KPMG

Revenue

IFRS 15 handbook

November 2022

home.kpmg/ifrs

Contents

In step with the fast-changing world

When IFRS 15 *Revenue from Contracts with Customers* came into effect in 2018, the global economy looked very different. Since then, we have seen an extraordinary expansion in digital and intangible goods and services, the rapid growth of subscription services and the creation of new online platforms with innovative incentives.

IFRS 15 was designed to deal with a wide range of transactions and to accommodate changes. But changes can bring challenges in interpreting and applying standards. Our previous edition (in 2019) captured the lessons learned from the initial application of IFRS 15. This new edition reflects our more recent experience of how companies are applying the standard in this changing world. It includes new examples that address issues such as dealing with online platforms and using intermediaries.

This new edition also reflects how other standards are affecting the application of IFRS 15. For example, accounting for loss-making or onerous contracts now has its own section due to newly effective amendments to the provisions standard.

Amid all of this change, it is worth noting that the standard has also been scheduled for a post-implementation review by the International Accounting Standards Board – an opportunity to reflect on how the standard has performed so far, and how it might address future challenges and opportunities.

In the meantime, we hope you find this handbook a helpful resource as you interpret and apply the standard to your business in this fast-changing world.

Brian O'Donovan
Kim Heng

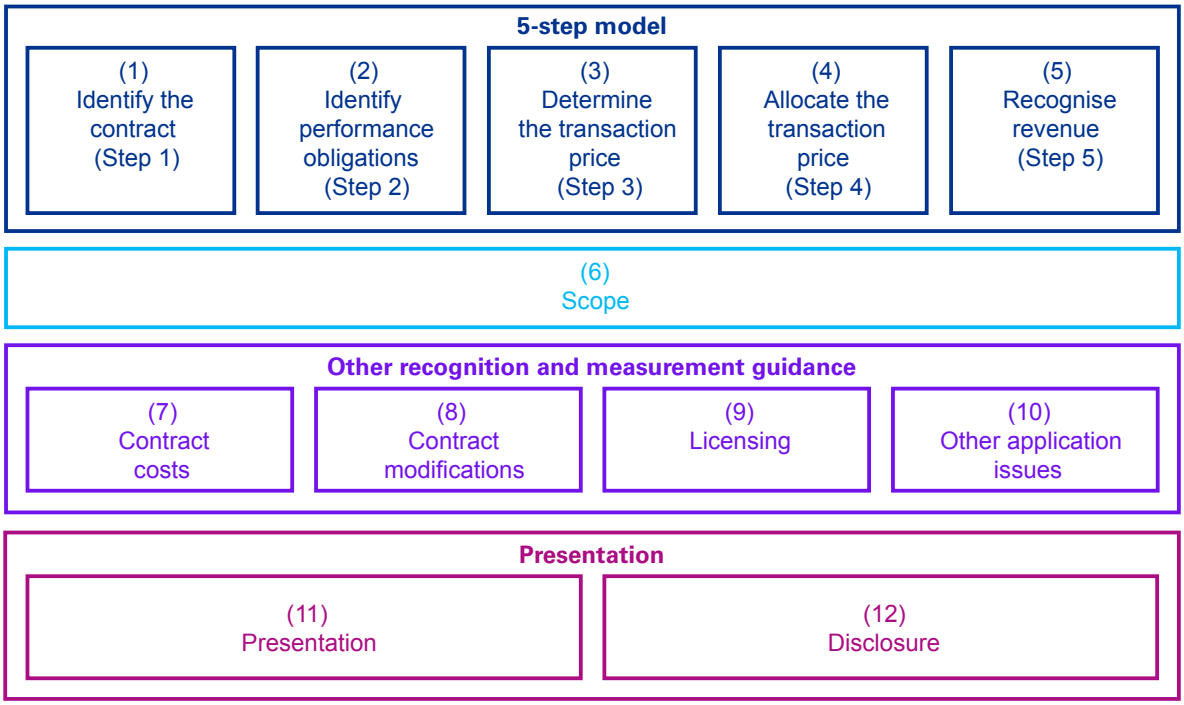
KPMG Global Revenue Recognition Leadership Team

Overview

This handbook provides a detailed analysis of the revenue standard, IFRS 15 *Revenue from Contracts with Customers*, including insights and examples to help entities to navigate the revenue recognition requirements. In many cases, further analysis and interpretation may be needed for an entity to apply the requirements to its own facts, circumstances and individual transactions. Furthermore, some of our insights may change and new insights will be developed as issues from the implementation of the revenue standard arise and as practice evolves.

Organisation of the text

The following diagram highlights the layout of the revenue standard and the corresponding sections in this handbook. Each section provides an overview, the requirements of the standard, examples illustrating basic scenarios and our insights. Some sections also have additional application examples illustrating more complex scenarios or sector-specific issues.



1 Identify the contract with a customer (Step 1)

Overview

A contract with a customer is in the scope of the standard when the contract is legally enforceable and certain criteria are met. If the criteria are not met, then the contract does not exist for the purpose of applying the general model of the standard, and any consideration received from the customer is generally recognised as a deposit (liability). Contracts entered into at or near the same time with the same customer (or a related party of the customer) are combined and treated as a single contract when certain criteria are met.

1.1 Criteria to determine whether a contract exists

IFRS 15.10

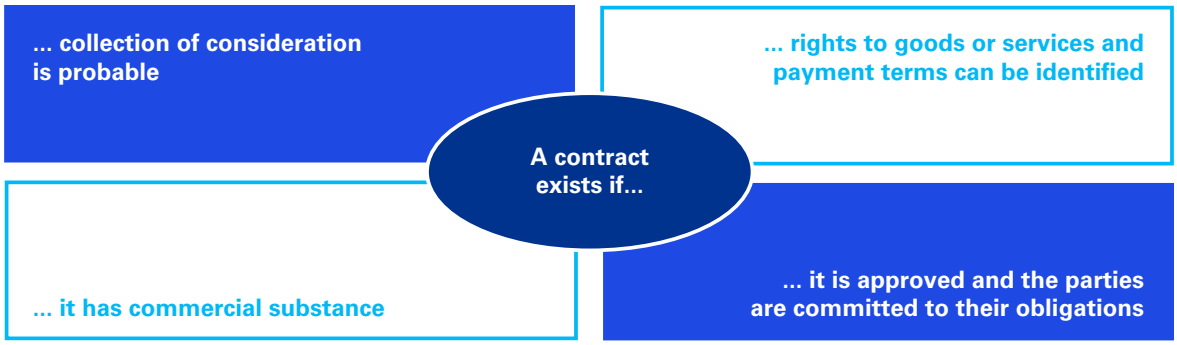
The standard defines a 'contract' as an agreement between two or more parties that creates enforceable rights and obligations and specifies that enforceability is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices.

IFRS 15.12

A contract does not exist when each party has the unilateral right to terminate a wholly unperformed contract without compensation.

IFRS 15.9

A contract with a customer is in the scope of the standard when it is legally enforceable and meets all of the following criteria.



IFRS 15.9(e)

In making the collectability assessment, an entity considers the customer's ability and intention (which includes assessing its credit-worthiness) to pay the amount of consideration when it is due. This assessment is made after taking into account any price concessions that the entity may offer to the customer (see Section 3.1).

IFRS 15.14

If the criteria are not initially met, then an entity continually reassesses the contract against them and applies the requirements of the standard to the contract from the date on which the criteria are met. Any consideration received for a contract that does not meet the criteria is accounted for under the requirements in Section 1.3.

IFRS 15.13

If a contract meets all of the criteria at contract inception, then an entity does not reassess the criteria unless there is an indication of a significant change in the facts and circumstances. If on reassessment an entity determines that the criteria are no longer met, then it ceases to apply the standard to the contract from that date, but does not reverse any revenue previously recognised.

Example 1 – Assessing the existence of a contract: Sale of real estate

In an agreement to sell real estate, Seller X assesses the existence of a contract. In making this assessment, X considers factors such as:

- the buyer's available financial resources;
- the buyer's commitment to the contract, which may be determined based on the importance of the property to the buyer's operations;
- X's prior experience with similar contracts and buyers under similar circumstances;
- X's intention to enforce its contractual rights;
- the payment terms of the arrangement; and
- whether X's receivable is subject to future subordination.

If X concludes that it is not probable that it will collect the amount to which it expects to be entitled, then a contract to transfer control of the real estate does not exist. Instead, X applies the guidance on consideration received before concluding that a contract exists (see Section 1.3), and initially accounts for any cash collected as a deposit (liability).

Example 2 – Assessing the existence of a contract: No written sales agreement

Shoe Manufacturer S holds products available to ship to customers before the end of its current fiscal year. Shoe Shop T places an order for the product, and S delivers the product before the end of its current fiscal year.

S generally enters into written sales agreements with this class of customer that require the signatures of the authorised representatives of both parties. S prepares a written sales agreement and its authorised representative signs the agreement before the end of the year. T does not sign the agreement before the end of S's fiscal year. However, T's purchasing department has orally agreed to the purchase and stated that it is highly likely that the contract will be signed in the first week of S's next fiscal year.

After consulting its legal counsel and obtaining a legal opinion, S determines that based on local laws and legal precedent in T's jurisdiction, T is legally obliged to pay for the products shipped to it under the agreement, even though T has not yet signed the agreement.

Therefore, S concludes that a contract exists and applies the general requirements of the standard to sales made under the agreement up to the year end.

Example 3 – Collectability threshold: Assessment based on goods or services to be transferred

Company C contracts with Customer D to sell 1,000 units for a fixed price of 1 million. D has a poor payment history and often seeks price adjustments after receiving orders and so C assesses that it is probable that it will collect only 70% of the amounts due under the contract.

Based on its assessment of the facts and circumstances, C expects to provide an implicit price concession and accept 70% of the fixed price from D. When assessing whether collectability is probable, C assesses whether it expects to receive 700,000, which is the amount after the expected implicit price concession.

On subsequent reassessment, if C expects to collect more than 700,000, then it recognises the excess as revenue. If C subsequently assesses that it will collect less than 700,000, then C recognises the shortfall as a bad debt expense, which is measured using the guidance on impairment of receivables. However, if C determined that it had granted an additional price concession, then the shortfall would be a reduction in transaction price and revenue.

Assessment focuses on enforceability, not form of the contract

IFRS 15.BC32

The assessment of whether a contract exists for the purpose of applying the standard focuses on the enforceability of rights and obligations based on the relevant laws, legal precedent and regulations, rather than the form of the contract (oral, implied or written). This may require significant judgement in some jurisdictions or for some arrangements, and may result in different assessments for similar contracts in different jurisdictions. In cases of significant uncertainty about enforceability, a written contract and legal interpretation by qualified counsel may be required to support a conclusion that the parties to the contract have approved and are committed to performing under the contract.

However, although the contract has to create enforceable rights and obligations, some of the promises in the contract to deliver a good or service to the customer may be considered performance obligations even though they are not legally enforceable (see Chapter 2).

Collectability is only a gating question

IFRS 15.9

Under the revenue standard, the collectability criterion is included as a gating question designed to prevent entities from applying the revenue model to problematic contracts and recognising revenue and a large impairment loss at the same time. The collectability criteria are likely to be met for many routine customer contracts.

Collectability is assessed based on the amount that the entity expects to receive in exchange for goods or services

The collectability threshold is applied to the amount to which the entity expects to be entitled in exchange for the goods and services that will be transferred to the customer, which may not be the stated contract price. The assessment considers:

- the entity's legal rights;
- past practice;
- how the entity intends to manage its exposure to credit risk throughout the contract; and
- the customer's ability and intention to pay.

The collectability assessment is limited to the consideration attributable to the goods or services to be transferred to the customer for the non-cancellable term of the contract. For example, if a contract has a two-year term but either party can terminate it after one year without penalty, then an entity assesses the collectability of the consideration promised in the first year of the contract (i.e. the non-cancellable term of the contract).

Judgement is required to differentiate between a collectability issue and a price concession

IFRS 15.52, IE7–IE13, BC45

Judgement is required in evaluating whether the likelihood that an entity will not receive the full amount of stated consideration in a contract gives rise to a collectability issue or a price concession.

The standard includes two examples of implicit price concessions: a life science prescription drug sale (Example 2 in the standard) and a transaction to provide health care services to an uninsured (self-pay) patient (Example 3 in the standard). In both examples, the entity concludes that the transaction price is not the stated price or standard rate and that the promised consideration is variable. Consequently, an entity may need to determine the transaction price in Step 3 of the model (see Chapter 3), including any price concessions, before concluding on the collectability criterion in Step 1 of the model.

Collectability threshold may be assessed using information derived at the portfolio level

IFRS 15.4

In some situations, an entity may use a portfolio of historical data to estimate the amounts that it expects to collect. This type of analysis may be appropriate when an entity has a high volume of homogeneous transactions. These estimates are then used as an input into the overall assessment of collectability for a specific contract.

For example, if on average a vendor collects 60 percent of amounts billed for a homogeneous class of customer transactions and does not intend to offer a price concession, then this may be an indicator that collection of the full contract amount for a contract with a customer within that class is not probable. Therefore, the criterion requiring collection of the consideration under the contract to be probable may not be met.

Conversely, if on average a vendor collects 90 percent of amounts billed for a homogeneous class of contracts with customers, then this may indicate that collection of the full contract amount for a contract with a customer within that class is probable. Therefore, the criterion requiring collection of the consideration under the contract to be probable may be met. However, if the average collections were 90 percent because the vendor generally collected only 90 percent from each individual contract, then this may indicate that the vendor has granted a 10 percent price concession to its customer. For a discussion of the differentiation between a collectability issue and a price concession, see the previous box.

Collectability is reassessed only when there is a significant deterioration in the customer's credit-worthiness

An entity does not reassess the Step 1 collectability criteria unless there is a significant change in facts and circumstances that results in a significant deterioration in the customer's credit-worthiness. For example, a significant deterioration in a customer's ability to pay because it loses one of its customers that accounts for 75 percent of its annual sales would be likely to lead to a reassessment.

The determination of whether there is a significant deterioration in the customer's credit-worthiness will be situation-specific and will often be a matter of judgement. The evaluation is not intended to capture changes of a more minor nature – that is, those that do not call into question the validity of the contract. Nor does it capture changing circumstances that might reasonably fluctuate during the contract term (especially for a long-term contract) that do not have a significant effect.

If the entity determines that collectability is no longer probable, then it discontinues revenue accounting and follows the guidance on accounting for consideration received when a contract does not exist – see Section 1.3.

Collectability assessment required for contracts with a significant financing component

The assessment of collectability in Step 1 of the model applies equally to contracts with or without a significant financing component. This is regardless of the fact that credit-worthiness is factored into the discount rate and therefore the transaction price for a contract with a significant financing component.

Fiscal funding clauses may affect the assessment of whether a contract exists

When the customer in a contract is a government, there may be a fiscal funding clause stating that the contract is cancellable if the funding authority does not appropriate the funds necessary for the government to pay. Judgement will need to be applied to determine whether a contract exists when delivery of goods or services commences before funding has been formally approved.

Enforceable rights and obligations for an expired contract when the entity continues to provide services

In some cases, an entity may continue to deliver services to a customer under the terms of a contract after it has expired – e.g. when the terms of a new contract to replace the existing one are not finalised before the expiry date of the existing contract. If the entity has legally enforceable rights and obligations related to these services, then the services delivered are accounted for using the general guidance of the standard. Conversely, if the entity does not have legally enforceable rights and obligations for the services delivered after the contract expires, then it applies the guidance on accounting for consideration received before a contract exists – see Section 1.3.

Making the assessment of whether enforceable rights and obligations exist will often be complex and may require an entity to seek legal advice to determine whether it has enforceable rights and obligations after the expiry date of the contract.

Free trial period offers

In some cases, an entity will offer customers the right to obtain its services for free for a period, during which time the customer can decide to contract for future services. For example, a customer can decide to obtain a 12-month subscription to a film streaming service after the end of a free trial period. Service providers may offer additional incentives – e.g. free or discounted services or a discounted price on the service – if the customer enters into a long-term contract.

In these cases, no contract exists until the customer accepts the entity's offer to provide services after the free trial period because the customer can opt out any time during the free trial period. No enforceable right to consideration exists for the entity until the customer contracts for post-free trial period services. Once the customer accepts the entity's offer, the entity accounts for the remaining free trial period services (from the date a contract exists) and the post-free trial services as performance obligations of the contract.

Services provided during the free trial period, before the customer accepts the entity's offer to provide services beyond the free trial period, are generally accounted for as sales incentives.

However, it may be reasonable to account for only the post-free trial period goods or services as performance obligations of the customer contract if either:

- the customer's right to the remaining free trial period goods or services is not enforceable; or
- on a portfolio basis, accounting for only the post-free trial period goods or services as performance obligations would not differ materially from accounting for both the remaining free trial period goods or services and the post-free trial period goods or services as performance obligations of the contract with the customer.

Success-based fee arrangements

IFRS 15.9

In some cases, an entity may be entitled to consideration for services performed only if a specific outcome is achieved and the customer can withdraw from the contract at any time before that event without compensating the entity. These arrangements are often referred to as 'success-based fee arrangements'. They are common in the services industry – e.g. real estate agents and travel agents. In our view, these arrangements, in which the entire amount of the promised consideration is contingent on the achievement of a specific outcome, are not contracts with a customer in the scope of the revenue standard before the specific outcome is achieved. This is because, in these arrangements, the entity does not have enforceable rights to payment for the services that it has performed to date and, similarly, the customer has no obligations. For example, a property holder enters into a contract with a real estate agent to sell their property. Under the contract terms, the property holder can cancel the contract at any time without penalty and is obliged to pay the real estate agent only if a sale of the property is completed. In this case, a contract with a customer arises only when sale of the property is completed, because before this point the real estate agent does not have an enforceable right to payment, nor does the property holder have an obligation to pay and, as such, the agreement does not meet all of the contract existence criteria.

Contracting practices may need to be evaluated by customer class

Contracting practices with different classes of customers in the same jurisdiction may need to be evaluated. For example, an entity may have a business practice of using written contracts. However, the entity may enter into arrangements with certain customers whose business practices of providing evidence of an arrangement differ from the entity's own practice.

If an entity establishes a different practice for evidencing an arrangement for specific customers, including implied contracts for various classes of customers (e.g. by customer type, geographic region, product type or sales price range), then it may need to consult legal counsel to determine whether these practices affect the determination of whether the arrangement is legally enforceable.

It may be advisable for an entity to document its conclusions about its evaluation of legal enforceability for each arrangement. Depending on the circumstances, it may also be appropriate for an entity to develop documentation for a particular customer or class of customer, or by jurisdiction.

Two definitions of a contract exist in IFRS® Accounting Standards

IAS 32.13

The definition of a contract in the revenue standard focuses on legal enforceability. Although the term 'contract' is also defined in the standard on presentation of financial instruments, that definition is different and stops short of requiring the contract to be legally enforceable.

The International Accounting Standards Board (the Board) did not amend the definition of a contract in the standard on presentation of financial instruments on the grounds that this may have unintended consequences on the accounting for financial instruments. As a result, there are two definitions of a contract in IFRS Accounting Standards.

1.1.1 Framework agreements

Generally, a framework agreement that includes no minimum purchase quantities only establishes the terms under which orders to purchase goods or services may be placed, rather than creating enforceable rights and obligations for the parties – i.e. it does not create a contract. However, enforceability is a matter of law in the relevant jurisdiction and each framework agreement will need to be evaluated based on its terms and conditions and local law.

When a framework agreement on its own does not create enforceable rights and obligations, it will normally be the purchase order in combination with the framework agreement that creates the enforceable rights and obligations between the entity and the customer. Therefore, the purchase order in combination with the framework agreement will be evaluated to determine whether the criteria in paragraph 9 of the standard are met and a contract exists.

An entity needs to consider whether the pricing of individual purchase orders is inter-related and:

- the purchase orders need to be combined (see Section 1.4); or
- there are implicit or explicit promises in the framework agreement: i.e. whether it includes a material right (see Section 10.4) or any variable consideration (see Section 3.1) – e.g. a rebate or discount.

Example 4 – Framework agreement: No specified minimum purchases

Manufacturer X enters into a framework agreement with Customer Z for the sale of widgets. The agreement sets out the general terms including pricing, warranty, return rights and ordering protocols. It does not include any minimum purchase requirements.

In this example, X determines that the framework agreement does not give rise to a contract because it does not create enforceable rights and obligations. Further, it determines that a contract exists for goods only once they are delivered because purchase orders are cancellable at any time before this point.

Example 5 – Framework agreement: Specified minimum purchases

Manufacturer X enters into a framework agreement with Customer Z for the sale of widgets. The agreement sets out the general terms including pricing, warranty, return rights and ordering protocols. In addition, it specifies that X will deliver 1,000 units on the first day of each month for one year.

X determines that the framework agreement gives rise to a contract because it creates enforceable rights and obligations with respect to 1,000 units to be delivered on the first day of each month.

Minimum purchase requirements

IFRS 15.9, 12

Some framework agreements may include a requirement for the customer to purchase a minimum quantity of goods or services. Such a requirement may be a cumulative minimum for the agreement period or for periods within the framework agreement – e.g. each year of a multi-year framework agreement. If the minimum is enforceable, then the framework agreement itself may constitute a contract. However, if the entity's past practice of not enforcing the minimum in the framework agreement results in a conclusion that, based on all of the facts and circumstances, the minimum is not legally enforceable, then the framework agreement would not be a contract.

