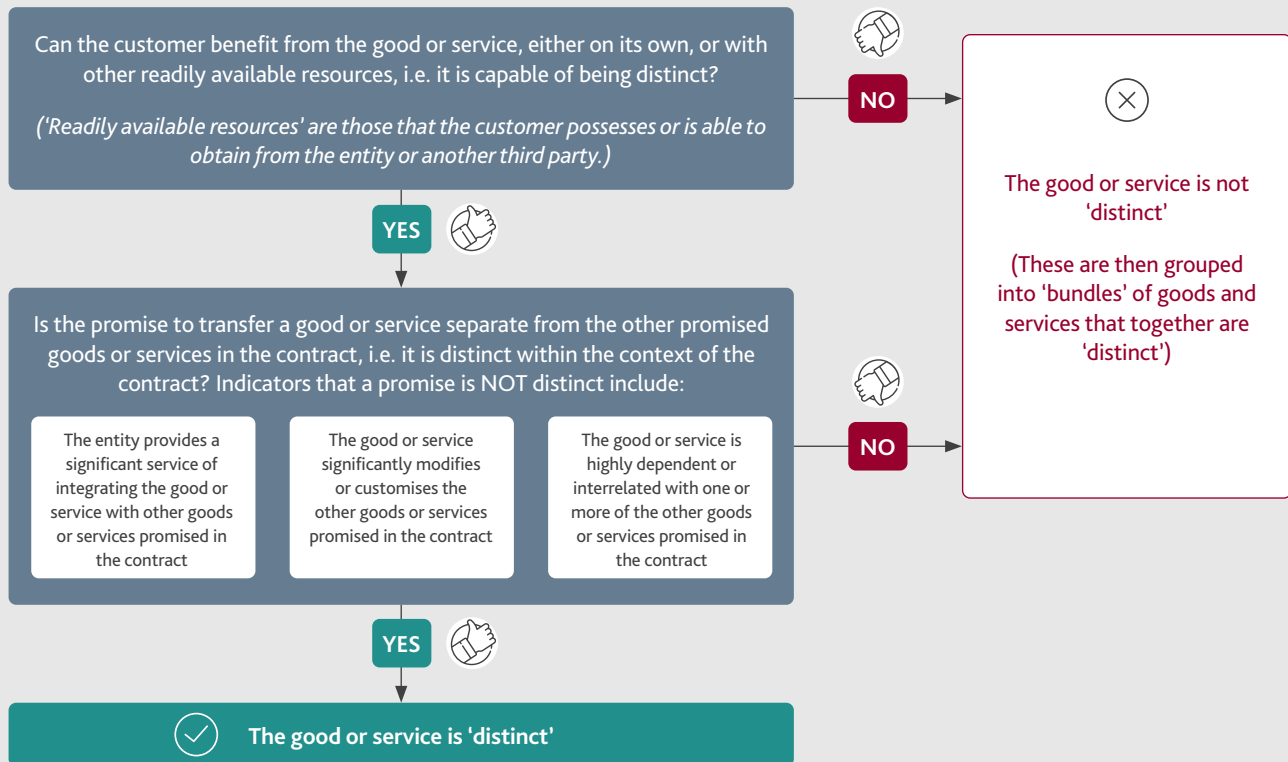


BDO comment

The identification of each of the distinct goods or services in contracts may require a detailed analysis of contractual terms, and linkage to IFRS 15's requirements on whether a promise in a contract is a distinct good or service (and hence constitutes a performance obligation) or needs to be combined ('bundled') with other promises in the contract to create a single performance obligation. Subtle differences in contractual terms and conditions, as well as individual facts and circumstances, can impact the analysis.

The importance of appropriately identifying the performance obligations in a contract cannot be underestimated as they each form a separate 'unit of account' for the purposes of determining how much revenue should be recognised and when revenue should be recognised. The conclusions reached in Step 2 could also bring substantial changes to the amount and timing of revenue recognition in comparison with current standards.

The following diagram illustrates the approach to determine whether a promise in a contract (i.e. a contract for accounting purposes determined in step 1) is a distinct good or service, and hence a performance obligation:



The two criteria that need to be met in order for a good or service to be distinct are set out in more detail below:

Criterion 1

The customer can benefit from the good or service either 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).

A customer can benefit from a good or service if the good or service can be used, consumed, or sold (other than for scrap value), or it can be held in a way that generates economic benefits. A customer may benefit from some goods or services on their own, while for others a customer may only be able to obtain benefits from them in conjunction with other readily available resources.

A readily available resource is either a good or service that is sold separately (either by the vendor or another vendor), or a resource that the customer has already obtained from the vendor (this includes goods or services that the vendor has already transferred to the customer under the contract) or from other transactions or events.

If the vendor regularly sells a good or service separately, this indicates that a customer can benefit from it (either on its own, or in conjunction with other resources).

Criterion 2

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 good or service is distinct within the context of the contract).

To assist in making this assessment, IFRS 15.29 includes indicators that a vendor's promise to transfer two or more goods or services to the customer are not distinct within the context of the contract. The guidance is explicit that these are not the only circumstances in which two or more promised goods or services are not distinct:

- The vendor provides a significant service of integrating one good or service with other goods or services promised in the contract into a bundle, which represents a combined output for which the customer has contracted (i.e. the vendor is using one good or service as an input to produce the combined output specified by the customer).

- One good or service significantly modifies or customises other goods or services promised in the contract.
- One good or service is highly dependent on (or highly interrelated with) other promised goods or services. That is, if the customer decides not to purchase the good or service it would not significantly affect any of the other promised goods or services in the contract.

To determine whether the vendor's promise to transfer a good or service is separately identifiable from other promised goods or services in the contract (i.e. distinct within the context of the contract) requires judgement in light of all relevant facts and circumstances. This is evident from the Basis for Conclusions to IFRS 15, which explains that the notion of two or more promises being 'separately identifiable' (i.e. distinct within the context of the contract) is in turn based on the notion that the risks assumed in one promise are separable from the risks assumed in another. The three factors included in paragraph 29 are therefore intended to assist entities in making that judgement. Further, the three factors are not mutually exclusive, because they are based on the same underlying principle of inseparable risks.

In the Basis for Conclusions to IFRS 15 the Board also makes it clear that an important consideration is whether one promise in a contract has a transformative effect on another promise. The principle is whether two or more goods or services that might be capable of being distinct are used as inputs that are then combined to produce one single identifiable item. In contrast, if a vendor's promise to its customer contains two or more goods or services that depend on each other (that is, they have a functional relationship), such as equipment and related consumables that are needed to operate the equipment, these would be distinct in the context of the contract because the supply of the consumables does not make any changes to the machine.



Example 6 - Telecoms

A telecoms company enters into a contract for the sale of a mobile device and connection to its mobile network. The contract, which lasts for 2 years, gives the customer:

- X minutes of calls per month;
- Y gigabytes of data per month; and
- Z texts per month.

The telecoms company frequently sells mobile devices without connecting them to the network. Although different combinations of minute, data and texts are available, it is not possible to buy only minutes, only data or only texts.

The telecoms company concludes that although the customer can benefit from the minutes, data and texts independently from one another (i.e. they are capable of being distinct), they are interrelated with each other because the risks associated with the promise to transfer of minutes, texts and data are not separable as part of the network connection. Therefore, 2 performance obligations are identified

- The sale of a mobile phone; and
- Network services.



Example 7 – Construction of a wall

A building company contracts with a customer to build a wall. It identifies two activities that are necessary to complete the wall:

- Arrange for raw materials (such as bricks) for the purposes of building a wall to be available at the customer's premises; and
- Provide construction services to build a wall with the raw materials.

The sale of raw materials and the provision of services for the construction of a wall are capable of being distinct. Although the failure to purchase construction services would not significantly affect the delivery of bricks (which, by itself, might result in a vendor identifying two distinct performance obligations), the nature of the overall promise is to build the customer a wall. Consequently, the risks associated with each activity are not separable, and hence they are not distinct within the context of the overall contract. This is for the

following reasons:

- the raw materials and construction services are both inputs that combined and result in the creation of a single identifiable output (the wall);
- the provision of construction services significantly modifies the nature of the raw materials (i.e. it transforms the raw materials into something that performs a very different function to the raw materials on their own).

The analysis would be the same even if the arrangement was structured as two contracts negotiated at or around the same time (i.e. a legal contract for the sale of bricks and a separate legal contract for construction services) because for accounting purposes there would be a single contract. Although there are two activities that are capable of being distinct, in the context of the single accounting contract, the assessment of whether they would be distinct within the context of that accounting contract remains the same.



Example 8 – Construction of a building

A building contractor (the vendor) enters into a contract to build a new office block for a customer. The vendor is responsible for the entire project, including procuring the construction materials, project management and associated services. The project involves site clearance, foundations, construction, piping and wiring, equipment installation and finishing.

Although the goods or services to be supplied are capable of being distinct (because the customer could, for example, benefit from them on their own by using, consuming or selling the goods or services, and could purchase them from other suppliers), they are not distinct in the context of the vendor's contract with its customer. This is because the vendor provides a significant service of integrating all of the inputs into the combined output (the new office block) which it has contracted to deliver to its customer.



Example 9 - Software – scenario A

A vendor enters into a contract with a customer to supply a licence for a standard 'off the shelf' software package, install the software, and to provide unspecified software updates and technical support for a period of two years. The vendor sells the licence and technical support separately, and the installation service is routinely provided by a number of other unrelated vendors. The software will remain functional without the software updates and technical support.

The software is delivered separately from the other goods or services, can be installed by a different third party vendor, and remains functional without the software updates and technical support. Therefore, it is concluded that the customer can benefit from each of the goods or services either on their own or together with other goods or services that are readily available. In addition, each of the promises to transfer goods or services is separately identifiable; because the installation services does not significantly modify or customise the software, the installation and software are separate outputs promised by the vendor, and not one overall combined output.

The following distinct goods or services are identified:

- Software licence
- Installation service
- Software updates
- Technical support.



Example 9 - Software - scenario B

The vendor's contract with its customer is the same as in scenario A, except that as part of the installation service the software is to be substantially customised in order to add significant new functionality to enable the software to interface with other software already being used by the customer. The customised installation service can be provided by a number of unrelated vendors.

In this case, although the installation service could be provided by other entities, the analysis required by IFRS 15 indicates that within the context of its contract with the customer, the promise to transfer the licence is not separately identifiable from the customised installation service. In contrast, and as before, the software updates and technical updates are separately identifiable.

The following distinct goods or services are identified:

- Software licence and customised installation service
- Software updates
- Technical support.



Example 9 - Software – scenario C

The vendor's contract with its customer is the same as in scenario B, except that:

- The vendor is the only supplier that is capable of carrying out the customised installation service
- The software updates and technical support are essential to ensure that the software continues to operate satisfactorily, and the customer's employees continue to be able to operate the related IT systems. No other entity is capable of providing the software updates or the technical support

In this case, the analysis indicates that in the context of its contract with the customer, the promise is to transfer a combined service. This combined service is identified as the single performance obligation.



Example 9 - Software – scenario D1

A vendor enters into a contract with a customer to supply them with a 3-year licence for tax software for the upcoming tax year along with software updates for the next 3 years to be provided in December of each year. The software updates are to provide tips and news on tax legislation each year. The vendor routinely sells the licence and updates together and the software remains functional during the licence period regardless of the software updates. The functionality of the software will only allow the single tax year to be filed (i.e. the updates will not allow subsequent years in the licence period to be filed using the software).

The customer can benefit from the software licence on its own without the software updates, as it has standalone functionality, therefore, the licence and the software updates are capable of being distinct. The licence and the software updates are also distinct in the context of the contract as the software remains functional without the updates and the updates do not significantly modify or customise the software. Therefore, two performance obligations are identified: a software licence and software updates.



Example 9 - Software – scenario D2

Same fact pattern as scenario D1, except the software updates will allow the customer to file tax returns in any of the years covered by the 3-year licence, as well as receive monthly updates for changes in tax legislation and regulation.

The customer can benefit from the software licence on its own without the software updates, as it has standalone functionality, therefore, the licence and the software updates are capable of being distinct. However, the licence and the software updates are not distinct in the context of the contract as the benefit a customer would obtain from the licence is significantly limited without the software updates. That is because the updates are necessary for the second and third years in the licence period to be functional, since changes for legislation and tax regulation would need to be updated in the software. The monthly updates for changes in tax legislation and regulation also limit the benefits obtained otherwise. Therefore, one performance obligation is identified in the contract.



Example 10 – Equipment and consumables

A vendor enters into a contract to supply a customer with an item of equipment and consumables that are required to operate the equipment. The contract also requires the vendor to provide replacement consumables on specified dates over the next three years. The consumables are specific to the equipment and only produced by the vendor, although they are sold separately to customers who have bought the equipment second hand.

The item of equipment and the consumables are both capable of being distinct, because each of them are regularly sold separately by the vendor. The customer can benefit from the consumables that will be delivered under the contract together with the item of equipment.

The item of equipment and the consumables are also distinct in the context of the contract. This conclusion is based on the following:

- There is no service being provided that integrates and transforms the equipment and consumables into a single combined output
- Neither the equipment nor the consumables are significantly customised or modified by the other
- The equipment and consumables are not highly inter-related because they do not significantly affect each other

Consequently, although there is a functional relationship between the equipment and the consumables because the consumables are needed in order to make the equipment work, the absence of any transformation (or integration) of the two components means that they represent separate performance obligations. The vendor would be able to fulfil each of its promises in the contract independently of each other; it could transfer the equipment to the customer even if the customer did not purchase any consumables, and could transfer consumables to the customer separately if the customer had acquired the equipment from another third party.

The scenarios in the following example demonstrates how two transactions which are substantively very similar but have different legal contract structures are accounted for in the same way (illustrating how the accounting is not affected by the legal form of the arrangements and instead focusses on the promises made by a vendor to its customer), and how subtle changes in the facts and circumstances can affect the assessment of whether two promises in a contract are separately identifiable (i.e. distinct within the context of the contract).





Example 11

Entity PD, a property development company, contracts with Entity PI a property investment company to:

- i) sell a piece of land currently owned by PD; and
- ii) construct a property on the land

Scenario A

Both (i) and (ii) are contained in separate legal contracts, with the first contract specifying the land is sold at a price of CU 1 million and the second contract specifying the construction services are sold at a price of CU 2 million.

The transfer of a piece of land results in local taxes being levied on the purchase price. It is not legally possible to transfer legal ownership of a building independently of the land on which it sits, and so the tax payable would be greater when a transaction involves the sale of both land and buildings. The tax authority does not permit structuring of a transaction to avoid tax on the building element by artificially breaking the contract into 2 elements, or by negotiating a price for the land that is clearly below market value, with this reduction being offset by the selling price for construction services being above market rate.

However, tax on the price of buildings can be avoided if the contracts are not linked. Therefore the transaction is structured as follows:

- The sale of land is completed (i.e. the customer pays PD in full for the land, and has legal ownership and physical possession) 4 weeks before a contract for construction services is signed.
- Although PI and PD may have previously discussed a project for construction services for CU 2 million on the land, and PI has the intention to engage PD to provide those construction services, both are 'on risk' following the sale of land. PD is on risk that, subsequent to purchasing the land, PI may decide to engage another entity to provide construction services or could change its mind about undertaking construction (i.e. it decides instead to hold the undeveloped land as investment property). PI is on risk that PD may change its mind about wanting to undertake the construction services or, for whatever reason, it might not be capable of providing the intended construction services. Experience with previous transactions indicates that in almost all cases the property construction does proceed, but in a small number of cases only the land is sold.
- The contract for the sale of land is priced at fair value in order to comply with tax legislation, and to protect the position of both PI and PD because of the risk that the property will not be constructed.
- The construction contract between PI and PD is signed 4 weeks after the sale of land was completed, as was the non-binding intention. If PD fails to construct the building in accordance with the terms of the contract PI will only have recourse against PD for its failure to perform that contract. It would have no recourse in relation to the contract for the sale of the land.

In this example, because of the separation of the contract for the sale of land and the contract for construction services, including the lack of any contractual obligation for either PI or PD to enter into the second contract for the construction of the building, PD concludes that the risks associated with the transfer of land are separable from those associated with the construction services. Consequently, there are two performance obligations:

- the sale of land; and
- the construction of the building.

Scenario B

A single contract priced at a total of CU 3 million is entered into for both the sale of land and subsequent construction services. Unlike scenario A there is no potential to save tax by having two separate legal contracts. On the day the contract is signed the land title passes irrevocably to PI, and PI is unconditionally required to pay the market value of the land to PD. The contractual and /or legal environment means that title

to the land cannot be transferred back to PD, and PI would have recourse to PD only in respect of any future underperformance by PD in relation to construction services.

PD concludes that the sale of land and the construction of a building are both capable of being distinct, and so then considers the factors in IFRS 15.29 to assess whether they are distinct within the context of the contract. PD notes the following, which might indicate they are not distinct within the context of the contract:

- The land is integrated with the buildings in the sense that foundations need to be laid which will ensure the building will not collapse;
- The construction of the building modifies the land in the sense that once constructed, the land can only be used to 'host' the building that has been constructed. The building would need to be demolished for the land to be available for other uses; and
- There is a high degree of interdependence between the land and building in the sense that the land is unique. Although it is possible for an equivalent building to be constructed on a different piece of land, that would not be what PI wants (which is a building on the specific piece of land).

However, PD notes the analysis is not limited to the above three factors specified in IFRS 15.29. PD also considers IFRS 15's Basis for Conclusions which notes that an important consideration is whether one promise in a contract (in this case the construction services) has a transformative effect on another promise (the land). Although the construction of a building on the land will modify the land (to the extent that foundations are required and its use will be limited), it does not result in the land being turned into something else. Consequently, although there is a relationship between the land and the building, this is a functional relationship, i.e. the building cannot exist without the land. However, instead of the land and the building being transformed into one overall item, the building is installed onto the land. In addition, PD notes that it would be able to fulfil its promise to transfer the land to PI even if PI engaged another developer for the construction services, and PD could fulfil its promise to construct the building even if the customer had purchased the land from another party.

PD concludes that there are two performance obligations:

- the sale of land; and
- the construction of the building.

Scenario C

In this scenario, the fact pattern is the same as for Scenario B, except that the contract contains an additional clause which states that if PD fails to perform as contractually required in respect of the building construction, PI will have the right to transfer title of the land back to PD for a full refund and also have recourse for damages.

PD concludes that in this case, the contract is for the supply of a single product - a building on the specified piece of land, and therefore there is a single performance obligation. The risks PD is assuming by transferring land are not separable from the risks assumed in constructing the building. This would also be the case even if the arrangement had been structured as two separate legal contracts as in Scenario A.

Combining a good or service with other promised goods or services

If a good or service is not distinct, the vendor is required to combine that good or service with other promised goods or services until a bundle of goods or services that is distinct can be identified. This may result, in some cases, in a vendor accounting for all the goods or services promised in a contract as a single performance obligation.



Example 12

A mobile application (app) is a computer program designed to run on mobile devices such as smartphones and tablets. Typically, such devices are sold with several apps bundled as preinstalled software. Apps that are not preinstalled are usually available through distribution platforms known as app stores. Mobile app providers are usually the owners of a licence to distribute, using their own channels, specific online applications.

It is common for software providers to make mobile applications available to users on mobile devices for free. For games, users can often then purchase virtual goods (non-physical objects) to enhance their experience of using the app (game).

The typical rights and obligations between the entity and user are:

- Users can log on to the entity's server and use the application for free on the entity's server after agreeing to the terms and conditions of the underlying license arrangement with the entity.
- Users can make 'in-app' purchases of virtual goods/services. Some of these are consumable and will be used immediately or at some point after purchase and others are durable and will be used for a period of time after purchase.
- The entity is responsible for operating the application, but it can terminate its operation of the application at any time at its discretion without any penalty.
- The costs of operating the application are recovered by revenue from these "in-app" purchases.
- Upgrades/future developments of the application are neither anticipated nor included in the terms and conditions of the hosted underlying licence agreement.

Assuming the entity is the principal in the arrangement with users, given it is responsible for maintaining and operating the application on its server, the issue is whether the 'in-app' purchases of virtual items are separate performance obligations or whether should they be combined into a single performance obligation along with the provision of access to the application.

Access to the application and the virtual goods should be accounted for as separate performance obligations. The virtual goods will be recognised either at a point in time or over time depending on the nature of the virtual good.

The virtual goods meet the criteria to be distinct in IFRS 15.27 for the following reasons:

- Users can use the application without purchasing anything further and in many cases that is what users will do. The underlying application is therefore 'capable of being distinct' because it is used by customers on a stand-alone basis.
- Users can decide not to purchase the virtual items without affecting the utility of the application. Therefore, the virtual items are not highly dependent on or highly interrelated with the application.
- Once the users have access to the application, the virtual items are also capable of being distinct because the customer can benefit from the virtual goods together with other resources that are readily available (i.e. the underlying application).
- No significant integration or modification service is provided by the entity, regardless of whether or not gamers choose to use the application with the additional virtual items.

TRG discussions Identifying performance obligations (Agenda Paper 22; January 2015)

The TRG considered issues relating to when a promised good or service is separately identifiable (i.e. distinct within the context of a contract) and the three supporting factors in paragraph 29. As a consequence of the discussions and the feedback received, the IASB clarified that it is important to determine whether the contract is to transfer:

- multiple distinct goods or services; or
- a combined item (or items) that each comprise a distinct bundle of goods or services.

To do this, an entity should consider the level of integration, interrelation or interdependence among promises to transfer goods or services in order to assess whether the promise to transfer a good or service is distinct within the context of the contract from other promises in the contract.

The TRG's discussions also highlighted that some stakeholders may be applying the three factors in IFRS 15.29 that indicate when a promise to deliver goods or services are distinct within the context of the contract as a series of criteria (i.e. all of the factors need to be met to conclude that a promise is separately identifiable). However, as a result of the TRG discussions and as noted above, the IASB and FASB clarified in the Basis for Conclusions that they did not intend the guidance to be read in this way.

Questions were also raised about the effect of contractual restrictions on the identification of performance obligations. The IASB therefore added an example to illustrate that a contract for the sale of specialised equipment and the installation of the equipment could be distinct within the context of the overall contract even if the vendor requires the customer to buy installation services when it buys equipment. Other relevant factors might be the extent to which the equipment could operate without the installation, whether other vendors would have been able to undertake the installation absent of the contractual restriction, and the extent to which the installation services significantly modify or customise the equipment being installed. It may also be relevant to consider whether the customer could benefit economically from the machine if it did not receive the installation services.

Series Provision

Under IFRS 15 a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer are accounted for as a single performance obligation. This is known as the 'series provision'.

A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

- each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria to be a performance obligation satisfied over time (see section 4.5 below); and
- the same method would be used to measure the entity's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer

There are three primary areas in which the accounting treatment may vary for a performance obligation if it is determined that a promise is a single performance obligation comprised of a series of distinct goods rather than a single performance obligation comprised of goods or services that are not distinct from each other

- contract modifications (see section 4.1 above) because if the remaining undelivered goods or services are distinct (even if part of a single performance obligation under the series provision), the entity will account for the modified contract on a prospective basis, whereas if the remaining goods or services are not distinct from those already provided, there will be a cumulative effect adjustment resulting from the modification.
- changes in transaction price (see section 4.3 below) because IFRS 15 requirements are applied differently, in some cases, to a single performance obligation comprised of non-distinct goods or services than to a single performance obligation resulting from the series provision; and
- allocation of variable consideration (see section 4.4 below) because the amount of the variable consideration that is recognised at each reporting date could be affected

The need to consider whether the series provision should apply will be relevant to many service contracts and also contracts involving the delivery of a quantity of similar items where those items are not all delivered at the same time, but over the contractual period.



BDO Comment

Although the series provision does simplify application of the standard in many situations, it is mandatory if the conditions for its application are met. It is not

a practical expedient which entities have a choice of applying.

TRG discussions

Series of distinct goods or services (Agenda Paper 27; March 2015)

The TRG discussed two issues. Firstly, whether goods must be delivered, or services performed, consecutively for the series provision to apply, specifically whether it applies when there is a gap or an overlap in the entity's delivery of goods or performance of services. For example, if a vendor is required to deliver 24,000 units over a two year period, the series provision would apply if there was a requirement to deliver 1,000 units per month, but would it also apply if a different quantity was delivered each month, but in aggregate 24,000 were delivered? Although IFRS 15 does not use the word 'consecutively', it is used in the Basis for Conclusions, which led some stakeholders to question whether the series provision would apply in certain circumstances.

The TRG generally agreed with the staffs' conclusion that it is not necessary for goods and services to be transferred consecutively for the series provision to apply. Therefore, in the above example, the series provision would apply even though the same number of units are not delivered each month.

The second issue addressed by the TRG is whether, in order for the series provision to apply, it is necessary for the accounting result to be substantially the same as if the underlying distinct goods and services were each accounted for as separate performance obligations? For example, in a contract for the delivery of 10 identical products for CU 5,000 over a two year period (with each product having the same standalone selling price of CU 500), the manufacturing cost of each product might reduce as a result of a learning curve. Were the series provision to apply, then the amount of revenue for each product delivered would similarly reduce if the percentage of completion of the contract was determined by reference to cumulative costs incurred for all products delivered to date. However, this would not be the case if the delivery of each product was identified as its own separate performance obligation.

The TRG generally agreed with the staffs' conclusion that it is not necessary for the accounting result to be substantially the same for the series provision to apply as it is not identified as one of the conditions in the standard. Further, it is noted that the series provision was introduced to simplify the application of IFRS 15, but the inclusion of a requirement for the accounting to be substantially the same would make it much more difficult for entities to be able to make use of it.



Implicit promises in a contract

Goods or services that are to be transferred to a customer are normally specified in a contract. However, a contract may also include promises that are implied by a vendor's customary business practices, published policies, or specific statements if those promises create a valid customer expectation that the vendor will transfer a good or service to it. This links to IFRS 15 extending the definition of a contract to include those which are written, oral, or implied by a vendor's customary business practices (provided in all cases that the arrangements are enforceable) consequently, the performance obligations identified in a contract with a customer may not be limited to the goods or services that are explicitly promised in that contract.

Performance obligations do not include activities that a vendor must perform in order to fulfil a contract, unless the vendor transfers a good or service to the customer as those activities occur. For example, a service provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed and are therefore not performance obligations.

4.3. STEP THREE - DETERMINE THE TRANSACTION PRICE OF THE CONTRACT

The transaction price is the amount of consideration that a vendor expects to be entitled to in exchange for the goods or services. This will often be the amount specified in the contract. However, the vendor is also required to consider its customary business practices and, if these indicate that a lower amount will be accepted, then this would be the transaction price.

Although a number of estimates about the future may need to be made when determining the transaction price, these are based on the goods and services to be transferred in accordance with the existing contract. They do not take into account expectations about whether the contract will be cancelled, renewed or modified.

The vendor must also consider the effects of the following:

- Variable consideration
- Constraining estimates of variable consideration
- The existence of a significant financing component
- Non-cash consideration
- Consideration payable to a customer.

Variable consideration

Instead of the amount of consideration specified in a contract being fixed, the amount receivable by a vendor may be variable. In other cases, the consideration may be a combination of fixed and variable amounts.

Variable consideration can arise for a wide range of reasons including discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. If there is any potential variation in the amount that a vendor will receive in return for its performance, then the provisions in IFRS 15 dealing with variable consideration apply.

However, the transaction price is not adjusted for the effects of a customer's credit risk. In some cases, such as when a discount is offered between the date of supply of goods or services and the payment date, it may be difficult to determine whether a vendor has offered a price concession (which will result in a reversal of revenue recognised for performance to date), or has chosen to accept that the customer has defaulted on the contractually agreed amount of consideration (which will result in the recognition of a bad debt expense rather than the reversal of revenue previously recognised). In the development of IFRS 15, it was noted that this judgment already exists in application of current IFRSs and it was decided not to include detailed requirements in IFRS 15 for making the distinction between a price concession and impairment losses.

As with the identification of contractual terms themselves, it is necessary to look more widely than the contract between a vendor and its customer. Variability in the amount of consideration receivable may arise if the customer has a valid expectation arising from a vendor's customary business practices, published policies or specific statements that the vendor will accept an amount of consideration that is less than the price stated in the contract. In addition, it is necessary to consider whether there are any other facts and circumstances that suggest the vendor has the intention of offering a price concession to its customer. For example, a manufacturer of retail goods might expect to offer a retailer a discount (or additional discount) from that specified in a contract in order to enable the retailer to sell the goods to its own customers at a discount and therefore to increase sales volumes.



Example 13

Variable consideration may be challenging to identify in some situations. For example, it is common in the mining and extractives industry for provisional pricing to occur upon delivery of goods to customers.

On December 28, 20x3 a vendor sells 1,000 tonnes of copper concentrate to a customer. At this point, control of the copper concentrate transfers to the customer. At the time of transfer, a provisional price of CU 700 per tonne is established for the core concentrate, which will be finalized in January 20x4 once final assaying occurs and the final quantity and quality of copper in the concentrate is established.

Is the provisional pricing in the contract variable consideration?

The variability arises from the fact that the precise quantity and quality of the underlying good being sold (the ore) is unknown at the time the performance obligation is satisfied (i.e. when control passes to the customer). As such, the variable consideration guidance would apply in this situation. This view is consistent with discussions held by the IASB at a December 2015 meeting, where the Board discussed that the variable consideration guidance was intended to capture 'uncertainty... related to the quality of promised goods or services...'

Additionally, as the seller's right to consideration is contingent on more than just the passage of time (i.e. it is not unconditional), their right to consideration is reflected as a contract asset, and not a trade receivable within the scope of IFRS 9.

When the consideration promised in a contract with a customer includes a variable amount, a vendor estimates the amount of consideration to which it expects to be entitled in exchange for the transfer of the promised goods or services. There are two possible methods which can be used, and which are required to be applied consistently throughout the term of each contract:

- *Expected value method*

The sum of probability weighted amounts in a range of possible outcomes. This may be an appropriate approach if the vendor has a large number of contracts which have similar characteristics.

- *Most likely amount*

The most likely outcome from the contract. This may be an appropriate approach if a contract has two possible outcomes, such as a performance bonus which either will or will not be received.

The approach chosen is not intended to be a free choice, and instead the approach chosen for each contract should be the one which is expected to provide a better prediction of the amount of consideration to which a vendor expects to be entitled.



