BDO

IFRS IN PRACTICE 2016

IFRS 15 *Revenue from Contracts with Customers*

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1. INTRODUCTION

On 28 May 2014, the International Accounting Standards Board (IASB) published IFRS 15 *Revenue from Contracts with Customers*. IFRS 15 sets out a single and comprehensive framework for revenue recognition and, for many entities, the timing and profile of revenue recognition will change. In some areas, the changes will be very significant and will require careful planning.

Existing IFRS guidance is set out in two relatively old standards (IAS 18 *Revenue* and IAS 11 *Construction Contracts*) which are accompanied by a number of Interpretations. In common with other more 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 new requirements (the Basis for Conclusions). As an indication of the scale of change, the following table compares the number of pages of guidance in IFRS 15 with existing standards and interpretations:

	IFRS 15	Existing IFRS	IAS 18	IAS 11	IFRIC 13	IFRIC 15	IFRIC 18	SIC-31
Standard/Interpretation	**39**	**33**	10	11	3	4	4	1
Application guidance	**17**	**1**	-	-	1	-	-	-
Transition guidance	**2**	**-**	-	-	-	-	-	-
Amendments to other standards	**26**	**-**	-	-	-	-	-	-
Implementation guidance and Illustrative examples	**82**	**21**	8	4	2	5	2	-
Basis for conclusions	**175**	**22**	-	-	7	8	5	2
Total	**341**	**77**	18	15	13	17	11	3

Figure 1: Comparison of the number of pages of guidance under IFRS 15 with existing guidance

The new standard also introduces 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 practice, even if the timing and profile of revenue recognition does not change, it is possible that new and/or modified processes will be needed in order to obtain the necessary information.

IFRS 15 was originally effective for annual reporting periods beginning on or after 1 January 2017 with earlier application permitted. This has since been deferred to annual reporting periods beginning on or after 1 January 2018, principally as a result of changes which have been made to the new standard.

To assist implementation, the IASB and FASB jointly established a Transition Resource Group (TRG) as a public forum for preparers, auditors and users to share implementation experience and discuss issues submitted to the TRG.

It should be noted that the TRG has been able to suggest further consideration of an issue by the two Boards (IASB and FASB) but does not issue any guidance.

In July 2015 the IASB published Exposure Draft ED/2015/6 which proposed clarifications in the following areas:

a) Identifying performance obligations

b) Principal versus Agent considerations

c) Licencing

d) Practical expedients on transition.

The IASB's proposals were based around a 'high hurdle' being applied when considering whether to amend the new Standard. Consequently these were only when:

a) The IASB considered that the proposed amendments were essential to clarifying its intentions when IFRS 15 was developed; or

b) The benefits of retaining converged requirements were greater than any potential costs of amending the requirements.

In April 2016 Clarifications to IFRS 15 *Revenue from Contracts with Customers* were issued.

The amendments clarify the existing guidance for:

– ***Identification of performance obligations***

  Performance obligations are identified on the basis of distinct goods or services. To further clarify the concept, additional illustrative examples have been added with others being amended. The amendments are the same as the FASB has made to its equivalent US GAAP guidance.

– ***Principal vs. agent considerations***

  IFRS 15 requires an entity to determine whether it is a principal or an agent based on whether it controls the underlying goods or services before the transaction. In order to clarify the approach the application guidance in Appendix B has been amended and additional illustrative examples have been added. The amendments are the same as the FASB has made to its equivalent US GAAP guidance.

– ***Licencing agreements***

  Revenue from a licencing agreement is either recognised over time or at a point in time. The pattern of revenue recognition is based on whether the entity is required to undertake activities that significantly affect the functionality of the intellectual property. The amendments include additional application guidance and examples to determine when an entity's activities significantly affect intellectual property, together with clarification for arrangements involving sales- or usage-based royalties.

– ***Transitional reliefs***

  – **Completed contracts**: there is no requirement to apply IFRS 15 retrospectively to completed contracts at the beginning of the earliest period presented. A completed contract is one where all of the promised goods or services have already been transferred to the customer, which may be earlier than the timing of recognition of the related revenue if this is for an uncertain variable amount.

  – **Modified contracts**: an entity is allowed to use hindsight when determining the effects of contract modifications on transition.

In IFRS 15 and Topic 606, issued in May 2014, the boards achieved their goal of reaching the same conclusions on all requirements for the accounting for revenue from contracts with customers. However, there were some minor differences in the standards as issued in May 2014:

- Collectability threshold;
- Interim disclosure requirements;
- Early application and effective date;
- Impairment loss reversal; and
- Non-public entity requirements.

In addition, the IASB's subsequent Clarifications to IFRS 15 differ in certain respects from the amendments to Topic 606 issued by the FASB, and those expected to be issued by the FASB based on its decisions up to March 2016. Some differences arise from the FASB addressing US specific issues, including where guidance is included in existing US GAAP. The differences are the following:

- Collectability criterion;
- Revenue recognition for contracts with customers that do not meet the Step 1 criteria;
- Promised goods or services that are immaterial within the context of the contract;
- Shipping and handling activities;
- Presentation of sales taxes;
- Non-cash consideration;
- Licencing:
  - Determining the nature of the entity's promise in granting a licence of intellectual property;
  - Contractual restrictions in a licence and the identification of performance obligations;
  - Renewals of licences of intellectual property;
  - When to consider the nature of an entity's promise in granting a licence.
- Completed contracts;
- Date of application of the contract modifications practical expedient.

2. BACKGROUND

The IASB's joint project with the Financial Accounting Standards Board (FASB) to develop a new accounting standard for revenue recognition dates back for over a decade. The international and the US standard setters had noted inconsistencies and weaknesses in each of their respective accounting standards. In IFRS, there was significant diversity in practice because existing standards contained limited guidance for a range of significant topics, such as accounting for contracts with multiple elements; should these be accounted for as one overall obligation, or as a series of separate (albeit related) obligations? Under US GAAP, concepts for revenue recognition had been supplemented with a broad range of industry specific guidance, which had resulted in economically similar transactions being accounted for differently.

Both the IASB and the FASB also noted that existing disclosure requirements were unsatisfactory, as they often resulted in information being disclosed that was not sufficient for users of financial statements to understand the sources of revenue, and the key judgements and estimates that had been made in its recognition. The information disclosed was also often 'boilerplate' and uninformative in nature.

IFRS 15 *Revenue from Contracts with Customers* 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 will now be recognised by a vendor when control over the goods or services is transferred to the customer. In contrast, IAS 18 *Revenue* based revenue recognition around an analysis of the transfer of risks and rewards; this 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:

Figure 2: Five-step approach

The first step is to identify the contract(s) with the customer. Whatever the form, a contract creates enforceable rights and obligations between a vendor and its customer.

After identifying the contract(s) with the customer, a vendor identifies the contract into what are termed 'performance obligations'. A performance obligation is a promise by a vendor to transfer goods or services to a customer. Each performance obligation is 'distinct', being either a good or service from which the customer can benefit on its own (or in combination with other readily available goods and services); two or more distinct goods and services (such as the supply of construction material and labour) are combined if, in reality, they represent one overall obligation.

In the third and fourth steps, a vendor determines the transaction price of the entire contract and then allocates the transaction price among the different performance obligations that have been identified.

In the fifth step, a vendor assesses when it satisfies each performance obligation (which may be at a point in time, or over time) and recognises revenue. The principle is based around the point at which the customer obtains control of the good or service.

3. SCOPE

IFRS 15 *Revenue from Contracts with Customers* applies to all contracts with customers, except for:

- Lease contracts within the scope of IAS 17 *Leases*;
- Insurance contracts within the scope of IFRS 4 *Insurance Contracts*;
- 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*.

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 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 (such as property, plant and equipment, investment property and intangible assets) have been amended so that they are consistent with the requirements in IFRS 15.

In addition, IFRS 15 does not apply to non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. An example is a contract between two oil companies that agree to exchange oil in different locations in order to fulfil demand from their customers.

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:

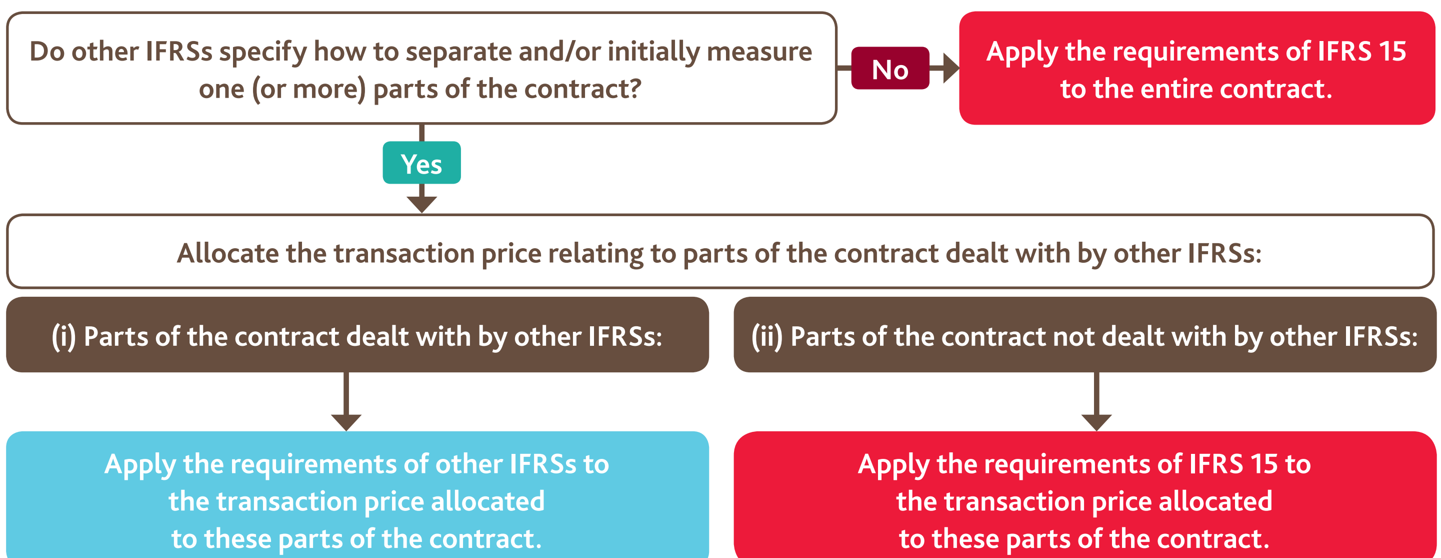

Figure 3: Scope of IFRS 15

This means that, 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.