In addition, if relevant experience with the customer suggests that the customer will not meet the required minimum and that the entity will not seek to enforce it, then this would typically demonstrate in the case of a framework agreement that the entity and the customer are not committed to the minimum in the framework agreement. Consequently, even if the minimum is legally enforceable, the contract may not meet all of the contract existence criteria, in which case it would not be a contract.

Additional steps may be required to create legally enforceable rights and obligations

Generally, the purchase order in combination with the framework agreement will be evaluated to determine whether the Step 1 criteria are met and a contract exists. However, if additional steps must be taken for the purchase order to create legally enforceable rights and obligations (e.g. executing a supplemental contract or addendum to the framework agreement subsequent to receipt of the purchase order), then a contract with a customer will not exist until those steps are completed.

Purchase orders under the same framework agreement may be inter-related

IFRS 15.BC73

In some cases, pricing among the purchase orders may be inter-related. Purchase orders that are issued separately should be evaluated to determine whether they affect other purchase orders under the same framework agreement. When purchase orders are inter-related, this may result in the transaction price for an individual purchase being different from the stated contract price. This may occur for a number of reasons. In some cases, purchase orders may meet the criteria for combining contracts, whereas in other cases the entity will need to consider whether purchase orders give rise to implicit or explicit promises that represent a material right in Step 2 or variable consideration in Step 3 (e.g. rebate or discount arrangements).

Additional application examples

Example 6 – Automotive: Combining nomination letter with subsequent purchase orders

On 1 January, Carmaker F approves Automotive Supplier S's offer to manufacture a specialised part for its cars. F's nomination letter confirms that the price of the units ordered in February and March will be 80 and 100 respectively. F expects to order 50,000 units in each of February and March. To place an order, F will submit a purchase order to S.

S notes that neither the nomination letter nor the framework agreement contains minimum quantities for F to purchase. It concludes that the nomination letter and the framework agreement, on their own, do not create enforceable rights and obligations and, therefore, a contract does not exist under the revenue standard.

S identifies each purchase order as a contract under the standard. This is because S can identify the payment terms and F's right to goods from the purchase orders together with the framework agreement and the nomination letter.

Example 7 – Automotive supplier: Contract exists for engineering services but not for supply of parts

On 1 January, Carmaker G approves Automotive Supplier S's offer to manufacture a specialised part for its cars. G and S agree that S will also perform engineering and design (E&D) activities on behalf of G, necessary for the production of the part. S concludes that these pre-production activities transfer a service to G. The framework agreement between G and S does not specify a separate price for E&D services, but the price of each part includes a mark-up to compensate S for the E&D services. The framework agreement does not state a minimum quantity of parts to be ordered by G.

The agreement also contains a termination clause under which S will be reimbursed for any costs incurred for the E&D services if G terminates the agreement.

On 1 April, S completes the E&D activities.

On 1 December, G orders the first batch of parts.

S concludes that on 1 January no enforceable rights and obligations arise in relation to the parts, because the agreement does not establish minimum quantities of parts to be purchased. However, because the termination clause in the agreement guarantees compensation for the E&D activities, a contract exists for the E&D services under the revenue standard.

1.2 Contract term

IFRS 15.11

The standard is applied to the duration of the contract (i.e. the contractual period) in which the parties to the contract have presently enforceable rights and obligations.

IFRS 15.12

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 both of the following criteria are met:

- 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.

In our view, an economic incentive to renew a contract generally does not itself create enforceable rights and obligations. However, if by terminating a contract a customer forfeits an up-front discount, then an entity should assess whether this represents a termination penalty – i.e. a transfer of value other than a payment due as a result of goods or services transferred up to the termination date.

In our view, foregoing a financing discount – i.e. the benefit of the time value of money – is a termination penalty that an entity should assess when evaluating the contract term. However, if a contract does not contain a significant financing component (see Section 3.2), then we believe that the loss of the financing discount generally does not represent a substantive termination penalty.

Example 8A – Contract term: No substantive termination penalty (1)

Company X enters into a month-to-month wireless contract with Customer Y that includes a handset and voice and data services. Y makes no up-front payment for the handset, but will pay the stand-alone selling price of the handset through monthly instalments over a 24-month period. X determines that the contract with Y does not contain a significant financing component (see Section 3.2). If Y fails to renew the monthly wireless contract, then the remaining balance for the handset becomes due immediately.

In addition, Y pays a monthly service fee for the voice and data services, which represents their stand-alone selling price. The contract does not include any payments other than for the handset and the services.

In assessing the enforceability of the contract, X considers the amounts due if Y decides not to renew at the end of Month 1. X observes that the requirement to repay the remaining balance for the handset when the service contract is not renewed is an economic incentive for Y to renew. X determines that this economic incentive is not a substantive termination penalty, but instead is a repayment of a loan for goods already transferred.

Because X cannot enforce the service contract for a period longer than one month, X concludes that the contract term is one month.

Example 8B – Contract term: No substantive termination penalty (2)

Company T enters into a one-month wireless contract with Customer C for a fee of 50, which represents the stand-alone selling price of the service. C also purchases a handset from T up-front at its stand-alone selling price of 1,000. Under the contract, C can receive a 25 credit on its wireless services each month if it renews the contract for up to 24 consecutive months – i.e. C can receive a discount on the wireless service of 600 (25 x 24 months).

In assessing the enforceability of the contract, T considers the amount due if C decides not to renew the contract. T observes that foregoing future credits in the wireless contract if it is not renewed is an economic incentive for C to renew. However, T determines that this is not akin to a penalty because it is not compensated for the non-renewal of the service. T concludes that it does not have enforceable rights and obligations beyond the first month of service, and therefore the contract term is one month.

T also considers whether 25 credit represents a material right because C has an option to renew the monthly contract at a reduced price (see Section 10.4).

Example 8C – Contract term: Substantive termination penalty

Company X enters into a month-to-month wireless contract with Customer Y for a monthly fee of 50, which represents the stand-alone selling price of the service. Y also purchases a handset that has a stand-alone selling price of 1,000. In exchange for entering into the wireless service plan, the handset is discounted to 400, which Y pays up-front on entering into the contract.

If Y fails to renew the monthly wireless contract for 24 months, then it is required to repay a portion of the discount on the handset in an amount of 25 for each remaining month of service. For example, if Y does not renew the service after 10 months, then it is required to pay 350 to X (25 x 14 months).

In assessing the enforceability of the contract, X considers the amounts due if Y decides not to renew the contract. Based on its analysis of quantitative and qualitative factors, X determines that the requirement for Y to repay a portion of the up-front discount is a substantive termination penalty that creates enforceable rights and obligations – i.e. the contract term is 24 months.

Example 9 – Contract term: Cancellation without penalty after a specified period

Contractor S enters into a manufacturing contract to produce 50 specialised sensors for Customer C for a fixed price of 2,000 per sensor. C can cancel the contract without a penalty after receiving 10 sensors.

S determines that because there is no substantive compensation amount payable by C on termination of the contract – i.e. no termination penalty in the contract – it is akin to a contract to produce 10 sensors that gives C an option to purchase an additional 40 sensors.

Example 10 – Contract term: Cancellable without penalty

Company X contracts with Customer R to provide its service offering for a flat fee of 130 per month, subject to annual increases based on the lesser of 2% or changes in the consumer price index (CPI). The stand-alone selling price for this service is 130. The contract term is indefinite and it is cancellable at the end of each month by either party without penalty.

X determines that the initial contract term is only one month and that the contract term will always be one month under this arrangement. This is because each party has the unilateral, enforceable right to terminate the contract at the end of the then-current month without compensating the other party.

A new contract is deemed to exist each month once each party chooses not to use its cancellation right for that period.

Contract term affects many parts of the standard

The determination of the contract term is important because it may affect the measurement and allocation of the transaction price, the collectability assessment, the timing of revenue recognition for up-front non-refundable fees, contract modifications, and the identification of material rights.

Consideration payable on termination can affect assessment of contract term

If a contract can be terminated by compensating the other party and the right to compensation is considered substantive, then its duration is either the specified period or the period up to the point at which the contract can be terminated without compensating the other party.

However, if a contract can be terminated by either party without substantive compensation, then its term does not extend beyond the goods and services already provided.

In making the assessment of whether the right to compensation is substantive, an entity considers all relevant factors, including legal enforceability of the right to compensation on termination. If an entity has a past practice of not enforcing a termination penalty and that practice changes the legally enforceable rights and obligations, then that could affect the contractual term.

Compensation is broader than only termination payments

A payment to compensate the other party on termination is any amount (or other transfer of value – e.g. equity instruments) other than a payment due as a result of goods or services transferred up to the termination date. It is not restricted only to payments explicitly characterised as termination penalties.

Ability of either party to cancel the contract at discrete points in time may limit the contract term

If an entity enters into a contract with a customer that can be renewed or cancelled by either party at discrete points in time without significant penalty, then it accounts for its rights and obligations as a separate contract for the period during which the contract cannot be cancelled by either party. On commencement of each service period (e.g. a month in a month-to-month arrangement), in which the entity has begun to perform and the customer has not cancelled the contract, the entity normally obtains enforceable rights relative to fees owed for those services and a contract exists.

Evergreen contracts

For the purpose of assessing contract term, an evergreen contract (i.e. a contract that automatically renews) that is cancellable by either party each period (e.g. on a month-to-month basis) without penalty is no different from a similar contract structured to require the parties to actively elect to renew the contract each period (e.g. place a new order, sign a new contract). In these situations, an entity should not automatically assume a contract period that extends beyond the current period (e.g. the current month).

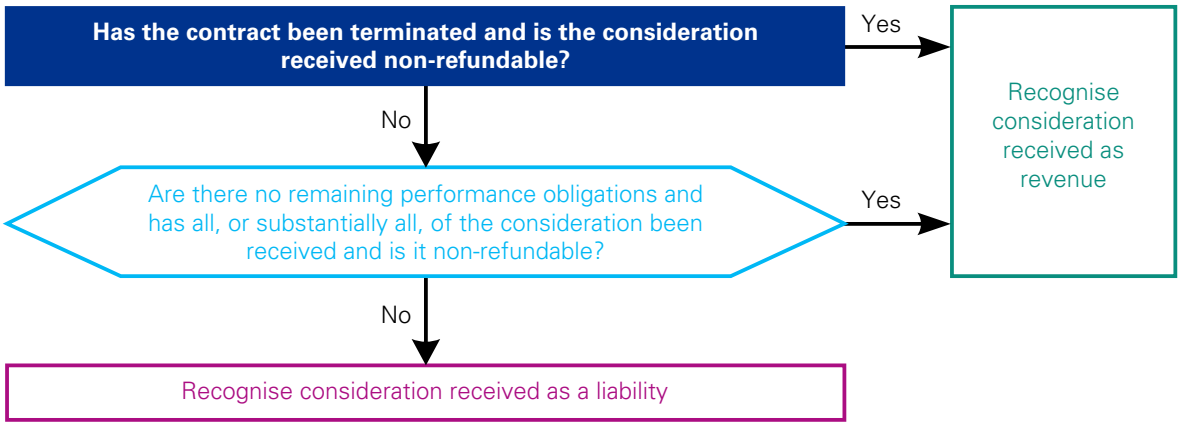
Only the customer has a right to terminate the contract

If only the customer has the right to terminate the contract without penalty and the entity is otherwise obliged to continue to perform until the end of a specified period, then the initial contract term ends on the earliest date on which the customer can terminate. The contract is evaluated to determine whether the customer option to continue the contract for the specified period gives the customer a material right (for discussion of customer options for additional goods or services, see Section 10.4).

1.3 Consideration received before a contract exists

IFRS 15.15–16

The following flowchart outlines when consideration received from a contract that is not yet in the scope of the standard can be recognised.



The entity is, however, required to reassess the arrangement and, if Step 1 of the model is subsequently met, begin applying the revenue model to the arrangement.

Example 11 – Cumulative catch-up adjustment for consideration received before a contract exists

IFRS 15.16

Company C and Customer D enter into a 12-month service agreement that requires D to pay service fees of 800 per month. The agreement expires on 31 May, but C continues to deliver services and D continues to pay 800 a month. A new agreement requiring a fee of 1,000 per month is signed on 31 July, which applies retrospectively from 1 June.

C's legal counsel advises that an enforceable obligation for D to pay C for services provided in June and July did not exist before the new agreement was executed on 31 July. C therefore concludes that a contract did not exist in June and July.

Because the existing contract was terminated on 31 May, C records the June and July payments of 1,600 received from D as revenue only once performance in those months is complete and substantially all of the promised consideration of 1,600 is collected and non-refundable.

Alternatively, if that was not the case then C would defer 1,600 of consideration received and recognise it as a liability until there was an enforceable contract (31 July). C would recognise 2,000 as of 31 July on a cumulative catch-up basis (1,000 for each month) once the agreement is enforceable because the pricing of 1,000 applies from 1 June. For further discussion of the timing of revenue recognition when an entity initially concludes that a contract does not exist and subsequently determines that a contract does exist, see 5.3.1.

However, if it had been determined that an enforceable contract existed as of 1 June even in the absence of a formally executed agreement on 31 July, then revenue would have continued to be recognised on a monthly basis based on a legal interpretation of the enforceable rights and obligations of the parties. Because the monthly fee amount may be uncertain, C would be required to estimate the total amount of variable consideration (subject to the constraint) to which it would be entitled in exchange for transferring the promised services (for further discussion of variable consideration and the constraint, see Section 3.1). In this case, the signing of the contract on 31 July would be accounted for either as an adjustment to the variable consideration or, if the consideration was not deemed to be variable, as a contract modification. For further discussion of contract modifications, see Section 8.2.

Revenue recognition may be deferred for a significant period

If an entity cannot conclude that a legally enforceable contract exists, then it may be difficult to evaluate when all or substantially all of the promised consideration has been received and is non-refundable. In some cases, an entity may have a deposit liability recognised for a significant period of time before it can conclude that a contract exists in the model or that the criteria for recognising the consideration as revenue are met.

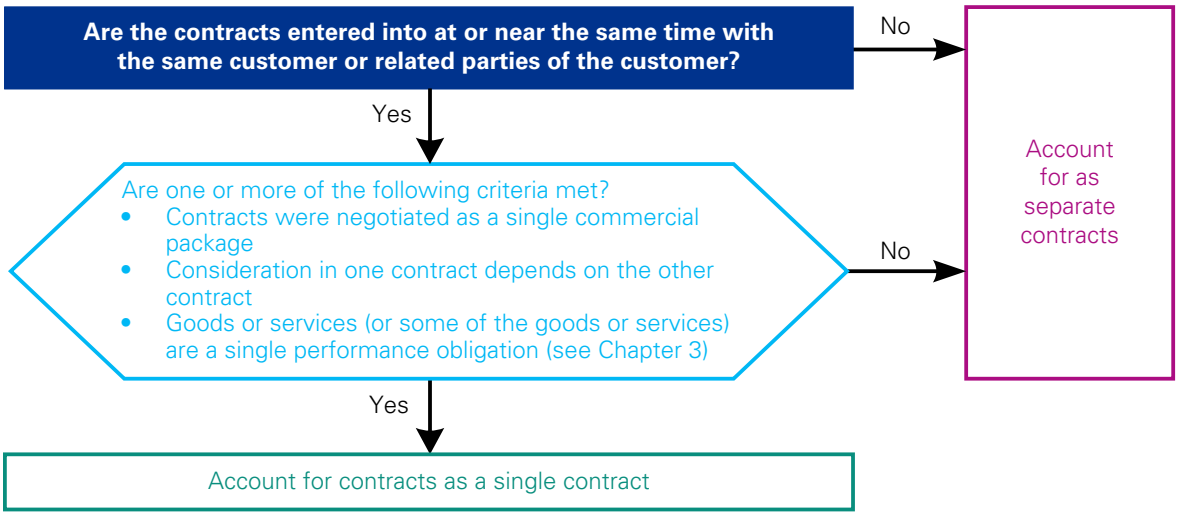
A receivable is generally not recognised when the collectability threshold is not met

Generally, when an entity concludes that a contract does not exist because the collectability threshold is not met, the entity does not record a receivable for consideration that it has not yet received, for the goods or services transferred to the customer.

1.4 Combination of contracts

IFRS 15.17

The following flowchart outlines the criteria in the standard for determining when an entity combines two or more contracts and accounts for them as a single contract.



Example 12 – Combination of contracts: Software-related licence and customisation services

Software Company S enters into a contract to license its customer relationship management software to Customer B. Three days later, in a separate contract, S agrees to provide consulting services to significantly customise the licensed software to function in B's IT environment. B is unable to use the software until the customisation services are complete.

S determines that the two contracts should be combined because they were entered into at nearly the same time with the same customer, and the goods or services in the contracts are a single performance obligation. For further discussion on identifying the performance obligations in a contract (Step 2 of the model), see Chapter 2.

Example 13 – Combination of contracts with government-related entities

Developer D enters into a contract to develop and sell a cyber security system to Government-related Entity X. Three days later, in a separate contract, D enters into a contract to sell the same system to Government-related Entity Y. Both entities are controlled by the same government. During the negotiations D agrees to sell the systems at a deep discount if both X and Y purchase the system.

D concludes that the two contracts should be combined because, among other things, X is a related party of Y, the contracts were entered into at nearly the same time and the contracts were negotiated as a single commercial package. D also needs to assess whether the two systems represent a single performance obligation.

Example 14 – Combination of contracts: Equipment and modification services

Company X sells equipment, Product P. P functions as designed without any customisation or modification services and can be installed at a customer site without X's assistance.

X enters into a contract with Customer R to sell P. After 45 days, X and R enter into a separate agreement for X to provide services to modify R's equipment P. The services include significant modification of P that enhances and changes its functionality.

Although they are executed separately, the two agreements are negotiated during the same time period (even though commencement and completion of the negotiations are not held over the same period) and largely by the same X and R personnel.

X concludes that, if the two contracts were combined, P and the service to customise P would be a single performance obligation (see Chapter 2). X also concludes that the two agreements were negotiated as a package with a single commercial objective – i.e. to enable R to use the customised equipment.

Therefore, because the contract for P and the services agreement are entered into near the same time, the two agreements constitute a single contract. X accounts for the transfer of P and the customisation services as a single performance obligation.

Evaluating 'at or near the same time' when determining whether contracts should be combined

IFRS 15.BC68

The accounting for a contract depends on an entity's present rights and obligations, rather than on how the entity structures the contract. The standard does not provide a bright line for evaluating what constitutes 'at or near the same time' to determine whether contracts should be combined for the purpose of applying the standard. Therefore, an entity should evaluate its specific facts and circumstances when analysing the elapsed period of time.

Specifically, the entity should consider its business practices to determine what represents a minimum period of time that would provide evidence that the contracts were negotiated at or near the same time. Additionally, the entity should evaluate why the arrangements were written as separate contracts and how the contracts were negotiated (e.g. both contracts negotiated with the same parties vs different divisions within the entity negotiating separately with a customer).

An entity needs to establish procedures to identify multiple contracts initiated with the same customer on a timely basis to ensure that these arrangements are evaluated to determine whether they should be combined into a single contract for accounting purposes.

In addition, an entity should consider whether a separate agreement is a modification to the original agreement and whether it should be accounted for as a new contract or as part of the existing contract. For a discussion of contract modifications, see Chapter 8.

Definition of related parties acquires new significance

IFRS 15.BC74, IAS 24

The standard specifies that for two or more contracts to be combined, they should be with the same customer or related parties of the customer. The Board stated that the term 'related parties' as used in the revenue standard has the same meaning as the definition in the related party standard. This means that the definition originally developed in IFRS Accounting Standards for disclosure purposes acquires a new significance, because it can affect the recognition and measurement of revenue transactions.

No exception for contracts entered into with different divisions of the same entity

There is no exception from considering whether two or more contracts should be combined because they were executed by different divisions of the entity or the customer. In fact, contracts with related parties of the customer that may not even be part of the same consolidated entity are considered for possible combination.

However, whether the contracts were negotiated by the same parties or, instead, were negotiated with different divisions of the entity or the customer may in practice influence whether any of the three specified criteria in the standard are met.

For example, two contracts entered into by different divisions of one or both parties may be less likely to have been 'negotiated as a package with a single commercial objective' or to have goods or services that are a single performance obligation.

Additional complexities for sales through distribution channels

When applying the guidance on combining contracts, an entity needs to determine who the customer is under the contract. Contracts entered into by an entity with various parties in the distribution channel that are not customers of the entity are not combined.

For example, for carmakers the customer for the sale of a vehicle is typically a dealer, whereas the customer for a lease of a vehicle is typically the end consumer. Because the dealer and the end consumer are not related parties, these contracts (the initial sales contract for the vehicle to the dealer and the subsequent lease contract with the end consumer) are not evaluated for the purpose of combining them, and are treated as separate contracts. However, in other situations an entity's customer may be acting as an agent for the end consumer. In these situations, the contracts will need to be evaluated for the purpose of combining them.

IFRS 15.BC74

However, performance obligations that an entity implicitly or explicitly promises to an end consumer in a distribution channel – e.g. free services to the end customer when the entity's sale is to an intermediary party – are evaluated as part of the contract. For further discussion on identifying the performance obligations in a contract (Step 2 of the model), see Chapter 2.