Example 14

Variable consideration – expected value method

On 1 January 20X4, a vendor enters into a contract with a customer to build an item of specialised equipment, for delivery on 31 March 20X4. The amount of consideration specified in the contract is CU 2 million, but that amount will be increased or decreased by CU 10,000 for each day that the actual delivery date is either before or after 31 March 20X4.

In determining the transaction price, the vendor considers the approach that will better predict the amount of consideration that it will ultimately be entitled to, and determines that the expected value method is the appropriate approach. This is because there is a range of possible outcomes.

Variable consideration – most likely amount

A vendor enters into a contract with a customer to construct a building for CU 1 million. The terms of the contract include a penalty of CU 100,000 if the building has not been completed by a specified date.

In determining the transaction price, the vendor considers the approach that will better predict the amount of consideration that it will ultimately be entitled to. It concludes that the most likely amount method is the appropriate approach. This is because there are only two possible outcomes: either the penalty will be applied (such that it will receive CU 900,000) or it will not (such that it will receive CU 1 million).

The estimated amount of variable consideration is updated at each reporting date to reflect the position at that date, and any changes in circumstances since the last reporting date.

Constraining estimates of variable consideration

Estimating the amount of variable consideration introduces uncertainty to the measurement of revenue. In order to reduce the possibility that variable consideration recognised in one period is reversed in a subsequent period, IFRS 15 only permits it to be recognised if it is highly probable that there will not be a subsequent significant reversal. This is known as the 'variable consideration constraint'. The estimated amount of variable consideration may change at each reporting date as more information becomes available and there is greater certainty about the expected amount of consideration.

The use of judgment and consideration of all facts and circumstances is required when assessing the potential for such a reversal. Factors that indicate potential for a significant revenue reversal include:

- The consideration is highly susceptible to factors outside the vendor's influence, including:
 - Volatility in a market
 - The judgement or actions of third parties (e.g. when the amount of variable consideration varies based on the customer's subsequent sales)
 - Weather conditions
 - A high risk of obsolescence of the promised good or service.
- Where uncertainty regarding the amount of variable consideration is not expected to be resolved for a long period of time
- The vendor's experience (or other evidence) with similar types of contracts is limited or it has limited predictive value
- The vendor 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
- The contract has a large number and broad range of possible variable consideration amounts.

The requirement to assess variable consideration in this way might lead to a change in the timing of revenue recognition for some transactions.



BDO comment

In practice, consideration will only rarely be constrained to nil (excluding instances where arguments surrounding materiality are made). In situations where variable consideration has a wide range of potential outcomes (e.g. anywhere from nil to CU 100,000 depending on number of website visits), it is unlikely that the transaction price would be constrained to nil, as the wide number of possible outcomes means that this outcome would be highly unlikely.

Additionally, when the portfolio practical expedient is used, where multiple similar contracts or performance

obligations are grouped together into one unit of account, it would also be rare for the amount of variable consideration included in the transaction price to be constrained to nil, as doing so would be assuming that the outcome of every instance of uncertainty would be nil.

The constraint may reduce the amount of variable consideration included in the transaction price to nil in situations where the outcome is binary (e.g. nil or CU 100,000) and significant uncertainty exists relating to the outcome.



Example 15

The example and two scenarios set out below illustrate the interaction between variable consideration and constraining estimates.

On 1 January 20X4, a vendor sells 1,000 identical goods to a distributor, which sells them to its own customers. The vendor's selling price is CU 100 per unit, and payment is due from the distributor when the distributor sells each of the goods to its own customers. Typically, those onward sales take place 90 days after the goods have been obtained by the distributor. Control of the goods transfers to the distributor on 1 January 20X4.

The vendor expects that it will subsequently grant a price concession (a discount) so that the distributor can in turn offer its own customers a discount and increase sales volumes. Consequently, the consideration in the contract is variable.

Scenario 1 – the vendor's estimate of variable consideration is not constrained

The vendor has substantial past experience of selling the goods and, historically, has granted a subsequent price concession of approximately 20% of the original sales price. Current market conditions indicate that a similar reduction in price will be applied to the contract entered into on 1 January 20X4.

The vendor considers the approach which will better predict the amount of consideration to which it will be entitled, and concludes that the expected value method should be used. Under this method, the estimated transaction price is CU 80,000 (CU 80 x 1,000 units).

In addition, the vendor considers the requirements for constraining the estimate of variable consideration to determine whether the transaction price can be the estimated amount of CU 80,000. In this scenario, the vendor determines that it has significant previous experience with the particular good and that current market information supports the estimate. In addition, despite there being some uncertainty (because the vendor will only receive payment when the distributor sells the goods to its own customers), this will be resolved in a relatively short time period.

Consequently, the vendor recognises revenue of CU 80,000 on 1 January 20X4, the date on which control of the goods passes to the distributor.

Scenario 2 – the vendor's estimate of variable consideration is constrained

Although the vendor has experience of selling similar goods, these goods (including the goods being sold in this transaction) have a high risk of obsolescence and the ultimate pricing is very volatile. Historically, the vendor has offered subsequent price concessions of 20-60% from the sales price for similar goods, and current market information indicates that a range of 15-50% might apply to the current transaction.

The vendor considers the approach which will better predict the amount of consideration to which it will be entitled, and concludes that the expected value method should be used. Under this method, it is estimated that a 40% price concession will apply, meaning that the estimated transaction price is CU 60,000 (CU 60 x 1,000 units).

In addition, the vendor considers the requirements for constraining the estimate of variable consideration. This is in order to determine whether the transaction price can be the estimated amount of CU 60,000. In this scenario, the vendor determines that the ultimate amount of consideration is highly variable and susceptible to factors outside its control, and that there is a wide range of possible price concessions that will need to be offered to the distributor. Consequently, the vendor cannot use its estimate of CU 60,000 because it is unable to conclude that it is highly probable that there will not be a significant subsequent reversal in the cumulative amount of revenue that has been recognised.

Although historic information shows that price concessions of 20-60% have been given in the past, current market information indicates that a price concession of 15-50% will be needed for the current transaction. The vendor has carried out an analysis of past prices and can demonstrate that they were consistent with the current market information that was available at that time. Consequently, it is concluded that it is

highly probable that a significant reversal in the cumulative amount of revenue recognised will not occur if a transaction price of CU 50,000 is used.

Consequently, the vendor recognises revenue of CU 50,000 on 1 January 20X4, and reassesses its estimates of the transaction price at each subsequent reporting date until the uncertainty has been resolved.



BDO comment

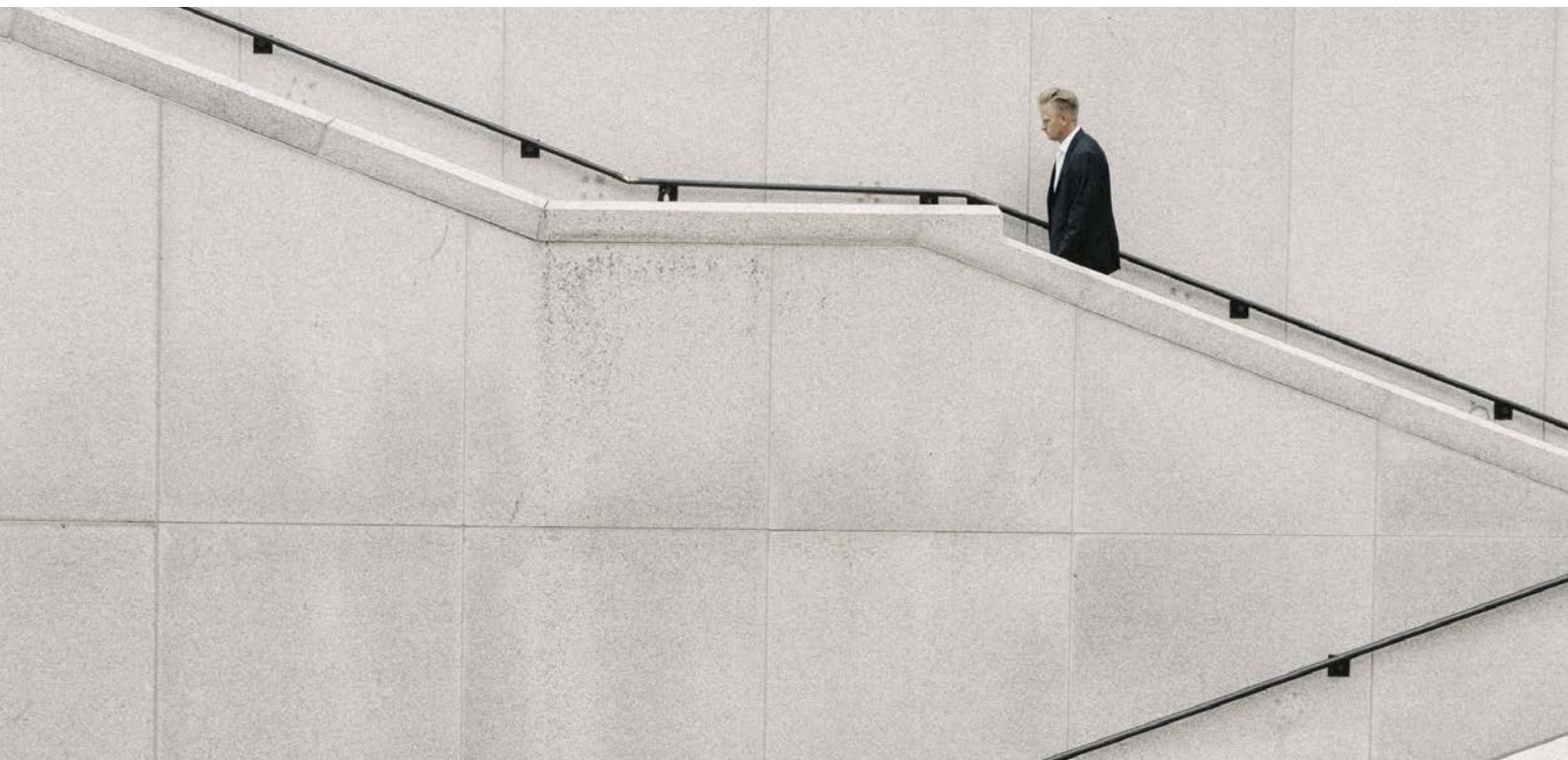
In scenario 2 above, although the uncertainties resulted in a restriction over the amount of revenue that was recognised when the goods were supplied to the distributor, there was still sufficient evidence to support the immediate recognition of a portion of the estimated transaction price. For those entities in the early stages of their operations, in particular those operating in relatively new sectors, it is possible that the constraint over estimates of variable consideration will result in no revenue being recognised on the date

on which control over goods passes to a customer, with recognition being postponed until a later date. However, in these circumstances the inventory sold would be derecognised with an associated cost of sale (and gross loss) at the point at which control passes to the customer. The estimate of variable consideration and appropriate constraint would then be reassessed at each reporting date, with a corresponding amount of revenue being recognised as appropriate.

Interaction between IFRS 15 and IAS 2

IFRS 15 requires contract costs within the scope of other standards to be accounted for in accordance with those standards (IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*). The derecognition guidance in IAS 16 and IAS 38 is consistent with the principles in IFRS 15 for the transfer of control and measurement of the transaction price. However, there were no amendments made to IAS 2 when IFRS 15 was issued, and IAS 2.34 requires that the carrying amount of inventories are expensed in the period in which the related revenue is recognised.

This might be interpreted as requiring the recognition of an expense for goods sold to be deferred until the point at which (constrained) revenue for its sale is recognised. However, there is a difference between recognition and measurement. IFRS 15 requires an entity to recognise revenue when or as it satisfies a performance obligation by transferring control of a good or service. Although revenue would be recognised when control is transferred, the measurement of the transaction price (and hence revenue) may be constrained when there is variable consideration. Consequently, the carrying amount of inventory will be recognised in full as an expense when control passes to the customer, even if the amount of revenue to be recognised as a result of constraining that variable consideration is very low, or even zero.





Example 16

Entity A sells a product to Customer B and control of the product transfers to Customer B upon shipment. However, the transaction price is dependent on certain targets being met and as a result the price can vary from nil to CU 100. Entity A has concluded that no revenue can be recognised upon control transfer due to the application of the variable consideration constraint in IFRS 15.56.

When should costs associated with inventories be recognised?

Entity A should recognise the costs of the product sold as an expense when control transfers. Upon shipment, Entity A no longer controls the asset nor is the asset held for sale. Therefore, it does not meet the definition of an asset in the Framework or the description of inventory in IAS 2.8. This conclusion also reflects the fact that the variable consideration constraint is focused on measurement. In this example, the entity is recognising revenue when it satisfies a performance obligation by transferring control of a good to a customer, but the application of the variable consideration constraint results in that revenue being initially measured at nil.

Sales- and usage-based royalties

Note that there are specific requirements for revenue relating to sales- or usage-based royalties that are receivable in return for a licence of intellectual property. In those cases, revenue is recognised when (or as) the later of the following events takes place:

- The subsequent sale or usage occurs
- The performance obligation to which some or all of the sale- or usage-based royalty has been allocated has been satisfied (in whole or in part).

This is discussed in more detail in section 5.10 below.

TRG discussions

Variable consideration and constraining estimate – constraint at contract or at performance obligation level? (Agenda Paper 14; January 2015)

In some contracts where more than one performance obligation has been identified, there may be both fixed and variable elements to the consideration stated in the contract. The TRG considered whether IFRS 15's requirement to constrain the recognition of any variable consideration element should apply at the contract or performance obligation level when the variable consideration has not been allocated proportionately to all performance obligations in a contract (the allocation of consideration to performance obligations is discussed in detail in section 4.4 below).

TRG members generally agreed with the staffs' view that the constraint on variable consideration should be applied at the contract level and not the performance obligation level. This is because the unit of account for determining the transaction price in Step 3 is the contract.

Portfolio practical expedient and application of variable consideration constraint (Agenda Paper 38; July 2015)

The TRG discussed the application of the optional practical expedient referred to in section 2 above that allows entities to apply the guidance to a portfolio of contracts with similar characteristics instead of to individual contracts. TRG members agreed with the staffs' view that estimating the transaction price using the evidence obtained from other similar contracts ('portfolio of data') is not the same as applying the portfolio practical expedient. The practical effect of this could be where an entity is developing an estimate of variable consideration for a single contract using the expected value method. The TRG conclusion means that although the entity might consider historic data for other, similar, contracts that have been carried out in the past does not mean that it is applying the portfolio practical expedient. Consequently, there is no need to comply with the restriction on the use of the portfolio practical expedient, which is to conclude that there is a reasonable expectation that the effects on the financial statements from applying the guidance to a portfolio of contracts would not differ materially from applying the guidance to individual contracts within the portfolio.

The TRG also discussed the application of the variable consideration constraint, which limits revenue recognition to the amount for which is highly probable that there will not be a significant reversal of revenue previously recognised when the uncertainty over the amount of revenue is resolved. TRG members discussed whether the new revenue standard requires applying the constraint to a portfolio of contracts when a 'portfolio of data' was used to estimate variable consideration or whether the constraint can be applied at an individual contract level. It was considered that the approach to be followed is linked to whether the entity concludes that it should use the expected value approach or the most likely amount method when it estimates the transaction price. If it is the expected value approach, then it would be consistent and appropriate to use the 'portfolio of data' to estimate variable consideration. If the most likely amount method was to be followed, then a portfolio approach should not be used.

The existence of a significant financing component in the contract

The timing of payments specified in a contract may be different from the timing of recognition of the related revenue (and, consequently, the timing of transfer of control of the related goods or services to the customer). If the timing of payments specified in the contract provides the customer or the vendor with a significant benefit of financing the transfer of goods or services, the transaction price is adjusted to reflect this financing component of the contract.

Again, it is necessary to look more widely than the documented contractual terms. A significant financing component may exist regardless of whether a financing component is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

As a practical expedient, adjustments for the effects of a significant financing component are not required if, at contract inception, the vendor expects that the period between when revenue is recognised for the transfer of the goods or services and the date of payment from the customer will be one year or less.

The objective of including adjustments for significant financing components is to require revenue to be recognised at the amount that would have been paid if the customer had paid for the goods or services at the point at which they are supplied (that is, when control transfers to the customer). This is because the result of excluding the effects of (say) a substantial payment in advance from a customer could result in two economically similar transactions giving rise to substantially different amounts of revenue.

For example, a vendor may require a customer to pay in advance for a long-term construction contract because the vendor requires funds in order to obtain materials to carry out the contract. In the absence of the advance payment, the vendor would typically need to borrow the funds. The vendor would need to pay finance charges on those borrowings and would therefore be likely to recharge those borrowing costs to the customer by way of a higher transaction price. However, the fair value of goods and services transferred to the customer would be the same. It is only the party providing the financing to the vendor that changes. Consequently, the amount of the vendor's revenue should not vary depending on whether the vendor receives financing from the customer or from a third party.

Factors to consider in assessing whether a contract contains a significant financing component include:

- The difference, if any, between the amount of consideration and the cash selling price of the goods or services
- The combined effect of:
 - The expected length of time between the point at which the vendor transfers the goods or services to the customer, and the point at which the customer pays for those goods or services; and
 - The prevailing interest rates in the relevant market.

When the existence of a significant financing component is identified, the applicable interest rate will not always be the rate which is implied by the contractual terms for the sales transaction. This is because IFRS 15 requires the borrowing rate to be the rate that would have been charged by an unrelated third party to the entity (vendor or customer) which receives the benefit of the financing. Consequently, in addition to considering any difference between the amount of consideration and the cash selling price of the goods or services, the interest rate that would apply to a particular borrowing arrangement needs to be considered.



Example 17

A vendor enters into a contract with a customer to build and supply a new machine. Control over the completed machine will pass to the customer in two years' time (the vendor's performance obligation will be satisfied at a point in time). The contract contains two payment options. Either the customer can pay CU 5 million in two years' time when it obtains control of the machine, or the customer can pay CU 4 million on inception of the contract.

The customer decides to pay CU 4 million on inception.

The vendor concludes that because of the significant period of time between the date of payment by the customer and the transfer of the machine to the customer, together with the effect of prevailing market rates of interest, that there is a financing component which is significant to the contract.

The interest rate implicit in the transaction is 11.8%. However, because the vendor is effectively borrowing from its customer, the vendor is also required to consider its own incremental borrowing rate which is determined to be 6%.

The accounting entries required are as follows:

Contract inception:

	CU '000	CU '000
Cash	4,000	
Contract liability		4,000
Recognition of a contract liability for the payment in advance		

Over the two year construction period:

Interest expense	494	
Contract liability		494
Accretion of the contract liability at a rate of 6%		

At the date of transfer of the machine to the customer:

Contract liability	4,494	
Revenue		4,494





BDO comment

For the purposes of identifying whether there is a significant financing component, the comparison made is between the timing of payment and the timing of transfer of control of the related goods or services. For those entities that provide goods or services where revenue is recognised at a point in time (such as in the above example) an adjustment for financing may be required even if the services are being carried out over a period of time. Section 4.5 below discusses in more detail whether revenue should be recognised at a point in time or over time.

Entities must also consider whether interest expense arising from adjusting the transaction price for the effect of a significant financing component should be capitalised into particular assets in accordance with IAS 23 Borrowing Costs. For example, consider an entity that receives an up-front payment for the construction of apartment units for clients that will take approximately 3 years, with revenue being recognised at a point in time.

The entity must consider whether the apartment building is a 'qualifying asset' in accordance with IAS

23.5. Assuming that this criterion is met, in our view, interest expense that accrues on the contract liability should be capitalised into the value of the apartment complex as it is constructed. That is because the interest expense is a 'borrowing cost' (IAS 23.5), since the finance charge is incurred in connection with the borrowing of funds.

This arrangement differs from the unwinding of the discount rate on asset retirement obligations, where the IFRS Interpretations Committee (IFRS IC) concluded that capitalisation should be precluded. That is because the unwinding of a discount on the asset retirement obligation does not represent the 'borrowing of funds', since the interest expense relates solely to deferred payment. In the case outlined above, the customer provides consideration to the vendor in advance of the receipt of goods and services, with the vendor using the funds in order to fulfil the performance obligation, which is consistent with the concept of the 'borrowing of funds'.

The discount rate used needs to reflect the credit characteristics of the party receiving financing, as well as any collateral or security provided by that party (which might include assets transferred in the contract). The discount rate may be capable of being determined by identifying the rate that discounts the nominal amount of consideration to the cash selling price of the good or service. However, the discount rate will not necessarily be the same as the implied rate that would be derived by using the timing of the amount(s) payable by the customer and the timing of the transfer of the related goods or services to the customer. For example, a lower than market interest rate might be granted as a sales incentive which would not reflect the creditworthiness of the customer.

After contract inception, the discount rate is not updated (e.g. for changes in interest rates or the customer's credit risk).

The effects of a financing component are presented separately from revenue in the statement of comprehensive income.

The following circumstances do not give rise to a significant financing component, even though there is a difference between when goods or services are transferred and when payment is received:

- A customer has paid in advance, and is able to call off the related goods or services at any point (such as a prepaid phone card)
- A substantial amount of consideration payable by the customer is variable, and the amount or timing of that consideration will be determined by future events that are not substantially within the control of either the vendor or the customer (such as a sales-based royalty)
- The timing of payment in comparison with the timing of supply of goods or services is for a reason other than financing such as to provide the customer with protection that the vendor has or will adequately complete its obligations, e.g. to ensure any necessary remedial works on a newly constructed or refurbished building are completed subsequent to ownership transferring to the customer.



TRG discussions

Financing component (Agenda Papers 20 and 30; January and March 2015)

The TRG discussed a number of questions related to whether a contract includes a significant financing component.

Members agreed that there is no presumption in the standard that a significant financing component exists when there is a difference in timing between when goods and services are transferred and when the promised consideration is paid. An entity will need to apply judgment to determine whether the payment terms are providing financing or are for another reason. Many members noted that it will require significant judgment in some circumstances to determine whether a transaction does, or does not, include a significant financing component.

It was agreed that the difference, if any, between the amount of promised consideration and the cash selling price is only one indicator, not a presumption, in determining whether a significant financing component exists. Entities would compare the cash selling price and the promised consideration as part of the evaluation based on the overall facts and circumstances of the arrangement.

TRG members agreed that the standard does not preclude accounting for financing components that are not significant in the context of the contract.

It was also noted that it may not always be clear if cash collected relates to a specific performance obligation. Therefore judgment will need to be applied to determine if the practical expedient can be applied in scenarios in which there is a single payment stream for multiple performance obligations.

It was acknowledged that calculating the adjustment of revenue in arrangements that contain a significant financing component and determining how to apply the significant financing component guidance when there are multiple performance obligations may be complex in some scenarios. However, it was agreed that the standard provides a framework to deal with those issues. In calculating the impact of a significant financing component, the new revenue standard includes guidance on selecting a discount rate and other U.S. GAAP and IFRS standards provide guidance on subsequent accounting.

It was also agreed that it may be appropriate in some circumstances to attribute a significant financing component to one or more, but not all, of the performance obligations in the contract. It was noted that, practically, this might be in a manner analogous to the guidance on allocating variable consideration or allocating a discount.

Non-cash consideration

In some cases, a vendor might enter into a contract with a customer where the payment is in the form of non-cash assets. For example, a vendor might accept shares as payment (in particular from a customer listed on a public market).

When determining the transaction price, the vendor should measure the non-cash consideration at its fair value. If it is not possible to measure the fair value of the non-cash consideration, then the vendor is required to estimate this by using the stand-alone selling prices of the goods or services subject to the contract.

A customer might contribute goods or services to a vendor (for example, a customer for a construction contract might supply materials, equipment or labour which the vendor is to use in performing the construction services). In those circumstances, the vendor is required to assess whether it obtains control of the contributed goods or services. If so, they are accounted for as non-cash consideration and the contractual transaction price will be greater. If the vendor does not obtain control of the contributed goods or services, then their value should not be included as part of the contractual transaction price.

Care should also be taken to ensure that contracts involving the exchange of non-cash consideration are within the scope of IFRS 15. For example, IFRS 15 would not apply to:

- Barter transactions in which two entities exchange non-monetary items in the same line of business to facilitate sales to customers (see Section 3 above); and
- Transactions in which a vendor accepts a non-cash item (such as shares in a customer) in settlement of a debt owed to the vendor, to which IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments should be applied.

TRG discussions

Measurement of non-cash consideration (Agenda Paper 15; January 2015)

Rather than being fixed, the fair value of non-cash consideration can be variable and might change due to the form of the non-cash consideration or other reasons. For example, this would be the case for a contract in which the customer pays by transferring a fixed number of its own shares to the vendor at the end of a contract for goods or services supplied over a period of time. The question which follows is when the non-cash consideration should be measured.

A number of TRG members thought that non-cash consideration should be measured at the earlier of (1) when the non-cash consideration is received (or is receivable) or (2) when the related performance obligation is satisfied. However, for contracts in which revenue is recognised over time it was accepted that this approach would often be difficult to apply. Other TRG members suggested support for measuring the consideration at contract inception, and others thought that it should be measured when the consideration is received (or receivable).

TRG members also discussed how the constraint on variable consideration should apply to transactions in which the fair value of non-cash consideration might vary due to both the form of the consideration (e.g. where the vendor is to receive a fixed number of shares, the value of the consideration is subject to variability) and for reasons other than the form of the consideration (e.g. where the vendor will receive between 1,000 and 2,000 shares in the customer depending on whether performance targets are met). Two views were discussed:

1. The constraint applies to variability resulting from both the form of the consideration (e.g. shares) and for reasons other than the form (e.g. the number of shares)
2. The constraint applies only to variability resulting from reasons other than the form of consideration.

Several TRG members noted that the bifurcation of the effects of variability required by View 2 might be challenging in some circumstances. In contrast, some members noted that the bifurcation of non-cash consideration under View 2 might be the more conceptual approach and therefore avoid some unintended consequences.

Consideration payable to a customer

A contract between a vendor and its customer might require the vendor to pay consideration to the customer (or to other parties that purchase the vendor's goods or services from the customer). Such consideration could include cash, credits or other items (such as coupons or vouchers) that can be applied against amounts owed to the vendor.

Consideration might be payable from the vendor to the customer if, for example, the customer is selling goods or services to the vendor at the same time as the vendor provides goods or services to the customer. If the payment by the vendor is for distinct goods or services provided by the customer to the vendor, then the vendor accounts for this as a purchase transaction, i.e. separate from the sales transaction (on which revenue is recognised) for the provision of goods and services to the customer. If the amount of consideration payable to the customer exceeds the fair value of a distinct good or service that the entity receives in exchange, the difference is accounted for as a reduction in the vendor's sales transaction price.

If, in contrast, the payment to the customer is not in exchange for distinct goods and services provided by the customer, then the vendor accounts for the full amount of that payment as a reduction of the transaction price (and hence, a reduction of revenue).



Example 18

Entity V, a vendor, sells goods to Entity C, its customer, for CU 100. As part of the contract Entity V is required to pay Entity C CU 25.

Scenario A

Entity C is not providing any distinct goods and services to Entity V. Therefore the transaction price (and hence total revenue) recognised by Entity V on the sale of goods to Entity C is CU 75.

Scenario B

As part of the contract, Entity C is also providing a service to entity V with a fair value of CU 25. Therefore the transaction price (and hence total revenue) recognised by Entity V on the sale of goods to Entity C is CU 100. Entity V separately recognises the services purchased from Entity C for CU 25.

Scenario C

As part of the contract, Entity C is also providing goods to entity V with a fair value of CU 15. Therefore the transaction price (and hence total revenue) recognised by Entity V on the sale of goods to Entity C is CU 90 (CU 100 – (CU 25 – CU15)). Entity V separately recognises the goods purchased from Entity C for CU 15.

If a vendor cannot reasonably estimate the fair value of a good or service received from the customer, then the full amount of the consideration payable to the customer is deducted from the vendor's own transaction price (and hence reduces revenue).

When any of the consideration payable to a customer is treated as a reduction of the transaction price, it is accounted for when (or as) the later of either of the following occurs:

- The vendor recognises revenue for the transfer of the related goods or services to the customer
- The vendor pays, or promises to pay, the consideration, even if the payment is conditional on a future event. Such a promise may be implied by the vendor's customary business practices.

A key point is that any amount paid by a vendor to its customer will be accounted for as a reduction in revenue, unless that payment is in return for a distinct good or service.



Example 19

A vendor that manufactures retail goods enters into a contract to sell goods to a customer (a large supermarket group) for a period of one year. The customer is required to purchase at least CU 20 million of goods during the year.

The contract requires the customer to make changes to the shelving and display cabinets at the stores from which the retail goods will be sold. On the date on which the contract is entered into, the vendor makes a non-refundable payment of CU 2 million to the customer to compensate for the related costs.

The payment by the vendor to its customer does not result in it obtaining any distinct good or service. This is because, although the shelving and display cabinets will be used by the customer to sell the retail goods, the vendor does not obtain control of any rights to those shelves or display cabinets.

Consequently, the CU 2 million payment is accounted for as a reduction in the transaction price when the vendor recognises revenue for the transfer of retail goods. To achieve this, the CU 2 million payment is recorded as an asset and is amortised to the revenue line in the income statement as the related sales of retail goods are recorded, resulting in total revenue of CU 18 million being recognised by the vendor.

Consideration is often paid by a manufacturer to a retailer to obtain a prominent positioning of its goods in the retailer's shops. These are sometimes referred to as slotting fees. Whether the retailer provides a distinct good or service can depend on the precise facts and circumstances, specifically whether the manufacturer obtains control of any good or service provided by the retailer. Careful analysis will be required, as control is not the same as obtaining the risks and rewards of the shelf or other space.



BDO comment

The requirement to focus on whether a vendor receives any distinct goods or services in return for a payment to a customer represents a subtle, but potentially significant, change. In some cases, vendors may currently account for these types of payments as marketing costs, rather than a reduction in revenue.

Although IFRS 15 addresses how a vendor accounts for consideration payable to a customer, it does not address directly how an entity should account for amounts received from a supplier. In our view, the above example should result in the supermarket reflecting a reduction in the cost of inventory purchased (and hence ultimately a reduction in cost of sales) and not either revenue or a contribution to be offset against the costs of changing shelving and display cabinets. To the extent the receipt from the supplier relates to future purchases from the manufacturer, which is the contractual minimum purchase of CU 20 million, the supermarket should recognise a liability, which is offset against the cost of inventory when the future products to which the payment relates are purchased.