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. Special 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.

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 some income streams, such as interest charges on late payments, are not within the scope of the new revenue standard, 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 US GAAP includes specific guidance on credit card fees, IFRS does not have specific guidance on this topic.

Most of the TRG members agreed with the IASB and FASB staff (hereinafter, the staff) view that under US GAAP these types of arrangements are outside the scope of the new revenue standard. The revenue standard would only apply if the overall nature of these arrangements is a not a credit card lending agreement.

If the credit card arrangement is determined to be outside the scope, the related reward program is also outside the scope of the revenue standard.

As there is no specific guidance on this topic under IFRS, some TRG members noted that preparers might have different views under US GAAP and IFRS.

4. THE 'FIVE STEP' APPROACH

4.1. Step One – Identify the contract

IFRS 15 *Revenue from Contracts with Customers* 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 introduces a collectability threshold for revenue recognition, which goes beyond the contractual terms of an arrangement with a customer. A key part of assessing whether a contract is valid is determining the extent to which the customer has both the ability and the intention to pay the promised consideration. In contrast, IAS 18 *Revenue* included a similar but softer criterion which was that in order for a vendor to recognise revenue, it was necessary for it to be probable that the economic benefits associated with the transaction would flow to the vendor.

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 the vendor expects to 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.

Example

A vendor sells 1,000 units of 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 believes that economic conditions will improve in future, and that by establishing a trading relationship now with the customer sales volumes in future will be enhanced. However, for this first contract, the vendor does not expect that the customer will be able to pay the full amount of the contractually agreed price.

Consequently, the vendor determines that it expects to offer a 50% discount to its customer. Having considered the customer's intention and ability to pay, taking into account the current poor economic conditions, it is concluded that it is probable that the estimated amount of CU 500,000 will be collected. If the other four criteria set out above are met, the contract for the sale of 1,000 units in return for estimated (and therefore variable) consideration of CU 500,000 is accounted for in accordance with IFRS 15.

TRG discussions

Collectability criteria (Agenda Paper 13; January 2015)

The TRG discussed several questions arising from the collectability criteria as its January 2015 meeting. 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. In addition to determining whether collectability of the transaction price is probable at contract inception, collectability also needs to be assessed when there is an indication of a significant change in facts and circumstances.

Example

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 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).

The third step (determine the transaction price) can also be viewed as being relevant, because IFRS 15.47 refers to the amount of revenue to which an entity expects to be entitled. In this example, for each sale the entity does expect to be paid at the point at which it enters into each transaction.

A contract with a customer might not meet all of the five criteria set out above. For those contracts, if the vendor receives consideration from the customer it is recognised as revenue only when one of the following applies:

(i) 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

(ii) The contract has been terminated and the consideration received is non-refundable.

In addition, contracts with customers that do not meet the five criteria are assessed on a continuous basis to determine whether these criteria are subsequently met. In contrast, if a contract does meet the five criteria it is only reassessed if there is an indication of a significant change in facts or circumstances. For example, this might arise if a customer's ability to pay consideration deteriorates significantly meaning that the customer no longer has the ability to pay when amounts are due. The result would be that revenue and a related asset balance (often a receivable) would be recorded up to the point at which the deterioration occurred, with no revenue being recorded after that point.

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, are accounted for as if they were a single contract, provided at least one of the following criteria is 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
- The goods or services that are promised in the contracts (or some of the goods or services) represent a single performance obligation.

BDO comment

The extension to cover 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. Related parties are as defined 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 contract modification is accounted for as a separate (and additional) contract only if:

– The scope of the contract changes due to the addition of promised goods or services that are distinct (in accordance with the guidance in IFRS 15); 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.

When a contract modification is not accounted for as a separate (and additional) contract, the vendor identifies the 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:

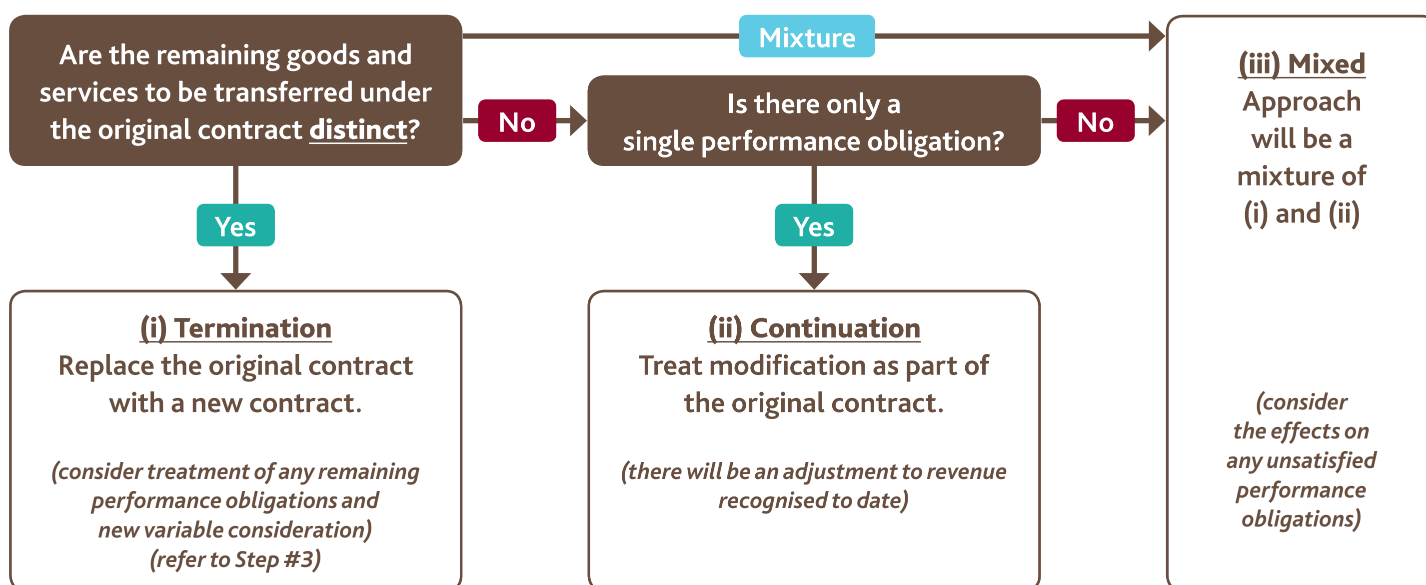

Figure 4: Accounting for contract modifications

Example – 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. 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.

In accordance with the requirements of IFRS 15, the additional units to be delivered are distinct. Consequently, the subsequent accounting 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.

Scenario B – the price of each of the additional units is CU 65, including a CU 10 discount for 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 CU 75 per unit for the 50 units that are added as a result of the contract modification.

Scenario C – the price of each of the additional units is CU 60

The selling price of the additional units is not the stand-alone price at the date of contract modification. 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 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

Careful consideration will be needed when determining the appropriate accounting approach in circumstances in which a contract is modified, and the selling price reflects both compensation for poor quality goods or services that have already been supplied to the customer, and a selling price for the additional goods or services that does not represent the stand-alone selling price at the date of contract modification.

TRG discussions

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

It was noted that 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 present enforceable rights and obligations.

The TRG considered a number of examples and generally agreed with the staff conclusions:

Example 1

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 2

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 3

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 4

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 in this example 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 term of 24 months.

4.2. Step Two – Identify separate performance obligations in the contract

Having identified the contract in step one, a vendor is then required to identify the performance obligations(s) contain in the 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 promise within a contract is a performance obligation if the contract contains either a good or a service that is distinct, or a series of distinct goods or services that are substantially the same, have the same pattern of transfer to the customer and meet two criteria:

(i) Each distinct good or service in the series is a performance obligation satisfied over time; and

(ii) The same method would be used to measure the vendor's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

Consequently, it is necessary to identify whether a good or service is distinct. The approach to be followed is illustrated in the following diagram:

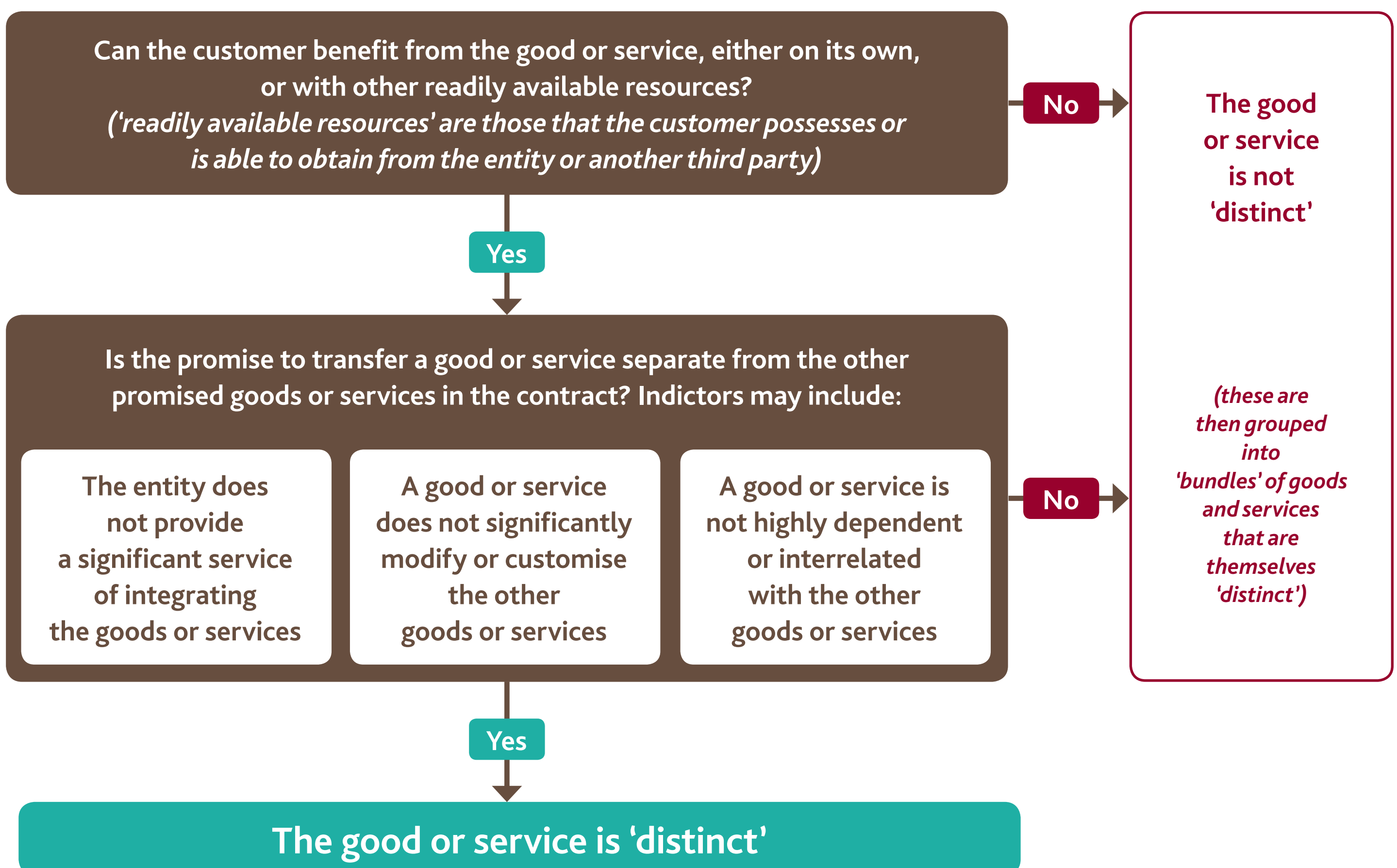

Figure 5: Distinct goods or services

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).*

In order 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, a vendor needs to apply judgment and consider all relevant facts and circumstances. Factors that indicate that a vendor's promise to transfer an element to the customer is separately identifiable include:

- The vendor does not provide a significant service of integrating the good or service with other goods or services promised in the contract as a bundle which represents a combined output for which the customer has contracted (i.e. the vendor is not using the good or service as an input to produce the combined output specified by the customer)
- The good or service does not significantly modify or customise another good or service promised in the contract
- The good or service is not 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 the other promised goods or services in the contract.

TRG discussions

Distinct within the context of the contract – goods or services that are highly dependent on other goods or services (Agenda Paper 9; October 2014)

Much of the TRG discussion focused on how to interpret the third indicator in criterion 2 above.

It was discussed whether any individual fact pattern (e.g., a complex and/or customised design) could be determinative in the evaluation of whether a good or service is distinct within the context of a contract. Factors could include a learning curve, a customer's motivation or contractual restrictions. While TRG members expressed varying levels of support for each of the factors in isolation, they said that all facts and circumstances would need to be considered.

To clarify the application of the concept of 'distinct', the IASB has amended the Standard and has included additional Illustrative Examples accompanying IFRS 15. The FASB has made the same changes to US GAAP.

Identifying promised goods or services (Agenda Paper 12; January 2015)

The TRG discussed an implementation question about whether an entity should identify items or activities as promised goods or services that are not identified as deliverables or components under previous revenue Standards. A specific concern was raised about the decision not to exempt an entity from accounting for performance obligations that the entity might regard as being 'perfunctory or inconsequential'. Some stakeholders held a view that IFRS 15 might require an entity to identify significantly more performance obligations than would be the case under previous revenue Standards. As a consequence of this, the FASB has amended the Standard to permit an entity not to identify promised goods or services that are immaterial in the context of the contract. This links to guidance that was previously included in US GAAP, which was deleted when the new revenue standard was issued. The IASB decided not to propose incorporating similar guidance into IFRS 15 as its view is that this issue relates to the application of materiality concept more generally, rather than the application of the requirements in IFRS 15. In addition, unlike under US GAAP, this issue was not previously addressed in IFRS.

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.

TRG discussions and Clarifications to IFRS 15 Revenue from Contracts with Customers

Identifying performance obligations (Agenda Paper 22; January 2015)

As noted above, an entity is required to identify performance obligations on the basis of promised goods or services that are distinct.

The IASB has issued Clarifications to IFRS 15 to amend the Illustrative Examples to clarify the application of the concept of 'distinct'. In order to achieve the same goal the FASB has clarified the requirements of the new revenue Standard and added illustrations regarding the application of performance obligations.

The TRG considered issues relating to the criterion in paragraph 27 (b) regarding when a promised good or service is separately identifiable (i.e. distinct within the context of a contract) and the supporting factors in paragraph 29.

As a consequence of the discussions and the feedback received, the IASB has amended paragraphs 27 and 29, has added some new examples and has amended some of the existing examples.

It is important to note that an entity should evaluate whether the contract is to transfer:

a) Multiple distinct goods or services; or

b) A combined item or a number of combined items that each comprise a distinct bundle of goods or services promised in the contract.

Therefore, 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 separately identifiable from other promises in the contract.

The TRG's discussions also highlighted that some stakeholders may be applying the factors supporting paragraph 27 (b) as a series of criteria (i.e. all of the factors need to be met to conclude that a promise is separately identifiable). It was noted that the Boards did not intend the guidance to be read as a series of criteria.

Questions were also raised about the effect of contractual restrictions on the identification of performance obligations. In its Clarifications to the Standard, the IASB has added an example to illustrate that an entity should focus on the characteristics of the goods or services themselves instead of the way in which the customer might use those goods or services.

The FASB has amended Topic 606 to expand the articulation of the separately identifiable principle and to reframe the existing factors in the standard.

TRG discussions

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

Unlike current revenue guidance, the new revenue standard includes the concept of a series of distinct goods or services that are substantially the same and have the same pattern of transfer (the 'series provision'). This concept was introduced to promote simplicity and consistency in application.

The staff noted that an entity may determine that goods and services constitute a single performance obligation if (1) they are 'bundled' together because they are not distinct or (2) they are distinct but meet the criteria that require the entity to account for them as a series (and thus as a single performance obligation). The staff further noted that a single performance obligation that comprises a series of distinct goods or services rather than a bundle of goods or services that are not distinct affects (1) how variable consideration is allocated, (2) whether contract modifications are accounted for on a cumulative catch-up or prospective basis, and (3) how changes in the transaction price are treated. Because of the potential implications associated with whether goods or services are determined to be a series, stakeholders raised questions about:

a) *Whether goods must be delivered (or services must be performed) consecutively for an entity to apply the series provision: the staff indicated that an entity should look to the series provision criteria in IFRS 15.23 to determine whether the goods or services are a series of distinct goods or services for which the entity is not explicitly required to identify a consecutive pattern of performance. Further, while the term 'consecutively' is used in the new revenue standard's basis for conclusions, the staff noted that they 'do not think whether or not the pattern of performance is consecutive is determinative [of] whether the series provision applies.' That is, goods or services do not need to be transferred consecutively to qualify as a series of distinct goods or services under the new revenue standard.*

b) *Whether the accounting result for the series of distinct goods or services as a single performance obligation needs to be the same as if each underlying good or service were accounted for as a separate performance obligation: the staff noted that they do not believe that the accounting result needs to be 'substantially the same.' Further, the staff stated that 'such a requirement would almost certainly make it more difficult for entities to meet the requirement, and since the series provision is not optional, it likely would require entities to undertake a 'with and without' type analysis in a large number of circumstances to prove whether the series provision applies or not.'*

TRG members generally agreed with the staff conclusions. However, TRG members discussed an apparent contradiction that while the series literature was meant to simplify accounting (akin to a practical expedient), it is mandatory if an entity meets the criteria. Treating performance obligations as a series may result in different accounting. As a result, certain TRG members questioned whether the guidance should be mandatory or whether it may be better to have a practical expedient. While the FASB did not commit to amending the standard for a practical expedient, it noted that it was open to gathering more information on the issue.

During the TRG discussions it was noted that to assess whether the series guidance is applicable, judgement has to be applied in order to identify the promise to the customer. Some TRG members considered that the series guidance should be optional in order to avoid unintended complexities.

The scope of contracts with customers

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 expectation of the customer that the vendor will transfer a good or service to the customer. 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; therefore these setup activities are not performance obligations of the contract.

Example – determining whether goods or services are distinct

Construction contract – goods and services are not distinct

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.

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.*

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.*

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 required by IFRS 15 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 distinct good or service.

BDO comment

The identification of each of the distinct goods or services in the scenarios above may require a detailed analysis of contractual terms, and linkage to the extent to which IFRS 15 requires either that each of the components is identified as distinct goods or services, or is combined with one or more other components into an overall distinct good or service.

Each distinct good or service will then be analysed separately to determine the amount of revenue to be allocated, and the timing of recognition. In practice, the approach required by IFRS 15 may bring substantial changes to the profile and timing of revenue recognition in comparison with current IFRSs.