2 Identify the performance obligations in the contract (Step 2)

Overview

The process of identifying performance obligations requires an entity to determine whether it promises to transfer either goods or services that are distinct, or a series of distinct goods or services that meet certain conditions. These promises may not be limited to those explicitly included in written contracts. The standard provides indicators to help determine when the 'distinct' criteria are met.

IFRS 15.22–23, 26

A 'performance obligation' is the unit of account for revenue recognition. An entity assesses the goods or services promised in a contract with a customer and identifies as a performance obligation either a:

- good or service (or a bundle of goods or services) that is distinct (see Section 2.1); or
- series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (i.e. each distinct good or service in the series is satisfied over time and the same method is used to measure progress) (see Section 2.3).

This includes an assessment of implied promises and administrative tasks (see Section 2.2).

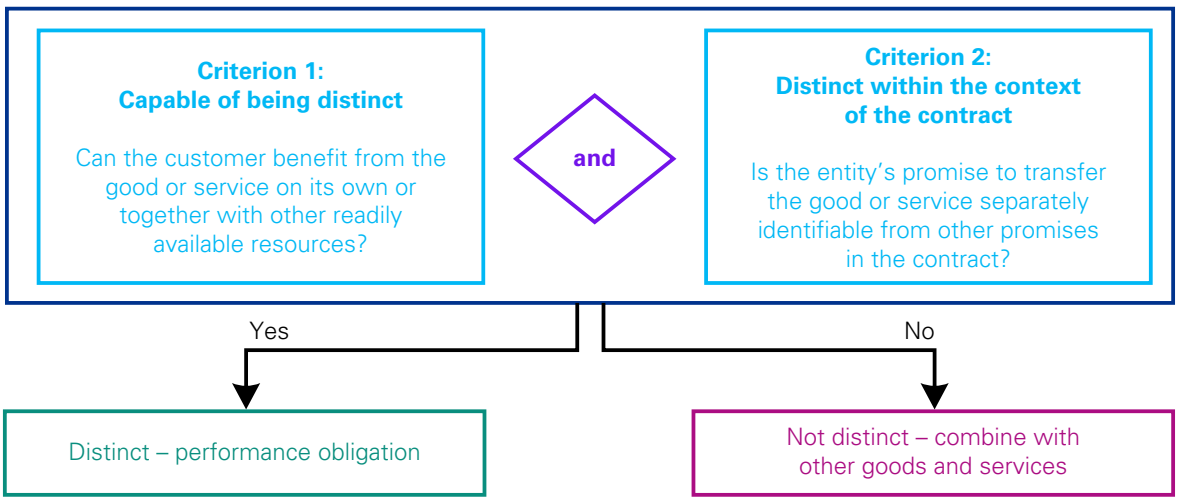
2.1 Distinct goods or services

IFRS 15.22

A single contract may contain promises to deliver to the customer more than one good or service. At contract inception, an entity evaluates the promised goods or services to determine which goods or services (or bundle of goods or services) are distinct and therefore constitute performance obligations.

A good or service is 'distinct' if both of the following criteria are met.

IFRS 15.27



IFRS 15.28

Criterion 1	**Good or service is capable of being distinct** A customer can benefit from a good or service if it can be used, consumed, sold for an amount that is greater than scrap value or otherwise held in a way that generates economic benefits. A customer can benefit from a good or service on its own or in conjunction with: • other readily available resources that are sold separately by the entity or by another entity; or • resources that the customer has already obtained from the entity (e.g. a good or service delivered up-front) or from other transactions or events. The fact that a good or service is regularly sold separately by the entity is an indicator that the customer can benefit from a good or service on its own or with other readily available resources.

IFRS 15.29

Criterion 2	**Distinct within the context of the contract** The objective when assessing whether an entity's promises to transfer goods or services are distinct within the context of the contract is to determine whether the nature of the promise is to transfer each of those goods or services individually, or whether the promise is to transfer a combined item or items to which the promised goods or services are inputs. The standard provides the following indicators to help in evaluating whether two or more promises to transfer goods or services to a customer are not separately identifiable. • The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. This occurs when the entity is using the goods or services as inputs to produce or deliver the output or outputs specified by the customer. A combined output (or outputs) might include more than one phase, element or unit.

	• One or more of the goods or services significantly modifies or customises, or is significantly modified or customised by, one or more of the other goods or services promised in the contract. • The goods or services are highly interdependent or highly inter-related, such that each of the goods or services is significantly affected by one or more of the other goods or services. This list of indicators is not exhaustive.

IFRS 15.30

If a promised good or service is determined not to be distinct, then an entity continues to combine it with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, this results in the entity accounting for all of the goods or services promised in a contract as a single performance obligation.

For guidance and discussion on determining whether the promise to transfer a licence along with other goods or services is distinct, see Section 9.2.

Example 1 – Single performance obligation in a contract

IFRS 15.IE45–IE48

Construction Company C enters into a contract with Customer D to design and build a hospital. C is responsible for the overall management of the project and identifies goods and services to be provided – including engineering, site clearance, foundation, procurement, construction, piping and wiring, installation of equipment and finishing.

C identifies goods and services that will be provided during the hospital construction that might otherwise benefit D on its own. For example, if each construction material is sold separately by other entities, then it could be resold for more than scrap value by D. It could also be sold together with other readily available resources such as additional materials or the services of another contractor.

However, C notes that the goods and services to be provided under the contract are not separately identifiable from the other promises in the contract. Instead, C is providing a significant integration service by combining all of the goods and services in the contract into the combined item for which D has contracted – i.e. the hospital.

Therefore, C concludes that the second criterion is not met and that the individual activities are not distinct and therefore are not separate performance obligations. Therefore, it accounts for the bundle of goods and services to construct the hospital as a single performance obligation.

Example 2 – Multiple performance obligations in a contract

Telco T has a contract with Customer R that includes the delivery of a handset and two years of voice and data services.

The handset can be used by R to perform certain functions – e.g. calendar, contacts list, email, internet access, accessing apps via Wi-Fi and to play music or games.

Additionally, there is evidence of customers reselling handsets on an online auction site and recapturing a portion of the selling price of the phone. T also regularly sells its voice and data services separately to customers, through renewals or sales to customers who acquire handsets from an alternative vendor – e.g. a retailer.

T concludes that the handset and the wireless services are two separate performance obligations based on the following evaluation.

Criterion 1	**Capable of being distinct** • R can benefit from the handset either on its own (i.e. because the handset has stand-alone functionalities and can be resold for more than scrap value and has substantive, although diminished, functionality that is separate from T's network) or together with the wireless services, which are readily available to R because T sells those services separately. • R can benefit from the wireless services in conjunction with readily available resources – i.e. either the handset is already delivered at the time of contract set-up, it could be purchased from alternative retail vendors or the wireless service could be used with a different handset.
Criterion 2	**Distinct within the context of the contract** • The handset and the wireless services are separable in this contract because they are not inputs into a single asset (i.e. a combined output), which demonstrates that T is not providing a significant integration service. • Neither the handset nor the wireless service significantly modifies or customises the other. • R could purchase the handset and the voice/data services from different parties (e.g. R could purchase the handset from a retailer), which provides evidence that the handset and voice/data services are not highly dependent on, or highly inter-related with, each other.

Applying the indicators will require judgement

The standard does not include a hierarchy or weighting of the indicators of whether a good or service is separately identifiable from other promised goods or services within the context of the contract. An entity evaluates the specific facts and circumstances of the contract to determine how much emphasis to place on each indicator.

Certain indicators may provide more compelling evidence in the separability analysis than others in different scenarios or types of contracts. For example, factors such as the degree of customisation, complexity, customer's motivation for purchasing goods or services, contractual restrictions and the functionality of individual goods or services may have differing effects on the distinct analysis for different types of contracts.

In addition, the relative strength of an indicator, in light of the specific facts and circumstances of a contract, may lead an entity to conclude that two or more promised goods or services are not separable from each other within the context of the contract. This may occur even if the other two indicators might suggest separation.

To help an entity apply the indicators, the standard includes many examples illustrating their application. The following table summarises them.

IFRS 15.IE45–IE65A

Example	Description of scenario	Conclusion
10A	Entity provides a significant integration service for a building construction and delivers a single output to the customer	Single performance obligation
10B	Entity provides a significant integration service and delivers multiple complex and specialised items as single outputs to the customer	Single performance obligation
11A	Entity provides the customer with software, installation, unspecified upgrades and telephone support from which it can benefit separately	Multiple performance obligations
11B	Entity provides the customer with installation services that involve significant customisation of the underlying software	Single performance obligation
11C & 11D	Entity provides the customer with equipment and a separately identifiable installation service; customer is required to use entity's installation service in 11D	Multiple performance obligations
11E	Entity provides the customer with equipment and proprietary consumables that are separately identifiable	Multiple performance obligations
12A	Entity provides the customer with a good and an explicit promise to provide a service to the customer's customer, who purchases the good	Multiple performance obligations
12B	Entity provides the customer with a good and an implicit promise to provide a service to the customer's customer, who purchases the good	Multiple performance obligations
12C	Entity provides the customer's customer with a service that is not part of its promise to the customer	Single performance obligation (service is not a performance obligation of the contract)

Applying Criterion 2 requires an entity to assess whether there is a transformative relationship between the two items being analysed

IFRS 15.BC116K

The International Accounting Standards Board (the Board) noted that the evaluation of whether an entity's promise to transfer a good or service is separately identifiable from other promises in the contract considers the relationship between the various goods or services in the contract in the context of the process of fulfilling the contract. An entity considers the level of integration, inter-relation or interdependence among promises to transfer goods or services in evaluating whether the goods or services are distinct.

The Board also observed that an entity does not merely evaluate whether one item, by its nature, depends on the other (i.e. whether the items have a functional relationship). Instead, an entity evaluates whether there is a transformative relationship between the two items in the process of fulfilling the contract.

Separability of risks considered in determining whether goods or services are separately identifiable

IFRS 15.BC105, BC116J–BC116K, IU 03-18

In evaluating whether goods or services are separately identifiable, an entity considers whether the risks that it assumes to fulfil its obligations to transfer goods or services are inseparable.

The IFRS Interpretations Committee discussed a scenario in which an entity enters into a contract with a customer to transfer a plot of land and to construct a building on that plot of land. The Committee noted that in determining whether there is a significant service of integrating the land and the building into a combined output, an entity considers whether the risks that it assumes in transferring the land to the customer are inseparable from the risks that it assumes in constructing the building – i.e. whether its performance would be any different if it did not also transfer the land and vice versa.

The Committee also noted that in determining whether the land and the building are highly interdependent or highly inter-related, the entity considers whether it would be able to fulfil its promise to transfer the land even if it did not construct the building and whether it would be able to fulfil its promise to construct the building even if it did not transfer the land.

The Committee observed that an entity's promise to transfer the land would be separately identifiable from its promise to construct the building if:

- its performance in constructing the building would be the same regardless of whether it transferred the land; and
- it would be able to fulfil each promise without fulfilling the other.

Goods or services promised to a customer's customer may be a performance obligation

IFRS 15.BC92

In some industries, a manufacturer may promise goods or services as sales incentives to the end customers of its customer to encourage the sale of its products through the distribution channel. The standard requires an entity to evaluate the promise to the customer's customer to determine whether it is a performance obligation in the contract with the customer.

Examples of these circumstances are a carmaker that offers free maintenance services to customers who purchase cars from dealerships, a software provider that implicitly offers customer support or updates to end users of its software and a consumer goods company that provides mail-in offers for free goods to end customers.

These promises may be made explicitly in the contract with the customer or implied by an entity's customary business practices, published policies or specific statements. For more discussion on implied promises, see Section 2.2.

Pre-sales advice provided by a software reseller before a contract with a customer exists – Not a promised good or service in the contract

The IFRS Interpretations Committee discussed whether pre-sales advice provided by a software reseller to end customers represents a specified good or service provided to the customer. The Committee observed that the pre-sales advice provided by the reseller to a customer under the distribution agreement between the software manufacturer and the reseller is not an implicit promise in a contract with the customer. The Committee also observed that at the time of entering into a contract with the customer, the reseller has already provided the pre-sales advice. Accordingly, the Committee noted that the only promised goods in the reseller's contract with the customers are the standard software licences. For further discussion of software resellers, see Section 10.3.

Contractual restrictions may not be determinative

IFRS 15.BC100

Contracts between an entity and a customer often include contractual limitations or prohibitions. These may include prohibitions on reselling a good in the contract to a third party or restrictions on using certain readily available resources – e.g. the contract may require a customer to purchase complementary services from the entity in conjunction with its purchase of a good or licence.

IFRS 15.IE58E–IE58F

In Example 11D in the standard, the customer is contractually required to use the seller's installation service to install the purchased good. The example notes that the contractual restriction does not affect the assessment of whether the installation services are considered distinct. Instead, the entity applies Criteria 1 and 2 to assess whether the installation services are distinct. By applying these criteria, Example 11D illustrates that substantive contractual provisions alone do not lead to a conclusion that the goods and services are not distinct.

IFRS 15.BC100

A contractual restriction on the customer's ability to resell a good – e.g. to protect an entity's intellectual property (IP) – may prohibit an entity from concluding that the customer can benefit from a good or service, on the basis of the customer not being able to resell the good for more than scrap value in an available market. However, if the customer can benefit from the good (e.g. telephone support) together with other readily available resources (e.g. a software licence), even if the contract restricts the customer's access to those resources (by requiring the customer to use the entity's products or services), then the entity may conclude that the good or service has benefits to the customer and that the customer could purchase or not purchase the products or services without significantly affecting that good.

Additional application examples

Example 3 – Telco: Purchased modem and router with internet

Telco T enters into a two-year contract for internet services with Customer C. C also buys a modem and a router from T and obtains title to the equipment. T does not require customers to purchase its modems and routers and will provide internet services to customers using other equipment that is compatible with T's network. There is a secondary market in which modems and routers can be bought or sold for amounts greater than scrap value.

T concludes that the modem and router are each distinct and that the arrangement includes three performance obligations (the modem, the router and the internet services) based on the following evaluation.

Criterion 1	**Capable of being distinct** • C can benefit from the modem and router on their own because they can be resold for more than scrap value. • C can benefit from the internet services in conjunction with readily available resources – i.e. either the modem and router are already delivered at the time of contract set-up, they could be bought from alternative retail vendors or the internet service could be used with different equipment.
Criterion 2	**Distinct within the context of the contract** • T does not provide a significant integration service. • The modem, router and internet services do not modify or customise one another. • C could benefit from the internet services using routers and modems that are not sold by T. Therefore, the modem, router and internet services are not highly dependent on or highly inter-related with each other.

Example 4 – Telco: Wi-Fi hotspot access

Telco T offers a premium internet package that includes, among other services, access to Wi-Fi hotspots. Alternatively, T offers a basic internet package that allows, for an additional fee, the same access to Wi-Fi hotspots as the premium package.

T determines that the access to the Wi-Fi hotspots is distinct from the other network services. This is because customers can benefit from the Wi-Fi hotspot access on its own (i.e. it is sold separately). Furthermore, this service is distinct within the context of the contract because the Wi-Fi hotspot access is not highly inter-related with the network services. This is because the customer could choose not to take Wi-Fi hotspot access and the network services would not be significantly affected.

Example 5 – Technology company: Ongoing support that is not distinct

Company V grants Customer C a three-year licence for anti-virus software. Under the contract, V promises to provide C with when-and-if-available updates to that software during the licence period. The updates are critical to the continued use of the anti-virus software.

V concludes that the licence and the updates are capable of being distinct because the anti-virus software can still deliver its original functionality during the licence period without the updates. C can also benefit from the updates together with the licence transferred when the contract is signed.

However, V concludes that the licence and the updates are not separately identifiable because the software and the service are inputs into a combined item in the contract – i.e. the nature of V's promise is to provide continuous anti-virus protection for the term of the contract. Therefore, V accounts for the licence and the updates as a single performance obligation.

Example 6 – Technology company: Software licence and customisation services

Company M licenses Product P – asset management system software – to customers. P functions as designed without any customisation or modification and can be implemented without M's help in its standard form.

M enters into a contract with Bank B to grant a licence of P and to provide customisation services. This includes modifying certain off-the-shelf settings – e.g. adding an option to access and value a portfolio in multiple foreign currencies. The customisation of P is expected to take a long time and will significantly affect B's ability to use P.

M evaluates the promised goods and services in the contract to determine the number of separate performance obligations.

M determines that the software licence and the customisation services are capable of being distinct, because:

- B could derive benefit from the licence for P on its own or with readily available implementation services; and
- B can benefit from the customisation services together with the licence to P that is transferred at contract inception.

However, M determines that the licence and the customisation services are not separately identifiable – i.e. there is a single performance obligation. This is because:

- the customisation services significantly customise P; and
- P, in its off-the-shelf form, and the customisation services are inputs into the combined output that the customer has contracted to receive – i.e. the customised software.

Example 7 – Technology company: Hosted software with on-premises application

Company D offers its customers access to its hosted software, which permits access to D's data. A customer can then manipulate that data in a variety of ways. The software is hosted only on D's servers and is accessible only in online mode. D also offers customers use of an on-premises application that converts the data into other, more useable, formats – e.g. an Excel spreadsheet. However, the on-premises application can provide search results only when it is connected to the hosted software. There are no other hosted applications that a customer can use with D's on-premises application and D does not sell access separately.

D concludes that the licence for the hosted software is not capable of being distinct from its hosting services. This is because the software can be used only while it is hosted on D's servers and is not available separately in the market.

D also concludes that the on-premises application is not capable of being distinct, because customers cannot benefit from the on-premises feature without the hosted software or together with other readily available resources.

Example 8 – Media company: Magazine subscription that includes printed copies and access to online content

Media Company P offers magazine subscriptions to customers. When customers subscribe, they receive a printed copy of the magazine each month and access to the magazine's online content.

P evaluates whether the promises to provide printed copies and online access are separate performance obligations. P determines that the arrangement includes two performance obligations for the following reasons.

- The printed copies and online access are both capable of being distinct because the customer could use them on their own.
- The printed copies and online access are distinct within the context of the contract because they are different formats so they do not significantly customise or modify each other, nor is there any transformative relationship into a single output.

Example 9 – Automotive supplier: Pre-production activities are not distinct from prototype

Automotive Supplier S enters into a contract with Carmaker B to supply a prototype of a specialised component as part of a new product that B is developing. The component is based on a newly developed technology and supplying it will require extensive pre-production engineering activity. According to the contract, B has the right to the IP resulting from S's activities and S is obliged to provide periodic updates on its development process, which B requires for the development of other parts of the product.

B guarantees that S will be compensated for the costs of the engineering activities, including a reasonable margin. However, B does not commit to a minimum quantity of parts. Any subsequent purchase order will be priced in accordance with its stand-alone selling price. Therefore, S observes that the contract does not include a promise to produce additional components. Further, it concludes that the contract does not provide a material right to purchase components at a discount (see Section 10.4).

S concludes that it effectively transfers the know-how arising from its pre-production activities to B. Therefore, it identifies two promises in its contract with B:

- pre-production engineering activities; and
- production of a component prototype.

Criterion 1	**Capable of being distinct** S assesses the promises in the contract and determines that each of the promised goods and services is capable of being distinct. This is because B can benefit from the IP generated by the pre-production activities using readily available production services offered by other suppliers. S can also produce the prototype using IP that it has already transferred to B.

Criterion 2	**Distinct within the context of the contract** When determining whether the pre-production activities and the production of the prototype are distinct within the context of the contract, S notes that there is a transformative relationship between the two, because the outcome of the engineering and the development process will determine to a great extent the structure of the prototype. It also notes that the nature of the promise to B is to provide it with a customised prototype, built to its specifications. Therefore, it concludes that the pre-production activities and the production of the prototype are a single performance obligation.

2.2 Implied promises and administrative tasks

IFRS 15.24–25

Promises to transfer a good or service can be explicitly stated in the contract or be implicit based on established business practices or published policies that create a valid expectation that the entity will transfer the good or service to the customer.

Conversely, administrative tasks do not transfer a good or service to the customer and are not performance obligations – e.g. administrative tasks to set up a contract.

Example 10 – Implied promise to reseller's customers

Software Company K enters into a contract with Reseller D, which then sells software products to end users. K has a customary business practice of providing free telephone support to end users without involving the reseller, and both expect K to continue to provide this support.

In evaluating whether the telephone support is a separate performance obligation, K notes that:

- D and the end customers are not related parties and, as such, these contracts will not be combined; and
- the promise to provide telephone support free of charge to end users is considered a service that meets the definition of a performance obligation when control of the software product transfers to D.

As a result, K accounts for the telephone support as a separate performance obligation in the transaction with D.

Example 11 – Administrative task: Registration of software keys

Software Company B licenses and transfers operating system software to Customer L. The operating system software will not function on L's computer hardware without a key provided by B. L has to provide B with the serial number from the hardware to receive the key. If L orders hardware from a different supplier and has not received the hardware when the operating system software is delivered, then it is still obliged to pay for the operating system software because payment is not contingent on delivery of the key.

In this example, the operating system software is ready for use by L and delivery of the key is contingent only on L's actions. As such, it is an administrative task that does not transfer a promised good or service and therefore is not considered to be a promised service in the contract. Assuming that all other revenue recognition criteria have been met – including L obtaining control of the operating system software – B recognises revenue on delivery of the operating system software. For discussion on the timing and pattern of recognition of licences, see Section 9.4.