The manufacturer is not the retailer's customer in this situation, i.e. the adaption of shelving space and cabinets are not an output of the supermarket's ordinary activities and do not represent a good or service that is distinct from its purchases from

the manufacturer. This results in consistency in the accounting because, if the manufacturer is not receiving a distinct good or service for the consideration paid to the retailer, then the supermarket is similarly not providing a distinct good or service to the manufacturer.

However, in other circumstances, a retailer can receive consideration from manufacturers that do constitute revenue. This is illustrated by the following three scenarios:

Scenario A - Discount granted based on purchases not related to manufacturers' products

A manufacturer agrees with a retailer a promotion under which:

- the retailer's customers receive coupons based on their total purchases in the retailer's store;
- the retailer's customers use the coupons in order to acquire the manufacturers' products at a discounted price in the retailer's stores; and
- the difference between the sales price and the discounted price granted to the customer is borne by the manufacturer.

Suppose, a customer receives coupons of CU 10 for each CU 100 of purchases in the retailer's store. The

manufacturer's product has a selling price of CU 60. The customer purchases the product for 3 coupons (with a value of CU 30) and cash of CU 30. The manufacturer reimburses cash of CU 30 to the retailer, being the face value of the coupons. The retailer will record revenue of CU 60, being the cash received from the customer (CU 30) and the cash reimbursement from the manufacturer (CU 30).

Scenario B - Promotional discount granted to the customer

A manufacturer and a retailer agree the annual commercial strategy, which includes promotional activities. For instance, the retailer normally purchases the manufacturer's product for a price of CU 85. The retail selling price of the product is CU 102. During the promotional period, the retailer sells the product for CU 97 to its customers, with the discount of CU 5 to the regular retail price of CU 102 being reimbursed by the manufacturer.

The retailer will record revenue of CU 102, being the price paid by its customer (CU 97) plus the amount reimbursed by the manufacturer (CU 5).

Scenario C - Discount granted to the end-customer based on coupons issued by the manufacturer

A manufacturer initiates a promotional campaign under which end customers receive coupons issued by the manufacturer when they purchase the manufacturer's

products. When customers use the coupons, the difference between the normal retail price and the discounted price is borne by the manufacturer. For example, a customer receives coupons of CU 10 for each CU 100 of purchases of the manufacturer's products. Manufacturer's Product A has a selling price of CU 60. The customer purchases Product A for 3 coupons (with a value of CU 30) and cash of CU 30. The retailer receives CU 30 from the manufacturer.

Although the payments received by the retailer in all three scenarios are from the manufacturer (i.e. its supplier), the payments are received on behalf of the retailer's end customer and, as a result, the retailer recognises the amounts due from the manufacturer as revenue. As long as the manufacturer reimburses the retailer at an amount that exactly matches the discount that the end-customer receives, the coupon has in effect been issued by the manufacturer (not the retailer) to the end-customer and therefore is recognised as revenue by the retailer. Therefore, it is not a payment to a customer from the perspective of the retailer (the end customer has not paid the retailer anything), and is therefore not a rebate for the cost of inventory sold.

However, from the manufacturer's perspective it is a payment to its customer (i.e. the retailer), and so should result in a reduction to the amount of revenue recognised by the manufacturer.



TRG discussions

Variable Consideration and Consideration Payable to a Customer (Agenda Paper 14; January 2015 and Agenda Paper 28, March 2015)

The TRG discussed how consideration payable to a customer should be accounted for when that promise to pay is made only after revenue has already been recognised (because goods and services have already been transferred to the customer). The example considered by the TRG was:

An entity that manufactures consumer goods enters into a contract to sell a new product to a customer (a retail store chain) on December 15th. Before delivering any of the new products to the retail store chain, the entity's marketing department assesses whether the entity should offer CU 1-off coupons in newspapers to encourage customers to buy the new product. The entity will reimburse the retail store chain for any coupons that are redeemed. The entity has not historically entered into similar coupon offerings in the past.

The entity delivers the new consumer goods (1,000 units at CU 10/unit) to the retail store chain on December 28th. Assume for this example, that the customer has no right to return the products. On December 31st, the entity decides to make the coupon offering. On January 2nd, the entity communicates to its customers that it will reimburse the retail store chain on March 30th for any coupons redeemed by the retail store's customers. Assume the entity prepares its financial statements based on a calendar year end.

TRG members generally agreed with the staffs' view that the reversal of revenue from consideration payable to a customer should be made at the earlier of the date that there is a change in the transaction price (as specified in IFRS 15.70) or the date at which the consideration payable to a customer is promised (as specified in IFRS 15.72).

Although the standard's variable consideration guidance would arguably apply to consideration payable to a customer if such consideration is variable, some stakeholders believe that a requirement to include variable consideration payable to a customer in the transaction price may be inconsistent with the requirement to delay the recognition of consideration payable to a customer until the entity pays or promises to pay. Further, the staffs noted that there are different interpretations regarding (1) which entities meet the definition of a customer and (2) what payments to a customer could result in a reduction of revenue.

During the TRG discussions the staff highlighted that a vendor must first identify its customer in order to determine whether payments represent consideration payable to a customer.

The staffs subsequently carried out further analysis and presented the following issues at the TRG's March 2015 meeting:

Question 1: Which payments to a customer are within the scope of the guidance on consideration payable to a customer?

The staffs identified three dominant views:

- Entities should assess all consideration payable to a customer ('View A');
- Entities should assess only consideration payable to a customer under a contract (or combination of contracts) with the customer ('View B'); and
- Entities should assess only consideration payable to a customer under a contract (or combination of contracts) and consideration payable to customers in the customer's distribution chain ('View C').

The staffs concluded that View A is the only supportable interpretation because the boards acknowledge in paragraph BC257 of the Basis for Conclusions that the receipt of consideration from a customer and the payment of consideration to a customer can be linked even if they are separate events. In all cases, it would be necessary to assess whether consideration paid to a customer was in return for distinct goods or services at a price that is not more than fair value. This assessment would be eliminated in some circumstances under Interpretations B and C, which are therefore not supported by the requirements of the standard.

Some members agreed with the staffs view and others favoured Interpretation B. TRG members generally agreed that an entity should evaluate a payment to a customer (or to a customer's customer) — particularly when no goods or services have been transferred — to determine the commercial substance of the payment and whether the payment is linked to a revenue contract with the customer. No TRG members supported view C.

Question 2: Does the guidance on consideration payable to a customer apply only to customers in the distribution chain or more broadly to any customer of an entity's customer?

The staffs' view is that the guidance on consideration payable to a customer should be applied broadly. The staffs noted that 'those in the distribution chain are the customer's customers' and that 'the phrase customer's customer is a plain English way to describe the concept.'

The TRG did not agree with the staffs. Most TRG members thought that an entity must identify its customer in each revenue transaction and entities within the distribution chain. In addition, an entity that is acting as an agent (that is, arranging for another party to provide goods or services), might identify multiple customers depending on the facts and circumstances of the arrangement.

Question 3: What is the appropriate timing for recognising consideration payable to a customer?

The staffs' view is that if the consideration payable to a customer is variable, the guidance on variable consideration should be applied. Conversely, they determined that if such consideration is not variable, the guidance on consideration payable to a customer is applicable.

The TRG did not agree with the staffs on this issue either. The guidance on consideration payable to a customer states that such amounts should be recognised as a reduction of revenue at the later of (i) when the related revenue is recognised; or (ii) the entity pays or promises to pay such consideration. Some TRG members highlighted that if an entity intends to provide its customer with a price concession when entering into the contract (regardless of the form of the price concession, for example, cash payment, rebate, account credit, or coupon), then the contract includes variable consideration and it should consider that price concession when estimating variable consideration. If the contract includes variable consideration because of an expected price concession, then the entity would not wait until it has communicated the price concession to the customer to recognise a reduction in revenue under the above 'later of' requirement. Instead, it should re-estimate the expected price concession at each reporting date.



4.4. STEP FOUR - ALLOCATE THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS

Having determined the transaction price of the contract in step 3, it is then necessary to allocate that transaction price to each of the performance obligations identified in step 2. The objective is to allocate an amount to each performance obligation that reflects the consideration to which a vendor expects to be entitled in exchange for transferring the distinct goods or services (comprising each identified performance obligation in step 2) to the customer. The starting point for the allocation is to determine the stand-alone selling prices of each of those performance obligations.

Allocating the transaction price based on the stand-alone selling price

At contract inception a vendor is required to determine the stand-alone selling price of the good or service underlying each performance obligation and then allocate the transaction price proportionately based on these stand-alone selling prices. The 'stand-alone selling price' is the price at which a vendor would sell a good or service separately to a customer. The best evidence of a stand-alone selling price is the observable price charged for that good or service sold in similar circumstances and to similar customers in a single transaction. Although a contractually stated price or a list price for a good or service may represent the stand-alone selling price, this will not always be the case. For example, a vendor might typically grant discounts from its list prices, or it might not sell the distinct good or service separately from others.

When a stand-alone selling price is not directly observable, it is estimated. The objective is to determine the amount of consideration that the vendor expects to be entitled in return for the good or service. This is achieved by using all available information including market conditions, vendor-specific factors and information about the customer or class of customers. In all cases, the use of observable inputs is required to be maximised to the extent possible.

Approaches that might be used include:

- *Adjusted market assessment*

Estimating the price that a customer in the particular market would be prepared to pay, which might include referring to prices charged by the vendor's competitors for similar goods or services, and adjusting those prices as necessary to reflect the vendor's costs and margins.

- *Expected cost plus margin*

Estimating the expected costs of satisfying a performance obligation and adding an appropriate margin.

- *Residual*

Deducting observable stand-alone selling prices that are available for other goods or services to be supplied from the total contract price. However, the use of this approach is restricted to those goods or services for which there is a wide range of selling prices (meaning that these cannot be observed from past transactions or other observable evidence), or in circumstances in which the selling price is uncertain because no selling price has been set for the good or service and it has not previously been sold on a stand-alone basis.





BDO Comment

In some situations a distinct good or service is never sold separately by the vendor. Instead it is sold as part of a bundle and the bundle may be sold for a broad range of amounts. This is common in the software industry where software licenses are often bundled with maintenance for an initial period. Software maintenance (or PCS – Post Contract Support) can typically be renewed after the initial period on a stand-alone basis. However, the licence and the PCS could represent separate performance obligations despite the fact that the vendor might never sell one without the other (see section 4.2 above which discusses factors to take into account in determining whether two deliverables are distinct within the context of the contract).

In certain circumstances, an entity may have strong pricing policies for PCS where the entity charges customers a fixed amount for maintenance renewals and the price does not vary from customer to customer. This could also be the case if PCS renewals are stated as a percentage of a licence's list price (that is, the list price prior to any customer specific discounts or adjustments) provided that the list price was not subject to significant regular, artificial adjustments.

The question that arises is whether it would be acceptable for an entity to apply the residual approach to establish the standalone selling price for a licence that is never sold separately.

In our view, a residual approach to calculating the stand-alone selling price of the software licence is appropriate if an entity is able to identify that the pricing variability that exists in the software licence and PCS bundle is attributable to the software licence and that the standalone selling price of the PCS is not highly variable. Although the entity does not sell the software licence on its own for a broad range of amounts, the entity does sell a bundle that contains both software and PCS for a broad range of amounts. However, there is observable evidence that PCS renewals are always sold for either a fixed amount or a fixed percentage of the list price of the software being sold. The entity can identify that it is the licence component of the bundle that is sold to different customers for a broad range of amounts, and not the PCS, because there is an observable stand-alone selling price for the PCS. This means that the use of the residual approach is appropriate to calculate the stand-alone selling price of the licence.

Allocating discounts

A discount exists if the sum of the stand-alone selling prices of the goods or services in a contract exceeds the consideration payable by the customer. A discount is allocated proportionately to all performance obligations in the contract based on their stand-alone selling prices, unless there is observable evidence that the discount is attributable to only some performance obligations in a contract. This might be the case if a contract is for the supply of three goods, but only two of these are frequently sold together at a discount from the total of the two stand-alone selling prices.



Example 20

A vendor sells three products (A, B and C) to a customer for CU 100. Each product will be transferred to the customer at a different time. Product A is regularly sold separately for CU 50, but products B and C are not sold separately. The estimated stand-alone selling prices of products B and C are CU 25 and CU 75 respectively.

There is no evidence that suggests the discount of CU 50 relates entirely to one, or a group of two, of the products being sold. Consequently the discount is allocated proportionately to the three products and revenue is recognised as follows:

A	(100 x (50/150))	CU 33
B	(100 x (25/150))	CU 17
C	(100 x (75/150))	CU 50

If a discount is allocated to only some of the performance obligations in the contract, the discount is allocated before considering whether it is appropriate to use the residual approach to estimate the stand-alone selling price of a remaining performance obligation.



Example 21

Assume the same fact pattern as above, except that products B and C are regularly sold together for consideration of CU 50, the total amount payable by the customer is 90 and product A is regularly sold for amounts between CU 35 and CU 50. Because the vendor has evidence that a discount of CU 50 is regularly applied to products B and C, the selling price attributed to those products is determined first with a residual amount being attributed to product A.

Consequently, revenue will be attributed to each product as follows:

A		CU 40
B	$(50 \times (25/100))$	CU 12.5
C	$(50 \times (75/100))$	CU 37.5

It should be noted that the residual approach results in an amount being attributed to product A that is within the range of prices at which it is regularly sold. If, for example, product A was never sold for less than CU 50, then the residual approach illustrated above would not be appropriate. Instead, the stand-alone selling prices for each separate product would be estimated and the discount allocated on a relative stand-alone selling price basis to all 3 products.



BDO comment

It is common for vendors in the retail sector to 'bundle' a number of different goods together and sell them at a discount. Although the approach set out in IFRS 15 appears straightforward, care will be required to ensure that discounts are allocated on an appropriate

basis. Historically, when using a residual approach, some entities may not previously have considered the range of prices at which each good within a bundle has historically been sold separately.

Allocation of variable consideration

Variable consideration may be attributable either to the entire contract, or to specific part(s) of the contract, such as:

- one or more, but not all, performance obligations. For example, a bonus may be contingent on the vendor transferring a good or service within a specified period of time
- one or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation. This would apply if, for example, the consideration promised for the second year of a two-year maintenance service contract will increase based on movements in a consumer price index.

A variable amount of consideration (and subsequent changes to that amount) is allocated entirely to a single performance obligation (or a distinct good or service that forms part of a single performance obligation to transfer a series of distinct goods or services that are substantially the same) if both:

- The terms of a variable payment relate specifically to the vendor'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
- The allocation of the variable amount in its entirety to a performance obligation or distinct good or service is consistent with the objective that the selling price is allocated to each performance obligation in order to reflect the consideration to which the vendor expects to be entitled in exchange for the good or service.



Example 22

A vendor enters into a contract with a customer for two licences of intellectual property (licences A and B). Assume each licence represents a separate performance obligation, which is satisfied at a point in time (the transfer of each licence to the customer). The stand-alone selling prices of Licences A and B are CU 1,200 and CU 1,500 respectively.

Scenario A

The prices specified in the contract are as follows:

- Licence A: a fixed amount of CU 1,200
- Licence B: a royalty payment of 5% of the selling price of the customer's future sales of products that use the intellectual property to which licence B relates

The vendor estimates that the amount of sales-based royalties that it will be entitled to in respect of licence B will be approximately CU 1,500.

The vendor then determines the allocation of the transaction price to each of the two licences. It is concluded that the allocation should be as follows:

- Licence A: CU 1,200
- Licence B: the variable royalty payment

This allocation is made because both of the following conditions apply:

- The variable payment relates solely to the transfer of licence B (the subsequent royalty payments); and
- The fixed amount of licence A, and the estimated amount of sales-based royalties for licence B, are equivalent to their stand-alone selling prices.

Although revenue will be recognised for licence A on its transfer to the customer, no revenue will be recognised when licence B is transferred to the customer. Instead, revenue attributable to licence B will be recognised when the subsequent sales of the customer's products that use licence B take place (see section 5.11 below).

In contrast, the allocation of variable consideration is different if the prices included in a contract do not reflect stand-alone selling prices.

Scenario B

Assume the same example as above, except that the prices included in the contract are:

- Licence A: a fixed amount of CU 450
- Licence B: a royalty payment of 7.5% of the selling price of the customer's future sales of products that use licence B.

The vendor estimates that the amount of sales-based royalties that it will be entitled to in respect of licence B will be approximately CU 2,250.

In this case, although the variable payments relate solely to the transfer of licence B (the subsequent royalty payments), allocating the variable consideration only to licence B would be inappropriate. This is because allocating CU 450 to licence A and CU 2,250 to licence B would not reflect a reasonable allocation based on the stand-alone selling prices of those two licences.

Instead, the fixed amount receivable in respect of licence A is allocated to the two licences on the basis of their stand-alone selling prices. This allocation is calculated as:

- Licence A: $(1,200 / 2,700) \times \text{CU } 450$ CU 200
- Licence B: $(1,500 / 2,700) \times \text{CU } 450$ CU 250

As the sales by the customer of products that use licence B occur, the royalty income will be allocated to

licences A and B on a relative stand-alone selling price basis. Recognition of the royalty income allocated to each of the two licences will be deferred to future periods because IFRS 15 requires that royalty income is only recognised when the related product sales take place (see section 5.11 below). Although the royalty income relates solely to the transfer of licence B, the allocation of the fixed selling price of licence A and the estimate of sales-based royalties to be generated by licence B is disproportionate in comparison with the stand-alone selling prices of the two licences, i.e. there was pricing interdependency. This means that, some of the royalty income to be generated by licence B in fact relates to the sale of licence A, and some of the licence fee specified in the legal contract as relating solely to licence A relates in part to the sale of licence B.

TRG discussions

Allocation of discounts and variable consideration (Agenda Paper 31; March 2015)

The guidance in IFRS 15 on allocating discounts to only one or some (but not all) performance obligations in a contract is different from the guidance on allocating variable consideration to only one or some (but not all) performance obligations. TRG members discussed a question about how an arrangement which includes both variable consideration and a discount should be dealt with.

TRG members agreed with the staffs' view that IFRS 15 establishes a hierarchy for allocating variable consideration, including variable discounts. When a contract includes variable consideration, an entity first applies the guidance on allocating variable consideration before considering the guidance on allocating discounts.

TRG members also noted that not all discounts are variable and that if a discount is fixed, that discount does not give rise to variable consideration. In those cases, an entity would apply the guidance for the allocation of discounts and not the guidance for the allocation of variable consideration.



4.5. STEP FIVE - RECOGNISE REVENUE WHEN EACH PERFORMANCE OBLIGATION IS SATISFIED

Having allocated in step 4 the transaction price (as determined in step 2) to the performance obligations (identified in step 3) it is then necessary to determine when the revenue allocated to each performance obligation should be recognised. A vendor recognises revenue when (or as) goods or services are transferred to a customer. A vendor satisfies a performance obligations (that is, it fulfils each promise to the customer) by transferring control of the promised good(s) or service(s) underlying that performance obligation to the customer.

Existing requirements for revenue recognition are based on an assessment of whether the risks and rewards of ownership of a good or service have been transferred to a customer. Under the control model, an analysis of risks and rewards is only one of a number of factors to be considered and this may lead to a change in the timing and profile of revenue recognition in certain industries.

Control in the context of IFRS 15 is the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. It includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. Indicators that control has passed include that the customer has:

- A present obligation to pay
- Physical possession of the asset(s)
- Legal title
- Risks and rewards of ownership
- Accepted the asset(s).

The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly, such as by:

- Using the asset to produce goods or provide services (including public services)
- Using the asset to enhance the value of other assets
- Using the asset to settle liabilities or reduce expenses
- Selling or exchanging the asset
- Pledging the asset to secure a debt liability
- Holding the asset.

When evaluating whether a customer obtains control of an asset, a vendor considers any agreement to repurchase the asset transferred to the customer, or a component of that asset.

For each performance obligation, a vendor determines at contract inception whether control is transferred over time or at a point in time. If it is determined that a vendor does not satisfy a performance obligation over time, the performance obligation is deemed to be satisfied at a point in time.



Performance obligations satisfied over time

A vendor satisfies a performance obligation and recognises revenue over time when one of the following three criteria is met:

- (i) The customer simultaneously receives and consumes the economic benefits provided by the vendor's performance
- (ii) The vendor creates or enhances an asset controlled by the customer
- (iii) The vendor's performance does not create an asset for which the vendor has an alternative use, the vendor has an enforceable right to payment for performance completed to date.

(i) The customer simultaneously receives and consumes the economic benefits provided by the vendor's performance

This criterion applies to certain contracts for services, and in some cases it will be straightforward to identify that it has been met. For routine or recurring services (such as certain cleaning contracts) it will be clear that there is simultaneous receipt by the customer of the vendor's performance. The concept of control of an asset applies, because services are viewed as being an asset (if only momentarily) when they are received and used. However, even in cleaning contracts care is needed. For example, take a 3-year cleaning contract of an office block in which the windows are cleaned once every 6 months (taking 5 days to complete), carpets deep cleaned once a month (taking place over a weekend), bins are emptied daily, with vacuuming and dusting undertaken on a continuous basis outside normal office working hours. Each cleaning activity is likely to constitute a separate performance condition and so it would be necessary to allocate the total contractual price to each of those performance obligations. The contractual price allocated to window cleaning and the deep cleaning of carpets would be recognised as those activities take place, and not spread evenly over the 3 year contractual period.

For other performance obligations, it may be less straightforward to identify whether there is simultaneous receipt and consumption of the benefits from the vendor's performance. In these cases, a key test is whether, in order to complete the remaining performance obligations, another vendor would need substantially to re-perform the work the vendor has completed to date. If another vendor would not need to re-perform the work, then the customer is simultaneously receiving and consuming the economic benefits arising from the vendor's performance.

In determining whether another entity would need substantially to re-perform the work completed to date, the vendor is required to:

- Disregard any contractual or practical barriers to the transfer of the remaining performance obligations to another entity; and
- Presume that any replacement vendor would not have the benefit of any asset that the entity currently controls, and would continue to control (such as a partially completed service or item of property, plant and equipment), were the remainder of the contract to be fulfilled by the entity.



Example 23 – Shipping Company

Entity S, a shipping company enters into a contract to transport goods from New York to Rotterdam. When Entity S enters into the contract, the ship to be used to transport the goods is docked in Miami. On Entity S's reporting date, the goods have been collected from New York and are half-way across the Atlantic Ocean.

Entity S concludes that it can recognise revenue for its performance to date (being the transport of goods from New York to appoint half-way across the Atlantic Ocean) because another entity would not need to re-perform the transportation services provided to date. In reaching this conclusion Entity F disregards the practical limitation associated with a hypothetical transfer of the goods from its ship to another shipping company's ship mid-Atlantic. Entity S therefore recognises revenue over time to reflect its partial performance to date.



BDO Comment

Careful analysis of shipping contracts is needed because, in some circumstances, shipping contracts may contain a lease of the ship used to transport goods because control of the ship is transferred to the customer. In such cases, IFRS 16 would apply to the contract rather than IFRS 15. Lease income would be recognised from the date control of the ship passes to the customer, which could result in lease income being recognised as the ship sails from Miami to New York.

If the contract is not, or does not contain, a lease of the ship then a shipping company would apply IFRS 15 for the shipping services provided to its customer. As noted above, if IFRS 15 applies, revenue is not recognised to reflect the journey from Miami to New York because Entity S does not provide any service to the customer during this part of the ship's overall journey. Instead it recognises revenue at the reporting date to reflect the extent to which the goods have been transported from New York to Rotterdam.

TRG discussions

Transfer of control – commodities (Agenda Paper 43; July 2015)

The TRG discussed whether the control of a commodity (such as gas, electricity or heating oil) is transferred at a point in time or over time.

The TRG members generally agreed that all known facts and circumstances should be considered when determining whether a customer simultaneously receives and consumes the benefits of a commodity. These facts and circumstances might include, for example, the following:

- contract terms
- customer infrastructure
- whether the commodity can be stored or not

In consequence, revenue related to the sale of a commodity may or may not be recognised over time.

(ii) The vendor creates or enhances an asset controlled by the customer

This criterion is most likely to be relevant when an asset is being constructed on the customer's premises. The asset being sold by the vendor could be tangible or intangible (for example, a building that is being constructed on land owned by the customer, or customised software that is being written into a customer's existing IT infrastructure).

(iii) The vendor's performance does not create an asset for which the vendor (1) has an alternative use and (2) the vendor has an enforceable right to payment for performance completed to date

This criterion may be relevant to entities in the construction and real estate sector, and also applies when a specialised asset is to be constructed that can only be used by the customer. It may also apply when an asset is to be constructed to a customer's specification. As can be seen, this criterion comprises two sub-conditions – alternative use and an enforceable right to payment – both of which are discussed in more detail below.

Alternative use

A vendor does not have an alternative use for an asset if the vendor is unable, either contractually or practically, readily to direct the asset (which may be an asset to be constructed in future, or a partially completed asset) for another use during the creation or enhancement of that asset. The assessment is made at contract inception, and takes into account the characteristics of the asset that will ultimately be transferred. It is not updated unless there is a modification to the contract that results in a substantive change to the vendor's performance obligation(s).

The contractual 'alternative use' restriction applies if the vendor would expect the customer to enforce its rights to the promised asset if the vendor (hypothetically) sought to direct the asset for another use. However, a contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets that

the vendor could transfer to the customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract. This might apply when the asset being sold is mass produced, and it would be straightforward for a particular item subject to an existing contract with a customer to be substituted for another, with the original item being sold to another customer. This would apply even if each of the items produced (for example, a car) could be specified individually by each customer from a range of optional extras, because it is straightforward for another car to be produced with the same options and therefore still to meet the requirements of the original contract.

A vendor does not have a practical alternative use for an asset if the vendor would incur significant economic losses to direct the asset for another use, for example,

- Incurring significant costs to rework the asset; or
- Only being able to sell the asset at a significant loss.

This may occur in some manufacturing contracts where the customisation of the asset being produced under one contract is substantial, and therefore it would not be possible to redirect it to another (hypothetical) customer during production. This is because it would either require significant rework or result in the entity not being able to transfer the asset to the original customer in accordance with the contractual timescales.

A vendor does not consider the possibility of a contract termination in assessing whether the vendor is able to redirect the asset to another customer.

Enforceable right to payment for performance completed to date

The second condition that needs to be satisfied is that the entity has to have an enforceable right to payment for performance completed to date throughout the contract (except in circumstances in which the contract is terminated due to the vendor's failure to carry out its obligations). In assessing that enforceability a vendor considers the terms of the contract as well as any laws or regulations that relate to the contract.

If a customer were to terminate (or take steps to terminate) a contract without having the right to do so, or if the customer fails to perform its obligations as promised, the contract (or other laws) might entitle the vendor to continue to carry out its obligations set out in the contract and require the customer to pay the contractual consideration. In this circumstance the vendor does have a right to payment for performance completed to date because the vendor has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations which include paying the promised consideration.

If, as is commonly the case, a contract (or other laws) does not grant the vendor these rights when the customer seeks to terminate the contract without the vendor having defaulted on its obligations, the amount which the vendor could force the customer to pay must at least compensate the vendor for performance completed to date (i.e. it must be an amount that approximates the selling price of the goods or services transferred to date), whether or not the customer has a contractual right of termination. This means a vendor must be able to demonstrate that at all times throughout the contract it would be entitled to compensation for recovery of costs incurred to date plus either of the following amounts:

- a proportion of the expected profit margin under the contract, reasonably reflecting the extent of the vendor's performance under the contract before termination by the customer or another third party; or
- a reasonable return on the vendor's cost of capital for similar contracts (that is, the vendor's typical operating margin in similar contracts or transactions) if the contract specific margin is higher than the return the vendor usually generates from similar contracts.

A vendor's right to payment for performance completed to date does not need to be a present unconditional right to payment. In many cases, a vendor will have that right only at an agreed-upon milestone or upon complete satisfaction of the performance obligation, and not throughout the contract term. However, in the event of contract termination, the vendor must always be entitled to payment for performance completed to date.

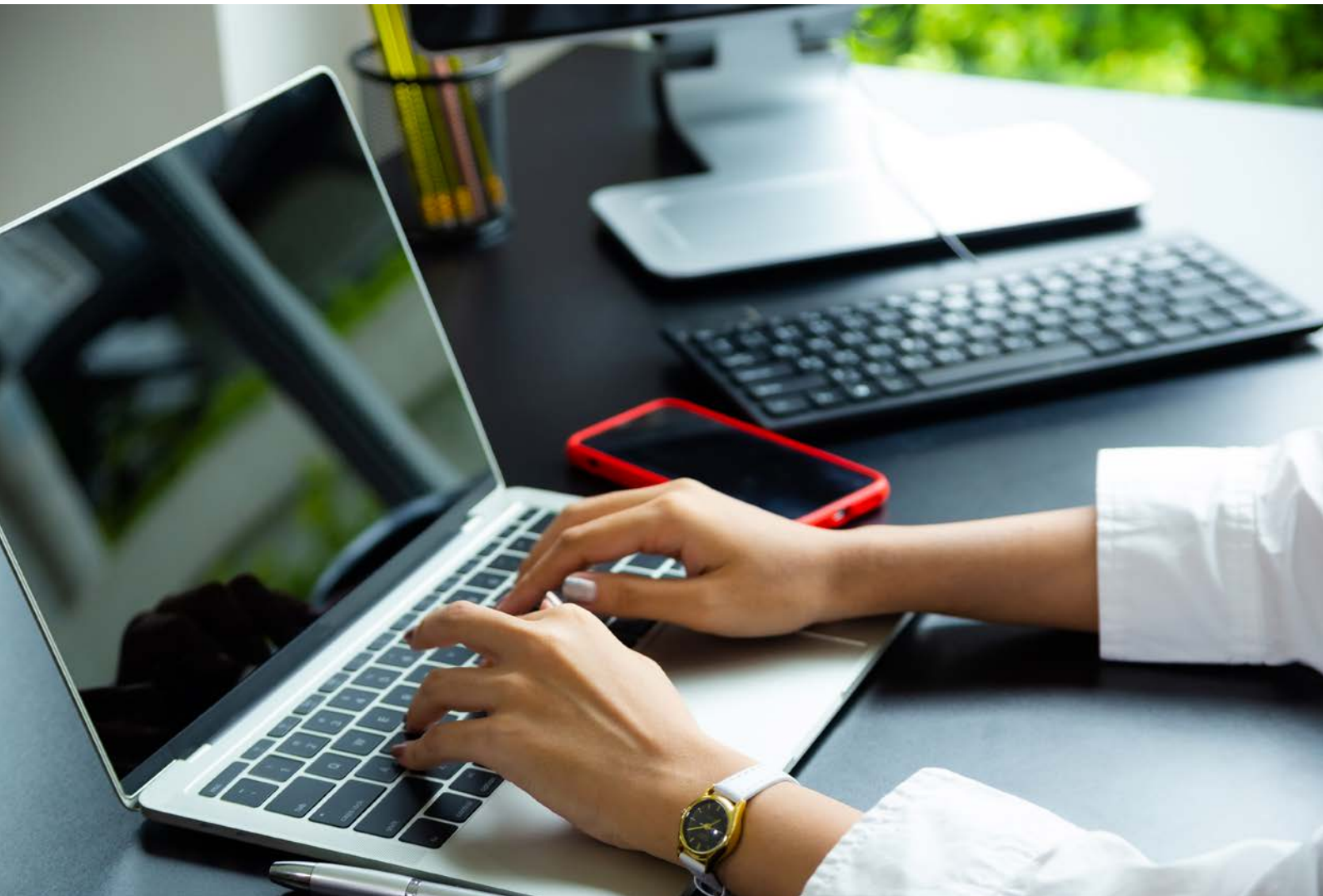
In assessing the existence and enforceability of a right to payment, a vendor considers whether:

- Legislation, legal precedent or administrative practice gives the vendor a right to payment for performance to date even though that right is not specified in the contract

- A court (or other relevant legal precedent) has previously decided that similar rights to payment for performance to date in similar contracts have no binding legal effect
- Its own customary business practices of choosing not to enforce a right to payment have caused that right to be unenforceable in that legal environment. If the vendor concludes that the right would still be enforceable, the vendor would have a right to payment for performance to date notwithstanding that the vendor has previously chosen, and may in the case being analysed choose, to waive that right.