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 is the expected amount of consideration.

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 also needs to consider effects of the following:

- Variable consideration
- Constraining estimates of variable consideration
- The existence of a significant financing component in the contract
- 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. The principle is that if there is any potential variation in the amount that a vendor will receive in return for its performance, then the related provisions in IFRS 15 will 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, or has chosen to accept the risk of the customer defaulting on the contractually agreed amount of consideration. 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 that 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 for goods, in order to enable the retailer to sell the goods to its own customers at a discount and therefore to increase sales volumes.

When the consideration promised in a contract with a customer includes a variable amount, a vendor estimates the amount of consideration to which it is entitled to in exchange for the transfer of the promised goods or services. There are two possible methods which can be used, 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 will or will not be received.

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

Example

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, and determines 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 or it will not.

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

Estimates introduce a degree of uncertainty into the amount of revenue that a vendor expects to receive. In order to avoid overly optimistic estimates being included in the calculation (and related revenue recognised), followed by a subsequent downward adjustment to actual amounts receivable (together with a reversal of previously recognised revenue), a constraint on the amount of variable revenue that can be recognised has been introduced.

The effect of the constraint (or restriction) is that the estimated transaction price can only include an amount of variable consideration if it is highly probable that there will not be a subsequent significant reversal in the amount of revenue recognised at the point at which uncertainty over the amount of variable consideration is resolved. As noted above, the position 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 and, includes the likelihood of a change in the estimate of variable consideration and the amount of the possible revenue reversal. Factors that indicate a significant revenue reversal may result from including an estimate of variable consideration in the transaction price 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 of a good or service)
  - 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.

Example

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 to the vendor 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), in order that the distributor can 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. This is in order 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 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. The position would then be reassessed at each reporting date, with a corresponding amount of revenue being recognised as appropriate.

In addition, 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).

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

TRG discussions

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

As noted above, the new revenue standard requires entities to perform a qualitative assessment that takes into account both the likelihood and the magnitude of a potential revenue reversal and provides factors that could indicate that an estimate of variable consideration is subject to significant reversal (e.g., susceptibility to factors outside the entity's influence, a long period before the uncertainty is resolved, limited experience with similar types of contracts, practices of providing concessions, or a broad range of possible consideration amounts).

Questions have arisen about whether to apply the variable consideration and constraint guidance at contract level or at performance obligation level when variable consideration is not allocated proportionately to all performance obligations in a contract. For example, if one performance obligation is fixed (e.g., sale of equipment) and another performance obligation is variable (e.g., variable performance based fee), an entity must assess the potential for a significant reversal of revenue for the variable consideration. Many stakeholders believe that it is unclear whether an entity should apply the constraint at the contract level (i.e., total transaction price for the contract) or at the performance obligation level (i.e., transaction price specific to the variable consideration).

TRG members generally agreed with the staff view that the constraint on variable consideration should be applied at the contract level because 'the unit of account for determining the transaction price (Step 3 of the model) is the contract, not the performance obligation'.

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

The TRG discussed the application of the optional practical expedient 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 staff 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 TRG also discussed the application of the variable consideration 'constraint', which limits revenue recognition to the amount for which is 'highly probable' ('probable' under US GAAP) 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.

BDO comment

Constraining estimates of variable consideration – interaction between IAS 2 Inventories and IFRS 15

IFRS 15 requires contract costs within the scope of other standards to be accounted for under those Standards (IAS 2, 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 measuring the transaction price. Nevertheless, there were no amendments made to the derecognition guidance in IAS 2 when IFRS 15 was issued. IAS 2.34 requires that 'the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised'.

IFRS 15 requires an entity to recognise revenue when or as it satisfies a performance obligation by transferring control of a good or service. The transaction price (and therefore revenue) may be constrained if it is variable. Consequently, the carrying amount of inventory could be recognised as an expense even if the amount of revenue recognised at the same time is very low, or even zero.

Example

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 when the recognition of revenue is constrained?

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 measured at nil.

Refund liabilities

Some contracts contain provisions which entitle the customer to return a good and receive one (or a combination) of the following:

– A full or partial refund of any consideration which has been paid
– A credit that can be applied against other amounts owed, or which will be owed in future, to the vendor
– Another product in exchange.

For those items which are expected to be returned, the vendor does not recognise revenue. Instead, the vendor recognises a refund liability together with an asset representing item(s) expected to be returned. 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 (See section 5.3 below).

Any refund liability is reassessed and updated at each reporting date.

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.

BDO comment

This new requirement may bring a significant change in practice for some entities. Under existing guidance, consideration has typically not been given to whether a schedule of payments in advance from a customer gives rise to a financing arrangement.

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

The new guidance brings a significant change in practice, because although some entities have previously adjusted for a financing component when payment is received after the supply of goods or services, adjustments have not typically been made by a vendor when payment is received in advance. In addition, for those arrangements where customers pay in arrears, there may be a change in practice. For example, in high interest rate environments when the financing component is material but relates to a period of less than one year, some vendors currently account for the financing effect; this will no longer be required under IFRS 15.

The objective of including adjustments for significant financing components 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, for example, a substantial payments 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 such an advance payment, the vendor would typically need to borrow the funds from a bank (or other financial institution). If the vendor obtained financing from the bank, the vendor would need to pay finance charges and would be likely to recharge those 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 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. 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

A vendor (a construction company) enters into a contract with a customer to supply a new building. Control over the completed building 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 building, 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 asset (the completed building) to the customer, together with the effect of prevailing market rates of interest, that there is a significant financing component.

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 asset (the building) 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 (such as those in the construction sector) where revenue is not recognised until a point in time (on transfer of the completed item to the customer), an adjustment for financing may be required even if construction services are being carried out over a period of time.

When a significant financing component is recognised, consideration may be required of whether the interest income or expense is required to be capitalised by IAS 23 Borrowing Costs.

In some cases, although there may be a difference between the timing of the goods or services and payment, this is not regarded as giving rise to a significant financing component. This is the case in any of the following circumstances:

- 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 – such as completion of post completion remedial work on a building).

The discount rate used is the rate that would apply to a separate financing transaction between the vendor and the customer at contract inception. It 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 for changes in interest rates or other circumstances (including a change in the customer's credit risk).

The effects of a financing component are presented separately from revenue in the statement of comprehensive income. Interest revenue or interest expense is only recognised by a vendor to the extent that a related contract asset/receivable or contract liability (such as deferred revenue) is recognised.

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 or does not exist 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 consider the cash selling price as compared to the promised consideration in making 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 US 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 customer might pay for goods or services in the form of non-cash assets. For example, a customer (in particular one which is listed on a public market) might issue shares to the vendor.

When determining the transaction price, the starting point is that 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 contribute materials, equipment or labour). 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.

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 due to other reasons. The question which follows is when the non-cash consideration should be measured. Several TRG members expressed the view 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, they noted that this interpretation may be difficult to apply, especially for determining the intervals for assessment when performance in a contract occurs over time. Other TRG members suggested support for another view in the agenda paper (measurement at contract inception). In addition, many TRG members noted that they can understand how measurement at either contract inception or when the non-cash consideration is received could be viewed as meeting the requirements of the standard and that the boards should therefore clarify the guidance for practicality and to reduce potential diversity in practice.

TRG members also discussed how the constraint on variable consideration could apply to transactions in which the fair value of non-cash consideration might vary due to both the form of the consideration and for reasons other than the form of the consideration. Two views were discussed:

a) The constraint applies to variability resulting from both the form of the consideration and for reasons other than the form

b) The constraint applies only to variability resulting from reasons other than the form of consideration.

The FASB decided to amend the Standard to require non-cash consideration to be measured at its fair value at contract inception. It has also specified that the constraint on variable consideration applies only to variability in the fair value of the non-cash consideration that arises for reasons other than the form of the consideration. The IASB decided not to make any amendments to IFRS 15 and acknowledges that it is possible that diversity between IFRS and US GAAP could arise in practice.

Consideration payable to a customer

Consideration payable to a customer includes cash amounts that a vendor pays, or expects to pay, to a customer (or to other parties that purchase the vendor's goods or services from the customer), credits or other items such as coupons or vouchers that can be applied against amounts owed to the vendor. Alternatively, the payment may be part or all of an amount payable to the customer in return for the supply of goods or services.

Consideration payable to a customer is accounted for as a reduction of the transaction price (and hence, a reduction of revenue), unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the vendor.

A vendor might sell goods or services to a customer and at the same time purchases goods or services from the same customer. If the amount of consideration payable to the customer exceeds the fair value of a distinct good or service that the vendor receives in exchange, the difference is accounted for as a reduction in the vendor's sales transaction price.

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 revenue).

When the consideration payable to a customer is treated as a reduction of the transaction price the reduction of revenue is recognised 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

A vendor that manufactures retails 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 10% 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 as the related sales of retails goods are recorded.

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.

TRG discussions

Consideration payable to a customer (Agenda Paper 14; January 2015)

Questions have arisen about when to apply the new revenue standard's guidance on consideration payable to a customer. Many stakeholders believe that the new revenue standard is not clear about how to account for consideration payable to a customer when an entity promises to pay consideration after it has already recognised revenue from transferring control of goods or services to the customer. Some stakeholders believe that consideration payable to a customer (i.e., reduction of revenue) should be recognised when revenue is recognised. However, others believe that the guidance could be interpreted to allow recognition at a later date (i.e., when the entity promises or pays the consideration).

The staff view is that the reversal of revenue from variable consideration or consideration payable to a customer 'should be made at the earlier of the date that there is a change in the transaction price in accordance with paragraph 70 of IFRS 15 or the date at which the consideration payable to a customer is promised in accordance with paragraph 72 of IFRS 15.'