Only promises that transfer goods or services to the customer can be performance obligations

IFRS 15.BC93, BC411(b)

An entity does not account for a promise that does not transfer goods or services to the customer. For example, an entity's promise to defend its patent, copyright or trademark is not a performance obligation.

Set-up activities as administrative task

A software-as-a-service (SaaS) provider may perform tasks that are necessary for the customer to access its web-based software application. These tasks range from a simple activation service in some situations to more complex up-front activities needed to allow the customer to access the SaaS services from the customer's IT platform.

Generally, these types of set-up activities provide no incremental benefit to the customer and therefore constitute an administrative task. However, the necessity of completing these activities before the customer can begin accessing the underlying service may affect the timing of when revenue recognition may begin.

Providing end-user documentation is generally an administrative task

Providing end-user documentation (e.g. instruction manuals) is generally an administrative task if it is provided to allow the customer to obtain the inherent utility of the good or service (i.e. does not provide incremental benefit to the customer).

Conversely, information of an advisory or consulting nature that helps the customer do more than simply achieve the base utility from the good or service may provide incremental benefit to the customer and therefore represent a good or service to be transferred to the customer.

Distinguishing between an administrative task and a promised good or service

The transfer of a promised good or service requires the customer to be able to obtain the benefit from that good or service. Therefore, an activity that does not provide any benefit beyond access to other goods or services is generally an administrative task or set-up activity.

In general, set-up activities involving the entity's own systems or IP will not provide the customer with incremental benefits and therefore do not represent goods or services. Examples of set-up activities include the following.

- *Activation of a wireless contract:* Entities may charge a fee to activate a wireless customer's access to the network and to cover the cost of required tasks such as setting up the wireless service, processing a new customer in the billing system and performing a credit check. These activities do not provide the customer with benefit beyond allowing the customer to access the subsequent services.
- *Outsourcing contracts:* An entity may need to design or build technology for its internal use to provide a service to a customer. The costs of designing and migrating data for internal use to provide services to the customer in the future do not provide the customer with incremental benefits beyond accessing the service.
- *Software as a service:* A SaaS provider may implement a user interface that permits the customer to access its online platform. These activities, permitting the customer to access the SaaS for which it has contracted, provide no incremental benefit beyond the customer accessing the platform.

However, goods or services transferred to a customer that provide some measure of benefit beyond solely being able to access another good or service will generally be promised goods or services. When another entity provides similar services to customers on a stand-alone basis or the customer could perform the tasks, it is a strong indicator that the good or service is a promised service rather than a set-up activity.

Examples of up-front activities that are generally promised goods or services include:

- performing customer-specific services that enhance the customer's asset; and
- providing training services to permit the customer to use the service more effectively.

Example 12 – Implied performance obligation: Pre- and post-sale incentives

Carmaker N has a historical practice of offering free maintenance services – e.g. oil changes and tyre rotation – for two years to the end customers of dealers who buy its vehicles. However, the two years' free maintenance is not explicitly stated in the contract with its dealers, but it is typically stated in N's advertisements for the vehicles.

Therefore, the maintenance is treated as a separate performance obligation in the sale of the vehicle to the dealer. Revenue from the sale of the vehicle is recognised when control of the vehicle is transferred to the dealer. Revenue from the maintenance services is recognised as the maintenance services are provided to the retail customer.

IFRS 15.IE64–IE65

However, if N did not have a customary business practice of offering free maintenance, and instead announced a maintenance programme as a limited-period sales incentive after control of the vehicle has transferred to the dealer, then the free maintenance would not be a separate performance obligation in the sale of the vehicle to the dealer.

In this case, N would recognise the full amount of revenue when control of the vehicle was transferred to the dealer. If N subsequently created an obligation by announcing that it would provide incentives, then N would accrue as an expense its expected cost of providing maintenance services on the vehicles in the distribution channel – i.e. controlled by dealers – when the programme was announced.

Determining whether a sales incentive to end customers was offered before or after sale to the dealer will be challenging for some entities, especially for implied sales incentives in which the entity has a customary business practice of offering incentives or does so on a seasonal basis. The entity will need to assess whether the dealer and customer have a valid expectation that the entity will provide a free service.

Example 13 – Technology company: Set-up activities vs implementation services

Company S enters into a contract to provide Customer C with a licence to its hosted software for three years.

As part of the contract and before commencement of the licence term, S creates C's user interface so that C can access the software. S also agrees to convert and migrate C's data to the new software.

S evaluates each of these activities and concludes that:

- creating the user interface is a set-up activity rather than a promised service to C, because it provides no incremental benefit to C beyond permitting C to access and use the software; and
- the data conversion and migration activities are services that give C incremental benefits beyond the ability to access and use the software. The data conversion and migration activities that S performs would otherwise need to be performed by C or another service provider. Therefore, S determines that the data conversion and migration activities represent a service to C and assesses whether they represent a separate performance obligation from the ongoing hosting services.

Example 14 – Telco: Activation fee in a wireless contract

Telco T charges a one-time activation fee of 25 to Customer C when C enters into a wireless contract for a voice and data plan. The activation of a new wireless customer to the network requires various tasks, including setting up the wireless service, processing C in the billing system and credit checks.

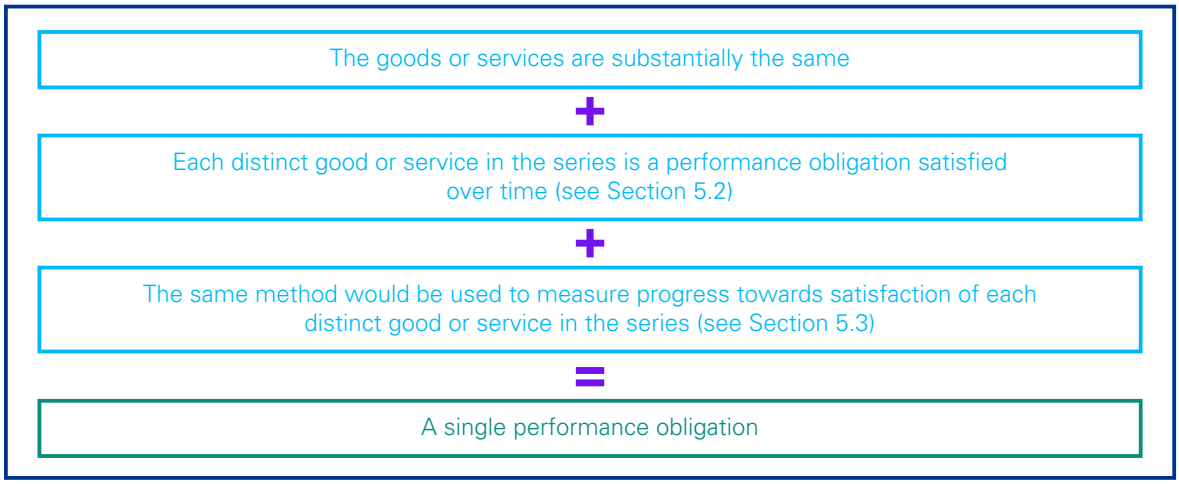
T determines that activation activities are administrative in nature and therefore do not constitute a separate promise to C to be assessed as a separate performance obligation. Because the activation fee is charged at contract inception and is not refundable, T applies the guidance on non-refundable up-front fees (see Section 10.6).

2.3 Series of distinct goods or services

IFRS 15.22(b)

A contract may contain promises to deliver a series of distinct goods or services that are substantially the same. At contract inception, an entity assesses the goods or services promised in the contract and determines whether the series of goods or services is a single performance obligation. This is the case when they meet the following criteria.

IFRS 15.23



Example 15 – Series of distinct goods or services treated as a single performance obligation

Contract Manufacturer X agrees to produce 1,000 customised widgets for use by Customer C in its products. X concludes that the widgets will transfer to C over time because:

- they have no alternative use to X; and
- C is contractually obliged to pay X for any finished or in-progress widgets, including a reasonable margin, if C terminates the contract for convenience.

X already has the process in place to produce the widgets and is given the design by C, such that X does not expect to incur any significant learning curve or design and development costs. X uses a method of measuring progress towards complete satisfaction of its manufacturing contracts that takes into account work in progress and finished goods controlled by C.

X concludes that each of the 1,000 widgets is distinct, because:

- C can use each widget on its own; and
- each widget is separately identifiable from the others because one does not significantly affect, modify or customise another.

Despite the fact that each widget is distinct, X concludes that the 1,000 units are a single performance obligation because:

- each widget will transfer to C over time; and
- X uses the same method to measure progress towards complete satisfaction of the obligation to transfer each widget to C.

Consequently, X recognises the transaction price for all 1,000 widgets over time using an appropriate measure of progress. This outcome may be different from the outcome of allocating a fixed amount to each widget if each one were a performance obligation.

Example 16 – Distinct service periods within a long-term service contract

Cable Company R enters into a two-year service contract with Customer M to provide cable television service for a fixed fee of 100 per month. R has concluded that its cable television service is satisfied over time because M consumes and receives the benefit from the service as it is provided – e.g. customers generally benefit from each day that they have access to R's service.

R determines that each increment of its service – e.g. day or month – is distinct because M benefits from that period of service on its own. Additionally, each increment of service is separately identifiable from those preceding and following it – i.e. one service period does not significantly affect, modify or customise another. However, R concludes that its contract with M is a single performance obligation to provide two years of cable television service because each of the distinct increments of service is satisfied over time. Also, R uses the same measure of progress to recognise revenue on its cable television service regardless of the contract's time period.

No exemption from applying the series guidance

If the series guidance requirements are met for a good or service, then that series is treated as a single performance obligation (i.e. the series guidance is not optional).

Accounting for a series is intended to provide a simplification of the model

IFRS 15.BC113–BC114

The Board believes that accounting for a series of distinct goods or services as a single performance obligation if they are substantially the same and meet certain criteria generally simplifies application of the model and promotes consistency in identifying performance obligations in a repetitive service arrangement. For example, without the guidance on series of goods or services, an entity may need to allocate consideration to each hour or day of service in a cleaning service contract.

The Board also gave transaction processing and the delivery of electricity as examples of a series of goods or services.

However, in some cases applying the series guidance may complicate application of the model. For example, this may be the case for common transactions in certain industries (e.g. aerospace and defence) and other types of transactions that involve producing a relatively small number of products that meet the series guidance. For this reason, some stakeholders requested amendments to the standard to make application of the series guidance optional. The Board declined to do so and reiterated that this guidance is not optional.

IFRS 15.BC115

However, if the contract is modified then the entity considers the distinct goods or services, rather than the performance obligation. This in turn simplifies the accounting for the contract modification (see Chapter 8).

Determining the nature of the entity's promise to the customer is the first step in applying the series guidance

Determining the nature of the entity's promise is the first step in determining whether the series guidance applies. For example, if the nature of the promise is the delivery of a specified quantity of a good or service, then the evaluation considers whether each good or service is distinct and substantially the same.

Conversely, if the nature of the entity's promise is to stand ready or to provide a single service for a period of time (i.e. there is not a specified quantity to be delivered), then the evaluation will probably focus on whether each time increment, rather than the underlying activities, is distinct and substantially the same.

Identifying distinct goods or services as a series may affect the allocation of variable consideration

Even if per-unit pricing is fixed, if the quantity related to a series is not specified then it results in variable consideration (see Section 3.1). However, an entity is not required to allocate variable consideration across the distinct goods or services included in a series on a stand-alone selling price basis. Instead, it follows the general guidance in the standard on allocating variable consideration entirely to a performance obligation or a distinct good or service that forms part of a performance obligation (see Chapter 4). For example, this may be relevant if the goods or services in the series and any other performance obligations in the contract are priced at market rates.

Not necessary for goods or services to be provided consecutively

To apply the series guidance, it is not necessary for the goods to be delivered or services performed consecutively over the contract period. There may be a gap or an overlap in delivery or performance and this would not affect the assessment of whether the series guidance applies.

Although the Board specifically contemplated a consecutively delivered contract (e.g. repetitive service arrangement), it did not make this distinction a criterion for applying the series guidance.

Additional application examples

Example 17 – Automotive supplier: Series of distinct goods

Automotive Supplier S enters into a framework agreement with Carmaker C to produce specialised sensors for a fixed price of 200 per sensor. Subsequently, C places a non-cancellable purchase order for 1,000 sensors. The framework agreement and the purchase order constitute a contract in the scope of the standard.

S concludes that each sensor is capable of being distinct and is distinct in the context of the contract because:

- the sensors individually provide a benefit;
- one sensor does not significantly affect, modify or customise another; and
- S does not provide a significant integration service.

S also determines that the contract meets the criteria for the revenue to be recognised over time. S concludes that the distinct sensors meet the series criteria because:

- all 1,000 sensors are of the same design: i.e. substantially the same;
- they meet the over-time criteria; and
- the measure of progress is the same because each sensor is manufactured identically.

Therefore, the 1,000 sensors are accounted for as a single performance obligation for which revenue is recognised over time, with a transaction price of 200,000.

S expects to incur significant learning curve costs in the production of the first units. Therefore, if S chose a cost-to-cost measure of progress for the performance obligation, then revenue recognised for the earlier units produced would be more than 200 per sensor and revenue for the later units produced would be less than 200 per sensor.

Example 18 – Investment management: Series of distinct services

Investment Management Company S enters into a five-year contract with a customer to provide investment management services. S receives a 2% quarterly management fee based on the assets under management at the end of each quarter.

S concludes that the individual time increments of service within the five-year contract are distinct from each other. Criterion 1 is met because the customer can benefit from each time increment of service provided independently of the others. Criterion 2 is met because each time increment does not significantly modify or customise the others and S is not providing a service of combining the time increments together to create a single combined output for the customer.

S concludes that the distinct time increments meet the series criteria because:

- the services provided in each time increment are substantially the same;
- the services meet the over-time criteria, because the customer consumes the benefits of the services as they are provided; and
- the same method to measure progress would apply to each time increment of service – i.e. a time-based measure of progress.

Therefore, S treats the contract as a single performance obligation.

Example 19 – Telco: Term wireless service contract with fixed fee and limited usage

Telco T enters into a two-year wireless contract with Customer C to provide 120 minutes of voice service for a fixed fee of 20 per month. The voice plan allows C to use 120 minutes each month for calls and the handset will not function for voice purposes once the minutes are used. The 120 minutes expire at the end of every month.

T concludes that the voice services are satisfied over time because C receives and consumes the benefit from the services as they are provided – e.g. customers generally benefit from each minute that they receive T's services.

T determines that each minute is distinct because C benefits from that minute of service on its own. Additionally, each minute is separable from those preceding and following it – i.e. one service period does not significantly affect, modify or customise another.

T applies the series guidance and concludes that its contract with C is a single performance obligation to provide 2,880 minutes (120 × 24 months) of wireless service. T determines that each of the distinct minutes of voice is satisfied over time and the same method would be used to measure progress.

Example 20 – Automotive: Maintenance contract

Carmaker M enters into a 10-year maintenance contract with Customer C. M provides C with an integrated service of maintenance and related activities for equipment that M sold to C. C pays M based on the equipment hours used during the contract period, regardless of whether M performs maintenance or makes repairs during that period.

M concludes that it is providing a stand-ready service to C because the nature of the promise is to deliver an unknown quantity of the underlying activities as an integrated service when and as needed by C for 10 years.

M concludes that each day of service is distinct, because C can continually benefit from the equipment covered by the contract and each day is separately identifiable – i.e. one service period does not significantly affect, modify or customise another.

However, M applies the series guidance and concludes that its contract with C is a single performance obligation to provide 10 years of maintenance, because revenue will be recognised over time as C consumes the benefit of the service as it's provided and the same measure of progress would be applied for each distinct increment because the promise is the same for each increment.

Example 21 – Transaction processor: Processing arrangement

Transaction Processor P enters into a 10-year transaction processing arrangement with Customer C under which P will provide continuous access to its system and process all transactions on behalf of C. C is charged a fee for each transaction processed but the number of transactions processed is outside the control of C.

P concludes that its promise is to stand ready to process transactions on behalf of C as they arise over the contract period. P concludes that each day of service is substantially the same because the nature of the promise (to provide continuous access to the platform) is the same for each increment.

P concludes that each day's service is considered distinct because C can benefit from accessing its system each day and each day is separately identifiable – i.e. one service period does not significantly affect, modify or customise another.

However, P applies the series guidance and concludes that its contract with C is a single performance obligation to provide transaction processing services for 10 years because revenue will be recognised over time as C consumes the benefit of the service as it is provided and the same measure of progress will be applied for each distinct increment because the promise is the same for each increment.

Example 22 – Series of distinct services treated as single performance obligation

Company X enters into a two-year service contract with a customer to provide a weekly cleaning service for a fixed fee of 100 per week.

X determines that its performance of the cleaning services is satisfied over time, because the customer consumes and receives the benefit from the services as they are provided – i.e. the customer benefits from cleaning services as X performs (see Section 5.2).

X determines that each increment of its services – e.g. month, day etc – is distinct, because the customer benefits from that period of service on its own and each increment of service is separable from those preceding and following it – i.e. one service period does not significantly affect, modify or customise another.

X determines that its contract with the customer is a single performance obligation to provide two years of cleaning services because:

- services are substantially the same;
- each of the distinct increments of services is satisfied over time; and
- the same measure of progress to recognise revenue is used.

3 Determine the transaction price (Step 3)

Overview

IFRS 15.47

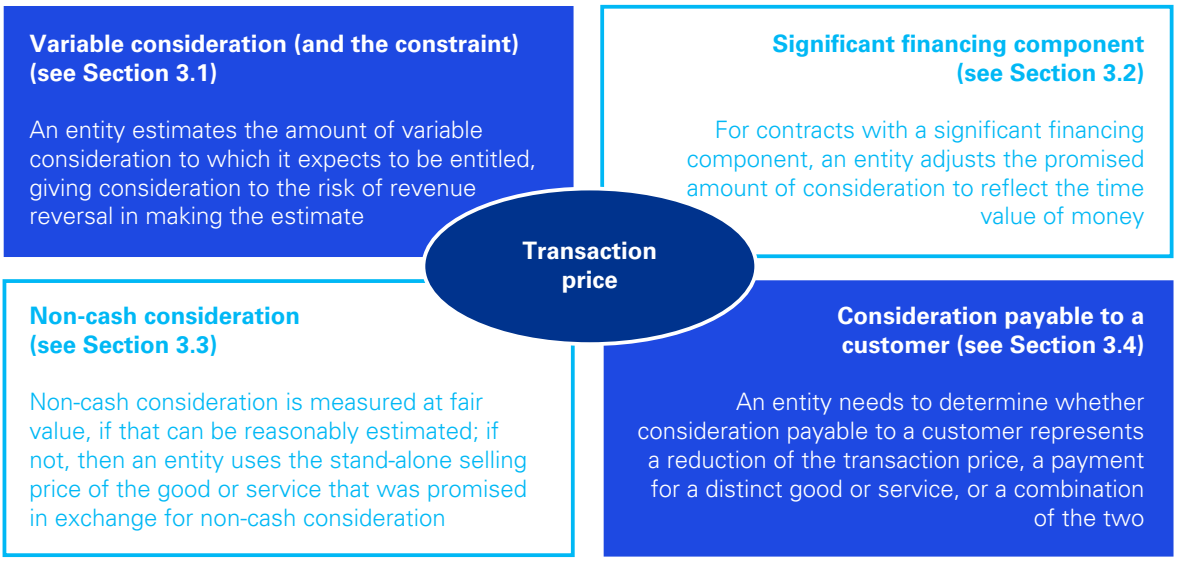
The 'transaction price' is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g. certain sales taxes. To determine this amount, an entity considers multiple factors.

IFRS 15.49

An entity estimates the transaction price at contract inception, including any variable consideration, and updates the estimate each reporting period for any changes in circumstances. When determining the transaction price, an entity assumes that the goods or services will be transferred to the customer based on the terms of the existing contract and does not take into consideration the possibility of a contract being cancelled, renewed or modified.

In determining the transaction price, an entity considers the following components.

IFRS 15.48



IFRS 15.9(e), 60

Customer credit risk is not considered when determining the amount to which an entity expects to be entitled – instead, credit risk is considered when assessing the existence of a contract (see Chapter 1). However, if the contract includes a significant financing component provided to the customer, then the entity considers credit risk in determining the appropriate discount rate to use (see Section 3.2).

IFRS 15.58, B63

There is an exception to the variable consideration guidance for sales- or usage-based royalties arising from licences of intellectual property (IP) (see Section 9.6).

Transaction price may include amounts not paid by the customer

IFRS 15.47, BC187

The transaction price may include amounts that are not paid by the customer. For example, a healthcare company may include amounts to be received from the patient, insurance companies and government organisations in determining the transaction price. In another example, a retailer may include in the transaction price amounts received from a manufacturer as the result of coupons or rebates issued by the manufacturer directly to the end customer.

Transaction price may include fair value of derivative on settlement date

IU 03-19

The transaction price may include the fair value of a derivative on the settlement date of a sales contract that does not meet the 'own use' scope exception in the financial instruments standard. For example, an entity may enter into a contract to sell non-financial items that fall in the scope of the financial instruments standard. The entity accounts for the contract as a derivative measured at fair value through profit or loss. At the settlement date, the entity physically settles the contract by delivering the non-financial items. If the entity's accounting policy for such contracts is to recognise revenue for the sale of non-financial items on a gross basis, then the transaction price includes cash received and the fair value of the derivative on the settlement date.