In the absence of terms in the contract itself that provide evidence of an enforceable right to payment for performance completed to date, entities may need to review relevant legal precedent in their jurisdiction. Different countries and sub-national jurisdictions may provide entities with legal rights that are applicable but are not explicitly included in a contract itself (for example, a contract might refer to compliance with applicable laws but not specify precisely what these laws are). Therefore, entities should not always automatically conclude that they do not satisfy this particular criteria solely based on the reading of the contract.

For entities operating in the real estate industry, in particular those that sell residential units in multi-unit apartment blocks, properties being sold in real estate contracts typically cannot be readily redirected to another customer (that is, the vendor's performance does not create an asset for which the vendor has an alternative use because it is unable to sell the unit specified in the contract to any other party). The focus is therefore on whether the contract requires the customer to pay for performance to date in all circumstances other than vendor default. If that right exists then revenue will be recognised over time. However, many real estate contracts do not require the customer to pay for performance to date, with the customer instead either forfeiting a deposit or having to pay a penalty for the vendor's loss of profit. In those cases, a vendor recognises the sale on completion of the contract (at a point in time) and not over time as construction progresses.





Example 24

Entity R, a residential development company, is developing a block of apartments and enters into binding contracts with customers to sell units before construction is complete. Entity R assesses whether it should recognise revenue over time (i.e. from the period it enters a contract for a unit until the residential unit is completed) or whether it should recognise revenue at a point in time (i.e. on the date the completed unit is transferred to the customer).

Entity R observes that the first two situations in which revenue is recognised over time are clearly not met (IFRS 15.35(a) and (b)):

- (i) Customers do not simultaneously receive and consume the economic benefits provided by the vendor's performance (i.e. a customer does not consume the economic benefits of a unit as the units are constructed, only after it has been constructed); and
- (ii) Control of residential unit does not pass to customers until each one is complete, and therefore Entity R does not create or enhance an asset controlled by the customer.

Entity R therefore looks to the third situation in which revenue must be recognised over time, i.e. that its performance does not create an asset for which the vendor has an alternative use and for which it has an enforceable right to payment for performance completed to date.

Entity R concludes that the first of these sub-criteria is met, because its performance does not create an asset for which it has alternative use. The contract with each customer specifies exactly which unit in the apartment block each customer will buy. Therefore, as construction progresses, it is not possible for Entity R to direct a pre-sold unit to another customer whilst at the same time being able to meet its contractual obligations. However, Entity R concludes that it cannot demonstrate an enforceable right to payment throughout the contract. This is because if a customer cancels the contract before completion (even though it has no contractual right to do so):

- legal precedent would not entitle Entity R to sue the customer for the full contractual price even if Entity R completes the development.
- irrespective of any contractual right granted to Entity R to complete the unit for full payment, legal precedent requires the entity to mitigate any loss. Developers are required to make reasonable efforts to find a replacement customer and the courts would only award compensation equal to the difference between the stated contractual price with the original customer and the price obtained from a replacement customer (i.e. loss of profit). In almost all circumstances this would be less than Entity R's cost of developing the unit plus a reasonable profit margin. Consequently, Entity R cannot demonstrate it would have an enforceable right to payment from its customer for performance completed to date throughout the period of the contract.

Therefore, Entity R concludes it cannot recognise revenue over time as it progresses development of units sold. Instead it must recognise revenue at a point in time when the pre-sold units are completed and provided to customers.



Example 25:

Entity A entered into an agreement with Entity B to produce a highly specialised product. It has no alternative use to Entity A because it is prohibited from selling the product to another customer. Entity B commits to purchase certain volumes of the product over the contract term because it needs a continuous supply of the product to avoid interruptions to its production process.

The contract also contains the following features:

- Entity B is required to compensate Entity A if it terminates the contract without cause for an amount equal to all costs incurred by Entity A to date plus an agreed upon margin;
- Payment is due upon delivery of the product;

- Products are shipped under FOB destination terms* to B's international premises and A insures shipment against potential losses and damages that might affect the product. Therefore, B will not pay for the products before they are delivered;
- Shipment term is around 30 days (from A's warehouse to B's international premises).

The contract does not meet the over time recognition criteria in IFRS 15.35(a) because Entity B does not consume the economic benefits of any product whilst they are being produced by Entity A. The contract also does not meet the over time recognition criteria in IFRS 15:35(b) because Entity B does not control the products whilst they are in production because, inter alia, they are being produced on Entity A's premises.

Regarding the third situation in which revenue must be recognised over time (i.e. no alternative use and enforceable right to payment for performance completed to date), the following issues arise:

- Does a termination clause imply that 'an enforceable right to payment for performance completed to date' does not exist?

If a customer has a contractual right to terminate a contract, then whether the vendor has an enforceable right to payment for performance to date depends on the facts and circumstances. In the facts above, Entity A has a contractual right to recover all costs plus an appropriate margin and therefore the condition is met. In some contracts, however, the vendor receives stage payments and on cancellation of the contract by the customer, there may be no contractual right to receive stage payments otherwise due after the cancellation date. In those cases, careful analysis would be needed on inception of the contract to ensure that on any potential customer cancellation date the total amounts received by the vendor would equal costs incurred up to that date plus an appropriate margin. Unless this can be demonstrated, the vendor would not have an enforceable right to payment for performance completed to date and would be required to recognise revenue at a point in time rather than over time.

- If the customer has no obligation to pay in the event that products are lost or damaged during the shipping period can Entity A still demonstrate a right to performance completed to date?

A failure by the vendor to complete its contractual obligations because the products are lost or damaged during the shipping period does not mean Entity A would not have an enforceable right for performance completed to date. The possibility that a vendor might not perform its contractual obligations is not something that is relevant to the analysis of over time or point in time. Further, an entity might conclude in its step 2 analysis of the contract, that an obligation to deliver manufactured products constitutes a separate performance obligation, i.e. separate from the obligation to manufacture the products, with the transaction price determined in step 3 then allocated to the two performance obligations in step 4. The vendor would then need to conclude separately for each of those performance obligations whether the criteria for recognising revenue over time are met. If there were a significant risk that a vendor might not be able to perform its contractual obligations such that it would not be entitled to payment, then it might not be able to conclude it is probable it will receive consideration, and hence for accounting purposes a contract would not exist (see Section 4.1 above).

* FOB stands for "Free on Board". FOB destination terms mean that the buyer takes delivery of goods being shipped to it by a supplier once the goods arrive at the buyer's receiving dock.





Example 26

Entities often create original parts for sale to Original Equipment Manufacturers (OEMs) in the development of new products. Initially, these parts will not typically have an alternative use (i.e. they can only be sold to the OEM) and the entity will often have a present right to payment for any production completed to date. Therefore the contract would meet the criteria in IFRS 15.35(c) to recognise revenue over time.

Once an aftermarket emerges, the parts which were originally sold only to the OEM and for which there was no alternative use can now be sold to the other customers, as further parts are manufactured under subsequent contracts entered into with either the OEM or other customers in the aftermarket. The existence of several customers for the parts means that as more parts are manufactured under a new contract with one customer, those parts could typically be sold to other customers, with subsequent production of additional units being used to satisfy the original contract. This in turn means that, once an aftermarket emerges, the manufacturer will typically have an alternative use for products being manufactured under any particular contract with a customer. Therefore, the conditions for recognising revenue over time would no longer be met.

IFRS Interpretation Committee Agenda Decisions

The IFRS IC published three final agenda decisions in March 2018 that all related to assessing the criteria in IFRS 15.35 to determine whether revenue is recognised at a point in time or over time.

Revenue recognition in a real estate contract (March 2018)

The IFRS IC addressed a specific fact pattern concerning the sale of multi-unit condominium units and whether revenue should be recognised over time (i.e. as they are constructed) or at a point in time. The entire fact pattern and discussions of the IFRS IC have not been reproduced in this publication, however, in summary:

- Customer buys a residential unit from Entity. At inception, customer obtains a right to an undivided interest in the land and the unit in the condominium being constructed on the land;
- Entity agrees to build and deliver condominium on the land within a given time, with the unit being sold for a specified price and according to specific conditions. Entity cannot alter or replace the specified unit;
- Entity retains legal title to the unit until customer pays full purchase price after construction is complete;
- Customer pays a portion of the purchase price for the unit as the unit is being constructed, and pays the remainder (a majority) after construction is complete;
- The undivided interest in the land represents a notional fraction of the land on which the condominium is being constructed;
- Customer can resell or pledge its right to the undivided interest in the land and part-constructed unit in the condominium during the period that the condominium is being constructed, subject to the entity performing a credit risk analysis of the new buyer of the right;
- Customer cannot change the structural design of the complex or the unit;
- The customer, and the other customers who have agreed to buy real estate units in the multi-unit complex, have the right to together decide to change the structural design, negotiate such change with the entity, bear the related costs;
- Without breach of contract, neither the entity nor the customer can unilaterally cancel the contract; and
- Although contract is irrevocable, courts have accepted requests to cancel contracts in particular circumstances, such as a deterioration in the customer credit status. In these situations, the contract has been cancelled and the customer has received most, but not all, of the payments it has already made to the entity. The entity has retained the remainder as a termination penalty.

In analysing this fact pattern, the IFRS IC noted that IFRS 15.35(a) is not relevant because the entity's performance creates an asset that is not consumed immediately.

The IFRS IC noted that IFRS 15.35(b) was not met in this fact pattern as the customer does not control the

underlying asset (the condominium) during the construction period. The customer can resell or pledge its contractual right to the undivided interest, but cannot sell the residential unit itself before construction is complete. The IFRS IC noted that it is important that in analysing paragraph 35(b), entities must apply the requirements concerning control of the asset that is being created or enhanced; not control over a right to obtain real estate in the future. The IFRS IC also noted that the customer cannot change the structural design nor can it use the partially constructed unit in any other manner.

The IFRS IC also noted that IFRS 15.35(c) was not met in this fact pattern as the entity does not have an enforceable right to payment for performance completed to date. The termination penalty that entities have been entitled to in the past in the particular jurisdiction does not compensate the entity for the performance completed to date.

As none of the criteria in IFRS 15.35 are met, revenue would be recognised at a point in time. It should be noted that the IFRS IC's comments relate solely to the fact pattern as presented. Careful analysis of the particular facts and circumstances of each entity's case will be crucial, especially where jurisdictional differences may arise due to differences in contracts and legal precedent.

Revenue recognition in a real estate contract that includes the transfer of land (March 2018)

The IFRS IC addressed a specific fact pattern concerning a real estate contract for the construction of real estate as well as the sale of the land that the real estate will be placed on. The issues were whether the sale of the land and the construction contract are one performance obligation or two and whether revenue is recognised over time or at a point in time. The entire fact pattern and discussions of the IFRS IC have not been reproduced in this publication, however in summary:

- Customer enters into a non-cancellable contract to buy an entire block of real estate units before the Entity constructs the units;
- At the point at which the contract is signed, Entity transfers legal title to the land on which the building will be constructed in exchange for consideration paid for the land. Legal transfer of the land (and hence its sale) cannot be revoked;
- Entity and the customer agree upon the design and specification of the building before the contract is signed. If customer changes the design during the contract period, it pays for those changes; and
- The customer is required to make milestone payments throughout the construction period, however these do not necessarily correspond to the amount of work completed to date.

On the first issue concerning whether there are one or two performance obligations, the IFRS IC analysed the issue using the criteria in IFRS 15.27 (see Section 4.2 for discussion of identifying performance obligations in contracts). The IFRS IC noted that land and a building are capable of being distinct (IFRS 15.27(a)). In analysing whether the land and building are distinct in the context of the contract (IFRS 15.27(b)), the IFRS IC noted that it would depend on whether a transformative relationship exists between the land and building. To determine this, an entity would consider whether its performance in constructing the building would be the same regardless of whether the land was also transferred. Entities would also consider whether the construction of the building would be possible without the land being transferred as well. The IFRS IC concluded that two performance obligations exist in the contract; the land and building do not transform each other into a single combined output, and the customer could purchase the land and arrange for another entity to construct the building (for the purposes of this latter part of the analysis, it is not relevant whether the contract prohibits the customer from obtaining construction services from another entity – the test is whether it would be possible for the two elements (the land and the building) to be provided by separate entities).

On the second issue concerning whether revenue is recognised at a point in time or over time for the two performance obligations, the IFRS IC concluded first that revenue would be recognised at a point in time for the land. This is because none of the criteria in IFRS 15.35 are satisfied. The IFRS IC observed that it is likely that IFRS 15.35(b) would be satisfied concerning the construction of the building as long as title to the land transfers prior to the commencement of construction. This is because once the customer owns and controls the land on which the building is constructed, the entity cannot redirect the building for another use and the customer will control the building as it is constructed as it controls the underlying land on which it is constructed.

Right to Payment for Performance Completed to Date (March 2018)

The IFRS IC addressed a specific fact pattern concerning the construction of a residential multi-unit complex. Specifically, the IFRS IC's discussions focused on paragraph 35(c) in IFRS 15 and how entities should determine whether an entity has an 'enforceable right to payment for performance completed to date'. The entire fact pattern and discussions of the IFRIC have not been reproduced in this publication, however in summary:

- An entity and its customer enter into a contract for the sale of a real estate unit in a residential multi-unit complex, before the entity constructs the unit. The entity's obligation is to deliver the completed real estate unit to the customer;
- The customer pays 10% of the purchase price at contract inception, and the remainder after construction is complete; and
- The customer has the right to cancel the contract at any time before construction is complete. When this happens, the entity is legally required to make reasonable efforts to resell the real estate unit to a third party. On resale, the entity enters into a new contract with the third party—the original contract is not novated. If the resale price is less than the original purchase price (plus selling costs), the customer is legally obliged to pay the difference to the entity.

The IFRS IC noted that in analysing IFRS 15.35(c), entities are required to consider payments that they are entitled to receive under the existing contract. Potential consideration that would be received from another party under a different contract in the event of a resale of the underlying asset is not a payment for performance under the existing contract. Consequently, the compensation that the entity is entitled to under the existing contract is the difference between the resale price of the unit and the original purchase price. This amount does not compensate the entity for its performance to date at all times throughout the duration of the contract, and thus IFRS 15.35(c) is not satisfied.



Measuring progress toward complete satisfaction of a performance obligation

For each performance obligation that is satisfied over time, revenue is recognised by measuring progress towards completion of that performance obligation based on either:

(i) Output methods

These include appraisals of results, milestones reached, units produced and units delivered; or

(ii) Input methods

These include resources consumed, labour hours expended, costs incurred, time lapsed or machine hours used.

Only those goods or services for which the vendor has transferred control of are included in the assessment of progress to date.

For each separate performance obligation, the same input or output method of assessing progress to date is required to be used. The same method is also required to be applied consistently to similar performance obligations and in similar circumstances.

Output methods result in revenue being recognised based on the measurement of the value of goods or services transferred to date in comparison with the remaining goods or services to be provided under the contract. When evaluating whether to apply an output method, consideration is given to whether the output selected would reflect the vendor's performance toward complete satisfaction of its performance obligation(s). An output method would not reflect the vendor's performance if the output selected fails to measure a material amount of goods or services (for example, work in progress or finished goods) which are controlled by the customer.



BDO comment

For performance obligations that meet the conditions for over time recognition of revenue, an entity would not recognise any work-in-progress under IAS 2. This is because the fundamental principle underlying over time recognition is that control of the good or service is transferred to the customer continuously as the vendor fulfils its contractual obligations. Therefore, such costs would be expensed as incurred. If an output method is used to measure performance to date then

entities will often find that profit margins will vary over the contractual period. In some cases, losses may be experienced in some periods, particularly in the early stages of the contract, even though the contract is anticipated to be profitable overall. This is because the measurement of cumulative (or periodic) outputs driving the amount of revenue to recognise may not be commensurate with the cumulative (or periodic) costs incurred.

In most cases, the measurement of revenue (when recognised over time) will not be the same as amounts invoiced to a customer. In these circumstances an entity recognises either a contract asset or a contract liability for the difference between cumulative revenue recognised on a contract and cumulative amounts invoiced to the customer. However, as a practical expedient, if the amount of a vendor's right to consideration from a customer corresponds directly with the value to the customer of the vendor's performance completed to date (e.g. a service contract in which a vendor bills a fixed amount for each hour of service provided), the vendor recognises revenue at the amount to which the vendor has the right to invoice.

TRG discussions

Upfront payments and measurement of progress (Agenda Paper 40; July 2015)

Questions were raised about whether the existence of an upfront payment in an arrangement (or a back-end rebate) would preclude an entity from applying the practical expedient to recognise revenue at the amount to which the vendor has the right to invoice. FASB members noted that the mere existence of an upfront payment would not automatically preclude application of the expedient. Nevertheless, the nature of the payment and its size as a percentage of the total arrangement has to be considered.

The TRG also discussed how to measure progress when multiple goods or services are included in a single performance obligation. It was noted that although a performance obligation may contain multiple goods or services, the standard requires entities to apply a single method to measure progress toward the satisfaction of each performance obligation. It cannot apply one method to one part of a performance obligation and a different method to another part of that performance obligation.

TRG members noted that in some circumstances it may be difficult to identify a single attribution method that reflects the entity's performance appropriately and therefore judgement may be required. However, it was also observed that if applying a particular method seems to result in the recognition of an inappropriate amount of revenue, this may indicate that the separate performance obligations have not been identified properly.

When the information that is required to apply an output method is not observable, or is not available without undue cost, it may be necessary to use an input measurement method.

Input methods result in revenue being recognised based on the vendor's efforts or inputs towards the satisfaction of a performance obligation. When the vendor's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for a vendor to recognise revenue on a straight-line basis.

A drawback of input methods is that there may not be a direct relationship between the vendor's inputs and the transfer of goods or services to a customer. Therefore, when using a cost-based input method, an adjustment to the measure of progress may be required if certain costs incurred do not contribute to the vendor's progress in satisfying its performance obligation(s). This would be the case when costs incurred are attributable to significant inefficiencies in the vendor's performance which were not reflected in the price of the contract. In addition, certain costs may not be proportionate to the vendor's progress in satisfying a performance obligation, in which case IFRS 15 requires an adjustment to be made to the amount of profit recognised to date.



Example 27

As part of a contract to refurbish a building, Entity X needs to install new elevators. Entity X has analysed the contract in accordance with the requirements of IFRS 15 and made the following judgements:

- The refurbishment constitutes a single performance obligation, i.e. the supply and installation of the elevators is not distinct from the overall obligation to refurbish the building.
- Revenue should be recognised over time because the customer controls the output of the refurbishment as the work takes place (because the customer owns the property).
- An input method should be used to measure progress to date, specifically cumulative costs incurred as a proportion of total expected contracts costs.

Shortly after signing the contract, and by its reporting date, Entity X has purchased the elevators and arranged for them to be delivered to the premises being refurbished. However, although it is assessed that control of the elevators has been transferred to the customer at Entity X's reporting date, the elevators have not been installed and limited other refurbishment work has been carried out. The cost of the elevators represents 50% of the overall costs to be incurred on the contract.

Entity X must expense the cost of the elevators. It would be inappropriate to recognise them as an asset because control of the elevators has passed to the customer. However, Entity X also concludes that it would be inappropriate to recognise 50% of total contract revenue and related profit because it has made limited

progress in refurbishing the building. Consequently, it restricts the amount of revenue recognised to the cost of procuring the elevators. As a result, although Entity X recognises revenue equal to the cost of the elevators, it recognises no profit from their transfer to the customer because its performance obligation is to refurbish the building.

In some cases, a vendor may not be able to reasonably measure the outcome of a performance obligation, but may expect to recover the costs incurred in satisfying that performance obligation (e.g. in the early stages of a contract). In these circumstances, the vendor recognises revenue only to the extent of the costs incurred to date, until such time that it can reasonably measure the outcome of the performance obligation.



BDO comment

Accounting for partial satisfaction of performance obligations prior to identifying the contract

For some arrangements, an entity may start to provide goods and services before the criteria for the recognition of a contract are met. Other than the absence of a contract (which is required for step 1 of the five-step approach in IFRS 15), revenue would be recognised over time. This might be the case where an entity starts to manufacture a highly customised good or provide a service in advance of obtaining an expected contract from a customer. It could also apply to an entity that constructs apartments in circumstances when the entity is able to demonstrate the criteria for overtime revenue recognition are met on inception of the contract

When the entity subsequently determines that the criteria for identification of a contract have been met, it would begin to apply the remaining four steps of the five-step model. If the terms of the arrangement are such that revenue for the related good or service is required to be recognised over time, the question that arises is whether revenue is recognised prospectively from inception of the contract or if there is a cumulative catch-up adjustment for the work done to date.

In our view, revenue should be recognised on a cumulative catch-up basis because IFRS 15 requires an entity to recognise revenue when, or as, an entity satisfies performance obligations by transferring promised goods or services to a customer. This occurs when (or as) the customer obtains control of the good or service. If, at the point at which the criteria for the identification of a contract have been met, the entity satisfies part or all of certain performance obligations by transferring fully or partially completed goods or services to its customer, it is required to recognise the related amount of consideration to which it expects to be entitled.

Recognising revenue on a prospective basis only from the point at which the contract criteria have been met would be inconsistent with the control model underlying revenue recognition in accordance with IFRS 15, as control of certain goods or services is transferred to the customer on inception of the contract.

This is consistent with views expressed at the March 2015 TRG meeting, at which a similar issue was discussed.

TRG discussions

Stand-ready obligations (Agenda Paper 16; January 2015)

A 'stand-ready' performance obligation is one in which the entity provides a service of 'standing ready' to provide goods or services. The customer consumes and receives benefit from a 'stand-ready' obligation from the assurance that a resource is available to it when-and-if needed or called-upon.

Examples of different types of stand ready obligations included in the agenda paper were:

- Obligations in which the delivery of the good(s), service(s) or intellectual property underlying the obligation is within the control of the entity, but for which the entity must still further develop its good(s), service(s) or intellectual property. For example, a software vendor might promise to transfer unspecified software upgrades at the vendor's discretion or a pharmaceutical company might promise to provide when-and-if-available updates to previously licensed intellectual property based on advances in research and development
- Obligations in which the delivery of the underlying good(s) or service(s) is outside the control of the entity and the customer. For example, an entity promises to remove snow from an airport's runways in exchange for a fixed fee each year
- Obligations in which the delivery of the underlying good(s) or service(s) is within the control of the customer. For example, an entity might agree to provide periodic maintenance, when-and-if needed, on a customer's equipment after a pre-established amount of usage by the customer; and
- Making a good or service available to the customer continuously, such as membership of a gym or health club.

The TRG discussed the nature of an entity's promise in 'stand-ready' obligations and how an entity should measure progress towards completion of a 'stand-ready' obligation that is satisfied over time.

It was generally agreed that, in some cases, the nature of the entity's promise in a contract is to 'stand-ready' for a period of time, rather than to provide the goods or services underlying the obligation. Several members emphasised that judgment must be exercised when determining whether the nature of the entity's promise is that of a 'stand-ready' obligation, with the judgement reached affecting how to measure progress towards completion. It was also noted that whether the entity's obligation is to provide defined goods or services or, instead, to provide an unknown type or quantity of goods or services, might be a strong indicator as to the nature of the entity's promise.

TRG members also agreed that judgment should be exercised in determining the appropriate method to measure progress towards satisfaction of a 'stand-ready' obligation over time, and the substance of the 'stand-ready' obligation must be considered to align the measurement of progress towards complete satisfaction of the performance obligation with the nature of the entity's promise. It was also observed that a straight-line measure of progress might not always be conceptually pure, but it was also acknowledged that a straight-line measure might be the most reasonable estimate an entity can make for a 'stand-ready' obligation.



Revenue recognition at a point in time

If a performance obligation is not satisfied over time, a vendor satisfies the performance obligation at a point in time. A vendor considers indicators of the transfer of control, which include the following:

- (i) The vendor has a present right to payment for the asset. If the customer is obliged to pay for the asset, this indicates that the customer may have the ability to obtain substantially all of the remaining benefits from the asset.
- (ii) The customer has legal title to the asset. Legal title may indicate that the customer has the ability to direct the use of and obtain substantially all of the remaining benefits from an asset or to restrict the access of other entities to those benefits. If a vendor retains legal title over an asset solely as protection against the customer's failure to pay, this is a protective right and does not preclude a customer from obtaining control of that asset.
- (iii) The customer has physical possession of an asset. This may indicate that the customer has the ability to direct the use of and obtain substantially all of the remaining benefits from the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset; for example, consignment stock or bill and hold arrangements may result in physical possession but not control.
- (iv) Significant risks and rewards of ownership. When evaluating whether the customer has the risks and rewards of ownership of an asset, a vendor considers any risks that may give rise to a performance obligation in addition to the performance obligation to transfer the asset. For example, a vendor may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.
- (v) Acceptance of the asset. The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of and obtain substantially all of the remaining benefits from the asset.

The existing requirements of other IFRSs for the recognition of a gain or loss on the transfer of some non-financial assets that are not an output of a vendor's ordinary activities have also been amended so that they are consistent with the requirements in IFRS 15. Therefore, profit and losses on the disposal of assets such as property, plant and equipment within the scope of IAS 16, intangible assets within the scope of IAS 38 and investment property within the scope of IAS 40 are only recognised by the vendor when control has passed to the purchaser.



Example 28

Entity P, a property development company, enters into contracts to sell properties (for example, stand-alone residential or commercial properties, or individual units in apartment blocks) to its customers. The arrangements have the following features:

- On date X, customers enter into a binding contract for the property and pay a deposit of 10% of the contractually agreed purchase price.
- If the property is incomplete at date X (for example, it may have been sold 'off plan' or some, but not all, construction activities may have been completed), Entity P completes the construction of the property.
- From the point construction of a property, which is subject to a sales contract with a customer, is complete (date Y, which could be the same as date X) the customer assumes certain ownership risks, including risks associated with damage to the property caused by an event (such as severe weather) or by unrelated third parties.
- On date Z, which is typically a few weeks after date Y (the point at which Entity P has completed its construction activities), customers pay the balance of consideration and take ownership, with legal title passing from Entity P to its customer.

From date X, because the customer has entered into a binding sales contract, the customer is exposed to subsequent changes in the market value of the property.

However, even though the construction activities are completed on date Y, up to date Z the customer is not permitted to occupy or sublet the property, and may have either limited or no rights to access the property. The customer also has no right to make any changes to the property or to pledge it as security in transactions

such as a lending arrangement.

If a customer does not fulfil its contractual obligation to pay the balance of consideration on date Z, Entity P will retain the 10% deposit that was paid on date X. The contract also requires the customer to pay compensation to Entity P for any loss of profit. This means that if Entity P sells the property to another customer, but is unable to obtain a price of at least 90% of the original contractually agreed price with the original customer, the original customer is required to pay the shortfall to Entity P. There is substantial past history in Entity P's jurisdiction that the courts will enforce this compensation clause.

Entity P first considers whether it meets any of the criteria to recognise revenue over time. It concludes that it does not, meaning that revenue will be recognised at a point in time.

Entity P then considers whether the contractual terms and the legal environment mean that the transfer of control of the properties (the point at which revenue is recognised in accordance with IFRS 15) is different from the point at which revenue has previously been recognised (which is the point at which it had been considered that substantially all of the risks and rewards of ownership had passed to the customer). Although the customer assumes certain risks associated with the property at dates X and Y, Entity P concludes that the restrictions over the customer's physical and other use of the property up to date Z mean that control does not pass until that date.

Consequently, Entity P will recognise revenue from the sale of properties on date Z and not the earlier date Y



BDO Comment

In determining when to recognise revenue, it is very important to understand the legal environment as well as the precise contractual terms and conditions. This is particularly true for transactions involving real estate as subtle differences in property law and the way it is

applied to a contract for the sale of real estate could affect the assessment of whether control passes at a point in time or over time and, if at a point in time, the specific date on which control passes.



5. Other issues

5.1 CONTRACT COSTS

Contract costs are initially recognised as an asset and expensed on a systematic basis that is consistent with the transfer to the customer of the good or service to which those costs relate. Contract costs comprise both incremental costs of obtaining a contract and costs to fulfil a contract.

Incremental costs of obtaining a contract

Incremental costs incurred in obtaining a contract are those that would not have been incurred had that individual contract not been obtained. This is restrictive and includes only costs such as a sales commission that is paid only if the contract is obtained, unless the costs can be explicitly recharged to a customer.

As a practical expedient, incremental costs of obtaining a contract can be recognised as an immediate expense rather than capitalised if the period over which they would otherwise be expensed (or amortised) is one year or less.