TRG members generally agreed with the staffs' conclusion, however certain TRG members noted that it is difficult to support that position on the basis of the wording in the new revenue standard (i.e., the standard contains internal inconsistencies that would need to be addressed to support the staffs' position).

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.

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 FASB and IASB 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.

Accordingly, the staffs performed an analysis of the following issues:

- ***Issue 1: Assessing which payments to a customer are within the scope of the guidance on consideration payable to a customer*** *– In evaluating this issue, the staffs indicated there are three prevailing interpretations: (1) an entity should assess all consideration payable (broadly, all payments) to a customer ('Interpretation A'); (2) an entity should assess only consideration payable to a customer under a contract with the customer (or combined contracts) ('Interpretation B'); and (3) an entity should assess only consideration payable to a customer under a contract with the customer (or combined contracts) and consideration payable to customers in the distribution chain of the entity's customer ('Interpretation C'). The staffs concluded that Interpretation A is the only interpretation supported under the new revenue standard because the boards acknowledge in paragraph BC257 of the standard's 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 unconnected events.*
- ***Issue 2: Determining whether the guidance on consideration payable to a customer applies only to customers in the distribution chain or more broadly to any customer of an entity's customer*** *– In the staffs' view, the phrase 'for example' in paragraph BC255 does not indicate that the guidance on consideration payable to a customer should be applied to a customer's customer that is not in the distribution chain. 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.'*
- ***Issue 3: Timing of recognition of consideration payable to a customer*** *– The staffs expressed their belief that the variable consideration guidance under the new revenue standard does not conflict with the standard's guidance on consideration payable to a customer. They concluded 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.*

TRG discussions (continued)

Consideration payable to a customer (Agenda Paper 14; January 2015) (continued)

Issue 1 *generated considerable debate among TRG members, with some members agreeing with the staffs' recommendation of Interpretation A and others viewing Interpretation B as the appropriate conclusion. However, 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 (economically) to a revenue contract with the customer. Accordingly, TRG members generally agreed that the FASB staff should seek to reconcile the* ***Issue 1*** *views articulated in TRG Agenda Paper 28 rather than recommend amendments to the new revenue standard.*

On ***Issues 2 and 3****, the TRG did not agree, and FASB members indicated that the Board and its staff should evaluate feedback from TRG members to determine next steps (most likely at a future TRG meeting), including whether 'workable solutions' are possible under the new revenue standard or whether a change to the standard is required. Concerns about* ***Issue 2*** *were primarily related to the identification of a customer, particularly for an agent that may have more than one customer (i.e., the principal and end customer in a revenue transaction); but TRG members generally agreed that an entity should evaluate a payment to a customer to determine whether the payment should be linked to a contract (as they did with respect to* ***Issue 1****).*

For ***Issue 3****, the crux of the TRG's debate was whether the appropriate timing for recognition of an adjustment to the transaction price is (1) the communication date (e.g., when a customer is informed of a planned 'coupon drop'), (2) the management approval date (e.g., when management with relevant authority approves a planned coupon drop), or (3) determined in accordance with the guidance on constraining variable consideration.*

4.4. Step Four – Allocate the transaction price to the performance obligations

The amount allocated to each separate performance obligation reflects the consideration to which a vendor expects to be entitled in exchange for transferring the related goods or services to the customer. The starting point for the allocation is to base it on the stand-alone selling prices of each performance obligation.

IFRS 15 brings a substantial change in approach, because existing IFRSs contain very little guidance for allocating a transaction price to components (or 'unbundling' contracts). Because of this, some entities applied the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in order to follow the detailed guidance in US GAAP, in particular those in the software and technology sector. Regardless of whether an entity is moving from existing IFRSs or from US GAAP that has been applied by analogy, there are likely to be changes in approach because IFRS 15 differs from both.

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 of a good or service sold in similar circumstances and to similar customers. 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.

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

There are instances where a good or service is never sold separately, but is instead 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 licences are typically 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. The licence and the PCS represent separate performance obligations.

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 were always 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 stand-alone selling price for a licence that is never sold separately.

In our view, a residual approach is appropriate in circumstances in which 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 stand-alone selling price of the PCS is not highly variable. While 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. Because there is an observable stand-alone selling price for the PCS, the entity can identify that it is the licence that is sold to different customers for a broad range of amounts and not the PCS, meaning that the use of the residual approach is appropriate.

Allocating discounts

A discount exists if the sum of the stand-alone selling prices of the goods or services in the contract exceeds the consideration payable by the customer. A discount is allocated on a proportionate basis to all performance obligations in the contract, 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, and two of these are frequently sold together at a discount from the total of the two stand-alone selling prices.

Example

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; products B and C are not sold separately, and their estimated stand-alone selling prices 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 entirely 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

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 x (25/100))*	*CU 12.5*
C	*(50 x (75/100))*	*CU 37.5*

It should be noted that the residual approach resulted 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.

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, of the distinct goods or services of a single performance obligation. This would apply if, for example, the consideration promised for the second year of a two-year maintenance service 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 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

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

Scenario A

The prices included in the contract are as follows:

- *Licence A: a fixed amount of CU 1,200, payable 30 days from the transfer of the licence to the customer*
- *Licence B: a royalty payment of 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 receive 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 receive 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) x CU 450 CU 200*
- *Licence B: (1,500 / 2,700) x 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. Because the royalty income will only be recognised when the related product sales take place, recognition of the royalty income allocated to each of the two licences will be deferred to future periods. 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. This means that, in effect, some of the income to be generated by licence B in fact relates to the sale of licence A.

TRG discussions

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

TRG members discussed a question about how an arrangement which includes both variable consideration and a discount should be dealt with. In particular, should the variable consideration guidance be applied first, with the allocation of the transaction price to performance obligations (including the collection of any discounts) then being applied as appropriate?

TRG members generally agreed with the staff view that the new revenue standard establishes a hierarchy for allocating variable consideration, including variable discount. In these cases an entity should first apply the guidance on allocating variable consideration and then apply the guidance on allocating the transaction price, including discounts, to performance obligations.

4.5. Step Five – Recognise revenue when each performance obligation is satisfied

Revenue is recognised when (or as) goods or services are transferred to a customer. A vendor satisfies each of its performance obligations (that is, it fulfils its promises to the customer) by transferring control of the promised good or service underlying that performance obligation to the customer.

Existing requirements for revenue recognition are based around an assessment of whether the risks and rewards of ownership of a good or service have been transferred to a customer. The application of the control criterion to all types of transactions for providing goods or services is one of the main changes in IFRS 15 compared with current practice. 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 example, for routine or recurring services (such as cleaning services) 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.

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 to substantially re-perform the work the vendor has completed to date. If another vendor would not need to do so, then it is considered that 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 reperform 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 benefit from an asset that it currently controls (such as a work in progress balance).

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 has an alternative use, the vendor has an enforceable right to payment for performance completed to date

This two-step 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.

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 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 one item to be sold and another substituted. 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.

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 basic design of the asset is the same across all contracts, yet the customisation is substantial and therefore to redirect a nearly completed asset to another customer would require significant rework.

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 right to payment for performance completed to date must be enforceable by the vendor in all circumstances, other than where 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. The enforceable amount must at least compensate the vendor for performance completed to date (i.e. an amount that approximates the selling price of the goods or services transferred to date), even if the customer has a right of termination.

A vendor must always be entitled to compensation for recovery of costs that it has incurred 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.

A customer might terminate (or take steps to terminate) a contract without having the right to do so (this includes when a customer fails to perform its obligations as promised). In those circumstances, 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 consideration promised in exchange for those goods or services. This would result in the vendor having 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 the vendor is capable of forcing completion of its own and its customer's contractual obligations (including payment in accordance with the original contractual terms), it is not necessary to satisfy other conditions for the right 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.

A vendor operating in the real estate industry, and in particular those entities that sell residential units in multi-unit apartment blocks, that currently analyse contracts in accordance with IFRIC 15 *Agreements for the Construction of Real Estate* will need to give careful consideration to whether their existing accounting approach will change.

For example, some real estate contracts may result in an asset that cannot (under the terms of the contract) 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). In those cases, the focus will be 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 typically be recognised over time. However, other real estate contracts that do not create an asset with an alternative use to the vendor may not require the customer to pay for performance to date, with either a deposit being forfeited or penalties being payable which represent only the vendor's loss of profit. For those contracts, a vendor will recognise the sale on completion (at a point in time).

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. This is achieved 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 direct 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

In some cases, depending on the contractual terms, contracts which are currently accounted for as giving rise to revenue at a point in time may give rise to revenue over time under IFRS 15. For example, this might apply to the construction and sale of certain multi-unit residential apartment blocks. In such cases, because each apartment unit would typically need to be accounted for separately (as these are each sold to unrelated third parties), practical considerations may arise when determining the stage of completion of each unit at a reporting date when a building has only partially been completed. This may require new or modified internal reporting systems.

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 (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. 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, a performance obligation may contain multiple goods or services. However, the standard requires that entities apply a single method to measure progress toward satisfying that 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. It was also observed that if applying a single attribution method provides an uneconomic result, this may be an indicator 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, and IFRS 15 then requires an adjustment to be made to the amount of profit recognised to date. For example if, as part of a contract to refurbish a building, a vendor needs to purchase new elevators from a third party, the vendor will recognise revenue when control of the elevators is transferred to the customer, but will recognise no incremental profit. This is because arranging the delivery of the elevators to the customer's premises does not result in any progress being made towards the refurbishment of the building.

In some cases, a vendor may not be able reasonably to 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. This guidance is similar to the current practice in IAS 11 *Construction Contracts* when a vendor cannot estimate the costs in a long term contract and applies the zero margin method.

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 5 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 in advance of obtaining an expected contract from a customer. It could also apply when an entity constructs an apartment building, with some apartments being presold from the plan and others not being sold until the units are partially completed.