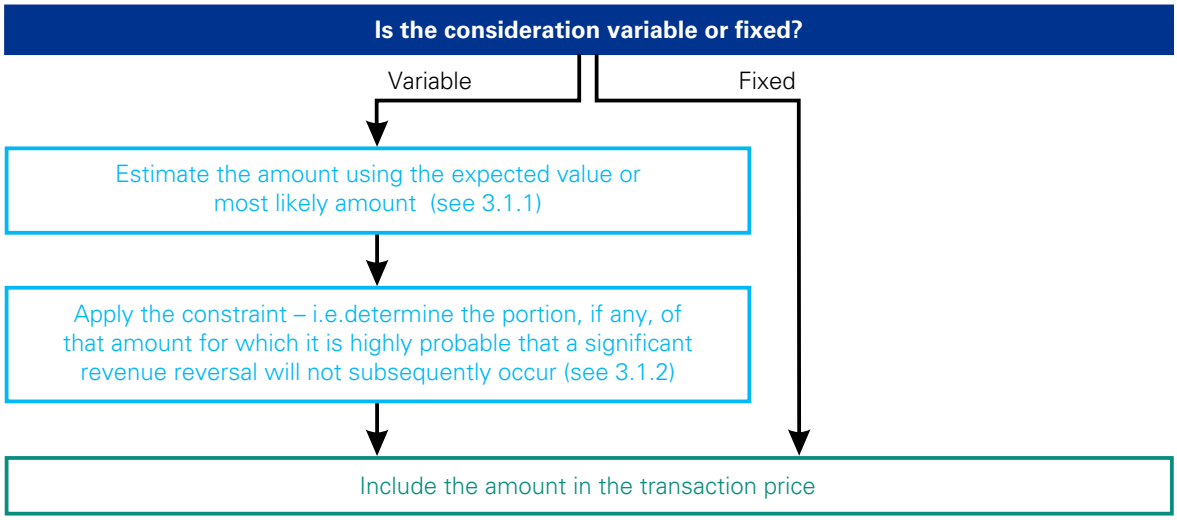
3.1 Variable consideration (and the constraint)

IFRS 15.51–52

Items such as discounts, rebates, refunds, rights of return, early settlement discounts, credits, price concessions, incentives, performance bonuses, penalties or similar items may result in variable consideration. Promised consideration can also vary if it is contingent on the occurrence or non-occurrence of a future event – e.g. the sale of an office building in which the consideration depends on the level of occupancy of the building at a future date. Variability may be explicit or implicit, arising from customary business practices, published policies or specific statements, or any other facts and circumstances that would create a valid expectation by the customer.

IFRS 15.53, 56, 58

An entity assesses whether, and to what extent, it can include an amount of variable consideration in the transaction price at contract inception. The following flowchart sets out how an entity determines the amount of variable consideration in the transaction price, except for sales- or usage-based royalties from licences of IP (see Section 9.6).



IFRS 15.55

An entity recognises a refund liability for consideration received or receivable if it expects to refund some or all of the consideration to the customer.

The standard applies the mechanics of estimating variable consideration in a variety of scenarios, some of which include fixed consideration – e.g. sales with a right of return (see Section 10.1) and customers' unexercised rights (breakage) (see Section 10.5).

Example 1 – Enterprise service contract with usage fee treated as variable consideration

IFRS 15.22(b), 23

Telco T enters into a contract with Customer C to provide call centre services. These services include providing dedicated infrastructure and staff to stand ready to answer calls. T receives consideration of 0.50 per minute for each call answered.

T observes that C does not make separate purchasing decisions every time a user places a call to the centre and that the nature of the services provided to C is substantially the same in each case. Therefore, T concludes that its performance obligation is the overall service of standing ready to provide call centre services, rather than each call answered being the promised deliverable. It therefore concludes that the per-minute fee is variable consideration.

Example 2 – Enterprise service contract with penalties

Telco B enters into an agreement to provide data hosting services to a large business customer, Company C, for a period of five years. Certain service-level agreements (SLAs) are signed by B as part of the contract with C. Specifically, the SLAs will result in a reduction of consideration paid by C to B, if B does not meet a specified level of service. Because the SLAs are part of the contract with C, the SLA penalties create variable consideration.

Therefore, B estimates the amount of the penalties at contract inception in determining the transaction price. For a discussion on the variable consideration allocation exception, see Section 4.2.

Example 3 – Estimate of variable consideration: Expected value

Manufacturing Company S introduced a new product on the market – 'Greener S' – which is a compostable bioplastic that can be used in a broad range of products, including 3D printing, durable goods and rigid food packing. Greener S is more expensive than the environmentally unfriendly plastic raw materials previously used. To make the new product more attractive, S offers Customer C the following volume-based incentive. C receives 100,000 warrants to acquire S's shares for every 5 million units purchased.

The contract between S and C does not specify a minimum order requirement and S recognises revenue for each order of Greener S on delivery of the units to C – i.e. at a point in time.

S evaluates the arrangement and determines that it does not receive any distinct goods or services from C in return for the warrants issued. Therefore, S considers the warrants as part of its analysis under the revenue standard and accounts for them as variable consideration payable to a customer because they represent a retrospective rebate. S considers the guidance on non-cash consideration in determining the transaction price. In addition, S applies the financial instruments guidance to determine the appropriate accounting for the warrants. This involves assessing whether the arrangement includes a derivative that requires remeasurement through profit or loss until settlement or expiry.

Consideration can be deemed to be variable even if the price stated in the contract is fixed

IFRS 15.BC190–BC194

The guidance on variable consideration may apply in a wide variety of circumstances. The promised consideration may be variable if an entity's customary business practices and relevant facts and circumstances indicate that the entity may accept a lower price than what is stated in the contract – i.e. the contract contains an implicit price concession or the entity has a history of providing price concessions or price support to its customers.

In these cases, it may be difficult to determine whether the entity has implicitly offered a price concession or whether it has chosen to accept the risk of default by the customer of the contractually agreed consideration (customer credit risk). Entities need to exercise judgement and consider all of the relevant facts and circumstances in making this determination (see Section 3.1).

A fixed rate per unit of output may be variable consideration

When an entity enters into a contract with a customer for an undefined quantity of output at a fixed contractual rate per unit of output, the consideration may be variable. In some cases there may be substantive contractual terms that indicate that a portion of the consideration is fixed – e.g. contractual minimums.

For contracts with undefined quantities, it is important to appropriately evaluate the entity's underlying promise to determine how the variability created by the unknown quantity should be treated under the standard. For example, the entity's underlying promise could be a series of distinct goods or services (see Section 2.3), a stand-ready obligation or an obligation to provide the specified goods or services. Unknown quantities could also represent customer options for additional goods or services for which the entity will need to consider whether a material right exists (see Section 10.4).

Quantity subject to confirmation after delivery is variable consideration

In some contracts, the actual quantity delivered may be confirmed after control transfers to the customer (see Chapter 5). For example, a mining entity transfers control of copper concentrate to a customer and then the customer determines the actual quantity of copper delivered after processing the concentrate. The final amount paid by the customer is based on this actual quantity. In our view, such arrangements, in which the transaction price may vary depending on the quantity subject to confirmation after delivery, include variable consideration.

Provisional pricing based on market price of commodity

IASBU 12-15

Some contracts may contain provisional pricing features under which the transaction price is based on the spot rate of the commodity at the payment due date. This may be later than the date at which the performance obligation is satisfied. In contrast with the scenarios discussed above, variability arising solely from changes in the market price after control transfers is not subject to the variable consideration guidance in the standard. This is because at the delivery date a receivable already exists and it is in the scope of the financial instruments standard.

Variable consideration or optional purchases

Different outcomes and disclosure requirements can arise depending on whether an entity concludes that purchases of additional goods or services by a customer are exercises of customer options or variable consideration. Future purchases that are options will be evaluated to determine whether they include a material right. Future purchases that are variable consideration are included in the initial identification of performance obligations and determination of the transaction price, and may lead to additional estimation and disclosure requirements.

Distinguishing between customer options and variable consideration will require significant judgement and will require entities to assess the nature of their promise to the customer and evaluate the presently enforceable rights and obligations of the parties to the arrangement.

- *Options for additional goods or services:* The customer has a present contractual right to purchase additional distinct goods or services. Each exercise of an option is a separate purchase decision and transfer of control of additional goods and services by the entity if the customer is not currently obliged under the contract to do so. Before the customer's exercise of the option, the vendor is not obliged to provide those goods or services and does not have a right to receive consideration. The customer options need to be evaluated to determine whether they provide the customer with a material right.
- *Variable consideration:* The contract with the customer obliges the vendor to stand ready to transfer the promised goods or services and the customer does not make a separate purchase decision for the additional goods or services to be provided by the vendor. The future event that results in additional consideration occurs as the performance obligation is being satisfied (i.e. when control of the goods or services is transferred to the customer).

Volume discounts or rebates may be variable consideration or may convey a material right

Different structures of discounts and rebates may have a different effect on the transaction price. For example, some agreements provide a discount or rebate that applies to all purchases made under the agreement – i.e. the discount or rebate applies on a retrospective basis once a volume threshold is met. In other cases, the discounted purchase price may apply only to future purchases once a minimum volume threshold has been met.

If a discount applies retrospectively to all purchases under the contract once the threshold is achieved, then the discount represents variable consideration. In this case, the entity estimates the volumes to be purchased and the resulting discount in determining the transaction price and updates that estimate throughout the term of the contract.

However, if a tiered pricing structure provides discounts for future purchases only after volume thresholds are met, then the entity evaluates the arrangement to determine whether the arrangement conveys a material right to the customer (see Section 10.4). If a material right exists, then this is a separate performance obligation, to which the entity allocates a portion of the transaction price. If a material right does not exist, then there are no accounting implications for the transactions completed before the volume threshold is met and purchases after the threshold has been met are accounted for at the discounted price.

Non-cash rebates may be either variable consideration or consideration payable to a customer

An entity may issue rebates or other incentives in the form of its own shares or warrants for its own shares. For example, a start-up entity may use such arrangements to save cash but still incentivise customers. Depending on the facts and circumstances, such arrangements may represent variable consideration and/or consideration payable to a customer, and therefore result in a reduction of the transaction price.

An entity needs to consider the guidance on non-cash consideration (see Section 3.3) in arriving at the transaction price and then determine when to recognise that reduction in the transaction price as a reduction in revenue. In addition, an entity also needs to consider the accounting for the shares and warrants under the standard on financial instruments. In applying the financial instruments guidance, an entity may need to consider, among other matters, whether the instruments are classified as equity or liabilities, when the instruments should be recognised and whether the instruments require remeasurement through profit or loss until settlement or expiry.

A transaction price denominated in a foreign currency does not constitute variable consideration

IFRS 15.68

When a contract is denominated in a foreign currency, changes in exchange rates may affect the amount of revenue recognised by an entity when it is measured in the entity's functional currency. However, this does not constitute variable consideration for the purpose of applying the standard because the variability relates to the form of the consideration (i.e. the currency) and not to other factors.

Instead, an entity applies the guidance on foreign currency transactions and translation to assess whether and, if so, how to translate balances and transactions denominated in a foreign currency.

Liquidated damages may represent variable consideration or a product warranty

IFRS 15.51

Many contracts contain terms providing for liquidated damages and similar compensation to the customer on the occurrence or non-occurrence of certain events. These terms are often similar in nature to penalties and may represent variable consideration. Conversely, in other cases they may represent a warranty.

An example of a liquidated damages term that represents variable consideration is a penalty for late delivery. For example, a construction company enters into a fixed-price contract for 10 million to construct a building for a customer. The contract includes a liquidated damages term under which the company is subject to a 2 million penalty if it does not complete the building by a specified date. In this case, the contract comprises an 8 million fixed component and a 2 million variable component.

Judgement is required to determine the appropriate accounting. For further discussion, see Section 10.2.

Compensation payable to customers for delayed or cancelled journeys represents variable consideration

IU 09-19

In some jurisdictions, a transportation company – e.g. an airline or a railway company – may be required by law to pay compensation to passengers for delayed or cancelled journeys. The amount of compensation is usually specified by the law. The IFRS Interpretations Committee discussed this scenario and noted that the compensation represents variable consideration under the revenue standard because any compensation for delays or cancellations forms part of the consideration to which the transportation company expects to be entitled in exchange for transferring the promised service – i.e. transporting the customer from one specified location to another within a specified time period after the scheduled flight time. It does not represent a warranty obligation to compensate for harm or damage caused by the transportation company's products or services under the provisions standard. The fact that the law, rather than the contract, stipulates the compensation payable does not affect the entity's determination of the transaction price. An entity considers the expected level of claims when estimating variable consideration; see 3.1.1.

3.1.1 Estimate the amount of variable consideration

IFRS 15.53

When estimating the transaction price for a contract with variable consideration, an entity's initial measurement objective is to determine which of the following methods best predicts the consideration to which the entity will be entitled.

Expected value	The entity considers the sum of probability-weighted amounts for a range of possible consideration amounts. This may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
Most likely amount	The entity considers the single most likely amount from a range of possible consideration amounts. This may be an appropriate estimate of the amount of variable consideration if the contract has only two (or perhaps a few) possible outcomes.

IFRS 15.54, BC195

The method selected is applied consistently throughout the contract and to similar types of contracts when estimating the effect of uncertainty on the amount of variable consideration to which the entity will be entitled.

Example 4 – Estimate of variable consideration: Most likely amount

Electronics Manufacturer M sells 1,000 televisions to Retailer R for 500,000 (500 per television). M provides price protection to R by agreeing to reimburse R for the difference between this price and the lowest price that it offers for that television during the following six months. Based on M's extensive experience with similar arrangements, it estimates the following outcomes.

Price reduction in next six months	Probability
0	70%
50	20%
100	10%

After considering all relevant facts and circumstances, M determines that the expected value method provides the best prediction of the amount of consideration to which it will be entitled. As a result, it estimates the transaction price to be 480 per television – i.e. (500 × 70%) + (450 × 20%) + (400 × 10%) – before considering the constraint (see 3.1.2).

Example 5 – Estimate of variable consideration: Expected value: Multiple-tier rebates

Construction Company C enters into a contract with Customer E to build an asset. Depending on when the asset is completed, C will receive either 110,000 or 130,000.

Outcome	Consideration	Probability
Project completes on time	130,000	90%
Project is delayed	110,000	10%

Because there are only two possible outcomes under the contract, C determines that using the most likely amount provides the best prediction of the amount of consideration to which it will be entitled. C estimates the transaction price – before it considers the constraint (see 3.1.2) – to be 130,000, which is the single most likely amount.

All facts and circumstances are considered when selecting estimation method

IFRS 15.BC200

The use of a probability-weighted estimate, especially when there are only two possible outcomes, could result in revenue being recognised at an amount that is not a possible outcome under the contract. In these situations, using the most likely amount may be more appropriate. However, all facts and circumstances need to be considered when selecting the method that best predicts the amount of consideration to which an entity will be entitled.

Expected value method – No need to quantify less probable outcomes

IFRS 15.BC201

When using a probability-weighted method to estimate the transaction price, a limited number of discrete outcomes and probabilities can often provide a reasonable estimate of the distribution of possible outcomes. Therefore, it may not be necessary for an entity to quantify all possible outcomes using complex models and techniques.

Expected value method – Estimated amount does not need to be a possible outcome for an individual contract

When an entity has a population of similar transactions, it may be appropriate to use this portfolio of data to estimate the transaction price for an individual contract using the expected value method. In this case, the transaction price may be an amount that is not a possible outcome for an individual contract but that is still representative of the expected transaction price.

It is important for an entity to have a sufficiently large number of similar transactions to conclude that the expected value method is the best estimate of the transaction price. Using a portfolio of data to help in estimating the transaction price for a contract is not the same as applying the portfolio approach (see Section 6.4).

An entity uses judgement to determine whether:

- its contracts with customers are sufficiently similar;
- the contracts with customers from which the expected value is derived are expected to remain consistent with subsequent contracts; and
- the volume of similar contracts is sufficient to develop an expected value.

For example, if there are three possible outcomes for the transaction price, then the entity calculates an expected value as follows.

Transaction price	Probability	Weighting
100,000	30%	30,000
110,000	45%	49,500
130,000	25%	32,500
Expected value	**100%**	**112,000**

Although 112,000 is not a possible outcome, when the conditions are met, the expected value is *appropriate* because the entity is really estimating that 30% of the transactions will result in 100,000, 45% of the transactions will result in 110,000 and 25% of the transactions will result in 130,000 which, in the aggregate, will be representative of the entity's expectations of the price for each transaction.

Historical experience may be a source of evidence

IFRS 15.53, 56, 79(a), BC200

An entity may use a group of similar transactions as a source of evidence when estimating variable consideration, particularly under the expected value method. The estimates using the expected value method are generally made at the contract level, not at the portfolio level. Using a group as a source of evidence in this way is not itself an application of the portfolio approach (see Section 6.4).

For example, an entity may enter into a large number of similar contracts whose terms include a performance bonus. Depending on the outcome of each contract, the entity either will receive a bonus of 100 or will not receive any bonus. Based on its historical experience, the entity expects to receive a bonus of 100 in 60 percent of the contracts. To estimate the transaction price for future individual contracts of this nature, the entity considers its historical experience and estimates that the expected value of the bonus is 60. This example illustrates that when an entity uses the expected value method, the transaction price may be an amount that is not a possible outcome of an individual contract.

The entity needs to use judgement to determine whether the number of similar transactions is sufficient to develop an expected value that is the best estimate of the transaction price for the contract and whether the constraint (see 3.1.2) should be applied.

A combination of methods may be appropriate

IFRS 15.BC202

The standard requires an entity to use the same method to measure a given uncertainty throughout the contract. However, if a contract is subject to more than one uncertainty, then an entity determines an appropriate method for each uncertainty. This may result in an entity using a combination of expected values and most likely amounts within the same contract.

For example, a construction contract may state that the contract price will depend on:

- *the price of a key material, such as steel:* this uncertainty will result in a range of possible consideration amounts, depending on the price of steel; and
- *a performance bonus if the contract is finished by a specified date:* this uncertainty will result in two possible outcomes, depending on whether the target completion date is achieved.

In this case, the entity may conclude that it is appropriate to use an expected value method for the first uncertainty and a most likely amount method for the second uncertainty. Once the methods are selected, the entity cannot change them and needs to apply each method consistently throughout the duration of the contract.

Additional application examples

Example 6 – Estimate of variable consideration: Most likely amount (One-tier rebate)

Pharmaceutical Company M enters into a contract to sell to Customer F a drug for 10 per unit. The arrangement includes no minimum purchase quantities. At the end of each year, F is entitled to a rebate on its annual purchases. Based on M's extensive experience with similar arrangements, it estimates the following outcomes.

Units purchased	Per-unit rebate	Probability
0–100,000	10%	40%
100,001–1,000,000	20%	50%
1,000,001+	30%	10%

After considering all relevant facts and circumstances, M determines that the expected value method provides the best prediction of the amount of consideration to which it will be entitled. As a result, it estimates the amount of the rebate to be 17% – i.e. (10% × 40%) + (20% × 50%) + (30% × 10%).

Therefore, M estimates the transaction price at 8.3 (10 × (1 - 0.17)) per unit before it considers the constraint (see 3.1.2).

Example 7 – Applying the constraint: Investment management contract

Food Company F enters into an arrangement with Customer C to supply Product P. The arrangement includes a fixed price of 1.0 per unit and an annual retrospective rebate – i.e. if total sales in an annual period exceed 500, then C is entitled to a rebate of 0.1 on every item purchased in that year. The arrangement includes no minimum purchase quantities but F expects that C will purchase approximately 1,000 units annually.

Purchases	Rebate
0–500	-
501+	0.10

C makes an initial purchase of 100 units. F considers the effect of the rebate arrangement and determines that, because the rebate arrangement is a retrospective arrangement, the contract includes variable consideration.

Therefore, in determining the transaction price for the sale of 100 units, F needs to incorporate any expected rebate. F uses the most likely amount method to estimate the amount because there are only two possible prices: C will pay either 1 per unit or 0.9 per unit. If the rebate included multiple tiers, then the expected value approach would probably be a more appropriate method to estimate the variable consideration.

F assesses the likelihood of selling more than 500 units to C using historical sales data for C and other similar customers and forecast sales based on current market conditions. F determines that it is 80% likely that C will purchase more than 500 units and, therefore, that the expected price per unit is 0.90.

F estimates the transaction price to be 90 (see 3.1.2).

Conversely, if the rebate applied prospectively – e.g. if F's total sales to C were 1,000 such that C received a rebate of 0.10 × 500 – then the rebate arrangement would be evaluated to determine whether it represented a material right (see Section 10.4).

3.1.2 Determine the amount for which it is highly probable that a significant reversal will not occur ('the constraint')

IFRS 15.56

After estimating the variable consideration, an entity may include some or all of it in the transaction price – but only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

IFRS 15.57

To assess whether – and to what extent – it should apply this 'constraint', an entity considers both the:

- likelihood of a revenue reversal arising from an uncertain future event; and
- potential magnitude of the revenue reversal when the uncertainty related to the variable consideration has been resolved.

In making this assessment, the entity uses judgement, giving consideration to all facts and circumstances – including the following factors, which could increase the likelihood or magnitude of a revenue reversal.