All other ongoing costs of running the business, including costs that are incurred with the intention of obtaining a contract with a customer, are not incremental and will be expensed unless they fall within the scope of another accounting standard (such as IAS 16) and are required to be accounted for as an asset.



BDO comment

The recognition threshold of 'expected' recovery of incremental costs of obtaining a contract in accordance with IAS 38 is similar to IFRS 15. However, IFRS 15 is more restrictive in permitting only those costs that are incremental to obtaining a contract to be considered. This is a high threshold, and goes well

beyond the 'directly attributable' threshold of IAS 38. In practice, costs eligible to be capitalised may typically be restricted to the example given in IFRS 15 of a sales commission, with any other costs that would have been incurred regardless of whether the contract had been obtained being expensed as incurred.



Example 29

Scenario 1

A sales employee is paid a commission for each contract obtained with a customer. CU 100 is paid for a new customer contract. CU 60 is paid each time that same customer renews the contract. Assume the CU 60 renewal commission is not considered commensurate with the CU 100 commission paid on the initial contract.

The CU 100 paid for the new customer contract must be capitalised at contract inception.

The CU 60 for each renewal must be capitalised upon renewal because it is considered an incremental cost that would not have been incurred if the renewal contract was not obtained.

For the CU 100 capitalised when the new customer contract is obtained, alternative amortisation approaches include:

- a) amortising the initial CU 100 over the contract period that includes the specific anticipated renewals (that is, over the expected customer relationship) and amortise each capitalised renewal amount over the respective renewal period; or
- b) separating the initial CU 100 commission into two components: CU 60 to be amortised over the original contract term and CU 40 to be amortised over the period of the initial contract and the specific anticipated renewals. Upon renewal capitalise the CU 60 renewal commission and amortise it over the renewal period.

If the renewal contract was not a specifically anticipated future contract and the renewal commission is considered commensurate with the initial commission, an entity would amortise the CU 100 paid for the new customer contract over the original contract term and then amortise each capitalised renewal amount over the respective renewal period.

Scenario 2 (looking at subsequent commission) –

An employee receives an initial sales commission based on the contract price when a contract is obtained. This commission is considered incremental, so it is capitalised under IFRS 15. Subsequently, the customer modifies the contract to purchase additional goods, and the modification does not result in the company accounting for the modification as a separate contract. The employee is paid an additional commission based on the increase in the contract price arising from the modification.

Even though the contract modification is not accounted for as a separate contract, the increase in the contract price results in additional commission that is incremental to obtaining the modified contract. Therefore, the additional commission paid is an incremental cost of obtaining a contract and should be capitalised and amortised (along with any unamortised amount relating to the initial commission) on a systematic basis that is consistent with the transfer to the customer of the remaining goods or services to be provided over the remaining contractual period.

Example 30



Engineering

Co enters into a contract with Customer Z to design a water treatment plant. The design project is expected to take two years to complete. Assume that Engineering Co will transfer the services to Customer Z over time.

In order to win the project Engineering Co incurred the following costs:

- External marketing company for \$100,000 as part of developing the tender
- Other internal labour costs amounting to \$350,000 as part of developing the tender

After Engineering Co won the tender the following costs were incurred:

- Solicitor's fee of \$50,000 to draw up the contract with Customer Z
- Commission of \$120,000 to a PR Agent after the contract was signed (this amount would not have been paid if the contract had ultimately not been signed)
- After the contract is signed, the PR Agent is also paid an additional \$50,000 bonus

Question 1:

How should Engineering Co account for the costs incurred?

- (a) \$100,000 marketing fee
- (b) \$350,000 labour costs
- (c) \$50,000 solicitors fee
- (d) \$120,000 PR Agent commission

Part (a) Marketing fee

The \$100,000 fee paid to the external marketing company was incurred as part of the tender process to win the contract and would have been incurred by Engineering Co even if had lost the tender. Consequently, this fee would not be considered an incremental cost of obtaining the contract in accordance with IFRS 15.91-92. Engineering Co should therefore expense the \$100,000 marketing fee as incurred in accordance with IFRS 15.93.

Part (b) Labour cost for tender

The internal labour costs incurred, of \$350,000, were incurred in connection with the development of the tender and would have been incurred by Engineering Co even if had lost the tender. This means that these costs would not be considered incremental costs associated with obtaining the contract in accordance with IFRS 15.91-92. Engineering Co should expense the \$350,000 labour costs as incurred, in accordance with IFRS 15.93.

Part (c) Solicitor's fee

The solicitor's fees were only incurred because Engineering Co won the tender. The greater the extent to which negotiations are still to be finalised, the more indicative of the uncertainty of the contract, and therefore more likely the costs are NOT incremental; therefore, judgement is required to determine whether this fee is an incremental cost of obtaining the contract.

- Is it virtually certain that the contract will be signed?
- Have all the significant terms of the contract been agreed to prior to the solicitor's involvement, meaning that the legal costs were incurred merely to draw up the contract based on all pre-agreed terms?
- Is signing the contract a mere formality?
- Are there still substantial negotiation between the two parties?

The FASB's TRG considered this issue and supported the principle that at the point of signature of the contract (and therefore at the very last minute), if the counterparty decides to walk away, would the costs be incurred anyway? If the answer is yes, then the costs are not incremental.

Under the requirements of IFRS 15, assuming that all the significant terms have been agreed to at the tender stage and that signing the contract is a mere formality, the solicitor's fee could be considered an incremental cost of obtaining the contract in accordance with IFRS 15.91-92. Engineering Co should capitalise the solicitor's fee as a 'costs to obtain a contract' asset (IFRS 15.92) and amortise it over the project period (i.e. to reflect the pattern of transfer of the design service to Customer Z) (IFRS 15.99).

Part (d) PR Agent commission

The PR Agent commission and bonus were only incurred and were only payable after the contract had been signed. The commission and bonus are considered incremental costs of obtaining the contract in accordance with IFRS 15.91-92, since these amounts would not have been paid unless the contract has been signed. Engineering Co should capitalise the PR Agent commission and bonus as a 'costs to obtain a contract' asset (IFRS 15.92) and amortise it over the project period (i.e. to reflect the pattern of transfer of the design service to Customer Z) (IFRS 15.99).

Question 2:

How would the answer change if the design will only take 10 months to complete?

If the design will only take 10 months to complete (rather than two years), the solicitor's fees and PR agent commission and bonus, which would otherwise be required to be capitalised, can be expensed if the practical expedient in IFRS 15.94 is used.



Costs to fulfil a contract

In contrast with the incremental costs of obtaining a contract, which fall wholly within its scope, the requirements of IFRS 15 apply only to costs to fulfil a contract which do not fall within the scope of another IFRS (for example, IAS 2, IAS 16 and IAS 38). For those costs which do fall within the scope of IFRS 15, the threshold for recognising costs to fulfil a contract is lower than the 'incremental' threshold for costs in obtaining a contract. However, there are still restrictions and all of the following criteria need to be met:

- The fulfilment costs relate directly to a contract or to an anticipated contract that can specifically be identified
- The costs generate or enhance resources of the vendor that will be used to satisfy performance obligations in future; and
- The costs are expected to be recovered.



BDO Comment

The requirement to capitalise fulfilment costs that relate to an anticipated contract might appear similar to the requirements in IAS 11 Construction Contracts, under which costs incurred before a contract has been obtained were capitalised if it was 'probable that the contract will be obtained'.

However, there is significant focus in IFRS 15 on the need for any capitalised costs to meet the definition of an asset, which requires an entity to control a resource

rather than having only an expectation of the recovery of the associated costs. The explicit reference to the requirements of other Standards can also result in costs being expensed as incurred. The requirement in IFRS 15 that revenue is only recognised when control of a good or service is transferred to a customer may also result in additional costs being incurred in advance of revenue recognition in comparison with IASs 11 and 18.



Example 31

Entity A enters into a contract with Entity B that is within the scope of IFRS 15. As part of the services that Entity A will provide to Entity B, Entity A must incur training costs to train its own employees to utilise Entity B's equipment and learn about their processes. The requirement to train its own staff does not meet the definition of a performance obligation for Entity A as the act of training its own employees does not transfer a distinct good or service to the customer, Entity B (IFRS 15.22). Instead, the staff training enables Entity A to provide the service that it has promised to Entity B.

The training is included in a specific section of the contract between Entity A and Entity B, with a specified recharge which will at least cover the costs incurred. The recharge covers the number of Entity A's employees who require training at the start of the contract, and the training of new employees if operations expand. Costs associated with training replacement employees (because employees leave their employment with Entity A) are not covered and must be paid by Entity A.

The question which then arises is whether training costs incurred relating to fulfilling a contract with a customer should be recognised as a contract asset (i.e. as an asset arising from a cost to fulfil a contract (IFRS 15.95)).

In our view training costs should not be capitalised as a cost to fulfil a contract, regardless of whether they are explicitly chargeable in the contract with the customer.

IFRS 15.95 states:

'If the costs incurred in fulfilling a contract with a customer are not within the scope of another Standard (for example, IAS 2 Inventories, IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets), an entity shall recognise an asset from the costs incurred to fulfil a contract only if those costs meet all of the following criteria...'

Therefore, IFRS 15.95 first requires that another applicable IFRS does not address the accounting for the costs

incurred prior to the criteria in paragraph 95 being considered. Training costs are specifically addressed in IAS 38, which prohibits the recognition of an asset. IAS 38.69 states (extract):

'In some cases, expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognised. ... Other examples of expenditure that are recognised as an expense when it is incurred include:

- a) ...
- b) Expenditure on training activities'

Consequently, training costs that are incurred in respect of a contract with a customer which is within the scope of IFRS 15 cannot be recognised as an asset and must be expensed as incurred. This is consistent with the IASB's discussion in the Basis for Conclusions to IFRS 15 at paragraph BC307 (extract):

'Because the boards decided not to reconsider all cost requirements comprehensively, paragraphs 91-98 of IFRS 15 specify the accounting for contract costs which are not within the scope of other Standards. Consequently, if the other Standards preclude the recognition of any asset arising from a particular cost, an asset cannot be recognised under IFRS 15...'

The requirement in IAS 38 to expense all training costs as incurred was included in the original version of that standard which was issued by the International Accounting Standards Committee (IASC) in 1998 (and subsequently adopted by the IASB). As part of the IASC's Basis for Conclusions, it is noted at paragraph BCZ46 that:

'IAS 38 also clarifies that expenditure on research, training, advertising and start-up activities will not result in the creation of an intangible asset that can be recognised in the financial statements. Whilst some view these requirements and guidance as being too restrictive and arbitrary, they are based on the IASC's interpretation of the recognition criteria in IAS 38...'

This analysis has been confirmed in an agenda decision finalised by the IFRS IC at its March 2020 meeting.



Example 32

Multi Construction Co. constructs a large building consisting of retail space and residential units. It specifically borrows funds for construction of the large building and it incurs borrowing costs in connection with the borrowing. Before construction begins, Multi Construction Co. signs contracts with customers for the sale of some of the units in the building 'off the plan'. It intends to enter into contracts with other customers for sale of the remaining partially constructed units (i.e. the unsold units) as soon as it finds suitable customers.

Multi Construction Co. transfers control of each unit over time, in accordance with IFRS 15.35(c), and therefore recognises revenue 'over time'. It will receive consideration from customers in the form of cash or another financial asset.

The issue that arises is whether Multi Construction Co has a 'qualifying asset', as defined in IAS 23, such that it capitalises directly attributable borrowing costs associated with the construction of the building.

The issue was considered by the IFRS IC at its meeting in March 2019, with the conclusion being that borrowing costs may not be capitalised. In reaching this conclusion it was observed that:

- Any receivable that is recognised is not a qualifying asset because IAS 23.7 specifies that financial assets are not qualifying assets
- Any contract asset that is recognised is not a qualifying asset. A contract asset (as defined in IFRS 15.Appendix A) represents the right to consideration that is conditional on something other than the passage of time in exchange for transferring control of a unit. The intended use of a contract asset, which is to collect cash or another financial asset, is not a use for which it necessarily takes a substantial period of time to get ready

- Any inventory (work in progress) for unsold units that is recognised is not a qualifying asset. Each of the unsold units is ready for intended sale in its current condition, because the intention is to sell the part-constructed units as soon as suitable customers are found and, on signing a contract with a customer, control of the related unit will be transferred to the customer.

IFRS Interpretation Committee Agenda Decision – costs to fulfil a contract

The IFRS IC published a final agenda decision in June 2019 that related to costs to fulfil a contract. The entire fact pattern and discussions of the IFRS IC have not been reproduced in this publication, however, in summary:

Costs to Fulfil a Contract (IFRS 15 Revenue from Contracts with Customers) - June 2019

The IFRS IC addressed a request concerning the recognition of costs incurred to fulfil a contract which contains a single performance obligation (for the construction of a building) and revenue is recognised over time (ie one or more of the criteria in IFRS 15.35 is met). The entity measures progress towards satisfaction of the performance obligation using an output method applying IFRS 15.39-43. At the reporting date, the costs incurred relate to construction work performed up to that date on the good that is being transferred to the customer as the good is being constructed.

The IFRS IC noted IFRS 15.98(c) requires an entity to recognise as expense when incurred for 'costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (ie costs that relate to past performance)'.

The IFRS IC observed the costs described in the request are costs that relate to the partially satisfied performance obligation in the contract (ie costs that relate to past performance). These costs do not, therefore, generate or enhance resources of the entity that will be used in continuing to satisfy the performance obligation in the future (IFRS 15.95(b)). Consequently, those costs do not meet the criteria in IFRS 15.95 to be recognised as an asset.

The request noted that different stages of construction of the building resulted in different profit margins being recognised and part of the question related to whether costs incurred in one stage could be allocated to others resulting in smoother profit margins. However, the staff noted that IFRS 15 precludes this approach, with the explanation in IFRS 15.BC308 noting that (emphasis added):

'IFRS 15 clarifies that only costs that give rise to resources that will be used in satisfying performance obligations in the future and that are expected to be recovered are eligible for recognition as assets. Those requirements ensure that only costs that meet the definition of an asset are recognised as such and that an entity is precluded from deferring costs merely to normalise profit margins throughout a contract by allocating revenue and costs evenly over the life of the contract. To provide a clear objective for recognising and measuring an asset arising from the costs to fulfil a contract, the boards decided that only costs that relate directly to a contract should be included in the cost of the asset.'

TRG discussions

Impairment testing of capitalised contract acquisition costs (Agenda Paper 4; July 2014)

The TRG considered whether, when testing capitalised contract assets for impairment, entities should factor in cash flows that are expected to arise in any period covered by customer options to extend or renew the contract. TRG members considered that extension and renewal periods should be taken into account if:

- it is expected that the customer will extend or renew the contract; and
- the contract costs capitalised relate to goods or services that would be transferred to the customer during such extension or renewal periods.



BDO Comment

Questions have arisen about the appropriate classification of costs eligible for capitalisation (or required to be capitalised) in the statement of financial position.

In our view, as a matter of accounting policy choice, an entity could choose to present costs incurred to obtain a contract as either:

- A separate class of intangible asset in the statement of financial position, with amortisation in the same line item as amortisation of intangible assets within the scope of IAS 38. Under this approach the amortisation would be classified as amortisation expense 'by nature' and would be presented outside of cost of goods sold 'by function' as it is not considered a cost of conversion.

- A class of asset separate from intangible assets in the statement of financial position. Under this approach amortisation would be considered part of cost of goods sold 'by function' and as a change in contract costs 'by nature'.

However, in our view, an accounting policy choice does not exist for fulfilment costs as these are part of the costs of conversion and are therefore similar to inventory. Therefore it is not appropriate to present fulfilment costs as a separate class of intangible assets. The second approach noted above should be followed for fulfilment costs.



BDO Comment – Fulfilment Costs and Success-Based Fees

In a purely success-based fee scenario (i.e. 100% of the consideration is contingent on a successful result being obtained), the customer is paying only for the service on which the success fee is based. For example, 'no win, no fee' legal services.

In scenarios where revenue is recognised over time, fulfilment costs cannot be recognised as an asset. If revenue is being recognised over time (i.e. one or more criteria in IFRS 15.35 is satisfied), then the customer is obtaining control of the goods and/or services as the performance obligation is satisfied. Said another way, the entity providing the goods or services does not control these costs, the customer does.

In scenarios where revenue is recognised at a point in time, costs cannot be deferred as fulfilment costs due to such costs not being able to satisfy all of the criteria in IFRS 15.95:

- (a) the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved);
- (b) the costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; and

(c) the costs are expected to be recovered.

In a success-based fee arrangement, entities cannot determine whether they will satisfy the performance obligation in each separate contract, therefore IFRS 15.95(b) is not satisfied. For example, in a 'no win, no fee' legal provider's case, the entity may incur significant costs as it attempts to win a case for their client, but it is unable to determine if it will succeed and success is not entirely within the control of the entity.

Since IFRS 15.95(b) is written to require that the costs will be used in satisfying performance obligations in the future, an entity's inability to demonstrate that it will satisfy a performance obligation in a success-based fee arrangement means that the requirements of IFRS 15.95(b) cannot be met. As such, all costs must be expensed as incurred, assuming they do not fall within the scope of another applicable IFRS (e.g. IAS 2, IAS 38, etc.) and meet that IFRS's criteria for capitalisation.

The practical consequence of this outcome is a mismatch in the timing of costs being recognised and the related revenue for some entities. In the 'no win, no fee' legal provider example, costs would be recognised as an expense in one period and all the revenue in another period when the performance obligation is satisfied, assuming the success-based fee criteria are satisfied.

The practical expedient in IFRS 15.4 to apply the requirements of the standard to portfolios of similar contracts cannot result in the recognition of fulfilment costs as assets because the practical expedient is dependent on the assumption that its application would not differ materially from applying the standard to individual contracts.

Applying IFRS 15 to the individual success-based fee arrangements would result in the entity being unable

to satisfy IFRS 15.95(b) for the reasons noted above. Despite an entity being able to demonstrate some level of certainty surrounding the satisfaction of some of the performance obligations in a portfolio of contracts, it cannot make that assertion at individual contract level, therefore, application of the practical expedient would not be permitted in this case (see further discussion on accounting for success-based fee contracts in Section 5.17).

5.2. CHANGES IN THE TRANSACTION PRICE AFTER CONTRACT INCEPTION

The transaction price can change subsequent to contract inception either because the contract contains variable consideration or because the contract is renegotiated with the customer.

Any change to the transaction price arising from re-estimating the amount of variable consideration receivable (or the amount of variable consideration being confirmed due to the resolution of uncertain events) is allocated to the performance obligations on the same basis as at contract inception. Therefore, no reallocation of the transaction price to performance obligations is made to reflect changes in stand-alone selling prices since contract inception. Amounts allocated to performance obligation(s) which have already been satisfied are recognised as revenue (or as a reduction of revenue if necessary) in the period in which the variable consideration is re-estimated.

A change in the transaction price arising from re-estimating variable consideration is allocated entirely to one or more distinct goods or services only if the criteria for allocation of variable consideration to performance obligations are met. These are that:

- The terms of a variable payment relate specifically to the satisfaction of a performance obligation or to distinct goods or services
- The allocation meets the objective that the amount allocated to each performance obligation or distinct good or service reflects the amount to which the vendor expects to be entitled in exchange for transferring the goods or services to the customer.

Changes in stand-alone selling prices after contract inception are not reflected in the basis of determining the reallocation of the transaction price.

The guidance on contract modifications applies to changes in the transaction price that occurs as a result of a contract modification (see Section 4.1 above). However, careful consideration needs to be given when identifying the performance obligations to which any change in the revised contract price should be allocated, particularly when the modification involves the addition of new performance obligations, the transaction price contains variable consideration, and estimates of that variable consideration change subsequent to contract modifications. For changes in the transaction price that occur after a contract modification, a vendor allocates the change in the transaction price in whichever of the following ways is applicable:

- The change in the transaction price is allocated to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for as termination of the original contract and the establishment of a new contract
- In all other cases, being those in which the modification is not accounted for as a separate contract, the change in the transaction price is allocated to the performance obligations in the modified contract (i.e. the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).



Example 33

Background

Entity X enters a contract involving the delivery of Products A and B (which are two distinct performance obligations with the same stand-alone selling price) for a fixed amount of CU 5,000 plus variable consideration. The variable consideration cannot be allocated specifically to one of the two products. Entity X includes variable consideration of CU 1,000 in the transactions price (i.e. a total of CU 6,000) because it concludes that it is highly probable there will not be a significant reversal of this amount. Entity X therefore allocates CU 3,000 to each of Products A and B.

Change in price arising from contract modification

After delivering product A (and recognising revenue of CU 3,000), the contract is modified, with a new performance obligation being added to the contract (delivery of Product C) for an additional CU 1,500, but which has a standalone selling price of CU 2,000. The remaining total contract consideration is therefore CU 4,500 (i.e. original price of CU 6,000 plus modification of CU 1,500 less CU 3,000 of revenue recognised on delivery of product A). In accordance with the guidance on contract modifications, this is accounted as a termination of the original contract because the remaining deliverables (Products B and C) are distinct from those that have already been delivered. The future consideration to be received of CU 4,500 is therefore allocated to products B and C in proportion to their relative standalone selling prices, i.e. CU 2,700 to Product B and CU 1,800 to Product C. The estimate of variable consideration not yet recognised as revenue of CU 500 (and previously included within the CU 3,000 allocated to Product B) is included in the price allocation to both Products B and C because the conditions in IFRS 15.85 for allocating it only to Products A and B are not met, i.e. it is also linked to performance associated with providing Product C.

Change in contract price arising from re-estimation of variable consideration

Prior to delivering either Product B or Product C, Entity X revises its estimate of variable consideration from CU 1,000 to CU 1,600. Because the increase of CU 600 to the transaction price is attributable to variable consideration promised before the modification and the modification was accounted for as a termination of the original contract, it is necessary to allocate some of this to Product A. The amount to allocate is based on the same proportion of variable consideration that was originally attributed to Product A (i.e. 50%), which means Entity X immediately recognises additional revenue of CU 300 as Product A has already been delivered. The remaining CU 300 is then allocated to each of Products B and C at the date of contract modification based on their relative standalone selling prices, i.e. CU 180 to Product B and CU 120 to Product C.



5.3. SALE WITH A RIGHT OF RETURN

A right to return enables a customer to receive:

- A full or partial refund of any consideration paid
- A credit that can be applied against amounts owed or that will be owed to the vendor
- Another product in exchange
- Any combination of the above.

A right to return may be given for various reasons such as customer dissatisfaction with the product or simply given if the customer changes their mind.

Although a right of return falls within the variable consideration guidance in IFRS 15, the price per item sold (i.e. the contractual price) does not vary. Unlike other situations in which there is variable consideration the entity will receive back the goods sold when a right of return is exercised. However, the aggregate amount of revenue recognised is subject to variability. Consequently, IFRS 15 requires that the variable consideration provisions in the standard (including the requirements for constraining variable consideration) should apply when measuring the amount of revenue to recognise for goods sold with a right of return.

For those items which are expected to be returned, the vendor does not recognise revenue. Instead, it recognises a refund liability together with an asset representing item(s) expected to be returned. Any refund liability is reassessed and updated at each reporting date. If the realisable value of the item to be returned (including any adjustment for expected costs of recovering the item and any potential decrease in value) is expected to be less than the cost of the related inventory, an adjustment is made to cost of sales.



Example 34

Entity R, a clothes retailer, grants customers a right to return any goods within 3 months of purchase for a full refund or an exchange of goods for equivalent value, if undamaged. At the reporting date, sales made in the previous 3 months amount to CU 1 million, with those goods costing Entity R CU 750,000. It has therefore made the following entries before accounting for customers' rights of return:

Dr Cash	1,000,000
Cr Revenue	1,000,000
Dr Cost of Sales	750,000
Cr Inventory	750,000

Entity R's historical experience is that 8% (by sales value) of goods on average are returned, with a 90% confidence that the value of goods that are returned will fall in the range of 6% to 10% of sales value. Therefore, Entity R's best estimate is that goods sold for CU 920,000 will not be returned (i.e. it estimates there will be a reversal of revenue recognised to date of CU 80,000), even though in theory all of the goods sold for CU 1,000,000 could be returned. It further concludes that it is highly probable that goods sold for CU 900,000 will not reverse (i.e. it is highly probable there will not be a significant reversal in excess of CU 100,000).

Entity R applies the variable consideration requirements in IFRS 15 and processes the following accounting entries at the reporting date.

Dr Revenue	100,000
Cr Refund liability	100,000
Dr Inventory to be returned	75,000
Cr Cost of Sales	75,000

Entity R separately considers whether the asset of CU 75,000, reflecting the cost of goods to be returned as a result of customers exercising their right of return, is recoverable.



BDO Comment

Paragraph B26 of IFRS 15 states that exchanges by customers of one product for another of the same type, quality, condition and price (for example one colour or size for another) are not considered returns. Although goods might be returned, there is no variability in the aggregate amount of revenue that will be received by the entity. This paragraph therefore ensures that those entities which only give such restrictive rights of return do not need to apply the variable consideration requirements in IFRS 15.

In our view, where customers are granted a general right of return (i.e. there is no restrictions on what products store credits can be used to purchase), there is no need to determine how any cash refund or store credit is subsequently used. If the customer chooses to use the store credit to purchase a similar product (for example, a different coloured shirt), this is a second transaction. However in other cases, where there are restrictions on the right of return, entities may be required to know to what extent customers

ultimately return goods for a product of the same type as opposed to taking cash, store credits, or exchanging the returned goods for a different type of product. In the above example, therefore, had Entity R not offered a general right of return, it would also need to know which customers ultimately return an item for one of the same type, quality, condition and price. This would in turn lead to the refund liability (and associated adjustment to revenue for variable consideration) being less than CU 100,000. The asset reflecting inventory to be returned (and associated adjustment to cost of sales) would similarly be less than CU 75,000.

In cases where an entity needs to know the extent to which returned goods are exchanged for a product of the same type, it may need to update its inventory systems to track this information. Determining whether such information must be tracked will be a matter of judgment as the level of restriction placed on returns could vary.

When a vendor transfers products with a right of return, revenue is recognised only to the extent that the vendor expects to be entitled to it. To determine the amount of consideration to which it expects to be entitled, a vendor:

- Applies the guidance regarding constraining estimates of variable consideration
- Considers the nature of the products expected to be returned.

In subsequent periods the vendor updates:

- Its assessment(s) of amounts to which it expects to be entitled in exchange for the transferred products
- The measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds
- The measurement of the asset (i.e. so that it corresponds with changes in the measurement of the refund liability and any impairment recognised).

Note that a vendor's obligation to accept a returned product during the return period is not accounted for as a performance obligation in addition to the obligation to provide a refund.

TRG discussions

Accounting for restocking fees and other related costs (Agenda Paper 35; July 2015)

Sometimes restocking fees are charged to customers when they return products to the entity. Most of the TRG members agreed with the staffs' view that these restocking fees and other related costs should be accounted for at the point at which the product is transferred to the customer. This is because the sale of a product with restocking fees is similar to a 'partial return right'.

5.4. WARRANTIES

IFRS 15 distinguishes between two types of warranties:

- Warranties that provide a customer with the assurance that the product will function as intended because it complies with agreed-upon specifications. These warranties may be provided in accordance with the contract (and hence included in the purchase price of the goods), required to be provided by law, or are provided in accordance with the vendor's customary business practices. They are accounted for in accordance with the guidance on product warranties included within IAS 37 Provisions, Contingent Liabilities and Contingent Assets and not as a separate performance obligation. Therefore, a vendor recognises a provision for the expected costs of meeting their obligation under the warranty. If the warranty provides the customer with a service in addition to the assurance that the product complies with agreed upon specifications, then only that incremental service will be a performance obligation to which some of the transaction price should be allocated.
- Optional warranties that provide the customer with assurance that the product complies with agreed-upon specifications for an extended period. These 'extended warranties' are accounted for as a separate performance obligation from the related goods which have been sold. It is therefore necessary to allocate a portion of the transaction price to the warranty in accordance with the requirements of IFRS 15.

In assessing whether a contract contains a service in addition to the assurance that the product complies with agreed-upon specifications, judgment may be needed. A vendor considers factors such as:

- Whether the warranty is required by law – if required by law then this indicates the warranty is not a separate performance obligation
- The length of the warranty coverage period – the longer the coverage, the more likely it is that the promised warranty is a performance obligation
- The nature of the tasks that the vendor promises to perform – if the vendor must perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (e.g. a return shipping service for a defective product), then those tasks are unlikely to give rise to a performance obligation.

If a customer does not have an option to purchase a warranty separately, it is accounted for in accordance with IAS 37 unless part or all of that warranty provides the customer with a service in addition to an assurance that the good or services complies with agreed-upon specifications.



BDO comment

In some cases, careful consideration will be needed of whether a warranty goes beyond providing assurance that a product complies with agreed-upon specifications, and needs at least partially to

be accounted for separately. For example, in some jurisdictions car manufacturers include a warranty period which goes well beyond the period required by law, and is used as a marketing tool to enhance sales.

TRG discussions

Warranties as performance obligations (Agenda Paper 29; March 2015)

The TRG considered how an entity should evaluate whether a product warranty is a separate performance obligation when the warranty is not separately priced. As part of their deliberations they considered a warranty provided by a luggage company to its customers in which it undertakes to repair or replace the luggage free of charge if it is damaged or broken. The staffs' view is that such a warranty would include a service because the luggage company is undertaking to fix any defect with the product for an indefinite period, which goes beyond an assurance that the luggage will operate as intended. That is, the nature of the vendor's promise goes beyond providing assurance that the product complies with an agreed-upon specification.

The TRG generally agreed with this conclusion, although there was some debate around whether the absence of an expiry date of the warranty provided in the luggage example was a more pervasive factor. Ultimately, it was generally agreed that entities will need to consider the substance of any particular warranty and exercise judgement based on specific facts and circumstances in concluding whether a warranty not separately priced contains a separate performance obligation that is a service. That assessment is not necessarily limited to the three factors identified in IFRS 15.



BDO comment

Some warranties give the purchaser a right to compensation (i.e. a refund), rather than replacement or repair.

A question which then arises is whether a warranty that gives the customer a right to a refund for a defective product should be accounted for as an assurance warranty in accordance with IAS 37, or as a right of return in accordance with IFRS 15 which will give rise to variable consideration?