When the entity subsequently determines that the criteria for the identification of a contract have been met, the entity would begin to apply the five step model to recognise revenue. When the terms of the arrangement are such that revenue for the related good or service is to be recognised over time, the question that raises is whether revenue is recognised prospectively or is there a cumulative catch-up adjustment.

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. When the criteria for the identification of a contract have been met, if the entity has already satisfied part or all of certain performance obligations by transferring goods or services to its customer, it will recognise the related amount of consideration to which it expects to be entitled.

Recognising revenue on a prospective basis once 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 has already been transferred to the customer.

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 licenced 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 in the health club example in the new revenue standard (Example 18, paragraphs IE92 to IE94).*

The TRG discussed the nature of an entity's promise in a '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 'standing ready' to provide goods or services or to provide specified goods or services. It was further noted that whether the entity's obligation is to provide a defined good(s) or service(s) 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.

5. OTHER ISSUES

5.1. Contract costs

A distinction is made between incremental costs incurred in obtaining a contract, and costs incurred to fulfil a contract.

Incremental costs of obtaining a contract

Incremental costs are those costs incurred in obtaining a contract that would not have been incurred had that individual contract not been obtained. This is restrictive, as any ongoing costs of operating the business will be expensed as incurred. The only exception is when costs are explicitly charged to a customer regardless of whether a contract is obtained.
For all other, only costs such as a sales commission that is only paid if a specified contract is obtained are incremental; IFRS 15 *Revenue from Contracts with Customers* requires that these are recognised as an asset and then amortised on a basis that reflects the transfer of goods or services to the customer.

As a practical expedient, incremental costs of acquiring a contract can be recognised as an immediate expense if the amortisation period would have been one year or less.

BDO comment

Under current guidance, some entities account for the incremental costs of obtaining a contract in accordance with IAS 38 Intangible Assets. For those entities, IFRS 15 may bring a change in approach because those costs are now explicitly within its scope. In particular, although the recognition threshold of 'expected' recovery of those costs is similar, IFRS 15 is 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 that some entities may have used in the past. In practice, in many cases costs eligible to be capitalised may 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.

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 *Inventories*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*). For those costs which do fall within the scope of IFRS 15, the threshold for identifying 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 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.

Examples

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.

How would contract costs be accounted for?

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.

If the renewal contract is 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.

Alternative amortisation approaches include:

a) Amortising the initial amount capitalised 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) Separate the amortisation of the CU 100 capitalised into two components: amortise CU 60 over the original contract term and CU 40 over the period of the initial contract and the specific anticipated renewals and upon renewal, capitalise CU 60 and amortise it over the renewal period.

Scenario 2 (looking at subsequent commission)

An employee receives an initial commission based on the contract price when the contract is obtained. This commission is considered incremental, so it is capitalised under the new revenue standard. 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 from the modification.

How would contract costs be accounted for?

Even though the contract modification is not accounted for as a separate contract, the increase in the contract price results in a cost (that is, the 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.

TRG discussions

Amortisation and impairment of capitalised contract acquisition costs (Agenda Papers 4 and 23; July 2014 and January 2015)

At the July 2014 TRG meeting, the question about the period over which an asset arising from contract acquisition costs would be amortised was raised. In particular, it was discussed whether this should include a contract extension or renewal period when the extension or renewal is at the option of the customer. It was noted that this period should be taken into account if the vendor expects that the customer will extend or renew the contract, and that the asset relates to goods or services that would be transferred to the customer during the extension or renewal period.

As explained above, the new revenue standard requires entities to capitalise (1) incremental costs of obtaining a revenue contract and (2) costs of fulfilling a revenue contract (if certain criteria are met) and test such assets for impairment. Under the new guidance, an impairment exists when the carrying amount of the contract asset exceeds 'the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates' less associated costs that have not yet been recognised.

To test contract assets for impairment, an entity must consider the total period over which it expects to receive an economic benefit from the contract asset. Accordingly, to estimate the amount of remaining consideration that it expects to receive, the entity would also need to consider goods or services under a specific anticipated contract (i.e., including renewals). However, the impairment guidance appears to contradict itself because it also indicates that entities should apply the principles used to determine the transaction price when calculating the 'amount of consideration that an entity expects to receive.' The determination of the transaction price would exclude renewals.

Many TRG members expressed the view that when testing a contract asset for impairment, an entity would consider the economic benefits from anticipated contract extensions or renewals if the asset related to the goods and services that would be transferred during those extension or renewal periods. No TRG members or board members presented an alternate view.

5.2. Changes in the transaction price after contract inception

For certain contracts, the transaction price is not fixed. Consequently, after contract inception, the resolution of uncertain events or changes in circumstances can result in a variation of the amount to which the vendor expects to be entitled in return for goods or services.

Any changes in the transaction price subsequent to contract inception are allocated to the performance conditions on the same basis as at contract inception. Amounts that are 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 transaction price changes. This approach ensures that changes in estimates of variable consideration that are included in (or excluded from) the transaction price will be allocated to the performance obligation(s) to which the variable consideration relates.

A change in the transaction price 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.

For a change in the transaction price that occurs as a result of 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).

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 (e.g. dissatisfaction with the product). In practice, a right to return is usually attached to the sale of goods, but can also be attached to the transfer of some services that are provided by the vendor subject to refunds.

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.

A refund liability (rather than revenue) is recognised for any consideration received to which the vendor does not expect to be entitled (that is, which relates to goods that it expects to be returned). An asset is also recognised for the vendor's right to recover the goods from customers on settling the refund liability. The asset is measured by reference to the former carrying amount of the good less any expected costs to recover those products (including potential decreases in the value of the good). The asset is presented separately from the refund liability (offsetting is not permitted). If the value is less than the amount recorded in inventory, the carrying amount of inventory is reduced with a corresponding adjustment to cost of goods sold.

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.

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).

Example

On 1 January 20X4, a vendor (a retailer) sells 100 identical goods to different customers, at a sales price of CU 100 (total CU 10,000). The cost of each good is CU 60. Revenue is recognised at the point at which a customer buys one of the goods, and customers have a right to return the good for a period of 30 days from the original purchase, in return for a full refund.

The right of return gives rise to variable consideration. Based on substantial historic experience with the good, and on future expectations, the vendor estimates that three of the goods will be returned. The amount and quality of evidence available means that the vendor is able to conclude that it is highly probable that there will not be a significant reversal of revenue if it recognises revenue attributable to the 97 goods that it does not expect to be returned.

On 1 January 20X4, the vendor recognises revenue of CU 9,700 (CU 100 x 97) together with a refund liability of CU 300 (CU 100 x 3). Inventory of CU 180 (CU 60 x 3) continues to be recorded, because the vendor concludes that the goods that it expects to be returned will be capable of being sold for at least that amount.

BDO comment

The effect of the accounting requirements is that a sale is not recognised for the three goods that are expected to be returned. The view taken is that, because the customers that have purchased these goods are expected to return them to the vendor, control over those goods has not passed from the vendor to the customer.

In some cases, the vendor may conclude that the goods it expects to be returned will either not be capable of being sold to other customers, or will need to be sold for an amount below their original cost. In such cases, in addition to recording a refund liability, a charge will be made to profit or loss for the write down in the carrying amount of the related inventory.

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 staff 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 are accounted for in accordance with the guidance on product warranties included within IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- Warranties that provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. These 'additional service' warranties are accounted for as a performance obligation and allocated a portion of the transaction price in accordance with the principles of IFRS 15.

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

- Whether the warranty is required by law
- The length of the warranty coverage period
- The nature of the tasks that the vendor promises to perform.

If a customer does not have an option of whether 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 will comply with agreed-upon specifications, and need 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, which is used as a marketing tool to enhance sales.

TRG discussions

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

Questions arise about how an entity would determine whether a product warranty that is not separately priced is a performance obligation (i.e., whether the warranty represents a service rather than a guarantee of the product's intended functionality). For illustrative purposes, the staff discussed an example in which a luggage company provides a lifetime warranty to repair any damage to the luggage free of charge. It was noted that such a warranty would be a separate performance obligation because the company agreed to repair any damage at any point after purchase (i.e. repairs extend beyond those that deal with defects preventing the luggage from functioning as intended).

The staff noted that the luggage example 'illustrates a relatively [straightforward] set of facts and circumstances that demonstrate an instance of when a warranty provides a service' and further observed that the conclusion for other warranty arrangements may be less clear. Accordingly, the staff reiterated that an entity will need to assess the substance of the promises in a warranty arrangement and exercise judgment on the basis of the entity's specific facts and circumstances.

TRG members generally agreed with the staff conclusion for the fact pattern presented. Some of the discussion focused on the duration of the warranty (i.e., the lifetime warranty in the luggage company example), but FASB staff members reiterated that while duration may be an indicator of whether a warranty is a separate performance obligation, it is not determinative. The FASB staff further reiterated that the paper's main purpose was educational – that is, its primary aim was to counter the claim made by some stakeholders that 'nothing has changed from current practice' and to demonstrate that an entity would need to use judgment in determining whether there are additional performance obligations to which the transaction price should be allocated.

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 compensation (a refund) should be accounted for as a right of return in accordance with IFRS 15. In many cases this will be a change in practice from how these refunds are accounted for under current guidance.

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 the basis for conclusions in IFRS 15.BC367 which states:

> *'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, in the section of the basis for conclusions related to warranties, IFRS 15.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 IFRS 15.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…'*

Again this omits the possibility of returning a defective item for a refund.

As a result, for 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 sold 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 are accounted for an upward or downward adjustment to revenue. This is consistent with the accounting for consideration payable to a customer, which is recorded as a reduction of the transaction price.

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 is 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. A vendor that qualifies as a principal 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.