- The amount of consideration is highly susceptible to factors outside the entity's influence – e.g. volatility in a market, the judgement or actions of third parties, weather conditions and a high risk of obsolescence.
- The uncertainty about the amount of consideration is not expected to be resolved for a long time.
- The entity's experience with (or other evidence from) similar types of contracts is limited or has limited predictive value.
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract has a large number and a broad range of possible consideration amounts.

IFRS 15.59

This assessment needs to be updated at each reporting date.

IFRS 15.58

There is an exception for sales- or usage-based royalties arising from licences of IP (see Section 9.6).

Example 8 – Applying the constraint: Success fee

IFRS 15.IE129–IE133

Investment Manager M enters into a two-year contract to provide investment management services to its customer Fund N, a non-registered investment partnership. N's investment objective is to invest in equity instruments issued by large listed companies. M receives the following fees payable in cash for providing the investment management services.

Quarterly management fee	2% per quarter, calculated on the basis of the fair value of the net assets at the end of the most recent quarter
Performance-based incentive fee	20% of Fund's return in excess of an observable market index over the contract period

M determines that the contract includes a single performance obligation (series of distinct services) that is satisfied over time and that both the management fee and the performance fee are variable consideration. Before including the estimates of consideration in the transaction price, M considers whether the constraint should be applied to either the management fee or the performance fee.

At contract inception, M determines that the cumulative amount of consideration is constrained because the promised consideration for both the management fee and the performance fee is highly susceptible to factors outside its own influence. At each subsequent reporting date, M makes the following assessment of whether any portion of the consideration continues to be constrained.

Quarterly management fee	M determines that the cumulative amount of consideration from the management fee to which it is entitled is not constrained, because it is calculated based on asset values at the end of each quarter. Therefore, once the quarter finishes the consideration for the quarter is known. M determines that it can allocate the entire amount of the fee to the completed quarters, because the fee relates specifically to the service provided for those quarters (see Section 4.2).
Performance-based incentive fee	M determines that the full amount of the performance fee is constrained and therefore excluded from the transaction price. This is because: • the performance fee has a high variability of possible consideration amounts and the magnitude of any downward adjustment could be significant; • although M has experience with similar contracts, that experience is not predictive of the outcome of the current contract because the amount of consideration is highly susceptible to volatility in the market based on the nature of the assets under management; and • there are a large number of possible outcomes.

As a result, M determines that the revenue recognised during the reporting period is limited to the quarterly management fees for completed quarters. This determination is made each reporting date and could change towards the end of the contract period.

Example 9 – Applying the constraint: Consideration based on occupancy of property

Bank B enters into a contract with Customer E to help it with an equity placement. Under the contract, in addition to a fixed amount B will receive a bonus of 1 million if the placement is successful.

Outcome	Bonus	Probability
Successful	1 million	75%
Unsuccessful	-	25%

Because there are only two possible outcomes related to the bonus under the contract, B determines that using the most likely amount provides the best prediction of the amount of consideration to which it will be entitled. Therefore, using the most likely amount method, B estimates the variable consideration that it expects to be entitled to as 1 million.

B also applies the constraint to evaluate whether it is limited in the amount of this estimate that it can include in the transaction price. As part of evaluating the application of the constraint, B considers the magnitude of the variable amount and the likelihood of a reversal. Although B has a lot of experience with these arrangements, the payment is highly susceptible to market volatility, which is outside the control of both B and E. B therefore concludes that the variable consideration should be constrained to zero until the equity placement is undertaken.

A similar evaluation would be required for success-based fees related to other types of advisory arrangements – e.g. mergers and acquisitions and debt restructurings.

Constraint assessment made against cumulative revenue

When constraining its estimate of variable consideration, an entity assesses the potential magnitude of a significant revenue reversal relative to the cumulative revenue recognised – i.e. for both variable and fixed consideration, rather than on a reversal of only the variable consideration. The assessment of magnitude is relative to the transaction price for the contract, rather than the amount allocated to the specific performance obligation.

Specified level of confidence included in constraint requirements

IFRS 15.BC209

The inclusion of a specified level of confidence – 'highly probable' – clarifies the notion of whether an entity *expects* a significant revenue reversal. This is an area of significant judgement and entities need to align their judgemental thresholds, processes and internal controls with these requirements. Documenting these judgements is also critical.

Constraint introduces an element of prudence

IFRS 15.BC207

The constraint introduces a downward bias into estimates, requiring entities to exercise prudence before they recognise revenue – i.e. they have to make a non-neutral estimate. This exception to the revenue recognition model reflects the particular sensitivity with which revenue reversals are viewed by many users of financial statements and regulators.

Additional application examples

Example 10 – Applying the constraint: Consideration dependent on regulatory approval

Developer D buys land and obtains approval to develop a retail centre. This is the first development that it has undertaken in a new regeneration zone – e.g. conversion of an industrial area into a retail centre.

D then enters into a contract with Company V, a large listed property fund, to sell the land and retail centre for a fixed price of 1 million and an amount based on occupancy levels one year after completion. D determines that control of the land and retail centre will transfer on completion of the development.

At the completion date, D has estimated the variable consideration amount to be 500,000 using the expected value method. D then applies the constraint guidance and notes that:

- D does not have previous experience with similar contracts;
- occupancy levels are outside D's control;
- the uncertainty will not be resolved for a long time; and
- the range of possible outcomes is large.

As a result, D concludes that the amount of variable consideration should be constrained to zero. D re-evaluates its conclusions at each reporting date until the uncertainty is resolved.

Example 11 – Applying the constraint: Bonus payment

Biotech Company B enters into a contract with Pharma Company C for Compound X, which is under development. Under the arrangement, C will receive a licence for X and B will continue to perform the research and development activities required to take X through to commercialisation. Under the contract, B will receive an up-front payment of 2,000, an additional 5,000 if regulatory approval is granted and 2% of any future sales of X made by C.

B identifies the 5,000 payable if regulatory approval is obtained as variable consideration and uses the most likely amount approach to estimate it. Using this approach, B assesses that it is 60% likely that regulatory approval will be obtained, and therefore its unconstrained estimate of the variable consideration is 5,000.

However, before including this estimate in the transaction price, B applies the constraint guidance. B notes that:

- payment is considered highly uncertain;
- the uncertainty is highly susceptible to factors outside B's control;
- the uncertainty will not be resolved for a long time; and
- the payment is significant to the overall transaction price.

For these reasons, B concludes that the constrained amount should be zero.

The variable consideration guidance is not applied to the sales-based royalty because it is subject to the royalty exception – see Section 9.6.

Therefore, B determines that the transaction price of the arrangement is initially 2,000, being the up-front payment.

Example 12 – Applying the constraint: Price concessions (1)

Investment Manager M enters into a three-year contract to provide investment management services to Fund L. L is nearing its final liquidation and M is asked to execute the investment policy during the run-off period. M will be entitled to a significant bonus at the end of the contract if the proceeds from the liquidation of L's assets exceed 2 million. M notes that:

- L's net asset value at the end of Year 2 was 5 million: i.e. the fair value of the remaining assets in the fund is significantly in excess of 2 million;
- L's remaining assets have low risk; and

- market volatility and macro-economic variables affecting L's asset value indicate that a significant decrease is very unlikely to occur.

Therefore, during Year 3 M may be able to conclude that:

- it is sufficiently likely that the proceeds from L's liquidation will exceed the required threshold; and
- it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur at the end of the contract.

If this is the case, then M may include the expected bonus in the transaction price during Year 3, before the final resolution of the uncertainty.

Example 13 – Applying the constraint: Price concessions (2)

Company E licenses enterprise resource planning (ERP) software to its customers and provides post-contract support services throughout the licence period. To retain its existing customers, E has developed a practice of frequently giving its customers a discount on the post-contract support fees stated in the original contract for the final year. This discount has ranged from 20% to 60% with no discernible pattern.

E enters into a contract with Customer C for a three-year licence of its ERP software for 300,000 (paid up-front) and 180,000 in total for three years of post-contract support services, paid in three 60,000 instalments at the beginning of each year. The software licence and the post-contract support services constitute two separate performance obligations. E transfers the software licence to C at contract inception.

E concludes that its history of providing post-contract support fee discounts means that the transaction price is variable and therefore needs to be estimated. E uses an expected value method because there are many possible outcomes. It estimates that it will give C a discount of 42% on the Year 3 post-contract support fees.

Consequently, E's estimate of the transaction price at contract inception – before applying the constraint – is 454,800[1]. Assuming that the stand-alone selling prices of the licence and the post-contract support services are 300,000 and 200,000 respectively, the relative stand-alone selling price allocation would be as follows. Discounts and variable consideration are allocated between all distinct goods or services in the contract unless specific criteria are met – see Section 4.2.

	Stand-alone selling price	Relative stand-alone selling price
Licence	300,000	272,880
Post-contract support	200,000	181,920

Because E has a history of granting price concessions of between 20% and 60% of the final year's contractual post-contract support fees, including any of the potential post-contract support discount less than the 60% maximum in the transaction price carries the risk of a revenue reversal. However, E does not constrain its estimate of the transaction price below 454,800 because the revenue reversal that would result from the possible incremental discount of 18% (60% - 42%) or 10,800[2] would not be significant to the cumulative revenue recognised to date under the contract. For example, an adjustment to the transaction price immediately after transfer of control of the software licence would result in a reversal of only 6,480[3] (compared with cumulative revenue recognised of 272,880).

If E did not have a history of granting price concessions and it was not expected at contract inception, then it would account for any subsequent price concession as a contract modification (see Section 8.2).

Notes

1. Calculated as 480,000 - (42% × 60,000).
2. Calculated as 60,000 × 18%.
3. Calculated as 10,800 × (300,000 / 500,000).

3.2 Significant financing component

IFRS 15.60 To estimate the transaction price in a contract, an entity adjusts the promised amount of consideration for the time value of money if that contract contains a significant financing component.

IFRS 15.61 The objective when adjusting the promised amount of consideration for a significant financing component is to recognise revenue at an amount that reflects what the cash selling price of the promised good or service would have been if the customer had paid cash at the same time as control of that good or service transferred to the customer. The discount rate used is the rate that would be reflected in a separate financing transaction between the entity and the customer at contract inception.

To make this assessment, an entity considers all relevant factors – in particular the:

- difference, if there is any, between the amount of promised consideration and the cash selling price of the promised goods or services;
- combined effect of:
  - the expected length of time between the entity transferring the promised goods or services to the customer; and
  - the customer paying for those goods or services; and
- prevailing interest rates in the relevant market.

IFRS 15.62 A contract does not have a significant financing component if any of the following factors exists.

Factor	Example
An entity receives an advance payment, and the timing of the transfer of goods or services to a customer is at the discretion of the customer	A prepaid phone card or customer loyalty points
A substantial portion of the consideration is variable, and the amount or timing of the consideration is outside the customer's or entity's control	A transaction whose consideration is a sales-based royalty
The difference between the amount of promised consideration and the cash selling price of the promised goods or services arises for non-finance reasons	Protection against a counterparty not completing its obligations under the contract

IFRS 15.64

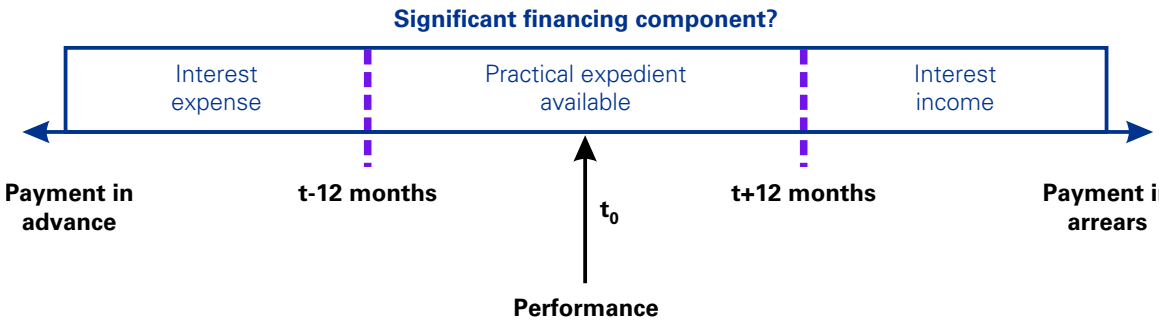
The standard indicates that:

- an entity should determine the discount rate at contract inception, reflecting the credit characteristics of the party receiving credit; and
- the discount rate should not generally be updated for a change in circumstances.

IFRS 15.63

As a practical expedient, an entity is not required to adjust the transaction price for the effects of a significant financing component if, at contract inception, it expects the period between customer payment and the transfer of goods or services to be one year or less.

For contracts with an overall duration greater than one year, the practical expedient applies if the period between performance and payment for that performance is one year or less.



IFRS 15.65

The financing component is recognised as interest expense (when the customer pays in advance), or interest income or revenue (when the customer pays in arrears), and is presented separately from revenue from contracts with customers.

If after contract inception there is a change in the expected period between customer payment and the transfer of goods or services, then in our view the transaction price – i.e. the promised amount of consideration adjusted for the significant financing component – should not be revised for the effect of the change in the expected period between payment and performance. Instead, an entity should revise the period over which it recognises the difference between the transaction price and the promised consideration as interest. This is because the cash selling price of the goods or services is agreed by the parties at contract inception and does not vary in response to changes in the estimated timing of the transfer of the goods or services. If the entity had used the revised timing at inception of the contract, then this would have changed either the amount of promised consideration or the implied interest rate.

For a discussion of the presentation of interest income arising from a significant financing component, see Section 11.2.

Example 14 – Significant financing component: Multiple-element arrangement

Product Company B enters into a contract with Customer C to deliver Products X and Y for 150,000 payable up-front. X will be delivered in two years and Y in five years.

B determines that the contract contains two performance obligations that are satisfied at the points in time at which the products are delivered to C. B allocates the 150,000 to X and Y at an amount of 37,500 and 112,500 respectively – i.e. based on their relative stand-alone selling prices. B concludes that the contract contains a significant financing component and that a financing rate of 6% is appropriate based on B's credit-standing at contract inception.

B accounts for the contract as follows.

Contract inception	Recognise a contract liability for the payment of 150,000
Years 1 and 2	During the two years from contract inception until the transfer of X, recognise interest expense of 9,000 and 9,540[1] on 150,000 at 6% for Years 1 and 2, respectively, for a cumulative interest expense of 18,540
	Recognise revenue of 42,135[2] for the transfer of X
Years 3, 4 and 5	Recognise annual interest expense of 7,584, 8,039 and 8,522[3] for Years 3, 4 and 5, respectively, based on the contract liability at the beginning of Year 3 of 126,405[4]
	Recognise revenue of 150,550[5] for the transfer of Y

Notes

1. Calculated as 150,000 × 0.06 for Year 1 and 159.000 × 0.06 for Year 2.
2. Calculated as 37,500 + 4,635, being the initial allocation to X plus X's portion of the interest for Years 1 and 2 of the contract (37,500 / 150,000 × 18,540).
3. Calculated as 126,405 × 0.06 = 7,584; (126,405 + 7,584) × 0.06 = 8,039 and (126,405 + 7,584 + 8,039) × 0.06 = 8,522.
4. Calculated as 150,000 + 18,540 - 42,135, being the initial contract liability plus interest for two years less the amount derecognised from the transfer of X.
5. Calculated as 126,405 + 24,145, being the contract liability balance after two years plus interest for three years.

Example 15 – Significant financing component: Change in expected completion date

Company K enters into a contract with Customer C to construct and deliver a piece of equipment. K determines that the contract contains a single performance obligation that is satisfied at a point in time when the equipment is delivered to C. Construction is expected to take two years.

K and C agree consideration of 80, which is payable and paid on the date the contract is signed.

At contract inception, K considers the terms of the sale and determines that the contract includes a significant financing component because:

- there is a significant period between payment and delivery of the asset;
- the asset is regularly sold at a higher price; and
- there is no evidence to suggest the advance is for another reason.

K determines the discount rate, based on its credit characteristics, to be 12%.

Therefore, to reflect the financing that it is receiving from the advance payment, K recognises interest expense of 20 in the construction period and revenue of 100 (80 × 1.122) on the delivery date.

After Year 1, K determines that the construction will take three rather than two years.

K should revise the period over which it recognises the difference between the transaction price and the promised consideration as interest expense. K should not revise the transaction price of 100.

Example 16 – Determining whether an arrangement has a significant financing component: Payment in advance

Technology Company T signs a three-year, non-cancellable agreement with Customer C to provide hosting services. C may elect to pay either:

a. 140 per month (total payment is 5,040); or

b. 4,200 at the beginning of the contract term, with no additional monthly payments.

T determines that the contract includes a financing component.

The difference in pricing between options (a) and (b) indicates that the contractual payment terms under option (b) have the primary purpose of providing T with financing. The cash selling price is the monthly fee of 140 because it reflects the amount due when the monthly hosting services are provided to C. A comparison of the payment terms between options (a) and (b) indicates total cumulative interest of 840 and an implied discount rate of 13%.

T considers whether factors indicating that a significant financing component does not exist apply in this case and concludes that they do not. T determines that the financing component is significant because the difference between the cumulative cash selling price of 5,040 and the financed amounts of 4,200 is 840, or approximately 20% of the financed amount. Therefore, an adjustment to reflect the time value of money will be needed if C elects option (b) to pay at the beginning of the contract.

T evaluates whether the implied discount rate of 13% is consistent with the market rate of interest for companies with the same credit rating as its own. Assuming that it is, T recognises revenue of 5,040 rateably over the contract term as the performance obligation is satisfied and interest expense of 840 using the effective interest method. The amount of interest expense to recognise each period is based on the projected contract liability, which decreases as services are provided and increases for the accrual of interest.

Below is one example interest calculation under the effective interest method.

Period	Contract liability – beginning of month	Transaction price/delivery of service	Interest expense at 1.083% (monthly rate – 13% / 12)	Contract liability – end of month
	A	B	(A – B) × 1.083% = C	A – B + C
1	4,200	140	44	4,104
2	4,104	140	43	4,007
3	4,007	140	42	3,909
4	3,909	140	41	3,810
5	3,810	140	40	3,710
		Continue for each period…		
36	140	140	-	-

If, in this example, the implied discount rate of 13% were determined to be an above-market rate, then the transaction price would be adjusted to reflect a market rate, based on T's credit-worthiness. The difference between the implied discount rate and the market rate would represent a discount granted to the customer for purposes other than financing. For an illustration of a scenario with a below-market rate, see Example 17.

Example 17 – Determining whether an arrangement has a significant financing component: Payment in arrears

Manufacturer B enters into a contract to provide equipment to Customer C priced at 2 million. C is a start-up entity with limited cash and B agrees that C will pay for the equipment over two years by monthly instalments of 92,000.

The contract includes a financing component. The difference in pricing between the selling price of 2 million and the total of the monthly payments of 2.208 million (24 × 92,000) indicates that the contractual payment terms have the primary purpose of providing C with financing. The cash selling price is 2 million because it reflects the amount due at the point the equipment is transferred to C. A comparison of the cash selling price and the total payments to be received indicates total cumulative interest of 208,000 and an implied interest rate of 9.7%.

B considers whether factors indicating that a significant financing component does not exist apply in this case and concludes that they do not. B determines that the financing component is significant because the difference between the cash selling price of 2 million and the total promised consideration of 2.208 million is 208,000, or approximately 10% of the financed amount. Therefore, an adjustment to reflect the time value of money is needed.

B evaluates whether the implied interest rate of 9.7% is consistent with the market rate of interest for companies with the same credit-standing as C. Assuming that it is, B recognises revenue of 2 million on delivery of the equipment – i.e. as the performance obligation is satisfied – and interest income on a monthly basis using the effective interest method. The amount of interest income for each month is based on the balance of the receivable for equipment sold, which decreases as payments are received.

Below is one example interest calculation under the effective interest method.

Period	Receivable – beginning of month	Monthly payment – end of month	Interest income at 0.81% (monthly rate – 9.7% / 12)	Receivable – end of month
	A	B	A × 0.81% = C	A - B + C
1	2,000,000	92,000	16,143	1,924,143
2	1,924,143	92,000	15,531	1,847,674
3	1,847,674	92,000	14,913	1,770,587
4	1,770,587	92,000	14,291	1,692,878
5	1,692,878	92,000	13,664	1,614,542
		Continue for each period…		
24	91,263	92,000	737	-

If, in this example, the implied interest rate of 9.7% were determined to be a below-market rate, then the transaction price would be adjusted to reflect a market rate, based on C's credit-worthiness. The difference between the implied interest rate and the market rate would represent a discount granted to the customer for purposes other than financing. For an illustration of a scenario with an above-market rate, see Example 16 in this chapter.

Assessment is undertaken at the individual contract level

IFRS 15.BC234

An entity determines the significance of the financing component at an individual contract level, rather than at a portfolio level. The individual contract level for a particular customer could consist of more than one contract if the contract combination criteria in the standard are met. In developing the standard, the International Accounting Standards Board (the Board) noted that it would be unduly burdensome to require an entity to account for a financing component if the effects of the financing component are not material to the individual contract but the combined effects for a portfolio of similar contracts would be material to the entity as a whole. An entity should apply judgement in evaluating whether a financing component is significant to the contract.