In our view, a customer's right to return a defective item for a cash refund should be accounted for as a right of return as discussed in Section 5.3 above. In many cases, many entities will recognise a provision and associated cost for the profit that will reverse when the goods are returned, rather than a reduction in revenue for the estimated refund and a separate asset for the original cost of goods that will be returned.

IFRS 15 is clear that a warranty that provides the customer with a right to a refund should be accounted for as variable consideration based on the definition of a right of return. This view is supported by IFRS 15's Basis for Conclusions which states at paragraph BC367:

'A return right gives an entity a contractual right to recover the good from a customer if the customer exercises its option to return the good and obtain a refund.'

In addition, paragraph BC376 states that

'...the Boards decided that an entity should recognise an assurance-type warranty as a separate liability to replace or repair a defective product.'

This definition of an assurance-type warranty does not include defective products that are returned for a refund, but only contemplates defective products that are replaced or repaired. When discussing warranties the Boards state in paragraph BC369 that:

'...a unifying feature of all warranties is that an entity promises to stand ready to replace or repair the product in accordance with the terms and conditions of the warranty...'

As a result, revenue that is recognised for the sale of goods that are sold with a warranty that gives the customer the right to return a defective product in return for a refund will be subject to the guidance for variable consideration. This requires an estimate to be made of the amount of revenue to which the vendor will be entitled which will be the gross amount for all goods less the amount of revenue attributable to the items that are estimated to be returned. That is, no revenue is recognised for items expected to be returned.

When estimating the amount of revenue to which a vendor will be entitled, IFRS 15 restricts the amount of

revenue that can be recognised to an amount for which it is highly probable that there will not be a subsequent significant reversal in the cumulative amount of revenue recognised when the subsequent uncertainty (in this case, the number of defective products returned in exchange for a refund) is resolved. In estimating the amount of revenue, either an expected value approach (the sum of probability weighted amounts for a portfolio of contracts for similar items) or the most likely amount approach (the single most likely outcome of a contract) is required to be used. The approach selected is based on which is expected better to predict the amount of consideration to which an entity will ultimately be entitled once the actual returns experience is known.

This means that no revenue is ultimately recognised for returned products for which a refund is made and any changes to the estimated amount of refunds from one reporting period to the next are accounted for as upward or downward adjustments to revenue. This is consistent with the accounting for variable consideration, which is similarly recorded as an adjustment to the transaction price. Under existing guidance, the way in which these arrangements are accounted for varies and so some entities will need to change their approach.



5.5. PRINCIPAL VS. AGENT

When a third party is involved in providing goods or services to a customer, the vendor is required to determine whether the nature of its promise is a performance obligation to:

- provide the specified goods or services itself (principal); or
- arrange for a third party to provide those goods or services (agent).

A vendor acting as principal controls a good or service before the vendor transfers the good or service to the customer. It may satisfy a performance obligation by itself or engage another party (for example, a subcontractor) to satisfy some or all of a performance obligation on its behalf. When a vendor, in its role as a principal, satisfies a performance obligation, it recognises revenue at the gross amount. However, the vendor is not necessarily acting as a principal if the vendor obtains legal title of a product only shortly before legal title is transferred to a customer.

The obligation of an agent is to arrange for the provision of goods or services by another third party. When a vendor represents an agent, and satisfies a performance obligation, it recognises revenue as the amount of any fee or commission to which it expects to be entitled. A vendor's fee or commission might be the net amount of consideration that the vendor retains after paying the third party the consideration received in exchange for the goods or services to be provided by that party. A vendor acting as agent does not control the good or service before it is transferred to the principal's customer.

Indicators that an entity is acting as principal include:

- having primary responsibility for fulfilling the promise to provide the specified good or service
- assuming inventory risk before the specified good or service has been transferred to the customer or after transfer of control to the customer (e.g. the customer has a right of return)
- having discretion in establishing the price for the specified good or service.

The relevance of each of these indicators depend on the nature of the specified good or service, and different indicators may provide more evidence in different contracts.



BDO comment

In practice it is sometimes difficult to identify whether a vendor is acting as principal or agent. For example, transactions involving virtual goods and services are often executed in milliseconds and involve multiple counterparties. Consequently, control over a virtual good may, in some cases, transfer almost instantaneously.

Assessing whether a vendor is acting as a principal or an agent may also be complex in situations where collaboration exists between two parties to deliver a product on demand to a customer. For example, Entity A installs water filtration systems on Entity B's retail premises, where the product (filtered water) is delivered on demand from a municipal water supplier, with Entity B receiving a portion of the proceeds from the customer. Neither party would appear to control the underlying good (the water) prior to delivery to the customer, so assessing which entity is acting as the principal or the agent is challenging. In our view, a principal must be identified in any revenue transaction, meaning gross presentation of revenue should be presented by at least one party in a transaction, even if

significant collaboration does exist with other entities in delivering an underlying good or service.

It is likely that significant focus will need to be placed on the precise contractual terms of the arrangements to determine the nature of the promises made (that is, what each party is providing) and the consideration payable to each party. This links to the first of the five steps in IFRS 15, which is to identify the contract, including the goods or services to be transferred and the payment terms.

The complexity of this issue can also be seen in situations where 'drop shipment' arrangements. Drop shipping is a supply chain management in which an entity does not keep physical stock of the goods it sells; it simply arranges for the sale between a customer and its supplier, and the supplier ships directly to the customer. This is becoming more common in the online retail environment, where online retailers are keeping less physical inventory on hand, as customers do not ever need to interact with inventory held by a retailer.

In such instances, physical possession and legal title are less likely to be relevant in establishing whether the retailer who facilitates the shipment between its supplier and the end customer is a principal or an agent in the transaction. In this case, entities should carefully consider other factors in determining whether they are acting as a principal or an agent, including:

- Does the entity have latitude in establishing price?
- Does the entity only receive a fixed fee for establishing the relationship between the supplier and the customer?
- Who does the customer deal with in the case of product quality issues or returns?
- Are the goods customised or interchangeable for other goods?
- Which entity has the primary (or greater) responsibility towards the customer that receives the goods?

TRG discussions

Principal vs Agent (Agenda Paper 1; July 2014 and Clarifications to IFRS 15)

In connection with the guidance set out above, the TRG discussed a number of issues regarding paragraphs B34-B38 (Principal vs Agent considerations). Some stakeholders questioned whether control is always the basis for determining whether an entity is a principal or an agent, and how the control principle and the indicators in paragraph B37 work together. Other stakeholders questioned how to apply the control principle to contracts involving intangible goods or services.

As a consequence of this, the IASB issued Clarifications to IFRS 15 in April 2016 to clarify the application of the control principle. It amended paragraphs B34-B38 of IFRS 15, Examples 45-48 accompanying IFRS 15 and added Examples 46A and 48A. The FASB reached the same decisions as the IASB regarding the application of the control principle when assessing whether an entity is a principal or an agent.

The TRG discussed at its July 2014 meeting whether certain types of billing to customers should be accounted for as revenues:

- shipping and handling fees
- reimbursements of other out-of-pocket expenses
- taxes collected from customers.

TRG members noted that the revenue standard provides sufficient guidance about determining the appropriate presentation of amounts billed to customers and that an entity would therefore record the gross amount received from a customer unless the entity is only collecting amounts on behalf of third parties. It is necessary to consider the principal and agent guidance to help determine how to present these types of billings.



BDO comment

The clarifications issued by the IASB concerning principal vs. agent assessments provided further guidance on how the standard should be interpreted

and applied, however, there are still many situations which will require significant judgment. The example below illustrates two such scenarios.



Example 35

Scenario 1 – intermediary is an agent

Entity Z operates a large multiplayer online role-playing game where customers pay a fixed fee to purchase the video game and then can pay additional funds for accessories and weapons, and to purchase monthly access to an enhanced version of the game. Entity Z sells monthly access to the game via physical cards sold at various retail locations owned and operated by unrelated third parties. The retailer does not pay any consideration to Entity Z until they are sold to the end consumer (i.e. the retailer has no inventory risk), and as such, they are acting as an agent. The retailer reports the number of cards sold to Entity Z quarterly, and remits payment, less their fee per card sold. Retailer is free to charge the end customer any fee it wishes, but Retailer must pay a fixed fee per card sold to Entity Z.

Applying the guidance in IFRS 15, Entity Z concludes that it is a principal in the transaction. The issue is whether Entity Z must estimate the amount of revenue to record, since the gross amount paid by the customer to the retailer may not be reported to Entity Z. In our view, an entity would be required to estimate the gross amount of revenue it records. The IASB acknowledged this potential complexity in the Basis of Conclusions to the amendments it issued to IFRS 15 concerning principal vs. agent considerations. In acknowledging this complexity, the IASB noted that it was primarily an issue related to Step 3 in the IFRS 15 process (i.e. determining the transaction price).

Scenario 2 – intermediary is a principal

The fact pattern is the same as Scenario 1, except Retailer is a principal, since it pre-purchases the cards and has inventory risk in that it does not have a right to return unsold cards.

The issue is whether Entity Z should present revenue based on the price that the end consumer pays or the price established between Entity Z and Retailer.

In this case, the Retailer is not acting as a 'pass through' entity where it merely facilitates a transaction between Entity Z and the end consumer. The nature of Retailer's relationship with Entity Z is to purchase a promise (e.g. access to the video game) and transfer it to an end consumer at a mark-up. Consequently, the amount of revenue charged by Retailer to the consumer is independent of the consideration earned by Entity Z in exchange for the promise it transfers to Retailer. This means that Entity Z's revenue should be determined based on the price agreed between Entity Z and Retailer.

IFRS Interpretation Committee Agenda Decisions

The IFRS IC published a final agenda decisions in May 2022 that related to assessing the criteria in IFRS 15.B34 – B38 to determine whether an entity is a principal or an agent.

Principal versus Agent: Software Reseller

The IFRS IC address the following specific fact pattern concerning a reseller of software licenses.

The reseller has a distribution agreement with a software manufacturer that:

- a. gives the reseller the right to grant (sell) the manufacturer's standard software licences to customers;
- b. requires the reseller to provide pre-sales advice to each customer—before the sale of the software licences—to identify the type and number of software licences that would meet the customer's needs; and
- c. provides the reseller with discretion in pricing the software licences for sale to customers.

If the customer decides to buy no software licences, it pays nothing. The reseller and the customer do not enter into an agreement. If the customer decides to buy a specified type and number of software licences, the reseller negotiates the selling price with the customer, places an order with the software manufacturer on behalf of the customer (and pays the manufacturer), and invoices the customer for the agreed price.

The software manufacturer provides the customer with the software licences ordered—issued in the customer's name—via a software portal and with the key necessary for activation. The software manufacturer and the customer enter into an agreement specifying the customer's right to use the software, a warranty covering the software's functionality and the term of the licence.

If the reseller advises the customer to order an incorrect type or number of software licences (that fails to meet the customer's needs), the customer may refuse to take delivery of the licences. The reseller is unable to return unaccepted licences to the software manufacturer or sell them to another customer.

The first step in accounting for the software licences is to identify the specified goods or services to be provided to the customer.

In the fact pattern described in the request, the reseller's contract with the customer includes an explicit promise to provide a specified type and number of standard software licences to the customer.

The Committee observed that the pre-sales advice the reseller provides—under the distribution agreement between the software manufacturer and the reseller—is not an implicit promise in the contract with the customer. At the time of entering into the contract with the customer, the reseller has already provided the advice. There is no further advice to be provided by the reseller and the advice already provided will not be transferred to the customer after contract inception. Consequently, at the time of entering into the contract with the customer, there is no valid expectation that the reseller will transfer a good or service to the customer other than the standard software licences.

Accordingly, the Committee concluded that, in the fact pattern described in the request, the promised goods in the reseller's contract with the customer are the standard software licences. Because the standard software licences are the only promised goods in the contract with the customer, they are distinct goods to be provided to the customer. Those licences are therefore the specified goods to be provided to the customer as described in paragraph B34A(a).

The second step is assessing whether the reseller controls the standard software licences before they are transferred to the customer

In the fact pattern described in the request, the reseller assesses whether it obtains control of the standard software licences from the software manufacturer before they are transferred to the customer. That assessment of control requires consideration of the specific facts and circumstances, which include the terms and conditions of the contracts between the reseller and the customer, the reseller and the software manufacturer, and the software manufacturer and the customer.

If—after applying the principles and requirements on control in IFRS 15—it is unclear whether the reseller is a principal or agent, the reseller considers the indicators in paragraph B37 in assessing whether it obtains control of the standard software licences from the software manufacturer before they are transferred to the customer. In the fact pattern described in the request, the Committee observed that:

- a. the software licences provided to the customer exist only after the reseller places an order with the software manufacturer and the software manufacturer issues the software licences in the customer's name. The software manufacturer is responsible for the software's functionality, as well as for issuing and activating the licences. The software manufacturer is therefore responsible in those respects for fulfilling the promise to provide the licences to the customer (paragraph B37(a)).
- b. the reseller is the party that engages with the customer before and after the software licences are provided to the customer, taking responsibility for unaccepted licences. The reseller is therefore responsible in those respects for fulfilling the promise to provide the licences to the customer (paragraph B37(a)).
- c. the reseller does not obtain a pool of software licences before entering into the contract with the customer and cannot, for example, direct the software licences to another customer. The reseller therefore has no inventory risk before the licences are provided to the customer but then has inventory risk until the customer accepts the licences (paragraph B37(b)).

- d. the reseller has discretion in establishing the price for the software licences (paragraph B37(c)). Pricing discretion may be less relevant to the assessment of control if, for example, the market for the software licences is such that the reseller, in effect, has limited flexibility in establishing the price.

The Committee observed that the conclusion as to whether the reseller is a principal or agent depends on the specific facts and circumstances, including the terms and conditions of the relevant contracts. The reseller would apply judgement in making its overall assessment of whether it is a principal or agent—including considering the relevance of the indicators to the assessment of control and the degree to which they provide evidence of control of the standard software licences before they are transferred to the customer—within the context of the framework and requirements set out in paragraphs B34–B38 of IFRS 15.

The Committee also observed that the reseller would disclose (a) material accounting policy information in accordance with IAS 1 Presentation of Financial Statements, and (b) information required by IFRS 15, including about its performance obligations (paragraph 119) and the judgements made in applying IFRS 15 that significantly affect the determination of the amount and timing of revenue from contracts with customers (paragraph 123).

5.6. CUSTOMER OPTIONS FOR ADDITIONAL GOODS OR SERVICES

Customer options to acquire additional goods or services (either free of charge or at a discount) come in many forms, including sales incentives, customer award credits (or points), contract renewal options, or other discounts on future goods or services. Such customer options give rise to a performance obligation in the contract when the option provides a material right to the customer that it would not receive without entering into the contract. In those cases, the vendor is required to defer the portion of payment received from its customer that relates to those future goods or services and recognise that portion as revenue only when those future goods or services are transferred to the customer (or when the option expires).

The allocation is based on the relative stand-alone selling prices of the goods or services and, if the prices of the future potential goods or services are not observable, they are estimated. This estimate takes into account any discount that the customer would receive without exercising the option together with the likelihood that the option will be exercised.



Example 36

Entity P, A pizza restaurant chain, undertakes a promotional campaign giving customers a voucher entitling them to a 50% discount on their next purchase (valid until 30 June 20X8) if they spend more than CU 50 in a single transaction during December 20X7. Entity P considers that each voucher issued grants the customer with a material right (i.e. a discount of 50% off their next purchase) and therefore constitutes a separate performance obligation to which revenue on each qualifying meal sold should be allocated.

During December 20X7 Entity P issued 10,000 vouchers on sales of CU 600,000 (i.e. an average spend of CU 60). Total sales during December 20X7 were CU 700,000 as some customers spent less than CU 50 in a single transaction (generating sales of CU 100,000 in total) and therefore did not receive a discount voucher.

Based on historical experience of recent similar promotions, Entity P anticipates 25% of customers receiving a voucher will return and use the voucher during the first 6 months of 20X8, with the expected average spend to which the discount will apply being CU 80. Entity P therefore estimates the standalone selling price of each voucher to be CU 10 (i.e. CU 80 x 50% x 25%).

Entity P therefore allocates the CU 60 received on each qualifying purchase during December 20X7 as follows:

Revenue:	$CU\ 60 / (CU\ 60 + CU\ 10) \times CU\ 60 =$	CU 51.43
Consideration allocated to each voucher:	$CU\ 10 / (CU\ 60 + CU\ 10) \times CU\ 60 =$	<u>CU 8.57</u>
		<u>CU 60.00</u>

Consequently, Entity P processes the following accounting entries in December 20X7:

Dr Cash	700,000
Cr Revenue	614,300
Cr Deferred income	85,700

Assuming that there is no change in the number of vouchers that Entity P expects to be used, Entity P recognises the deferred income as revenue on the earlier of:

- the voucher being used; and
- expiry of the voucher (30 June 20X8).

TRG discussions

Accounting for a customer's exercise of a material right (Agenda Papers 18 and 32; January and March 2015)

IFRS 15 does not provide explicit guidance on the accounting model to apply when such an option is exercised. The question that arises is whether it should be:

- considered a continuation of the original contract whereby the additional consideration would be allocated to the material right;
- a contract modification, which could require consideration to be re-allocated between performance obligations; or
- treated as variable consideration.

TRG members considered that the option to exercise the material right should be viewed as a continuation of the contract, but agreed with the staff view that it would be reasonable for an entity to account for it as either a continuation of the contract or a contract modification. The possibility of treating the amount allocated to the material right as variable consideration was rejected.



TRG discussions

Assessment of whether an option gives rise to a material right (Agenda Paper 6; October 2014)

The TRG discussed two issues associated with the evaluation of whether customer options to acquire additional goods and services give rise to a material right:

- 1) Whether the evaluation be performed only in the context of the current transaction or whether it should factor in past and expected future transactions
- 2) Whether the evaluation should consider qualitative as well as quantitative factors

Most TRG members agreed that the evaluation should both

- factor in past and future transactions as well as present ones; and
- consider qualitative factors (such as whether the right accumulates over time as happens with loyalty points).

Distinguishing options and variable consideration (November 2015)

Another question raised was how an entity should determine when a contract contains an option to purchase additional goods and services or includes variable consideration based on a variable quantity. This question might arise, for example, if a software company grants 500 licenses to use software for a fixed fee of CU 500,000, with the price for additional users being CU 800

TRG members agreed that all facts and circumstances should be taken into account when analysing these kinds of contracts and that this analysis requires judgement. However, they concluded that the first step to distinguishing between optional goods or services and variable consideration for promised goods or services is to identify:

- the nature of the entity's promise to the customer; and
- the enforceable rights and obligations of the parties.

With an option for additional goods or services, the customer has a present right to choose to purchase additional distinct goods or services (or change the goods and services to be delivered). Prior to the customer's exercise of that right, the vendor is not presently obligated to provide those goods or services and the customer is not obligated to pay for those goods or services.

In contrast, in the case of variable consideration for a promised good or service, the vendor and the customer previously entered into a contract that requires the entity to transfer the promised good or service and the customer to pay for that promised good or service. The future events that result in additional consideration occur after (or as) control of the goods or services have (or are) transferred. When a contract includes variable consideration based on a customer's actions, those actions do not oblige the vendor to provide additional distinct goods or services (or change the goods or services to be transferred), but rather, resolve the uncertainty associated with the amount of variable consideration that the customer is obligated to pay.



5.7. RENEWAL OPTIONS

A renewal option is different from customer loyalty programmes and many discount vouchers. With loyalty programmes and vouchers, the underlying goods or services in the contract with the customer will often have a different nature, and accordingly they would be considered as separate deliverables rather than being similar to the original goods or services in the original contract. A renewal option, in contrast, gives a customer the right to acquire additional goods or services of the same type as those supplied under an existing contract.

If an entity grants a customer the option to acquire additional goods or services, that option only gives rise to a performance obligation if it provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given). Similarly, an option to acquire additional goods or services at a price that would reflect their stand-alone selling price also does not constitute a material right even if it can be exercised only by entering into an earlier contract.



Example 37

Entity G operates gyms for its members. To become a member, a customer must pay a one-off upfront joining fee of CU 1,000 and an annual subscription fee. The joining fee therefore entitles the customer to renew the contract, i.e. an option to acquire gym services in the future by paying the annual subscription and avoiding the upfront joining fee in subsequent years.

Entity G assesses whether the joining fee relates to the transfer of a promised good or service on inception of the customer's membership and concludes that it does not. Instead, the joining fee is an advance payment for future gym services. To determine whether the upfront fee should be recognised over the contract period (e.g. one year) or based on expected renewal behaviour (e.g. potentially longer than 1 year), Entity G must assess whether the renewal option gives rise to a material right.

Entity G concludes that the renewal option (i.e. the right to continue beyond year 1 as a gym member) is a separate performance obligation because it results in a material right being given to members. As a member does not pay the upfront fee in renewed membership years, the option to purchase additional goods and services is a material right, as it essentially discounts subsequent membership periods in comparison to a gym member signing up for a new membership.

Entity G therefore recognises the CU 1,000 on a straight-line basis over the period it expects customers to remain as gym members. The annual subscription fee is recognised over the annual period to which it relates.

If a renewal option does constitute a material right, as a practical alternative to estimating the stand-alone selling price of the option, an entity can allocate the transaction price to the optional goods and services by reference to the goods and services expected to be provided and the corresponding expected amount of consideration if the following two conditions are met:

1. The additional goods or services are similar to the original goods or services in the contract (i.e. a vendor continues to provide what it was already providing). Consequently, it is more intuitive to view the goods or services underlying such options as part of the initial contract.
2. The additional goods or services are provided in accordance with the terms of the original contract. Consequently, the vendor's position is restricted because it cannot change those terms and conditions and, in particular, it cannot change the pricing of the additional goods or services beyond the parameters specified in the original contract.



Example 38

Entity F, a professional football club, offers season tickets for the following season (season 1) at a price of CU 5,000. As part of a promotion drive it offers supporters the opportunity to buy a season ticket for the following season (season 1) for CU 8,000, which will also grant those supporters the right to a 25% discount off the standard season ticket price for the subsequent 4 seasons (seasons 2-5).

It is expected that the price of annual season tickets in future years will remain at CU 5,000. In addition, it is expected that all supporters that purchase a season ticket for CU 8,000 will exercise the option to purchase season tickets at a discount in seasons 2-5 (that is, there will be a 100% renewal rate).

Entity F concludes that the practical expedient applies because:

- The services to be provided in seasons 2 to 5 are similar to the services to be provided in season 1; and
- The services to be provided in seasons 2 to 5 will be provided in accordance with the terms of the contract (with no contractual right to change or withdraw the 25% discount offer).

Under the practical expedient, the total transaction price is allocated across all of the season tickets that are expected to be sold over the five year period. IFRS 15.BC393 explains that the practical alternative requires 'an entity to include the optional goods or services that it expects to provide (and corresponding customer consideration) in the initial measurement of the transaction price'. This results in the contract being viewed as being a single contract for its expected term (in this case a term of five years as all renewal options are expected to be exercised), and not a one year contract with a series of renewal options.

This means that the total consideration receivable (CU 8,000 in season 1 plus CU 3,750 for each of seasons 2-5) is recognised evenly over the five year period, resulting in revenue of CU 4,600 $((\text{CU } 8,000 + (\text{CU } 5,000 * 4 * 0.75))/5)$ being recognised in each year.

Note that in order to simplify this example, no adjustment has been made for any potential financing component.

It might be thought that an appropriate approach would be, for each season ticket sold for CU 8,000, Entity F recognises revenue of CU 5,000 during season 1 and allocates CU 3,000 to customer renewal options rather than allocating amounts based on relative stand-alone selling prices. However, this is incorrect as it results in separate contracts being accounted for in the initial and subsequent periods instead of as a single overall contract for a five year period. The allocation of CU 3,000 would also be similar to the use of a residual approach for the allocation of the transaction price to the renewal options, which would also be inappropriate.

Accounting for early renewal rights

It is common for entities to offer non-cancellable contracts that provide the customer with the option to renew the contract prior to contract expiry. This would be common in telecommunications industry and other industries where a product is sold on day 1 of the contract with ongoing services to be provided over the contract period.



Example 39

Company X is in the telecommunications industry, and offers the following contract to customers:

- 24 month non-cancellable contract which includes a device and a package of services.
- Customers pay 24 equal monthly instalments. Company X allocates each instalment between the device and the services on the same basis.
- The contract states that the customer has an option to renew their contract at any time after 21 months without penalty (no recovery is made of instalments that would have been made during the period from renewal up to the end of the original 24 month contract period).
- The early renewal results in the customer obtaining a new device and the same services for a subsequent 24 months from the renewal date.
- The renewed contract is priced at the stand-alone selling price for that contract at the time that the customer exercises the early renewal right.

The issue is how the customer's option to renew early (prior to the full contract term of 24 months ending) should be accounted for in accordance with IFRS 15.

The early renewal right was embedded in the rights and obligations agreed to by the parties at contract inception. Therefore the early renewal option is not a contract modification because it is not an amendment to

the original rights and obligations of the parties. IFRS 15.18 states that:

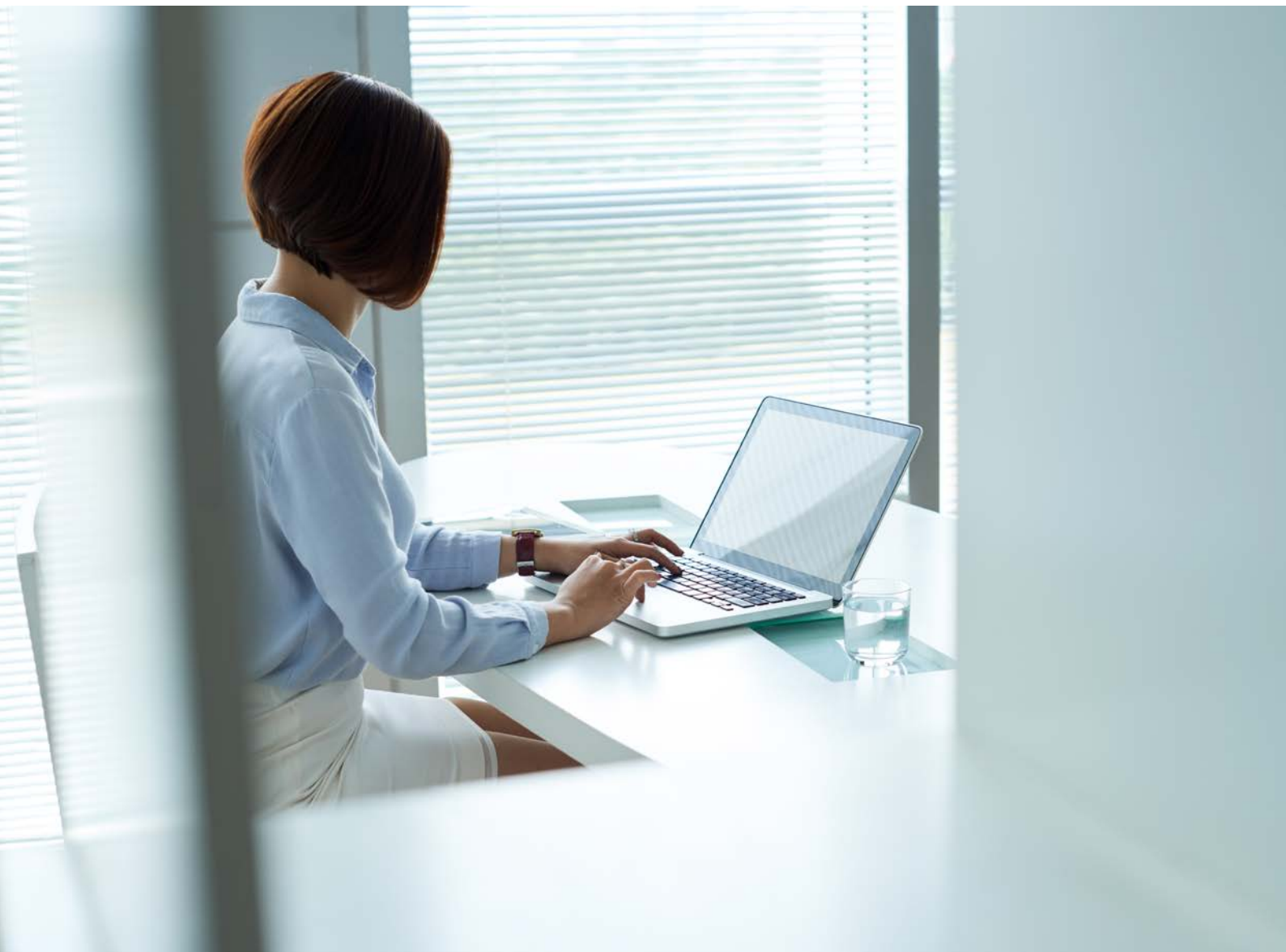
'A contract modification exists when the parties to the contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract.'

The option to renew early affects the amount of consideration to which the entity expects to be entitled for the device provided to the customer on day 1. This is because the amount of consideration could vary depending on when customers exercise their option to renew. Consequently, the amount of consideration in respect of the device is variable consideration as described in IFRS 15.51.

Company X will therefore need to estimate the amount of variable consideration to which it will be entitled, in accordance with IFRS 15.56-59. This requires that variable consideration (in this case the monthly instalments between months 21 and 24) will only be recognised as revenue to the extent that it is highly probable that there will not be a significant reversal in the amount of cumulative revenue recognised when the uncertainty over the variable consideration is resolved.

In this case, the uncertainty will be resolved when it is known whether the customers will exercise their renewal rights early. This will affect the allocation of monthly instalments between the handset (for which revenue will be recognised on inception of the contract with a related receivable being settled through the partial allocation of future monthly instalments) and the services (for which revenue will be recognised over the period of the contract, being the residual amount after deduction of the amount allocated to the handset).

The amount of variable consideration that is taken into account will depend on the facts and circumstances in each case. However, for a period of more than 21 months to be taken into account for part or all of the customer base, clear evidence would be required of the expected pattern of exercise of the early renewal option.



5.8. BREAKAGE (UNEXERCISED RIGHTS)

Breakage refers to situations where customers do not exercise all of their contractual rights to receive goods or services in the future. Common examples include:

- forfeiting balances on gift cards;
- not claiming loyalty points or air miles; and
- non-refundable theatre and travel tickets, where the customer foregoes amounts paid in advance if they do not turn up.