The following points indicate that the vendor qualifies as an agent:

– Another third party is responsible for fulfilling the contract
– The vendor does not have inventory risk
– The vendor does not have discretion in establishing prices for the other third party's goods or services
– The vendor's consideration is in the form of a commission
– The vendor is not exposed to credit risk for the amount receivable from the customer.

BDO comment

Under current guidance, in practice it has sometimes been difficult to identify which party is acting as principal and which as agent. We expect those judgements to continue to be challenging when accounting in accordance with IFRS 15, which reflects the complexity of certain transactions, and the way in which they are undertaken. 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.

It is likely that significant focus will need to be placed on the precise contractual terms of the arrangements, in order 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.

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 has amended paragraphs B34-B38 of IFRS 15, Examples 45-48 accompanying IFRS 15 and has 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.

Shipping and handling fees (Agenda Paper 2; July 2014 and Amendments to Topic 606)

Some stakeholders in the US have expressed differing views about whether and when shipping and handling activities that occur after the transfer of control to the customer should be accounted for as a promised service or as a fulfilment activity. The FASB has made an amendment to Topic 606 to state explicitly that an entity is permitted (as an accounting policy choice) to account for shipping and handling activities that occur before the customer obtains control of the related good as fulfilment activities. The IASB has not made a similar amendment in order to avoid creating an exception to the revenue recognition model.

Taxes (Agenda Paper 2; July 2014 and Clarifications to IFRS 15)

Due to the concerns expressed by some US stakeholders about the cost and complexity of assessing tax laws in each jurisdiction, the FASB decided to permit entities an accounting policy choice to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected from customers (for example, sales, use or value added taxes). The IASB has decided not to provide a similar accounting policy choice under IFRS 15.

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 recognises 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.

TRG discussions

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

The revenue standard 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 or a contract modification.

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 apply either approach.

TRG discussions

Loyalty programs (Agenda Paper 6; October 2014)

Questions have arisen regarding the application of this guidance to (1) loyalty programs in which customers accumulate points that may be used for future goods or services, (2) certain types of discount vouchers, (3) certain renewal options, and (4) contracts that include a customer's payment of a nonrefundable up-front fee and renewal options. In particular, views differ on whether an entity's evaluation of an option (to determine whether it represents a material right) should:

a) Take into account only the current transaction, or should include past and expected transactions

b) Include an assessment of only quantitative factors or both quantitative and qualitative factors.

TRG members generally agreed that in determining whether an option for future goods or services is a material right, an entity should (1) consider factors outside the current transaction (e.g. the current class of customer) and (2) assess both quantitative and qualitative factors. Further, TRG members noted that an entity should also evaluate incentives and programs to understand whether they are customer options designed to influence customer behaviour because this could be an indicator that an option is a material right.

In addition, some TRG members expressed concerns about the examples in the new revenue standard. Board members noted that the quantitative examples were not meant to establish thresholds but to illustrate how the related guidance would be applied. It was also acknowledged that an entity would need to exercise significant judgment in assessing whether an option is a material right.

Regarding certain offers, such as buy three and get one free, TRG members noted that the quantities involved are less important than the fact that an entity would be 'giving away' future sales in such cases. While not determinative, such an indicator may lead an entity to conclude that a customer option is a material right.

TRG members also discussed loyalty programs that have an accumulation feature. Some TRG members noted that through the presence of an accumulation feature in a loyalty program, the entity gives its customers a material right. Others, however, indicated that the accumulation feature is not a determinative factor that would automatically lead an entity to conclude that the entity grants its customers a material right. Instead, if an accumulation feature is present, an entity would be required to evaluate the program.

TRG discussions (continued)

Loyalty programs (Agenda Paper 6; October 2014) (continued)

Other of the questions 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 (a usage – based fee, for example).

TRG members agreed that all facts and circumstances should be taken into account when analysing these kind of contracts and that this analysis requires judgement.

When a customer's option exists the vendor is not required to provide additional goods and/or services until the customer exercises the option. On the other hand, in a contract that includes variable consideration the vendor has a present obligation to transfer all goods and services requested by the customer.

The following example was discussed:

A vendor enters into a multi-year software arrangement with a customer, where there is a fixed fee amounting to CU 500,000 for up to 500 users. For each additional user the customer has to pay CU 800.

It was generally agreed that whether the contract is for a single licence or for multiple licences requires judgment and consideration of all facts and circumstances.

The analysis that needed to be performed in this case was to determine whether the additional software usage represented an option to purchase additional goods and services or variable consideration based on a variable quantity.

If it was concluded that the customer had an option, the vendor would need to determine at contract inception whether the option represented a material right and, if so, allocate a portion of the transaction price to that material right. If the option was not a material right, there would be no accounting until the additional purchases occur. If the customer's ability to add additional users was considered variable consideration, revenue would be recognised as the additional purchases occur.

5.7. Renewal options

A renewal option gives a customer the right to acquire additional goods or services of the same type as those supplied under an existing contract. If a renewal option provides a customer with what IFRS 15 terms a 'material right', the effect can be to defer the recognition of revenue to future periods.

IFRS 15 includes criteria to distinguish renewal options from other options to acquire additional goods or services:

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.

IFRS 15 also includes a practical alternative to estimate the stand-alone selling price of the option, by allowing entities to include the optional goods or services that it expects to provide (and corresponding expected customer consideration) in the initial measurement of the transaction price. This practical alternative acknowledges that for some entities it may be simpler to account for renewal options within a single contract, rather than as a contract with a series of options.

A renewal option is different from customer loyalty programmes and many discount vouchers. This is because, for those 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.

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

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. Customers' unexercised rights

Customers' unexercised rights refer to instances where there is breakage in a contract, such as where a customer does not exercise all its contractual rights from the contract to receive goods or services in the future. Common examples for customers' unexercised rights include the purchase of gift cards and non-refundable tickets.

When a vendor expects to be entitled to a breakage amount in a contract liability, the vendor recognises the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer. This effectively increases the transaction price allocated to the individual goods or services to be transferred to include revenue from the vendor's estimate of unexercised rights, and means that breakage is not recognised as revenue until the vendor has fulfilled its obligations. This reflects that an airline that sells non-refundable tickets would be presumed to increase its selling price per ticket if no breakage was expected.

When the vendor does not expect to be entitled to a breakage amount, the expected breakage amount is recognised as revenue when the likelihood of the customer exercising its remaining rights becomes remote.

BDO comment

IFRS 15 is restrictive and the way in which breakage is to be accounted for will depend on the underlying circumstances. This will include consideration of the constraint on recognition of variable consideration, which arises from uncertainty over the number of customers that will not exercise their remaining rights (for example, failing to use gift cards by a specified expiry date). Existing guidance is less prescriptive, and some entities may need to change their accounting approach. In some cases, customers' options may be perpetual and not have an expiration date. The question that arises in these cases is whether an entity can apply the guidance on unexercised rights in IFRS 15.

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 stand-alone 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 stand-alone 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 have a contract liability.

In situations where a single option exists and the portfolio approach is not or cannot be applied, the stand-alone 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.

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, joining fees in health club membership contracts). 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 performance obligations 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 other goods or services promised.

When the licence is not distinct from other goods or services to be provided in accordance with the contract, the licence and other goods or services 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, software 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 other promised goods or services in the contract, the licence is 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 a point in time the licence is granted.

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.

Clarifications to IFRS 15

The TRG discussed issues relating to the application of the licencing 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 has decided to clarify the application guidance on licencing and the accompanying Illustrative Examples.

Except for the scope and applicability of the sales-based and usage-based royalties 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 customers 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

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 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.

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.

Example

A vendor (a music record label) licences 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 customers 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 licenced intellectual property.

When determining the type of licence that has been granted (intellectual property as it exists at any point during the licence period vs. 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.

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.*

The 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 1

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 initially agreed licence period, the licence is renewed and extended for an additional multi-year period. In this example the licence is a separate performance obligation.

The conclusion of the staff was that licensor should recognise revenue for the renewal when it is agreed by the parties (before the end of the end of the initially agreed licencing period), because no additional performance is required from the licensor.

The renewal was considered to be a change to an attribute of the licence that the customer controls.

Example 2

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 conclusion reached by the staff was that the customer grants two distinct licences in this case, because the right to commercialise the product in one region is distinct from the right to commercialise it in other different region (two different performance obligations). Therefore, licensor recognises revenues for the second performance obligation when the rights are available to the customer.

Some TRG members did not agree with the staff 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 licencing 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 the consideration takes the form of a sales-based or usage-based royalty for a licence of intellectual property the vendor recognises revenue only when (or as) the later of the following events occurs:

- The subsequent sale or usage occurs; and
- The performance obligation to which some or all of the sales- 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 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, milestone payments).

Examples

- *An entity licences IP in exchange for a payment of CU 10 million if cumulative sales of the licencee of an item that makes use of the IP exceed CU 100 million over a specified five year period.*
- *An entity licences IP in exchange for 'stepped' payments. This might be no royalty is the licencee's sales of an item that makes use of the IP are between CU 1 and 10 million, a royalty of 1% of sales between CU 10 million and CU 25 million and a royalty of 2% of sales above CU 25 million.*

In our view, the exception does apply to these situations because the consideration is based on the sales to the customer's customer even though it might not be described as a royalty.

IFRS 15.BC415 notes that:

> *'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).

TRG discussions

Sales-based and usage-based royalties in contracts with licences and goods and services other than licences (Agenda Paper 3; July 2014)

Questions have arisen regarding how the royalty constraint would apply when 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).

Views differ on whether the royalty constraint should apply to circumstances in which a royalty is (1) related to both a distinct licence and non-licence goods or services that are distinct from the licence and (2) combined with other non-licence goods or services in the contract (i.e., it is not distinct). In addition, certain stakeholders have questioned whether the royalty constraint may partially apply to a sales- or usage-based royalty.