No significant financing component if the timing of transfer of goods or services is at the customer's discretion

IFRS 15.BC233(a)

Customers pay for some types of goods or services in advance – e.g. prepaid phone cards, gift cards and customer loyalty points – and the transfer of the related goods or services to the customer is at the customer's discretion. In these cases, the contracts do not include a significant financing component, because the payment term does not relate to a financing arrangement. Also, without this specific guidance the costs of requiring an entity to account for the financing component in these situations would outweigh any perceived benefits, because the entity could not know – and would therefore have to continually estimate – when the goods or services will transfer to the customer.

Contracts with a payment scheduled for part-way through the performance period may contain a significant financing component

Under some long-term contracts for which revenue is recognised over time, the payment of the promised consideration may be scheduled for part-way through the performance period – e.g. under a 26-month construction contract the promised consideration is to be paid in full at the end of Month 13. In our view, in these cases a significant financing component may exist. We believe that an entity should assess the contract as a whole and exercise judgement in determining whether the financing component is significant.

Contracts with material right may contain a significant financing component

IFRS 15.62(a)

Contracts under which a customer pays for goods or services in advance and has discretion over the timing of their transfer do not contain a significant financing component. This may be relevant to contracts with a material right if a customer chooses *when* to exercise that right. However, in some cases the customer may not have that discretion. In these cases, the contract may contain a significant financing component. The assessment of whether a customer has discretion over the timing of the exercise of the material right may require judgement.

Limited examples in the standard of when payments have a primary purpose other than financing

IFRS 15.BC233(c)

Determining whether a difference between the amount of promised consideration and the cash selling price of the goods or services arises for reasons other than the provision of finance requires judgement. An entity considers all relevant facts and circumstances, including whether the difference is proportionate to any other reason provided. Also, it may be more common for the difference to be for a reason other than financing when payments are received in advance of the delivery of goods or services.

IFRS 15.IE141–IE142

In some circumstances, a payment in advance or arrears on terms that are typical for the industry and jurisdiction may have a primary purpose other than financing. For example, a customer may withhold an amount of consideration that is payable only on successful completion of the contract or the achievement of a specified milestone. The primary purpose of these payment terms, as illustrated in Example 27 of the standard, may be to provide the customer with assurance that the entity will perform its obligations under the contract, rather than provide financing to the customer.

Judgement may also be required in assessing whether advance payments from government entities have a primary purpose other than financing. In some cases, the timing of the payment by a government entity may be driven primarily by budgetary considerations. For example, a local authority may receive an annual budget allocation and forfeit any amounts that are unused at the end of the year. If the local authority chooses to pay in advance for goods and services, disregarding an entity's standard contractual payment terms, then the entity will need to assess what the primary purpose of the payment is. This will include consideration of whether the amount of the payment has been adjusted to reflect the timing of the payment or represents the cash selling price of the goods or services.

Accounting for long-term and multiple-element arrangements with a significant financing component may be complex

Determining the effect of the time value of money for a contract with a significant financing component can be complex for long-term or multiple-element arrangements. In these contracts:

- goods or services are transferred at various points in time;
- cash payments are made throughout the contract; and
- there may be a change in the estimated timing of the transfer of goods or services to the customer.

If additional variable elements are present in the contract – e.g. contingent consideration – then these calculations can be even more sophisticated, involving significant cost and complexity for preparers.

In addition, an entity needs to have appropriate processes and internal controls to handle these potential complexities in assessing whether a significant financing component exists and, if so, developing the appropriate calculations and estimates.

Using an interest rate that is explicitly specified in the contract may not be appropriate

IFRS 15.BC239–BC241

It may not be appropriate to use an interest rate that is explicitly specified in the contract, because the entity might offer below-market financing as a marketing incentive. Consequently, an entity applies the rate that would be used in a separate financing transaction between the entity and its customer that does not involve the provision of goods or services.

This can lead to practical difficulties for entities with large volumes of customer contracts and/or multinational operations, because they will have to determine a specific discount rate for each customer, class of customer or geographical region of customer.

Interest income recognised from a significant financing component may be presented as 'revenue' but not 'revenue from contracts with customers'

IFRS 15.65, BC246–BC247

An entity that regularly enters into contracts with customers that include financing components may earn interest income in the course of its ordinary activities. If so, then it may present interest income arising from a significant financing component as a type of revenue in the statement of profit or loss. However, this interest income has to be presented separately from revenue from contracts with customers.

Advance payments may affect EBITDA

When an entity receives an advance payment that includes a significant financing component, it increases the amount of revenue recognised, with a corresponding increase in interest expense. This results in an increase in earnings before interest, taxes, depreciation and amortisation (EBITDA), which may affect compensation and other contractual arrangements.

Application of the practical expedient to a contract with multiple performance obligations

In a contract with two or more performance obligations, identifying the period between customer payment and the transfer of goods or services may present challenges, especially when the performance obligations are satisfied at different points in time and consideration is paid over time or all at once.

In some contracts that include consideration paid over time, one performance obligation is completed in the early stages of a contract, whereas a second performance obligation continues for an extended period of time. In these cases, the entity generally allocates each payment received to both performance obligations in the contract on a pro rata basis to calculate the financing component and determine whether the practical expedient applies (rather than allocating payments to a single performance obligation until it has been fully paid, as would be the case with a first-in, first-out (FIFO) allocation).

In other contracts, consideration includes an up-front payment and performance obligations are completed consecutively over time. An entity evaluates all relevant evidence, including termination clauses, to determine whether it is appropriate for an up-front cash payment to be allocated to the first performance obligation when determining whether the practical expedient can be applied at the contract level.

A contract with an implied interest rate of zero may contain a financing component

When the consideration to be received for a good or service with extended payment terms is the same as the cash selling price, the implied interest rate is zero. However, a significant financing component may still exist.

For example, retailers sometimes offer a promotional incentive that allows customers to buy items such as furniture and pay the cash selling price two years after delivery. Judgement is required to evaluate whether in these circumstances an entity is offering a discount or other promotional incentive for customers who pay the cash selling price at the end of the promotional period equal to the financing charge that would otherwise have been charged in exchange for financing the purchase.

If the entity concludes that financing has been provided to the customer, then the transaction price is reduced by the implicit financing amount and interest income is accreted. The implicit financing amount is calculated using the rate that would be used in a separate financing transaction between the entity and its customer.

Interest accrued on a contract liability is a borrowing cost eligible for capitalisation

IFRS 15.60, BC229–BC230

If an entity accrues interest on a contract liability that represents advance consideration received under a contract with a customer, then in our view this interest meets the definition of borrowing costs because the interest represents the cost to the entity of borrowing funds from its customer. To the extent that the other criteria in the borrowing costs standard are met, this interest should be capitalised.

Additional application examples

Example 18 – Determining whether an arrangement has a significant financing component: Advance payment and fixed delivery

Carmaker M submits a purchase order to Automotive Supplier P for the delivery of 10,000 parts over five years for a fixed price of 1 million. Under the contract, M will pay the full amount in advance. The contract also contains a predetermined delivery schedule for the parts. P has determined that if it received a loan for a similar amount, to be repaid over five years, then the loan would bear interest of 5%.

P determines that the contract includes a significant financing component, owing to the five-year period between the prepayment and the delivery date of the last part and the 5% interest rate. P does not identify any indicators that the deferred terms are for reasons other than financing.

Example 19 – Determining whether an arrangement has a significant financing component: Advance payment and delivery at customer's discretion

Carmaker M enters into a framework agreement with Automotive Supplier D. In the framework agreement, M commits to a minimum quantity of 10,000 parts to be delivered over five years. However, the timing of delivery is fully at M's discretion. M agrees to prepay 1 million for the first 10,000 parts. Purchase orders for additional parts will be paid for at the time of delivery.

D concludes that the framework agreement does not contain a significant financing component, because even though M has paid for 10,000 parts in advance, the timing of the transfer of the parts is at M's discretion.

Example 20 – Determining whether an arrangement has a significant financing component: Fixed vs variable payment

Media Company M enters into an arrangement with Television Company C. Under the arrangement, C receives rights to show a film five times per year for the next five years. C will pay M a fixed amount of 1,000 per year.

M concludes that the licence is a single right-to-use licence and recognises revenue when the copy of the content is transferred to C on commencement of the licence period.

M evaluates whether the arrangement includes a significant financing component. As part of its analysis, M determines that it would provide finance to C in a separate transaction at 6%.

M concludes that the arrangement includes a significant financing component because of the period between performance and payment and the rate that would be applied in a separate financing transaction. M does not identify any reasons other than financing for the difference between timing and payment. Therefore, M adjusts the transaction price for the effect of the significant financing component.

Conversely, if the consideration under the contract were entirely variable – e.g. based on viewer levels when the film is televised – then the arrangement would not include a significant financing component. This is because the standard states that when a substantial amount of the consideration is variable, the arrangement does not include a significant financing component.

Example 21 – Determining whether an arrangement has a significant financing component: Instalment payments throughout the contract period

Shipbuilder B enters into a contract with Customer C to build a ship for a fixed price of 1 million. Under the contract, C will pay the amount in monthly instalments throughout the expected production period of three years. B determines that it would apply a rate of 3% if it were to enter into a separate financing transaction with C. It also determines that revenue will be recognised over time, because it has no alternative use for the ship under construction and also has a right to payment for it.

B elects to apply the practical expedient and not account for a significant financing component when the period between performance and payment is 12 months or less.

B determines that the practical expedient applies to the contract because it expects the instalment payments to broadly align with performance throughout the period. Accordingly, the period between performance and payment is never more than 12 months.

Example 22 – Determining whether an arrangement has a significant financing component: Payment in arrears and an over-time contract

Developer D buys land and obtains approval to develop a retail centre. D then enters into a contract with Company V, a large listed property company, to sell the land and retail centre for a fixed price of 1 million. Under the contract, V will pay the full amount on completion of construction, which is expected to be in five years' time. D has also determined that it would apply a rate of 5% if it were to enter into a separate financing transaction with V.

D determines that revenue will be recognised over time and that the contract includes a significant financing component, owing to the five-year period between performance and payment and the 5% interest rate. D does not identify any indicators that the deferred terms are for reasons other than financing.

Example 23 – Determining whether an arrangement has a significant financing component: Financing component is not significant

Telco R enters into a contract with Customer S for a two-year wireless service plan at 85 per month (the stand-alone selling price is 65 per month). In the same contract, S buys a handset for 130 (the stand-alone selling price is 630). R determines that the contract term for accounting purposes is two years.

The transaction price and stand-alone selling prices in the contract are summarised as follows.

	Transaction price	Stand-alone selling price
Wireless service	2,040 (85 × 24 months)	1,560 (65 × 24 months)
Handset	130	630
Total	**2,170**	**2,190**

There is a difference in timing between performance and payment because the handset is delivered on day one and payment for at least a portion of that handset occurs over 24 months. Consequently, the contract includes a financing transaction.

However, because there is an overall discount on the bundle (2,170 transaction price vs 2,190 stand-alone selling price), R needs to allocate that discount before determining whether the financing component is significant. This is because it is necessary to determine the cash flows that relate specifically to the handset. To allocate the discount, R allocates the transaction price based on relative stand-alone selling prices (see 4.2.1). This results in an allocation of 624 to the handset and 1,546 to the wireless service.

The contract does not specify an interest rate. R concludes that 7% reflects the rate that would be used by R and S in a separate financing transaction. R then calculates the present value of the payment stream related to the handset (i.e. 624 less 130 repaid over 24 months) using the discount rate of 7%, which results in an imputed interest component of 33. The relative value of the financing component of 33, compared with the total contract price, is less than 2%. Based on its assessment of all relevant qualitative and quantitative factors, R concludes that a financing component that represents less than 2% of the contract is not significant and does not account for a financing component in this contract.

Example 24 – Determining whether an arrangement has a significant financing component: No adjustment for the financing component

Telco T enters into a one-month wireless contract with Customer C that includes voice and data services and a handset. The monthly service fee represents the price charged to customers that bring their own device (i.e. it is the stand-alone selling price of the service).

C makes no up-front payment for the phone but will pay its stand-alone selling price by monthly instalments over 24 months. There is no additional interest charge for the financing. Full repayment of the remaining balance of the phone becomes due if C fails to renew the monthly service contract. There is no other amount due if C does not renew.

T determines that the term of the contract is one month. T then needs to assess whether the instalment plan on the handset conveys a significant financing component to the customer.

In making this assessment, T observes that instalment payments are due immediately if the service contract is not renewed. Thinking about this conditionality and the contract term together, T may conclude that either the financing component may not be significant or the practical expedient applies. In these cases, T would not adjust the transaction price for the financing component. T also needs to consider the applicable financial instrument guidance in the measurement of any receivable resulting from the instalment plan.

Example 25 – Determining whether an arrangement has a significant financing component: Advance to secure supplier capacity

Supplier S is one of a small number of producers of a key component for the engineering sector. Manufacturing Company X is S's customer and the component is a key input to X's main product. Considering the limited supply and the market competition, X makes an up-front payment to secure 50% of S's existing manufacturing capacity over the next three years. In addition, X and S agree that each component delivered will be priced at the list price on the date of delivery – i.e. the cash selling price.

S notes that X makes the advance payment at its discretion to secure supply of a critical input to its manufacturing process – i.e. for reasons other than financing. S also notes that it does not require the cash for its own short- or long-term financing needs. Although X makes an advance payment, it pays the cash selling price for the components that it purchases – i.e. X pays the same amount for each unit as any customer who pays on the date when they obtain control of the component. S also does not identify any other reasons that may indicate that the advance payment was for financing purposes. As a result, S concludes that the contract with X does not contain a significant financing component.

Modifying the example, if S requires X to make an advance payment to secure access to its future manufacturing capacity from a new facility to be constructed, then this may indicate that S requires funds to finance the construction, an indicator that the contract contains a significant financing component.

3.3 Non-cash consideration

IFRS 15.66–67

Non-cash consideration received from a customer is measured at fair value. If an entity cannot make a reasonable estimate of the fair value, then it refers to the estimated selling price of the promised goods or services.

IFRS 15.68

Estimates of the fair value of non-cash consideration may vary. Although this may be due to the occurrence or non-occurrence of a future event, it can also vary due to the form of the consideration – e.g. variations due to changes in the price per share if the non-cash consideration is an equity instrument.

When the fair value of non-cash consideration varies for reasons other than the form of the consideration, those changes are reflected in the transaction price and are subject to the guidance on constraining variable consideration.

IFRS 15.69

Non-cash consideration received from the customer to facilitate an entity's fulfilment of the contract – e.g. materials or equipment – is accounted for if and when the entity obtains control of those contributed goods or services.

IFRS 15.126, IE156–158, BC254A–BC254G

The standard does not provide specific guidance on the measurement date for non-cash consideration. In the absence of specific requirements, in our view an entity should apply judgement, based on the relevant facts and circumstances, to determine whether to measure non-cash consideration with reference to the date on which the contract is entered into, the date the non-cash consideration is received or the date the performance obligation is satisfied. Changes in the fair value of non-cash consideration after the measurement date are not included in the transaction price.

Example 26 – Non-cash consideration: Measured at contract inception

Real Estate Developer D enters into a contract with Customer C to build an office block on C's land. As consideration, D will receive 50,000 in quarterly instalments as construction progresses and a piece of C's land adjacent to the construction site. The land title transfers to D up-front, but it is subject to recall if D defaults and does not complete the office block.

In this scenario, D determines that it is appropriate to measure the non-cash consideration at the date of contract inception.

Example 27 – Non-cash consideration: Measured when the performance obligation is satisfied

Real Estate Developer R enters into a contract with Customer M for the sale of a unit in a new retirement village. The project is scheduled to take three years. Under the contract, R will receive an up-front payment of 20,000 and M's existing house on completion of the unit. M retains all of the rights to occupy and pledge the house until the unit in the new retirement village is ready. R concludes that control over the unit transfers to M at the point in time when construction is completed.

In this scenario, R determines that it is appropriate to measure the non-cash consideration at the date when it satisfies the performance obligation.

Example 28 – Non-cash consideration: Free advertising

Production Company Y sells a television show to Television Company X. The consideration under the arrangement is a fixed amount of 1,000 and 100 advertising slots. Y determines that the stand-alone selling price of the show would be 1,500. Based on market rates, Y determines that the fair value of the advertising slots is 600.

Y determines that the transaction price is 1,600, comprising the 1,000 fixed amount plus the fair value of the advertising slots.

If the fair value of the advertising slots could not be reasonably estimated, then the transaction price would be 1,500 – i.e. Y would use the stand-alone selling price of the goods or services promised for the non-cash consideration in these circumstances.

Constraint does not apply when variation is due to the form of non-cash consideration

IFRS 15.BC251–BC252

The requirement to constrain estimates of variable consideration applies regardless of whether the amount received will be cash or non-cash consideration. Therefore, variability in the estimate of the fair value of non-cash consideration is constrained if that variability relates to changes in the fair value for reasons other than the form of the consideration – i.e. changes other than the price of the non-cash consideration. If the variability is because of the entity's performance – e.g. a non-cash performance bonus – then the constraint applies. If the variability is because of the form of the non-cash consideration – e.g. changes in the stock price – then the constraint does not apply and the transaction price is not adjusted.

The determination of whether a change in fair value was caused by the form of the non-cash consideration or other reasons, and the determination of how to allocate fair value changes between those affecting transaction price and those that do not, may be challenging in some situations.

Transfers of assets from customers

In certain industries, it is common for entities to receive transfers of property, plant and equipment (or cash to acquire it) from their customers in return for a network connection and/or an ongoing supply of goods or services.

The nature of these arrangements can vary widely. In some arrangements, the party that transfers the assets (the transferor) is the party that receives access to a supply of goods or services (the ultimate customer). In other arrangements, the transferor is not the ultimate customer or is the ultimate customer for only a short period of time. For example, a property developer builds a residential complex in an area that is not connected to the water mains. To connect to the water mains, the property developer is required to install a network of pipes and to transfer them to the water supply company, which will supply future services to the residents of the complex.

An entity that receives such contributed assets evaluates all relevant facts and circumstances to determine the appropriate accounting, including whether the contribution is part of a contract with a customer in the scope of the standard (see Chapter 6). If the contract is in the scope of the standard, then the entity determines whether:

- the connection to the supply of future services transfers a distinct good or service to the customer (see Chapter 2); and
- the contributed assets are non-cash consideration to be included in the transaction price.

An entity considers all of its obligations under the contract to determine the appropriate timing of revenue recognition.

Materials received from a customer

IFRS 15.70

An entity may receive materials from a customer that it uses in producing finished goods for that customer. In some cases, the entity may also be required to pay for the materials received. In these cases, a question arises about whether the amounts paid to the customer should be recognised as a reduction in the transaction price or as a payment for distinct goods (see Section 3.4).

In our view, if an entity obtains control of the materials received from the customer, then it should account for them in the same way as it accounts for other purchases from suppliers – i.e. the purchased materials are distinct goods. Conversely, if an entity does not obtain control of the materials received, then we believe that amounts paid to the customer should reduce the transaction price (see Section 3.4).

We believe that an entity should apply the general guidance on transfer of control (see Section 5.1) to determine whether it controls materials received from a customer. Indicators that the entity has not obtained control of materials received from a customer include the following:

- the customer is contractually committed to purchasing all finished goods produced by the entity that include the specific materials received from the customer;
- the contributed assets are non-cash consideration to be included in the transaction price;
- the risks and rewards directly related to the materials received from the customer reside principally with the customer – e.g. price risk;
- the customer is responsible for the design of the finished goods and acceptance that they meet the required specifications; and
- the customer would not recognise a sale under the repurchase guidance.

Barter transactions involving advertising services

The standard does not contain any specific guidance on the accounting for barter transactions involving advertising services; therefore, the general principles for measuring consideration apply.

Additional application example

Example 29 – Materials received from customer: No transfer of control

Automotive Supplier S enters into a contract with Carmaker C to sell rubber compounds (finished goods) for 1,000 on the following terms.

- C determines the production inputs, procedures and testing specifications for the finished goods.
- S receives the raw materials used in the production of the rubber compounds from C and is required to make a payment of 300 for them.
- S is contractually restricted from using the raw materials received from C to produce goods for other customers.
- C is contractually required to purchase all of the rubber compounds that S produces using the raw materials received from C.
- The sales price charged to C for the finished goods is calculated based on S's actual cost plus an agreed margin.

S concludes that it does not obtain control of the raw materials received from C for the following reasons.

- S is contractually restricted from using the raw materials for a purpose other than in the production of the finished goods for C.
- C does not recognise a sale of the raw materials transferred to S because it has an obligation to repurchase the finished goods of which the raw materials are components.
- The exposure to risks and rewards directly related to the raw materials principally resides with C. This is because C is responsible for the design and testing specifications for the finished goods and bears the price risk related to the raw materials because the sales price of the finished goods is determined based on S's cost plus a margin.

Therefore, S reduces the transaction price for the payment made to C for raw materials and recognises revenue of 700 (1,000 – 300).