When a vendor expects to be entitled to a breakage amount, it recognises revenue in proportion to the expected pattern of rights that customers will exercise (i.e. by comparing the goods or services delivered to date with those expected to be delivered overall). This increases the transaction price allocated to the individual goods or services transferred to include revenue from the vendor's estimate of unexercised rights.

When the vendor does not expect to be entitled to a breakage amount, it is recognised as revenue when the likelihood of the customer exercising its remaining rights becomes remote. As with the variable consideration constraint, it would only recognise breakage as revenue to the extent it was highly probable there would not be a significant reversal of that revenue.



Example 40 (continued from example in section 5.7)

Entity F sells 10,000 season tickets for CU 8,000 each that grant supporters the right to a 25% discount in each of seasons 2 to 5. At the start of season 1 Entity F has therefore received a total of CU 80 million of which CU 50 million is recognised as revenue in season 1 and CU 30 million relates to supporters' renewal options.

At the two extremes of potential outcomes:

- if no supporter exercises their renewal option CU 80 million would have been received for season 1; and
- if every supporter exercises their renewal options for all of seasons 2 to 5, then CU 7.5 million will be recognised as revenue in each of seasons 2 to 5 (i.e. a total of CU 30,000,000 or CU 750 per season ticket holder per season).

The contractual terms of the renewal option stipulate that if a supporter fails to renew a season ticket in any year, they lose their right to the 25% discount in all subsequent seasons (e.g. if a season ticket holder renews at a 25% discount in season 2, but does not renew their season ticket in year 3, they would lose their right to a 25% discount in seasons 4 and 5).

At the start of season 2, the price of a standard season ticket rises to CU 5,500. 800 supporters do not exercise their renewal option and hence also forfeit rights to a 25% discount in seasons 3 to 5. 9,200 supporters renew their season ticket at a price of CU 4,125 being the standard price of CU 5,500 less the 25% discount.

Scenario A

Entity F has no prior experience of offering such discounts to supporters and therefore cannot estimate whether it will be entitled to any breakage. Consequently, it concludes that it cannot recognise any of the CU 30 million as breakage revenue prior to knowing that supporters have forfeited their option (i.e. by not renewing their season ticket) as to do otherwise could result in their being a significant reversal in future periods of the amount of breakage recognised. Therefore Entity F does not recognise any revenue in season 1 for breakage.

At the start of season 2 Entity F recognises CU 2,400,000 as breakage (i.e. CU 750 x 800 x 4). This reflects that 800 supporters have forfeited their renewal rights (valued at CU 750 per season for each of seasons 2 to 5 inclusive) and is therefore accounted for as additional revenue earned for services provided in season 1. Entity F also recognises:

- CU 6,900,000 during season 2 (i.e. CU 750 x 9,200) reflecting that 9,200 supporters exercised their renewal right for season 2; and

- CU 37,950,000 during season 2 (i.e. CU 4,125 x 9,200) reflecting the amounts paid by those 9,200 supporters for the price paid for the season ticket.

Scenario B

Entity F estimates based on past experience that 60% of supporters buying such season tickets will renew their season ticket for all 4 subsequent seasons, with the remaining 40% relinquishing their renewal options broadly on a linear basis (i.e. 10% or 1,000 supporters in each of the 4 seasons to which a discount is available). It therefore recognises breakage in year 1 of CU 4,812,500. This is calculated as follows:

Season	Supporters not expected to renew in following season	Rights expected to be forfeited at end of each season	Value of breakage CU	Allocate season 2 breakage to seasons 1 and 2	Allocate season 3 breakage to seasons 1, 2 and 3	Allocate season 4 breakage to seasons 1, 2, 3 and 4	Expected attribution to each season CU
1	1,000	4,000	3,000,000	1,125,000	500,000	187,500	4,812,500
2	1,000	3,000	2,250,000	1,125,000	500,000	187,500	1,812,500
3	1,000	2,000	1,500,000		500,000	187,500	687,500
4	1,000	1,000	750,000			187,500	187,500
5	n/a	0					
Total		10,000	7,500,000	2,250,000	1,500,000	750,000	7,500,000

In season 2, Entity F:

- recognises revenue of CU 6,900,000 for the 9,200 supporters who actually exercised their renewal right for the season ticket (i.e. CU 750 x 9,200);
- recognises revenue of CU 37,950,000 reflecting the amounts paid by those 9,200 supporters for the price paid for the season ticket (i.e. CU 4,125 x 9,200);
- reverses revenue of CU 600,000 to reflect the fact that in recognising breakage in season 1 it overestimated by 200 the number of supporters that would not exercise their renewal rights in season 2 (i.e. CU 750 x 200 x 4); and
- re-assesses the rate of attrition for the 9,200 supporters over the remaining 3 seasons (i.e. a total of 27,600 renewal options) and recognises breakage attributable to seasons 1 and 2 accordingly.



BDO comment

In some cases, customers' options may be perpetual and not have an expiration date (e.g. air miles often have no expiry date). The question that arises in these cases is whether an entity should apply the guidance in IFRS 15 on unexercised rights.

In our view, an entity should apply the guidance on unexercised rights, subject to the guidance on constraining estimates of variable consideration.

The guidance on options requires an entity to estimate the standalone selling price of the option at contract inception, considering the likelihood that the option will be exercised. The guidance also requires an entity to recognise any change in the likelihood that the option will be exercised when estimating the measure of progress of the performance obligation related to the option.

As a result, the standalone selling price of the option is not updated; instead, the entity updates its estimate

of the portion of the option that will be redeemed. This results in the entity recognising revenue in proportion to the pattern or recognition of other performance obligations in the contract.

Once the number of options expected to be exercised have actually been exercised, the entity would no longer recognise a contract liability.

In situations where a single option exists and the portfolio approach is not or cannot be applied, the standalone selling price of the option would still include the likelihood that the option will be exercised. The revenue related to the option would be recognised when the option is exercised or when it is determined that the likelihood of the option being exercised becomes remote.

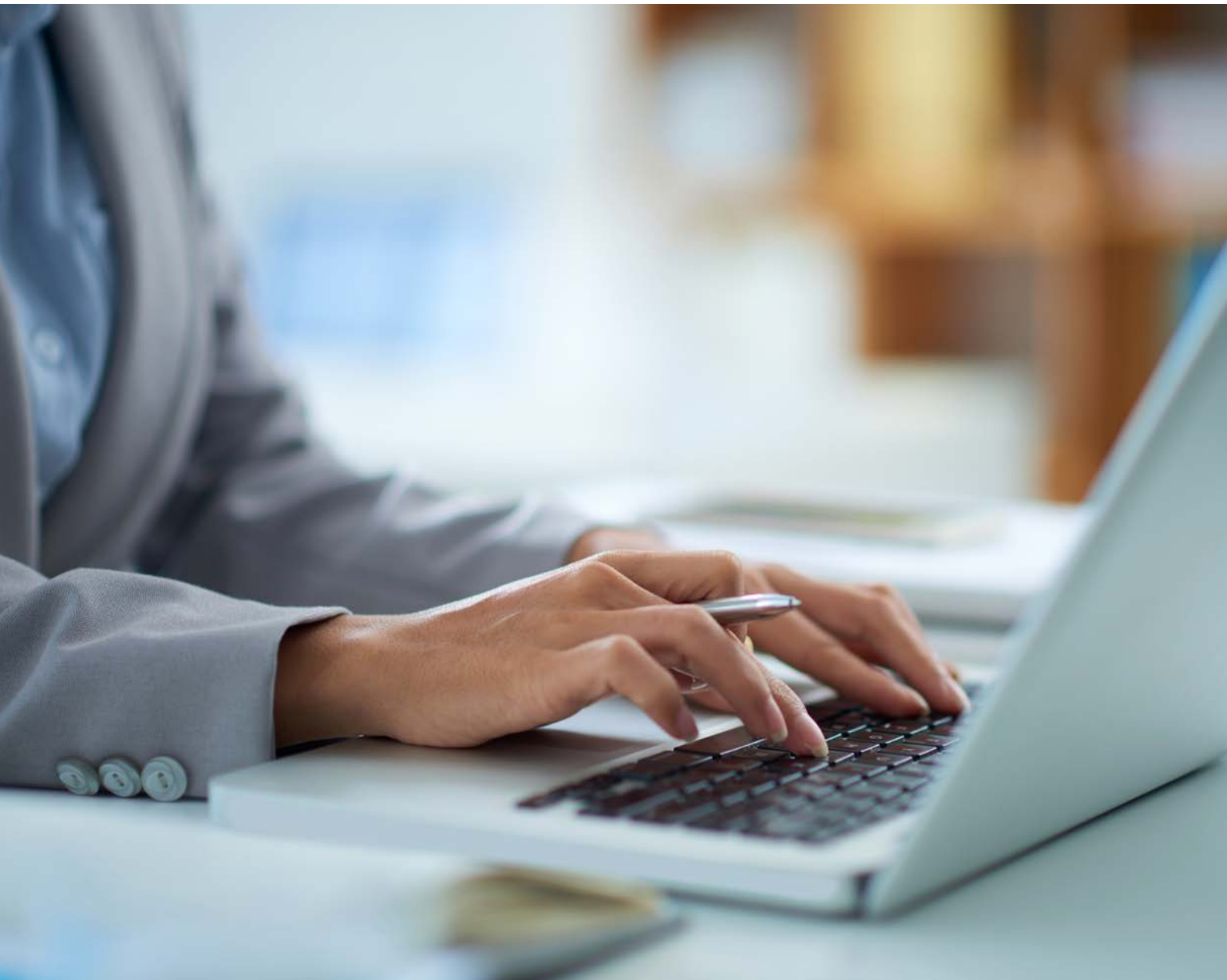
Existing guidance is less prescriptive on this issue, and some entities may need to change their accounting approach.

5.9. NON-REFUNDABLE UPFRONT FEES

A vendor may charge a customer a non-refundable upfront fee at (or near) contract inception, which may be related to an activity that the vendor is required to undertake at (or near) contract inception in order to fulfil the contract (for example, gym membership joining fees as discussed in section 5.7 above). The vendor is required to determine whether the fee relates to the transfer of a promised good or service, in order to identify the performance obligations within the contracts.

When the non-refundable upfront fee is not related to a performance obligation but to setup activities or other administrative tasks, the non-refundable upfront fee is accounted for as an advance payment for future goods or services and is therefore only recognised as revenue when those future goods or services are provided.

In practice, non-refundable upfront fees typically relate primarily to setup activities, and not to a performance obligation.



5.10. LICENCING

A licence establishes a customer's rights over the intellectual property of a vendor, such as:

- Software and technology
- Media and entertainment (e.g. motion pictures)
- Franchises
- Patents, trademarks, and copyrights.

A contract to transfer (provide) a licence to a customer may include obligations to provide other goods and services in addition to the promised licence. Those obligations may be specified in the contract or implied by the vendor's customary business practices, published policies or specific statements. The accounting treatment depends on whether or not the licence is 'distinct' from those other promised goods or services.

When the licence is not distinct from those other goods or services, they are accounted for together as a single performance obligation. This would be the case, for example, when the licence forms a component of a tangible good and is integral to the good's functionality (for example, a software license which requires ongoing maintenance and upgrade services in order for it to continue to operate), or it is a licence that the customer can benefit from only in conjunction with a related service (for example, a software hosting agreement on an internet site).

When the licence is distinct from the other promised goods or services, the licence is accounted for as a separate performance obligation. Revenue is then recognised either at a point in time, or over time, depending on whether the nature of the vendor's promise in transferring the licence to the customer is to provide that customer with either:

- Access to the vendor's intellectual property as it exists at any given time throughout the licence period (i.e. the vendor continues to be involved with its intellectual property); or
- A right to use the vendor's intellectual property as it exists at the point in time the licence is granted.



Example 41

ABC is a pharmaceutical company that discovers, develops and commercializes medications for cardiovascular disease. ABC owns a regulator-approved drug compound that, for a specified period, is patent protected for preventing heart disease in patients with high-cholesterol.

ABC enters into a licensing arrangement with a customer for the following:

- a licence to make and commercialise the drug compound, and
- a licence to a trademark for the drug compound (for branded product sales).

Customer can sell the generic product (without the use of the trademark) only after the patent period expires.

The issue is whether the licence to make and commercialise the drug and the licence relating to the trademark for branded product sales are distinct performance obligations. The conclusion as to whether they are distinct or not is important, as it may affect the timing of revenue recognition.

The analysis of whether the two licences are distinct or not will depend heavily on the particular facts and circumstances.

ABC appears to be able to benefit from the two licences separately from each other (i.e. in accordance with IFRS 15.27(a) the two licences are capable of being distinct). Despite the fact that ABC must use the trademark for the brand name, this is only for a particular period of time. ABC can produce generic drugs subsequent to the patent period expiring.

The trademark for the brand name of the product does not significantly affect the characteristics of the drug itself, meaning the promise is separately identifiable (i.e. in accordance with IFRS 15.27(b) the two licences are distinct in the context of the contract). This is similar to the analysis in section 4.2 concerning goods and

services and associated installation services. While a functional relationship exists between the two licences, there is no 'transformative' relationship in their use; the two products are added to each other, but they are not combined into a single overall output.

The conclusion on whether the two licences are distinct might differ if the fact pattern was altered. For example, if the patent period was of such a length that the potential benefits arising from generic drug manufacturing subsequent to the patent period elapsing were minimal, then ABC might conclude that the trademark for the brand name is necessary in order to obtain any economic benefit from the licence to produce the drug. In this case, the two licences would not satisfy the condition in IFRS 27.(b) (i.e. they would not be distinct in the context of the contract) as the nature of the promise in that case would be to allow an entity only to produce a combined branded drug, which is accomplished by granting two licenses in legal form only.

A vendor continues to be involved with its intellectual property by undertaking activities that do not transfer goods or services to the customer, but instead change its intellectual property to which the customer has rights. This applies if all of the following criteria are met:

(i) The contract requires, or the customer reasonably expects, that the vendor will undertake activities that significantly affect the intellectual property to which the customer has rights (that is, the intellectual property to which the customer has rights is dynamic).

Factors that may indicate that a customer could reasonably expect that a vendor will undertake activities that will significantly affect the intellectual property include:

- The vendor's customary business practices
- Published policies
- Specific statements
- The existence of a shared economic interest (e.g. a sales-based royalty) between the vendor and the customer related to the intellectual property licenced to the customer.

(ii) The rights granted by the licence directly expose the customer to any positive or negative effects of the vendor's activities that affect the intellectual property as and when the vendor undertakes those activities.

(iii) The vendor's activities do not transfer a good or a service to the customer as those activities occur (that is, the activities are not accounted for as performance obligations).

When all of the above criteria are met, a vendor accounts for the licence as a performance obligation satisfied over time because the customer will simultaneously receive and benefit from the vendor's performance as the performance occurs. An appropriate method is selected to measure the vendor's progress toward complete satisfaction of its performance obligation to provide access to the intellectual property.

When one or more of the criteria above are not met, the nature of the licence is to transfer a right to access intellectual property as it exists at the point at which the licence is granted. Because the intellectual property to which the customer has rights to is 'static' (i.e. is not affected by continuing involvement by the vendor), the right granted enables the customer to direct the use of and obtain substantially all of the remaining benefits from the intellectual property in its form at the point at which the licence is granted to the customer. Therefore, the promise of a licence that transfers a right is accounted for as a performance obligation satisfied at a point in time. The point in time cannot be before control of the licence is transferred to the customer. This means that, if the vendor provides (or otherwise makes available) to the customer an access code that is necessary to enable the customer to access or use licenced software, the vendor would not recognise revenue until the access code has been made available, even though the licence period could have started at an earlier date.

When determining the type of licence that has been granted (intellectual property as it exists at any point during the licence period or as it exists at the point at which the licence is granted), the following factors are disregarded:

- Restrictions of time, geography, or use. This is because these restrictions define the attributes of the promised licence, rather than define whether the vendor satisfies its performance obligation at a point in time or over time.

- Guarantees provided by the vendor that it has a valid patent to intellectual property and that it will defend that patent from unauthorised use. A promise to defend a patent right is not a performance obligation because it protects the value of the vendor's intellectual property asset and provides the customer with assurance that the licence transferred meets the related contractual specifications.

Clarifications to IFRS 15

The TRG discussed issues relating to the application of the licensing guidance in IFRS 15. Those issues related to:

- determining the nature of the entity's promise in granting a licence of intellectual property;
- the scope and applicability of the sales-based and usage-based royalties exception;
- the effect of contractual restrictions in a licence on identifying the performance obligations in the contract; and
- when the guidance on determining the nature of the entity's promise in granting a licence applies.

As a consequence of these discussions the IASB clarified the application guidance on licensing and the accompanying Illustrative Examples.

Except for the scope and applicability of the sales-based and usage-based royalty exception, the FASB reached different conclusions on these issues. Consequently, for a limited number of arrangements, it is possible that the accounting under IFRS and US GAAP will differ.

Activities affecting the intellectual property

To clarify when an entity's activities significantly affect the intellectual property to which the customer has rights, the IASB has added paragraph B59A to IFRS 15, which states the following:

An entity's activities significantly affect the intellectual property to which the customer has rights when either:

- a) those activities are expected to significantly change the form (for example, the design or content) or the functionality (for example, the ability to perform a function or task) of the intellectual property to which the customer has rights; or
- b) the ability of the customer to obtain benefit from the intellectual property is substantially derived from, or dependent upon, those activities. For example, the benefit from a brand is often derived from, or dependent upon, the entity's ongoing activities that support or maintain the value of the intellectual property.

Accordingly, if the intellectual property to which the customer has rights has significant stand-alone functionality, a substantial portion of the benefit is derived from that functionality. Consequently, the ability of the customer to obtain benefit from that intellectual property would not be significantly affected by the entity's activities unless those activities change its form or functionality. Types of intellectual property that often have significant stand-alone functionality include software, biological compounds or drug formulas, and completed media content (for example, films, television shows and music recordings).



Example 42

A vendor grants a franchise licence to a customer, which provides the right to use the vendor's trade name and sell its products for a period of 10 years. During this period, the vendor will undertake activities that will affect the franchise licence, including analysing changes in customer preferences, implementing product improvements and undertaking marketing campaigns.

The nature of the vendor's promise to its customer is to provide access to the vendor's intellectual property in its form as it exists throughout the licence period, and not only as it exists at the start of the licence period. Consequently, the performance obligation is satisfied over time.



Example 43

A vendor (a music record label) licenses a specified recording of a Beethoven symphony to a customer for a period of two years. The customer has the right to use the recording in all types of advertising campaigns (including television, radio and online media) in a specified country. The contract is non-cancellable and the customer is required to pay CU 10,000 per month.

The nature of the vendor's promise to its customer is to provide access to the recording in its condition as at the start of the licence period. Consequently, the customer's rights to the intellectual property are static and the vendor's performance obligation is satisfied at a point in time.

The vendor recognises all of the revenue (adjusted for a significant financing component, if appropriate) at the point at which the customer is able to use, and obtain substantially all the benefits, of the licensed intellectual property.

TRG discussions

Intellectual property sales (Agenda Paper 45; November 2015)

The following topics related to licences of Intellectual Property (IP) were discussed:

- The accounting for renewals of right-to-use licences (revenue accounted for at a point in time)
- The accounting for licence restrictions in terms of time, geography or usage

Most of the TRG members agreed that further clarification was needed in respect of how to account for licence restrictions and whether time-based restrictions should be addressed differently from other restrictions.

The following examples were discussed:

Example A:

Renewal of a right-to use licence (revenue recognised at a point in time)

A licensor and a customer enter into a multi-year software arrangement. Before the end of the initial licence period, it is renewed and extended for an additional multi-year period.

The staffs concluded that the licensor should recognise revenue for the renewal when it is agreed with the customer (i.e. before the end of the initial licence), because no additional performance is required from the licensor. Instead the renewal is a change to an attribute of the licence that the customer controls.

Example B:

Right-to-use licence containing additional rights that the customer obtains over the contract period

In this example the licensor grants the customer the right to use its patent to manufacture a product for a multi-year period. During the first 'x' years covered by the contract the customer can only commercialise the product in a specific geographical area. From that point in time onwards, the product can be commercialised in other regions as well.

The staffs concluded that the customer is granted two distinct licences because the right to commercialise the product in one region is distinct from the right to commercialise it in other regions. Therefore, the licensor recognises revenue for the second performance obligation when the rights are made available to the customer.

Some TRG members did not agree with the staffs' views, due to a potential conflict with other guidance in the standard.

Amendments to Topic 606

Some differences in comparison with IFRS have arisen from the FASB addressing licensing issues in its amendments to Topic 606.

The differences are as follows:

Determining the nature of the entity's promise in granting a licence of intellectual property:

The FASB decided to amend the criteria to determine the nature of a licence by requiring an entity to classify the intellectual property underlying the licence as functional or symbolic based on whether the intellectual property has significant stand-alone functionality. A licence to functional intellectual property is considered a right to use, while a licence to symbolic intellectual property is considered a right to access the underlying intellectual property. The IASB has not made similar amendments to the criteria in IFRS 15 for the purposes of determining the nature of the licence.

- Contractual restrictions in a licence and the identification of performance obligations:

Topic 606 has been amended to clarify that the requirements about contractual restrictions of the nature described in paragraph B62 do not replace the requirement for the entity to identify the number of licences promised in the contract. The IASB has not made similar amendments to IFRS 15.

- Renewals of licences of intellectual property:

The FASB has included an additional example in the Standard to specify that an entity would not generally recognise revenue from the transfer of a licence renewal until the beginning of the licence renewal period. The IASB has not made similar amendments.

- When to consider the nature of an entity's promise in granting a licence:

Unlike the IASB, the FASB has decided to make amendments that explicitly state that an entity considers the nature of its promise in granting a licence when applying the general revenue recognition model to a single performance obligation that includes a licence and other goods or services.



5.11. SALES-BASED OR USAGE-BASED ROYALTIES

When an entity earns royalties based on the extent to which a customer uses or benefits (through onward sales) from a license of IP, it has transferred control of the IP to its customer, with uncertainty over the amount of consideration (i.e. the consideration is variable). As an exception to the general principles in IFRS 15 that revenue is recognised when control of a good or service has been transferred to a customer and measured at an amount to which it expects to be entitled, royalties earned from sales-based or usage-based licences of intellectual property are recognised only at the later of the following:

- The subsequent sale or usage occurs; and
- The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

The interaction of this restriction, and the requirement to consider stand-alone selling prices when allocating consideration to multiple performance obligations in a contract, can lead to patterns of revenue recognition which differ from amounts stated in contracts. This arises, for example, in cases where two or more licences over intellectual property that are to be transferred to a customer at different times are included in a single overall contract, and the prices specified in the contract do not reflect the stand-alone selling prices of the licences. The approach required by IFRS 15 is designed to ensure that the timing and profile of revenue recognition is not affected by what might be considered to be artificial price allocations in contracts. See the example in section 4.4 'Allocation of variable consideration' above.



BDO comment

The term 'royalty' is not defined, and there are some cases where it is not clear whether a payment structure results in the sales- or usage-based royalty exception being applied. Certain payment terms may be 'in-substance' sales or usage-based royalties, even if the contract does not label the payments as royalties. In addition, there are situations where the amount of consideration is similar to a bonus and depends on the customer's subsequent sales or usage, even though the amount is not calculated on the basis of each sale or usage. For example:

- An entity licences IP in exchange for a payment of CU10 million if cumulative sales of the licensee's products making use of the IP exceeds CU100 million over a specified five year period.
- An entity licences IP in exchange for 'stepped' payments. This might be no royalty if the sales of the licensee's products making use of the IP are between CU1 and 10 million, a royalty of 1% of sales between CU10 million and CU25 million and a royalty of 2% of sales above CU25 million.

In our view, the exception does apply to these situations (unless the 'licence' is in fact an in-substance sale of the IP - see further comment and example below) because the consideration is based on the sales to the customer's customer even though it might not be described as a royalty. This follows from the discussion in the Basis for Conclusions to IFRS 15, which at paragraph BC415 states 'The boards decided

that for a licence of intellectual property for which the consideration is based on the customer's subsequent sales or usage, an entity should not recognise any revenue for the variable amounts until the uncertainty is resolved (that is, when a customer's subsequent sales or usage occurs).'

This supports the Boards' intention to apply the exception to consideration that relates to licences of IP and is based on the customer's subsequent sales or usage regardless of whether it is labelled as a royalty or whether it is structured so that consideration accumulates evenly over all sales or usage.

Care should be taken, to ensure this view is not being applied to contract clauses that have no economic substance (i.e. the payment is fixed and does not vary based on usage).

IFRS 15.BC421 also notes that:

'...The boards also noted that because this is a specific requirement intended for only limited circumstances, entities should not apply it by analogy to other types of promised goods or services or other types of variable consideration.'

This clarifies that the board is making a distinction between consideration that is based on sales or usage, and other forms of variable consideration (for example, an arrangement where the vendor may receive a performance-based bonus).

**BDO Comment**

Some arrangements that are licences in legal form are currently accounted for as 'in-substance sales'. Such arrangements are common in industries such as pharmaceuticals, where legal title to the IP may be retained by the vendor. The effect is that, although a transaction is described in the legal documents as being a licence, in reality it is a sale of the IP under which substantive control has been transferred to the customer.

In our view, the requirements in IFRS 15 dealing with sales and usage-based royalties in exchange for a licence of IP do not apply to outright sales of IP. Therefore it should also not apply to what are genuinely 'in substance sales'. This view reflects 'substance over form' and faithfully represents the economic substance of the transaction.

The determination of whether a licensing arrangement is an 'in substance sale' is a matter of judgement. Therefore an entity should also consider the requirements of IAS 1.122 related to disclosure of significant judgements. It is important to note that for a sale to be recognised in accordance with IFRS 15, control of the IP must be transferred. Looking only at risks and rewards is not sufficient to conclude that the arrangement is an 'in substance sale'. It should also be noted that if the arrangement is determined to be an 'in-substance sale' and an asset was previously recognised related to the IP, the related asset or a portion of that asset would also need to be derecognised.

Note that due to differences in the wording of the Basis for Conclusions, differences between the application of US GAAP and IFRS may exist. For US GAAP purposes, paragraph BC78(b) of ASU 2016-10 states that an entity should not discern whether a license to intellectual property is an 'in substance sale' of that intellectual property in deciding whether or not the royalties' exception applies. The wording in IFRS 15 is not as explicit and therefore treating a 'legal licence' as an 'in substance sale' may be possible. The following

example highlights the potential difference between IFRS and US GAAP

**Example 44**

BIOTECH and PHARMA entered into a license, development and commercialisation agreement for Drug X, a Phase III-ready drug candidate for the treatment of cancer and other potential indications. Under the terms of the agreement, PHARMA will get exclusive perpetual worldwide rights, including manufacturing and commercialisation rights, and will be responsible for funding the global development of Drug X. As compensation for such grant of rights, BIOTECH will receive payments of \$20 million, comprised of a \$15 million upfront payment and a \$5 million payment upon dosing of the first patient in the upcoming Phase III study of Drug X in newly diagnosed patients unfit to receive induction therapy. In addition, BIOTECH will be eligible to receive up to \$500 million in sales-based milestone payments, along with additional tiered royalty payments in selected territories.

US GAAP Analysis

Based on Paragraph BC78(b) of ASU 2016-10 BIOTECH should not attempt to determine whether a license is an in-substance sale. The legal form of the arrangement is licence of intellectual property therefore the sales and usage-based royalty exception would apply.

IFRS Analysis

BIOTECH would have to determine if control of the intellectual property has been transferred to PHARMA. Given this arrangement provides for the worldwide rights to the intellectual property in perpetuity, the conditions in IFRS 15.38 have been met and the licence agreement is an in-substance sale of the intellectual property. As a result the sales and usage based royalty exceptions would not apply. The milestone and royalty payments would be treated as variable consideration.

**BDO comment**

Royalty revenue can only be recognised once the subsequent sale or usage and related performance have both occurred. This exception applies regardless of whether the underlying licence provides a 'right to access' to an entity's IP, or a 'right to use' an entity's IP as it exists at a point in time. IFRS 15 also requires that performance obligations satisfied over time in

accordance with paragraphs 35-37 are recognised by measuring the progress towards satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (i.e. the satisfaction of an entity's performance obligation).

However, in some licenses that provide a customer with a right to access an entity's IP over time, royalty rates are not necessarily constant over the license term. A question therefore, arises as to whether the requirement to recognise royalties at the rate specified in a contract takes precedence over the requirement to measure revenue by reference to the entity's progress towards satisfying a performance condition.

In our view, it does not take precedence. It only overrides the requirement to constrain variable consideration.



Example 45

A vendor enters into a non-cancellable licence agreement for a 5 year period in exchange for a small amount of fixed consideration plus a sales-based royalty and determines that the licence gives its customer the right to access the entity's intellectual property as it may exist from time to time throughout the licence period, and not at the point in time when the license was granted. The entity estimates that:

- the customer sales on which the royalty is based will be approximately equal for each of the 5 years under licence, and
- any activities undertaken by the entity affecting its intellectual property will be performed on an even and continuous basis throughout the licence period.

The licensee agrees to the following royalty rates: Year 1: 10%, Year 2: 8%, Year 3: 6%, Year 4: 4%, Year 5: 2%.

Following the legal form of the royalty (i.e. recognising royalty rates of 10% in year 1, 8% in year 2, etc.) would not appropriately depict progress in satisfying the entity's performance obligation for providing access to its intellectual property as it may exist from time to time throughout the licence period. Although the requirement to recognise royalties on the later of (i) when the sale or usage occurs and (ii) satisfaction of the performance obligation to which the royalty relates sets a limit on the maximum amount of revenue that can be recognised, it does not mean that the maximum royalty receivable should necessarily be recognised. The entity also needs to consider whether it is required to defer royalty income to ensure it continues to comply with the requirement to measure revenue based on performance to date. Therefore the vendor decides it should initially apply an average expected royalty rate of 6%. It re-assesses this estimate on a regular basis throughout the license period to ensure the rate applied remains appropriate.

In some contracts an IP licence is offered with other goods or services in a contract (e.g., software licences with post-contract customer support, franchise licences with training services, biotechnology and pharmaceutical licences sold with research and development services or a promise to manufacture a drug for the customer), with the consideration again being in the form of a sales- or usage-based royalty. In some of those contracts the license and other goods or services are distinct and in other cases they are not distinct.