In its Clarifications to IFRS 15 the IASB has decided that the royalties constraint applies to those arrangements for which the licence is the predominant item to which the royalty relates. This is because users of financial statements are likely to view those arrangements as licencing arrangements.

The FASB has added an example of when a licence is the predominant item to which a royalty relates. The IASB decided that no further guidance on the term 'predominant' is necessary because stakeholders feedback suggests that the term can be applied in practice.

The IASB noted that an entity might conclude that a licence is the predominant item to which a sales-based or usage-based royalty relates when there is more than one performance obligation. This conclusion might be reached regardless of whether the entity concludes that the royalty can be allocated entirely to one performance obligation in accordance with the requirements for allocating variable consideration in paragraphs 84-85. The royalties constraint would also apply when a single licence is not the predominant item to which the royalty relates, but the royalty predominantly relates to two or more licences promised in a contract.

5.12. Repurchase agreements

A repurchase agreement arises when a vendor sells an asset to a customer and is either 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 of which the one which was originally sold is a component.

When a vendor has an obligation or right to repurchase the asset, the customer is limited in its ability to direct the use of and obtain substantially all of the remaining benefits from the asset. Therefore the customer does not obtain control of the asset. This means that the vendor does not recognise revenue from a sale and instead, depending on the contractual terms, the transaction is accounted for either as a lease or as a financing arrangement.

In determining whether a contract with a repurchase agreement gives rise to a lease or a financing arrangement, the vendor compares the repurchase price of the asset with it original selling price, taking into account the effects of the time value of money. When the repurchase price is lower than the original selling price of the asset the agreement is accounted for as lease in accordance with IAS 17 *Leases*. If the repurchase price is greater than or equal to the original selling price of the asset than the contract gives rise to a financing arrangement; the vendor recognises a financial liability for any consideration received from the customer and continues to recognise the asset.

When a vendor has an obligation to repurchase the asset at the customer's request (the customer has a put option) the accounting will depend on the relationship between the repurchase price of the asset and the original selling price of the asset.

When the repurchase price of the asset is lower than the original selling price of the asset, the vendor considers whether the customer has a significant economic incentive to exercise its right. If this is the case, the customer 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). If the repurchase price is expected significantly to exceed the market value of the asset at the date of exercise, it is assumed that the customer has a significant economic incentive to exercise the put option (meaning that the customer has not obtained control of the asset).

If the customer does not have a significant economic incentive to exercise its option, the customer obtains control of the asset and vendor records a sale of the product with a right of return.

The repurchase price of the asset might be equal to or greater than the original selling price and be more than the expected market value of the asset at the date of exercise of the customer's put option. In those cases, the customer does not obtain control of the asset and the contract is instead accounted for as giving rise to a financing arrangement.

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 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.

5.13. Consignment arrangements

A vendor may deliver a product to another party, such as a dealer or retailer, for sale to 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. However, there might be a requirement for a deposit to be paid.

5.14. Bill-and-hold arrangements

Bill-and-hold arrangements involve the vendor invoicing a customer for a product but, instead of delivering it to the customer, the vendor retains physical possession with the product 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 determining the point at which it is appropriate to recognise revenue from a sale of the product, the vendor applies the same control criteria as for any other sale (or performance obligation) to be recognised at a point in time. In addition, all of the following criteria are required to be met:

- 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.

When a vendor recognises revenue for the sale of an asset on a bill-and-hold basis, it is also required to consider whether there are any remaining performance obligations (e.g. for custodial services) to which a portion of the transaction price needs to be allocated.

BDO comment

The guidance in IFRS 15, and the effect of the IASB's proposed amendments, mean that some arrangements which have been viewed as meeting the criteria in existing guidance may no longer qualify. In some cases, questions may arise about whether the 'hold' activity gives rise to a separate performance obligation to provide a storage facility. Careful consideration of the terms of bill and hold arrangements will be needed to determine whether they meet the criteria in IFRS 15, and in the identification of performance obligations.

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. This might apply if the sale is subject to an asset meeting certain size and weight specifications; the vendor would be able to confirm whether these had been met. However, if revenue is recognised 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 been transferred to the customer 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 *Revenue from Contracts with Customers* does not contain specific guidance for onerous contracts, and instead refers to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (IFRS 15.5).

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 that might arise is whether the unit of account is the contract as a whole or the performance obligations identified through the application of IFRS 15.

In our view, the unit of account is the contract as a whole and not the individual performance obligations. 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 paragraphs 10 and 22. 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; or
- 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.

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.

6. PRESENTATION

In accordance with the requirements of IAS 1 *Presentation of Financial Statements*, a vendor presents or discloses revenue from contracts with customers separately from the vendor's other sources of revenue.

In its statement of financial position, a vendor is required separately to present contract assets, contract liabilities and receivables due from customers. Alternative descriptions are permitted to 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 a vendor's right to consideration in exchange for goods or services that the vendor has transferred to a customer, when that right is conditional on the vendor's future performance. A receivable is a vendor's unconditional right to consideration, and is accounted for in accordance with IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement*.

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 presents the amount received in advance as a contract liability.

TRG discussions

Presentation of assets and liabilities (Agenda Paper 7; October 2014)

Although certain types of assets and liabilities result from revenue arrangements under existing GAAP, questions have arisen regarding how contract assets and liabilities should be presented under the new revenue standard.

These questions include:

- *What is the appropriate unit of account? Some believe that, because of the way each term is entitled, presentation is determined at the contract level. However, others think that the unit of account should be at the level of performance obligations within contracts*
- *For individual contracts with both contract assets and contract liabilities, should contract assets and liabilities for the individual contracts be presented on a gross or net basis?*
- *For entities that have combined revenue contracts with a customer (because they have met the criteria to do so), should contract assets and liabilities be presented on a separate or combined basis?*
- *May an entity offset other assets and liabilities against contract assets and liabilities? If so, should an entity apply the guidance in existing accounting literature?*

TRG members generally agreed that:

- *The contract, and not individual performance obligations, is the appropriate unit of account for presenting contract assets and liabilities*
- *Contract assets or liabilities are presented for each contract on a net basis*
- *For contracts that meet the criteria for combination under the new revenue standard, a contract asset or liability would be presented for the combined contract.*

One board member noted that netting of contract assets and liabilities reflects an entity's net position for the remaining rights and obligations under the contract and therefore is different from offsetting. Further, TRG members generally agreed that entities should look to existing guidance to determine whether they have the right of offset.

7. DISCLOSURES

IFRS 15 *Revenue from Contracts with Customers* 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 current *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.

8. EFFECTIVE DATE AND TRANSITION

IFRS 15 *Revenue from Contracts with Customers* 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* with a choice of three practical; expedients, or
- The current period with a cumulative effect adjustment.

The three practical expedients are:

- For completed contracts, contracts that began and ended within the same annual reporting period do not need to be restated
- 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; and
- 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.

TRG discussions

Transition issues (Agenda Paper 42; July 2015)

The new revenue standard only applies to contracts that are not completed as of the adoption date (under the modified retrospective transition method).

A 'completed contract' is a contract for which the entity has transferred all of the goods or services to the customer before the application of the new standard.

The TRG discussions covered the following two issues regarding completed contracts at transition:

- *How to determine whether a contract is complete for transition purposes*
- *How to account for completed contracts at and after adoption of the new standard.*

Although a contract might appear to be 'complete' according to the definition set in the standard, there may be unrecognised revenue or accruals related to the contract.

TRG members had differing views about how to address these issues. The staff agreed to provide more examples and hold further discussions in coming meetings.

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 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

A vendor has a single four year contract which runs from 1 January 2014 to 31 December 2017. 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:

2014: CU 800,000

2015: CU 400,000

2016: CU 400,000

2017: 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:

	2014	*2015*	2016	2017	Total
					2016+2017
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 2016 between the cumulative amount of revenue recognised in accordance with existing IFRS (1,200, being 800 in 2014 and 400 in 2015) and the amount that would have been recognised in accordance with IFRS 15 (1,000, being 500 in each of 2014 and 2015).

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).

TRG discussions and Clarifications to IFRS 15

Evaluating contract modifications prior to the date of initial application (Agenda Paper 24; January 2015)

Given the high volume and long duration of customer contracts for some entities that are frequently modified, stakeholders have expressed concerns that applying the guidance will be challenging, if not impracticable, regardless of the transition method an entity applies. Furthermore, some believe that the costs may exceed the benefits because of the limited usefulness in applying the contract modification guidance to periods before the date of initial application. Accordingly, some stakeholders requested that the FASB and IASB add practical expedients to the standard's contract modification guidance to address the issue.

TRG members generally agreed that assessing contract modifications for transition under the new revenue standard would be onerous and perhaps impracticable. Some TRG members challenged whether it would be impracticable, noting that impracticability is a high threshold under existing guidance. TRG members were supportive of ways to simplify the treatment of contract modifications for transition, particularly for contracts that may have been modified numerous times over many years.

As a result, amendments have been made in order to simplify the approach on transition for these, and other similar, contracts:

Contracts modified before the beginning of the earliest period presented require no retrospective restatement for the modifications made. Instead, hindsight can be used with the aggregate effect of all modifications to be reflected when:

- *Identifying the satisfied and unsatisfied performance obligations;*
- *Determining the transaction price; and*
- *Allocating the transaction price to the satisfied and unsatisfied performance obligations.*

Completed contracts

The IASB added a further practical expedient, which is that contracts that are completed contracts at the beginning of the earliest period presented do not need to be restated in accordance with IFRS 15. A completed contract is one for which the seller has fully performed in accordance with revenue recognition requirements in effect before the date of initial application. If the practical expedient is followed, then for those contracts revenue will continue to be recognised in accordance with previous guidance.

In contrast, the FASB amended the definition of a completed contract to be one for which all or substantially all of the revenue was recognised in accordance with the revenue guidance that was in effect before the date of initial application of Topic 606.

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