Whether or not the other goods or services are distinct from the license IFRS 15 clarifies that the requirement to recognise royalties on the later of (i) when the sale or usage occurs and (ii) satisfaction of the performance obligation to which the royalty relates applies to arrangements for which the license is the predominant item. When the license is not the predominant item, the royalty income represents variable consideration which needs to be estimated (and constrained), and would then be allocated to each performance condition (including the license) based on relative standalone selling prices. The revenue allocated to each performance condition would then be recognised at a point in time or over time depending on when control of the good or service is transferred to the customer.

The requirement to recognise royalty income on the later of (i) when the sale or usage occurs and (ii) satisfaction of the performance obligation to which the royalty relates would apply, however, when a single license is not the predominant item to which the royalty relates, but the royalty predominantly relates to two or more licenses promised in a contract.

Although the FASB added an example to Topic 606 to illustrate when a licence is the predominant item to which a royalty relates, the IASB decided that no further guidance on the term 'predominant' was needed in IFRS 15 because stakeholders feedback suggests that the term can be applied in practice.



BDO Comment

In some licenses for intellectual property that pay a sales-based or usage-based royalty, the royalties receivable are subject to a guaranteed minimum amount. The pattern of revenue recognition depends on whether the licence meets the criteria for recognition at a point in time or over time (see Section 5.10 above). When the licence meets the criteria for point-in-time revenue recognition, the fixed guaranteed minimum should be recognised when the performance obligation is satisfied, i.e. when the licence is transferred to the customer. This treatment would be consistent with treatment for a licence that is provided on a fixed fee basis.

When the licence meets the criteria for over time revenue recognition, entities will need to consider the facts and circumstances and apply judgement to determine an appropriate approach that depicts progress towards the satisfaction of the performance obligation. In determining the pattern of revenue recognition factors to consider include:

- What is the appropriate measure of progress, time or the underlying sales or usage?
- Is the guaranteed minimum substantive?
- Are the royalties expected to exceed the guaranteed minimum?



Example 46

A licensor enters into a 5 year arrangement to licence intellectual property (IP). The licence requires the customer to pay a sales-based royalty of 5% of the customer's gross sales associated with the IP with a minimum guaranteed amount is CU 5,000. Over the term of the licence the expected royalties are:

Year 1	CU	750
Year 2	CU	1,500
Year 3	CU	2,000
Year 4	CU	1,000
Year 5	CU	3,000
Total	CU	8,250

In each of the scenarios below, it is assumed actual royalties received in each year equal the above expected royalties.

Scenario A – Point in time

If the licence meets the criteria for recognition at a point in time, i.e. when the licence is transferred to the licensee, the licensor recognises revenue as follows:

	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties Received	750	1,500	2,000	1,000	3,000
Cumulative Royalties	750	2,250	4,250	5,250	8,250
Annual Revenue	5,000	-	-	250	3,000
Cumulative Revenue	5,000	5,000	5,000	5,250	8,250

Scenario B – Over time

If the licence meets the criteria for recognition over time, the licensor applies judgement in light of the specific facts and circumstances, with a number of potential approaches. Under the first approach, the licensor recognises the royalty as revenue as the customer's gross sales associated with the IP occur. This approach is based on the underlying sales/usage being the appropriate measure on which to recognise revenue and results in annual revenue equaling the amount of royalties received each year. It is only appropriate when the royalties are expected to exceed the minimum guarantee.

	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties Received	750	1,500	2,000	1,000	3,000
Cumulative Royalties	750	2,250	4,250	5,250	8,250
Annual Revenue	750	1,500	2,000	1,000	3,000
Cumulative Revenue	750	2,250	4,250	5,250	8,250

Under the second approach, the licensor estimates the transaction price for the performance obligation (including fixed and variable consideration) and recognises revenue using an appropriate measure of progress, subject to the royalty constraint. This approach is based on time being the appropriate measure on which to recognise revenue, and like the first approach, is only appropriate when royalties are expected to exceed the minimum guarantee. It requires periodic reassessment of the estimate of total consideration and, if appropriate, an update to the measure of progress. This will result in periodic cumulative catch-up adjustments to revenue. Under this approach CU 1,650 (the expected total of CU 8,250 over 5 years) will be recognised each year, subject to the constraint which results in only CU 300 being recognised in year 4.

	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties Received	750	1,500	2,000	1,000	3,000
Cumulative Royalties	750	2,250	4,250	5,250	8,250
Annual Revenue	1,650	1,650	1,650	300	3,000
Cumulative Revenue	1,650	3,300	4,950	5,250	8,250

Under the third approach, the licensor recognises the minimum guarantee (fixed consideration) using an appropriate measure of progress and recognises royalties only when cumulative royalties exceed the minimum guarantee. Assuming time is the measure of progress, CU 1,000 (CU 5,000 over 5 years) will be recognised each year. Royalties in excess of the CU 5,000 are recognised in the year received, which result in the additional CU 250 and CU 3,000 recognised in years 4 and 5.

	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties Received	750	1,500	2,000	1,000	3,000
Cumulative Royalties	750	2,250	4,250	5,250	8,250
Annual Revenue	1,000	1,000	1,000	1,250	4,000
Cumulative Revenue	1,000	2,000	3,000	4,250	8,250

5.12. REPURCHASE AGREEMENTS

A repurchase agreement arises when a vendor sells an asset to a customer and is required, or has an option, to repurchase the asset. The asset itself could be the same one as was originally sold to the customer, one which is substantially the same, or another (larger) asset that includes as a component the asset which was originally sold. Typically the arrangements come in the following three forms:

1. the vendor has an obligation to repurchase, and the customer an obligation to sell back, the asset (a forward contract);
2. the vendor has a call option, giving it a right but not an obligation to repurchase the asset; and
3. the customer has a put option, giving it the right but not an obligation to sell back the asset.

In the first two types of arrangement (a forward and a vendor call option), the customer is limited in its ability to direct the use of and obtain substantially all of the remaining benefits from the asset, meaning that it does not obtain control of the asset. Therefore the vendor does not recognise any revenue from the sale and instead, depending on the contractual terms, the contract is accounted for as either a lease or a financing arrangement. To determine in which of these two ways the vendor accounts for the transaction it compares the repurchase price of the asset with its original selling price, taking into account the effects of the time value of money.

If the repurchase price is lower than the original selling price of the asset, the contract is accounted for as a lease in accordance with IFRS 16, unless the contract is part of a sale and leaseback transaction. If it is part of a sale and leaseback transaction, the vendor must continue to recognise the asset and also recognise a financial liability (accounted for in accordance with IFRS 9 for any consideration received from the customer).

If the repurchase price is greater than or equal to the original selling price of the asset, the contract is accounted for as a financing arrangement and, therefore, the vendor recognises a financial liability for any consideration received from the customer and continues to recognise the asset. The difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer on repurchase is interest and, if applicable, processing or holding costs (e.g. insurance). When the repurchase agreement is a vendor call option rather than a forward and the option lapses unexercised, the vendor derecognises the liability and recognises revenue.

In the third situation (i.e. a customer put option), the accounting also depends on the relationship between the repurchase price of the asset and the original selling price of the asset.

If the repurchase price of the asset is lower than the original selling price of the asset, then at contract inception the vendor considers whether the customer has a significant economic incentive to exercise its right. This may be the case if, for example, the asset's repurchase price is expected to significantly exceed its market value in the period the put option becomes exercisable. If the customer does have an economic incentive to exercise the put option then it does not obtain control of the asset and the agreement is accounted for as a lease (unless the contract is part of a sale and leaseback transaction, in which case the contract is accounted for as a financing arrangement in the same way as a forward or vendor call option).

If the customer does not have a significant economic incentive to exercise its option, the customer obtains control of the asset and the vendor accounts for the transaction as a sale with a right of return. This means the transaction price is variable and so the amount of revenue is only recognised to the extent that it is highly probable it will not reverse, i.e. revenue is only recognised to the extent it is highly probable the put option will not be exercised. Section 5.3 above discusses sales with a right of return in more detail.





BDO comment

The effects of this part of IFRS 15 may be significant in some industry sectors. For example, in many jurisdictions cars are sold to customers together with the right for the customer to require the vendor to repurchase the cars for a specified price after a period of between two and four years. Careful consideration of the exercise price of these customer put options will

be required, as well as identifying the various parties to the contractual arrangements. This includes whether the vendor or an unrelated third party finance company grants the put option and, if the latter, whether there are any associated contractual arrangements between the vendor and that third party finance company.



Example 47

A manufacturer of industrial equipment (Entity X) enters into a sales contract with a customer, under which it sells equipment with a production cost of CU 500 to the customer for a sales price of CU 750.

The customer is granted a contractual right to return the equipment to Entity X after 2 years in exchange for a predetermined amount of CU 450 (the repurchase price). The fair value of the equipment after 2 years is expected to be in the range of CU 425 to CU 475 with a linear distribution of expected values (that is, the mean of the various estimates is CU 450). The present value of the repayment obligation, discounted at Entity X's incremental borrowing rate of 6%, is CU 400.

The expected useful life of the equipment is 5 years.

At contract inception:

- the repurchase price of CU 450 is less than the original sales price of CU 750; and
- the customer does not have a significant economic incentive to exercise the right of return because the repurchase price is not significantly in excess of the expected market value of the equipment.

Consequently, Entity X accounts for the transaction as a sale with a right of return. This means that Entity X will only recognise revenue of CU 750 and derecognise its asset (the equipment) of CU 500 with an associated cost of sales, if it considers that it is highly probable that the customer will not exercise its option to require Entity X to repurchase the asset. This is likely to require consideration of past practice with other similar transactions and any other available evidence.

If Entity X has experience with other similar transactions (and, potentially, other supporting evidence), the transaction may be recorded as a sale. The accounting entry would be:

Dr Cash	750
Dr Cost of Sales	500
Cr Inventory	500
Cr Revenue	750

5.13. CONSIGNMENT ARRANGEMENTS

A vendor may deliver a product to another party, such as a dealer or retailer which will sell the product to its own end customers. In these circumstances, the vendor is required to assess whether the other party has obtained control of the product. If the other party has not obtained control, the product may be held in a consignment arrangement. A vendor does not recognise revenue on delivery of a product to another party which is held on consignment.

The following indicates the existence of a consignment arrangement:

- the product is controlled by the vendor until a specified event occurs (e.g. sale of the product to a customer of the dealer or retailer, or until a specified period expires);
- the vendor is able to require the return of the product or transfer the product to a third party (e.g. transfer to another dealer or retailer); and
- the dealer or retailer does not have an unconditional obligation to pay for the product, even if it is required to pay a deposit.



5.14. BILL-AND-HOLD ARRANGEMENTS

Bill-and-hold arrangements involve the vendor invoicing a customer for goods, but instead of delivering them to the customer, the vendor retains physical possession with the goods being shipped or delivered to the customer at a later date. A customer might request this type of arrangement if, for example, it does not have sufficient space of its own to accommodate the product. The effect is that in addition to selling the product, the vendor provides a custodial service.

In addition to evaluating whether control of the goods has transferred to the customer in the same way as for any other sale (or performance obligation) to be recognised at a point in time, all of the following criteria are required to be met for the vendor to recognise revenue:

- The reason for the bill and hold arrangement must be substantive (for example, the arrangement might be requested by the customer because of a lack of physical space to store the goods)
- The product must be identified separately as belonging to the customer (that is, it cannot be used by the supplier to satisfy other orders)
- The product must currently be ready for physical transfer to the customer
- The vendor cannot have the ability to use the product, or to direct it to another customer.



BDO Comment

Careful consideration of the terms of bill and hold arrangements will be needed to determine whether there are additional performance obligations (e.g. for

custodial services) to which some of the transaction price for the sale of goods should be allocated.

5.15. CUSTOMER ACCEPTANCE

If a customer accepts an asset, this may indicate that control over the asset has passed to the customer. However, contractual arrangements typically include clauses which enable the customer to require the vendor to take action if the asset does not meet its contractually agreed upon specifications, and might allow the customer to cancel the contract.

If a vendor can demonstrate that an asset that has been transferred to a customer meets the contractually agreed upon specifications, then customer acceptance is considered to be a formality that is not taken into account when determining whether control over the asset has passed to the customer. For example, if the sale of an asset is subject to it meeting certain size and weight specifications, the vendor would typically be able to confirm whether these had been met when the asset is delivered to the customer. However, if the vendor recognises revenue in advance of receiving customer acceptance, the vendor is required to consider whether there are any other performance obligations that have not yet been fulfilled.

If the vendor is not able to determine that the asset that has meets the contractually agreed upon specifications, then control over the asset does not transfer to the customer until the vendor has received the customer's acceptance. In addition, if products are delivered to a customer for trial purposes, and the customer has no commitment to pay any consideration until the trial period has ended, control of the asset does not pass to the customer until the earlier of the point at which the customer accepts the asset or the trial period ends.



5.16. TREATMENT OF ONEROUS CONTRACTS

IFRS 15 does not contain specific guidance for onerous contracts. Instead, IAS 37 applies to contracts within the scope of IFRS 15 that are, or have become, onerous (see IAS 37.5(g)).

IAS 37 does not provide any guidance on how to combine or segment contracts, while IFRS 15 provides significant guidance on these topics.

In addition IAS 37.68 specifies that onerous contracts need to be assessed taking into consideration economic benefits to be received. IAS 37 does not define these economic benefits, including contracts which contain variable consideration, while for those contracts IFRS 15.56-58 constrain the amount of variable consideration that can be recognised.

When assessing onerous contracts in accordance to IAS 37, an initial question is whether the unit of account is the contract as a whole or the performance obligations identified through the application of IFRS 15.

Because IAS 37 refers to contracts, the unit of account is the contract as a whole and not the individual performance obligations. Consequently, a provision would not be recognised for a contract with multiple performance obligations, in which one performance obligation was onerous but the overall contract was not. However, it is possible that two or more contracts would need to be combined into a single unit of account.

The contract level unit of account is consistent with IFRS 15, which clearly distinguishes between a contract and performance obligations in a contract. However if two or more contracts are entered into at or near the same time with the same customer (or related parties of the customer) and they meet one of the following criteria from IFRS 15.17, the contracts should be combined for the purposes of both IFRS 15 and IAS 37:

- the contracts are negotiated as a package with a single commercial objective;
- the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- the goods or services promised in the contracts are a single performance obligation.

In assessing whether a contract is onerous or not, an entity must determine which costs should be included in the calculation. In October 2019, the Board discussed feedback on an exposure draft of proposals to clarify which costs should be included in the measurement of onerous contracts. As at the time of publication of this document, the Board had tentatively decided to clarify that such costs comprise those that relate directly to the contract. It also tentatively decided to add examples to IAS 37 of costs that do, and costs that do not, relate directly to a contract, and to amend IAS 37.69 to refer to assets that relate directly to a contract, rather than assets dedicated to a contract.

An additional question, for the purposes of assessing onerous contracts in accordance with IAS 37 is whether variable payments should be subject to the variable consideration constraint in accordance with the requirements of IFRS 15.

For this issue, there is no requirement in IAS 37 that requires the revenue recognition constraint in IFRS 15 to be applied when a contract gives rise to variable consideration. IFRS 15 does not apply to an assessment of onerous contracts (instead referring to IAS 37), meaning that for the purposes of IAS 37 the definition of 'economic benefits to be received' is interpreted more widely. This means that for the purposes of accounting for an onerous contract in accordance with IAS 37, all expected revenues are included. This is in contrast to the constraint in IFRS 15, which permits revenue from a contract which gives rise to variable consideration to be recognised only when it is highly probable that there will not be a subsequent reversal in the amount of revenue which has been recognised to date.



Example 48

A professional services company has entered into a contract with its customer and identified 2 distinct performance obligations (POs), which meet the conditions for recognising revenue over time. Total contract revenue is CU 250,000 of which CU 100,000 relates to PO 1 and CU 150,000 relates to PO 2 (determined by reference to relative standalone selling prices). Expected costs on inception of the contract for PO 1 and PO2 were CU 75,000 and CU 120,000 respectively (i.e. a total of CU 195,000) meaning that both POs were expected to be profitable as well as the overall contract.

The company measures its progress towards completion using the cost input method.

At the end of year 1, costs incurred and expected to be incurred are as follows:

Scenario A

	Incurred to date	Forecast future costs	Total costs	Forecast profit/(loss)
- PO 1	50	70	120	(20)
- PO 2	30	95	125	25
- Contract Total	80	165	245	5

Amounts recognised in the income statement for year 1 prior to considering the need for an onerous contract provision is as follows:

- PO 1: $50/120 \times 100,000$	41,666
- PO 2: $30/125 \times 150,000$	36,000
- Total Revenue	77,666
- Less costs incurred to date	(80,000)
- Net loss	2,334

Because the overall contract is still expected to generate a profit in the end, no onerous contract provision is recognised, even though PO 1 is expected to be loss making.

Scenario B

	Incurred to date	Forecast future costs	Total costs	Forecast profit/(loss)
- PO 1	30	40	70	30
- PO 2	40	160	200	(50)
- Contract Total	70	200	270	(20)

Amounts recognised in the income statement for year 1 prior to considering the need for an onerous contract provision is as follows:

- PO 1: $30/70 \times 100,000$	42,857
- PO 2: $40/200 \times 150,000$	30,000
- Total Revenue	72,857
- Less costs incurred to date	(70,000)
- Net profit	2,857

However, the contract is now expected to result in an overall loss of 20,000. Consequently the company recognises an onerous loss provision in accordance with IAS 37 as follows:

Dr Income statement – contract costs	22,857
Cr Provision for onerous contract	22,857

5.17. SUCCESS-BASED FEES

In a purely success-based fee scenario (i.e. 100% of the consideration is contingent on a successful result being obtained), the customer is paying only for the service on which the success fee is based (e.g. 'no win, no fee' legal services). Therefore, any other services provided under the contract are ancillary to this primary service and are not the service for which the customer is paying.

In assessing whether revenue should be recognised over time or at a point in time, the criteria in IFRS 15.35(a) are not met as the customer only receives and consumes any benefit from the entity's performance at the point in time at which success is achieved. In addition, the criteria in IFRS 15.35(c) is not met as the entity does not have an enforceable right to payment until success is achieved.

In some scenarios the work performed would not need to be re-performed if the contract was cancelled and was to be completed by another entity. In these cases, the criteria in IFRS 15.35(a) will have been met (see IFRS 15.B3-B4). If the work does not need to be re-performed, the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. Therefore, revenue to be earned from the success-based fee can potentially be recognised. However, even when it is concluded that paragraphs 35(a) or 35(b) apply such that overtime revenue recognition is appropriate, it must be remembered that the success fee is variable consideration. An entity can only recognise variable consideration to the extent it is highly probable there will not be a significant reversal of the amount of the success fee estimated. This will often mean that the entity will be precluded from recognising revenue on a contract-by-contract basis, notwithstanding it is in an over-time recognition model, particularly, if the success fee is an 'all or nothing' fee. However, if the contracts are homogeneous or the portfolio of contracts can be split into sub portfolios of homogeneous contracts the practical expedient in IFRS 15.4 may be applied when estimating and constraining the variable consideration (see section 5.1 for further discussion on application of the portfolio approach to contract costs associated with success-based fees).



6. PRESENTATION

In accordance with the requirements of IAS 1, a vendor presents or discloses revenue from contracts with customers separately from the vendor's other sources of revenue.

This presentation requirements needs to be interpreted carefully in order to understand the implication of this requirement. Since IAS 1 requires disclosure of revenue arising from transactions in the scope of IFRS 15 separately from other sources of revenue, there are situations where economically-linked revenue streams will require separate presentation. For example, the presentation of:

- Leasing income in the scope of IFRS 16 separate from non-lease component revenue in the scope of IFRS 15, such as maintenance revenue; and
- Certain income derived from gambling contracts in the scope of IFRS 9 (i.e. income derived from fixed-odds wager sports bets) separate from the provision of other gambling activities in the scope of IFRS 15.

The requirement to separate transactions within the scope of IFRS 15 separately from those that are not within the scope of IFRS 15 may cause differences between entity's internal management reporting and IFRS compliant financial statements. It also highlights the importance of ensuring entities have systems and processes in place to accurately separate the transaction price attributable to separate components, even if it does not make a difference in the pattern or timing of revenue recognition.

In its statement of financial position, a vendor is required to present separate amounts for contract assets, contract liabilities and receivables due from customers. Alternative descriptions can be used for these line items.

When a vendor transfers control over goods or services to a customer before the customer pays consideration, the vendor presents the contract as either a contract asset or a receivable. A contract asset is defined as a vendor's 'right to consideration in exchange for goods or services that the vendor has transferred to a customer when that right is conditioned on something other than the passage of time (for example the vendor's future performance)'. A receivable due from customers, in contrast, is a vendor's unconditional right to consideration, and is accounted for in accordance with IFRS 9 or IAS 39. To have an unconditional right to consideration does not mean that the amount of consideration to be received is certain. Instead it is that the vendor is exposed only to credit risk, and not to other risks such as performance risk.



Example 49

Entity C is a construction company and has entered into a contract for which revenue will be recognised over time. The terms of the contract are:

- a stated contract price of CU 100 million
- CU 25 million is invoiced on each of 4 specified milestones.
- If construction is completed after a specified date, the last milestone payment is reduced by a fixed CU 10 million to CU 15 million (i.e. a total transaction price of CU 90 million) and if completed before a specified date the last milestone payment is increased by up to CU 10 million to a maximum of CU 35 million (i.e. a maximum total transaction price of CU 110 million). Consequently, the contract is analysed as comprising for fixed consideration of CU 90 million and additional variable consideration of somewhere between CU 10 and CU 20 million.

At its reporting date, Entity C is 80% of the way through the project, having just reached the third milestone, and is well ahead of schedule. Entity C considers it probable that it will receive CU 110 million. However, uncertainties mean that it constrains this estimate to CU 106 million to ensure that it is highly probable that none of the variable consideration recognised as revenue will subsequently reverse. Entity C therefore:

- recognises cumulative revenue of CU 84.8 million (estimated transaction price of CU 106m x 80%);
- recognises a receivable of CU 25 million for the third milestone amount invoiced but not yet received; and
- recognises a total contract asset of CU 9.8 million. Entity C is not unconditionally entitled to this amount, which is dependent on both achieving the 4th milestone (i.e. completing the construction) and also completing the construction by the date that will result in the 4th milestone payment being CU 21m.

When a customer pays consideration in advance, or an amount of consideration is due contractually before a vendor performs by transferring a good or service, the vendor recognises a contract liability. A contract liability represents the excess of consideration received by a vendor (plus amounts that it is unconditionally entitled to for which a receivable has been recognised) over cumulative revenue recognised to date.



BDO comment

In determining how an entity should present balances with its customers, it is important to note the definition of a contract asset. Consider a situation where an entity pays a non-refundable up-front fee to its customer in exchange for becoming an approved supplier. This payment takes place prior to any goods or services being transferred to the customer. Such an amount could not be presented as a contract asset as it is not a 'right to consideration in exchange for goods or services that the entity has transferred to a customer...' as the payment occurs prior to the transfer of any goods or services. In determining whether such an amount

could be recognised as some other type of asset, entities would have to give careful consideration to the contractual terms and the facts and circumstances surrounding the arrangement.

In the above example, the amount paid up front would be deducted from the overall transaction price. For example, if on agreeing to a contract with customer B with a sales price of CU 100, entity A paid customer B CU 10, The transaction price would be CU 90.

TRG discussions

Presentation of assets and liabilities (Agenda Paper 7; October 2014)

Three issues were discussed on presentation of contract assets and liabilities, with TRG members generally agreeing that:

- a contract is presented as either a contract asset or a contract liability but not both. This means that separate balances are not presented for separate performance obligations, but are aggregated into a single net amount, i.e. the unit of account for presentation purposes is the contract not the separate performance obligations identified in the contract;
- When, in step 1, two or more legal contracts are combined for accounting purposes, the presentation guidance is similarly applied to the combined contract, meaning a single net contract asset or liability is presented; and
- Entities should look to existing guidance (e.g. in IAS 32 Financial Instruments: Presentation) to determine whether other assets and liabilities can be offset against a contract asset or contract liability respectively.



7. DISCLOSURE

IFRS 15 includes an overall disclosure objective, which is for the disclosures to include sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. This is accompanied by comprehensive disclosure requirements about a vendor's:

- Contracts with customers
- Significant judgements, and changes in the judgements, made in applying IFRS 15 to those contracts
- Assets recognised in respect of costs of obtaining contracts, and in fulfilling contracts.

Consistent with the IASB's *Disclosure Initiative* project, IFRS 15 notes specifically that consideration is to be given to the level of detail that is necessary to satisfy the disclosure objective, and to the emphasis to be placed on each disclosure requirement. The purpose is to ensure that the information that users will find useful is not obscured by a large amount of insignificant detail, with items with sufficiently different characteristics being disaggregated and presented separately.



BDO comment

Linkage between determining performance obligations and segment disclosures

IFRS 15 Revenue from Contracts with Customers requires an entity to determine whether a good or service is 'distinct'. An entity's financial statements will also typically include disclosures made in accordance with the requirements of IFRS 8 Operating Segments, with those disclosures being based on internal management reporting information.

The IFRS 8 disclosures may include revenues for each product or service, or group of similar products and services, which are disaggregated to a lower level than the distinct performance obligations that are identified by IFRS 15.27. The question that might arise in such cases would be whether an entity needs to use this lower level of disaggregation when identifying performance obligations.

In our view this is not the case because segmental reporting disclosures are based on information provided to management, which may (or may not) be prepared on the basis of amounts reported in accordance with IFRS. Although disclosures in the segmental reporting note may be based on the same level of aggregation and disaggregation as separate performance obligations determined in accordance with IFRS 15.27, they will not always be the same, and hence disclosure required by IFRS 15 would need to be given in addition to the information required by IFRS 8.

8. EFFECTIVE DATE AND TRANSITION

IFRS 15 applies to annual reporting periods beginning on or after 1 January 2018. Earlier application is permitted.

The date of initial application is the start of the reporting period in which a vendor first applies IFRS 15. IFRS 15 is applied retrospectively either to:

- Each prior period presented in the financial statements in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors (sometimes referred to as the full retrospective method); or
- The current period with a cumulative effect adjustment on the date of initial application (sometimes referred to as the cumulative catch-up method).

The four practical expedients are:

1. An entity need not restate completed contracts, which are contracts that
 - (i) began and ended within the same annual reporting period; or
 - (ii) were completed at the beginning of the earliest period presented (i.e. completed by 31 December 2016 for an entity presenting one year of comparatives if adopting IFRS 15 for the first time for a year beginning 1 January 2018 or by 31 December 2015 if two years of comparatives are being presented).
2. For completed contracts that have variable consideration, the transaction price at the date the contract was completed can be used instead of estimating variable consideration amounts in comparative reporting periods.
3. For contracts that were modified before the beginning of the earliest period presented an entity can reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented when identifying satisfied and unsatisfied performance obligations, determining the transaction price and allocating the transaction price to performance obligations.
4. For all reporting periods presented before the date of initial application, disclosure is not required of the amount of the transaction price allocated to remaining performance obligations, and an explanation of when that amount was expected to be recognised as revenue.

For entities transitioning to IFRS 15 using the cumulative catch-up method:

- practical expedients 1 and 2 are not available;
- practical expedient 3 is available and, as an alternative, entities can also consider the combined effect of all contract modifications that occur before the date of initial application rather than only those prior to the start of the earliest comparative period presented; and
- practical expedient 4 is not applicable because disclosures for comparative periods presented would need to comply with the requirements of IAS 11 Construction Contracts, IAS 18 Revenue, and related Interpretations. However, IFRS 15 instead requires entities using the cumulative catch-up method to disclose in the year of adoption the amount by which each financial statement line item is affected as compared to IAS 11, IAS 18 and related Interpretations, as well as an explanation of the reasons for the changes.

Note that for the purposes of practical expedients 1 and 2, a 'completed contract' is one for which the entity has transferred all of the goods or services identified in accordance with IAS 11, IAS 18, and related Interpretations. This means that, for contracts where not all revenue had been recognised in accordance with previous standards (for example, because of uncertainty about the amount of revenue to be received), the remaining revenue will continue to be recognised in accordance with previous standards and not in accordance with IFRS 15.



BDO Comment

Although the cumulative catch-up method may at first seem attractive because it means comparatives do not need to be restated in the first period IFRS 15 is applied, a number of factors potentially make this unattractive:

- 1) Comparatives will not be prepared on the same basis and therefore makes period-on-period comparisons of performance difficult
- 2) It is still a retrospective approach in that the adjustment to reserves on the date of initial application still needs to reflect the position as if IFRS 15 had already applied but, unlike the retrospective approach, practical expedients 1 and 2 cannot be used to simplify the transition process
- 3) Dual systems will be needed to be able to show what the impact of IFRS 15 has been compared to current standards in the year of adoption, disclosures which are not required if the full retrospective method is applied.

Careful consideration will be needed of the transition approach to be followed. This is because, for a contract which is in progress in the comparative and current reporting periods when IFRS 15 is adopted, depending on the transition approach adopted some revenue might be recognised in profit or loss in more than one period, and some might not be recognised at all. The following example illustrates the potential effect.



Example 50

A vendor has a single four year contract which runs from 1 January 2015 to 31 December 2018. The total consideration receivable is fixed at CU 2,000,000 and, under current IFRSs, is being recognised over that four year period as follows:

2015: CU 800,000
 2016: CU 400,000
 2017: CU 400,000
 2018: CU 400,000

Under IFRS 15, revenue would have been recognised evenly over the four year period (CU 500,000 in each year)

Under each of the transition options, the effect would be:

	2015	2016	2017	2018	Total 2017 + 2018
Existing IFRS	800	400	400	400	800
IFRS 15					
Retrospective (no practical expedients)					
Revenue			500	500	1,000
Opening equity adjustment			(200)		(200)
Cumulative effect adjustment					
Revenue			400	500	900
Equity adjustment				(100)	(100)

Retrospective equity adjustment

The retrospective equity adjustment of 200 is calculated as the difference as at 1 January 2017 between the cumulative amount of revenue recognised in accordance with existing IFRS (1,200, being 800 in 2015 and 400 in 2016) and the amount that would have been recognised in accordance with IFRS 15 (1,000, being 500 in each of 2015 and 2016).

Cumulative effect adjustment

The cumulative effect adjustment of 100 is calculated as the difference as at 1 January 2017 between the cumulative amount of revenue recognised in accordance with existing IFRS (1,600, being 800 in 2014 and 400 in each of 2015 and 2016) and the amount that would have been recognised in accordance with IFRS 15 (1,500).



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