3.4 Consideration payable to a customer

IFRS 15.70

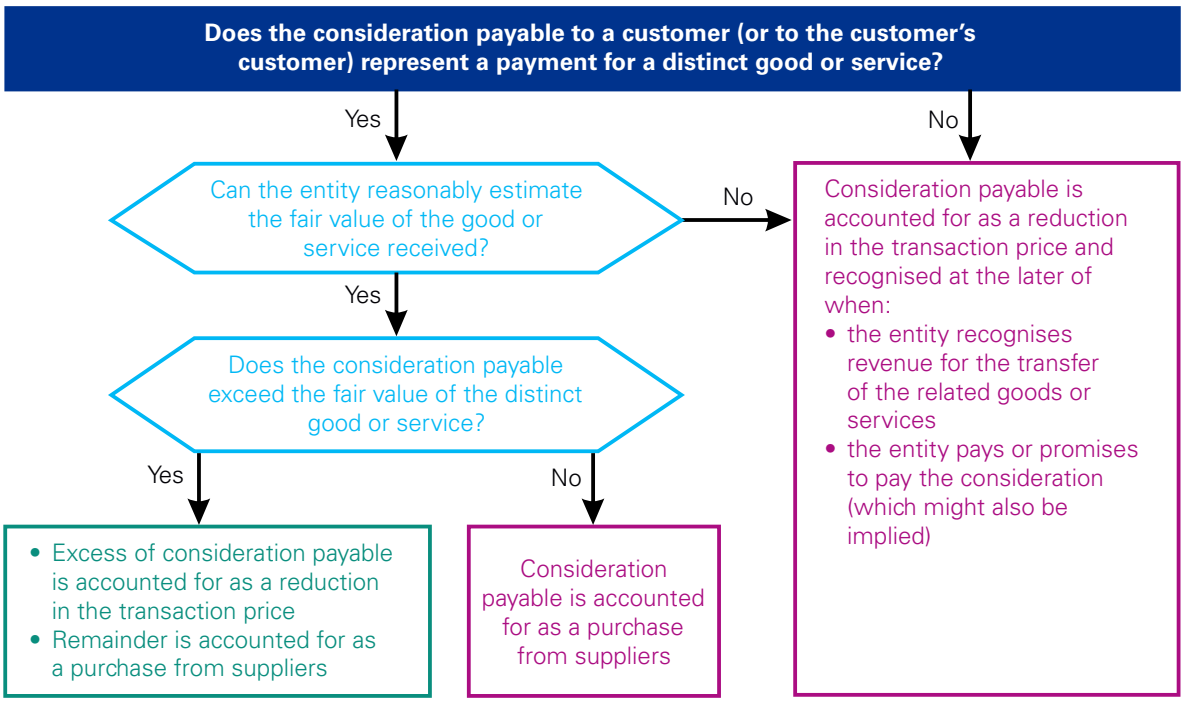
Consideration payable to a customer includes cash amounts that an entity pays or expects to pay to the customer or to other parties that purchase the entity's goods or services from the customer. Consideration payable to a customer also includes credits or other items – e.g. a coupon or voucher – that can be applied by the customer against the amount owed to the entity or to other parties that purchase the entity's goods or services from the customer.

An entity evaluates the consideration payable to a customer to determine whether the amount represents a reduction of the transaction price, a payment for distinct goods or services or a combination of the two.

IFRS 15.71

If the entity cannot reasonably estimate the fair value of the good or service received from the customer, then it accounts for all of the consideration payable to the customer as a reduction in the transaction price.

IFRS 15.70–72



IFRS 15.IE160–IE162

Example 30 – Payments to customers: Reduction in the transaction price

Consumer Goods Manufacturer M enters into a one-year contract with Retailer R to sell goods. R commits to buying at least 1,500 worth of the products during the year. M also makes a non-refundable payment of 15 to R at contract inception to compensate R for the changes that it needs to make to its shelving to accommodate M's products.

M concludes that the payment to R is not in exchange for a distinct good or service, because M does not obtain control of the rights to the shelves. Consequently, M determines that the payment of 15 is a reduction in the transaction price. M accounts for the consideration paid as a reduction in the transaction price when it recognises revenue for the transfer of the goods.

Example 31 – Payments to customers: Variable consideration vs consideration payable to a customer

Company C contracts with Retailer X and delivers goods on 15 December Year 1. On 20 January Year 2, C offers coupons in a newspaper to encourage retail sales of the goods sold to X. C agrees to reimburse X for coupons redeemed.

C has offered similar coupons in previous years.

C would probably determine that the transaction price for the goods sold on 15 December Year 1 included variable consideration, given its history of offering coupons.

Conversely, if C had not offered coupons in prior years and did not expect to offer any coupons at contract inception, then it would recognise the amount payable to X as an adjustment to revenue when it communicated to X its intention to reimburse X for any redeemed coupons.

Payments to distributors and retailers may be for distinct goods or services

Consumer goods companies often make payments to their distributors and retailers. In some cases, the payments are for identifiable goods or services – e.g. co-branded advertising. In these cases, the goods or services provided by the customer may be distinct from the customer's purchase of the seller's products.

If the entity cannot estimate the fair value of the good or service received from the customer, then it recognises the payments as a reduction in the transaction price. If the payments to customers exceed the fair value of the good or service provided, then any excess is a reduction in the transaction price.

Slotting fees

Slotting fees are payments made by an entity to a retailer for product placement in the retailer's store. Judgement is required to determine whether slotting fees are:

- *paid in exchange for a distinct good or service that an entity receives from the customer:* these are recognised as a purchase from the supplier – i.e. as a prepayment or an expense; or
- *sales incentives granted by the entity:* these are recognised as a reduction in the transaction price.

When making this judgement, an entity carefully considers its particular facts and circumstances.

Nomination fees

In some cases, an entity makes non-refundable up-front payments to a customer before a contract exists. For example, an entity may make a payment to a customer under, or in conjunction with entering into, a framework agreement. The nature of these payments is evaluated based on the specific facts and circumstances. In our view, if such a payment meets the definition of an asset, then it may be capitalised and amortised as a reduction in revenue over the expected purchases or service period (including renewals) to which it relates (see Section 7.3).

When determining the appropriate accounting for an up-front payment, factors to consider may include:

- the underlying reason for the payment;
- whether the payment is recoverable: e.g. if an exclusive relationship is secured and it is probable that the customer will make sufficient purchases to recover the payment; and
- the history of renewals and the average project life, which usually indicate whether the expected initial contract will be obtained and whether the payment will be recovered through the initial contract or anticipated renewals.

We believe that the entity should assess the recoverability of the capitalised payments at each reporting date. This assessment should generally be based on the expected future cash flows from the customer.

Scope of consideration payable to a customer is wider than payments made under the contract

Payments made to a customer that are not specified in the contract may still represent consideration payable to a customer. An entity needs to develop a process for evaluating whether any other payments made to a customer are consideration payable that requires further evaluation under the standard.

The determination of how broadly payments within a distribution chain should be evaluated requires judgement. However, an entity need not always identify and assess all amounts ever paid to a customer to determine whether they represent consideration payable to a customer.

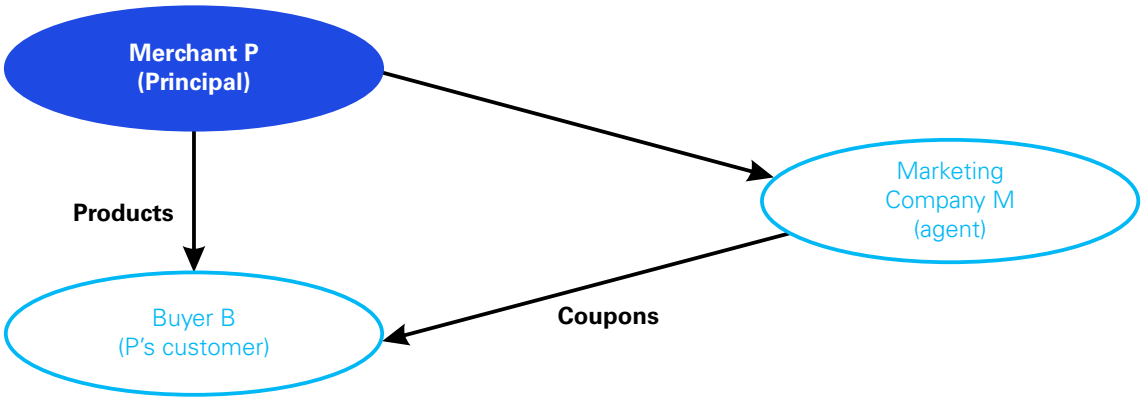
Consideration payable may include payments made outside a direct distribution chain

IFRS 15.70, BC92, BC255

Consideration payable to a customer includes amounts paid to a customer's customer – i.e. amounts paid to end customers in a direct distribution chain. However, in some cases an entity may conclude that it is appropriate to apply the guidance more broadly – i.e. to amounts paid outside the direct distribution chain.

For example, Marketing Company M may market and incentivise the purchase of Merchant P's products by providing coupons to P's Buyer B. When B buys from P as a result of M's actions, M earns revenue from P. B is not purchasing M's services and is not in a direct distribution chain.

Service fee based on number of units sold by Merchant P



Depending on the facts and circumstances, M may conclude that both P and B are its customers, or it may conclude that only P is its customer. As a consequence, judgement will be needed to evaluate a specific fact pattern to determine whether a payment to a party outside a direct distribution chain should be treated as consideration payable to a customer and therefore as a reduction of revenue.

Selling goods or services through an intermediary – Identifying the customer

If an entity involves an intermediary (e.g. an online platform) in selling its goods or services to end customers, then it may be challenging to identify the customer for the purposes of the analysis under the standard. To determine who the entity's customer is – i.e. the intermediary or the end customer – the entity considers to which party it transfers control of the goods.

To help in identifying its customer in the transaction, an entity may use the principal/agent guidance (see Section 10.3) to evaluate whether the intermediary is acting as a principal or an agent – i.e. to determine whether the intermediary controls the goods or services before they are delivered to the end customer.

Identifying which party is the entity's customer is important because it impacts the accounting for the payments to the intermediary – i.e. whether they are treated as an adjustment to the transaction price (payment to a customer) or an expense.

Amounts payable to a customer may be either variable consideration or consideration payable to a customer

The standard states that consideration payable to a customer includes amounts that an entity pays or expects to pay to a customer or to other parties that purchase the entity's goods or services from the customer. The guidance on consideration payable to a customer states that it is recognised at the later of when the entity recognises revenue or when the entity pays or promises to pay the consideration. However, because consideration payable to a customer can be included in the transaction price, it can also be a form of variable consideration.

Variable consideration is estimated and included in the transaction price at contract inception, and remeasured at each subsequent financial reporting date. This is different from the guidance on when to recognise consideration payable to a customer.

This discrepancy puts pressure on the determination, at contract inception, of whether the entity intends to provide an incentive or the customer has a reasonable expectation that an incentive will be provided.

This evaluation includes an assessment of the entity's past practice and other activities that could give rise to an expectation at contract inception that the transaction price includes a variable component. The consideration payable to a customer guidance is used only when an entity has not promised a payment to the customer at contract inception, either implicitly (including through its customary business practice) or explicitly.

Non-cash rebates may be either variable consideration or consideration payable to a customer

An entity may issue rebates or other incentives in the form of its own shares or warrants for its own shares. For example, a start-up entity may use such arrangements to save cash but still incentivise customers. Depending on the facts and circumstances, such arrangements may represent variable consideration and/or consideration payable to a customer, and therefore result in a reduction in the transaction price.

An entity needs to consider the guidance on non-cash consideration (see Section 3.3) in arriving at the transaction price and then determine when to recognise that reduction in the transaction price as a reduction in revenue. In addition, an entity also needs to consider the accounting for the shares and warrants under the standard on financial instruments. In applying the financial instruments guidance, an entity may need to consider, among other matters, whether the instruments are classified as equity or liabilities, when the instruments should be recognised and whether the instruments require remeasurement through profit or loss until settlement or expiry.

Additional application examples

Example 32 – Payments to customers: Goodwill credits

Customer C has a two-year network service contract with Telco T. In Month 6, T experiences two days of service quality issues. Past experience indicates that service quality issues are infrequent for T.

In Month 7, C receives a bill of 100 for Month 6 services. On receiving the bill, C calls T and requests a credit for the service outage. Although it is not its usual practice, T grants C a credit of 5.

Because the credit can be applied against amounts owed to T, it is accounted for as consideration payable to the customer. And, because the payment is not in exchange for a distinct good or service, the consideration is accounted for as a reduction in the transaction price.

Example 33 – Payments to customers: Credits to a new customer

Customer C is in the middle of a two-year contract with Telco B, its current wireless service provider, and would be required to pay an early termination penalty if it terminated the contract today.

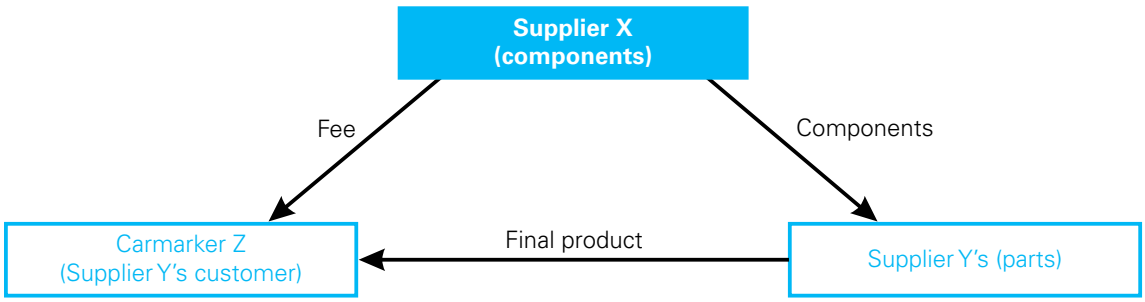
If C cancels the existing contract with B and signs a two-year contract with Telco D for 80 per month, then D promises at contract inception to give C a one-time credit of 200 (referred to as a 'port-in credit'). The amount of the port-in credit does not depend on the volume of service subsequently purchased by C during the two-year contract.

D determines that it should account for the port-in credit as consideration payable to a customer. This is because the credit will be applied against amounts owing to D. Because D does not receive any distinct goods or services in exchange for this credit, it will account for it as a reduction in the transaction price (i.e. 80 × 24 - 200). D will recognise the reduction in the transaction price as the promised goods or services are transferred.

Example 34 – Payments to customers: Consideration paid to a customer's customer

Supplier X enters into a contract with Supplier Y to sell components worth 1,500 during the year as a subcontractor. The contract is in the scope of the standard. Y will then integrate these components into parts that it sells to Carmaker Z.

As part of the arrangement, X has agreed to pay a one-off administrative fee of 15 to Z so that it can be added to Z's list of suppliers.



X notes that Z is the end customer in a distribution chain that includes Y. Therefore, payments to Z may be considered as consideration payable to a customer.

X concludes that the payment to Z is not in exchange for a distinct good or service. Consequently, X determines that the payment of 15 is a reduction in the transaction price, which it recognises as a reduction in the revenue earned as it transfers the promised components to Y.

Example 35 – Payments to customers: Identifying an entity's customer in a transaction involving an intermediary

Electronics Retailer K enters into a five-year arrangement with an intermediary Company M to sell its goods on M's online marketplace. Under the contract:

- M's primary responsibility is to ensure that the platform functions properly and provide assistance with product returns under K's terms and conditions. M is entitled to a commission of 15% of each sale on its own platform; and
- K is responsible for both the quality and delivery of the products ordered by the end customers.

To incentivise the end customers to buy its products, K offers them 50 cashback if they spend 250 or more in a single transaction on eligible products.

K performs an assessment to determine whether M or the end customer is its customer. As part of this assessment, K considers that M acts as an agent in the transaction – i.e. M does not take control of the goods before they are delivered to the end customer. Therefore, K concludes that its customer is the end customer.

Assume that End Customer C purchases K's products for 250 via M's online marketplace. K recognises revenue of 200 – calculated as the price of goods sold of 250 less the cashback of 50 (consideration payable to a customer). K treats the commission paid to M as an expense.

Modifying the fact pattern, if M acted as a principal and was identified as the customer, then K would recognise revenue of 162.50 – calculated as the price of goods sold of 250 less the commission of 37.5 (consideration payable to a customer) and less the cashback of 50 (consideration payable to a customer's customer).

Example 36 – Payments to customers: Payment on entering into a new framework agreement

Supplier S makes a non-refundable up-front payment of 1 million to Customer C as part of the negotiations for a three-year framework agreement to supply specialised parts to C exclusively. The parts will be assembled into C's main product, which has been successful in the market. C has been a customer of S for many years and S has been able to provide reliable forecasts of the results of its projects with C.

The framework agreement stipulates a price of 100 per part. C provides a non-binding projection of its supply requirements, which forecasts probable purchases of 100,000 parts over the three years (for a total of 10 million). S's profit margin on these parts is 20%. However, there is no enforceable contract until C submits a purchase order.

S considers the following factors to evaluate the accounting for the 1 million up-front payment to C.

- S has secured an exclusivity agreement with C.
- S has a long history of doing business with C that is used as a basis for forecasting C's future purchases.
- The payment is expected to be recoverable from probable future purchases that will earn S a margin of 2 million (10 million × 20% profit margin).
- The primary purpose of the fee is to secure an exclusive relationship with C and these transactions are common in the industry.

Based on its overall evaluation of these factors, S concludes that the payment should be capitalised and amortised as a reduction in revenue over the anticipated future purchases.

Example 37 – Payments to customers: New product for a new customer

Supplier S enters into a framework agreement with Carmaker B to supply a specialised component as part of a new product that B is developing. Supplying the part will require extensive pre-production engineering activities, for which S will be paid only if the development process succeeds. B does not commit to a minimum quantity of parts before S produces the first prototype. Because this is a new product, S does not have historical experience with it.

As part of the arrangement, S pays a non-refundable up-front fee to B of 100,000.

When determining how to account for the payment to B, S notes that it:

- cannot reasonably estimate whether the development process will be successful and therefore whether it will receive payment for this activity;
- has no contract for a minimum quantity of parts; and
- lacks historical experience with the new product. The uncertainty over the pre-production engineering activities indicates that the payment may not be recoverable through future purchases.

On evaluating these factors, S concludes that this up-front payment does not represent an asset. Therefore, it accounts for the payment in profit or loss when it is obliged to make the payment.

Example 38 – Payments to customers: Volume rebates

Media Company M provides advertising space to companies on its internet platform. M enters into a contract with Advertising Agency B for the referral of B's customers to M. Under the contract, B is entitled to a commission of 10% of M's billings for the use of its advertising space by B's customers. To secure its market share, M also agrees to pay a volume rebate directly to B's customers (i.e. the end users of the advertising space) if certain advertising volumes are met during an annual period.

M considers that it does not receive any distinct good or service in exchange for the payment of volume rebates to B's customers and therefore accounts for them as a reduction in revenue. M's accounting for these volume rebates is not impacted by its assessment of whether they are consideration payable to its customer or its customer's customer.

Example 39 – Payments to customers: Incentives granted to a customer

Company X is an online food ordering platform. X enters into contracts with restaurants and charges a commission to the restaurants on each order placed by an end user. X determines that it acts as an agent of the restaurants in arranging for the placement of the food order. X also provides delivery services on all orders and charges end users a fee for this delivery service. X determines that it acts as a principal in the delivery service provided to the end users.

From time to time, to incentivise end users to use its platform, X offers them a credit of 5 against the total amount of their current order. Consequently, the incentive granted to the end user is a reduction in the purchase price. X bears the full cost of the incentives offered to end users – i.e. it does not pass any of the cost on to the restaurants.

X concludes that the incentives represent consideration payable to a customer because they are paid to the end user who is a customer of X for the delivery service. X determines that it does not receive any distinct goods or services for the payment, and therefore accounts for the incentives as a reduction in revenue.

Example 40 – Payments to customers: Incentives granted to a customer's customer

Modifying Example 39, in addition to preparing the food the restaurants are also responsible for delivering it to the end user. Company X's only responsibility is to arrange for the placement of food orders – i.e. X acts as an agent of the restaurants.

X concludes that the incentives represent consideration payable to a customer because they are paid to a customer's customer and are part of the overall value chain. X determines that it does not receive any distinct goods or services for the payment, and therefore accounts for the incentives as a reduction in revenue.

3.5 Sales taxes

IFRS 15.47, BC188B

Revenue does not include amounts collected on behalf of tax authorities – e.g. some sales taxes, excise duties or value added taxes (VAT). The amount of taxes or duties may be computed as a percentage of either the selling price or the production cost.

To determine how to account for sales taxes or duties, an entity assesses whether it is primarily obligated for payment of the taxes or whether it collects the amount from the customer on behalf of the tax authorities. This determination is made based on an analysis of the local regulatory requirements.

The accounting for sales or excise duties may vary depending on the different tax regimes in various jurisdictions. This might lead to different accounting for different sales or excise duties by entities within a multinational group. Depending on how the legal or regulatory requirements are applied, the determination of whether an entity is primarily responsible for the tax may require significant judgement. In our view, if excise taxes are significant then the entity should disclose the judgements made and the line item(s) in which amounts are included, if applicable.

Example 41 – Sales taxes: Gross accounting for excise duties

Excise duties may be determined based on production levels and are payable to the authorities regardless of whether goods are sold – i.e. the tax payments are not refunded by the authorities if the goods are not sold. In our view, in these cases the seller is primarily responsible for the tax and it is another production cost to be recovered in the pricing of the goods. Accordingly, it does not collect the tax from the customer on behalf of the tax authorities and the transaction price should be determined on a gross basis, including the excise duties recouped from customers. As a result, any excise duties received from a customer should be included in the revenue line item and any excise duties incurred should be included in the 'cost of goods sold' line item.

Example 42 – Sales taxes: Net accounting for excise duties

Excise duties may be recouped from the authorities if the buyer defaults. In our view, in these cases the seller is likely to be collecting the tax from the customer on behalf of the tax authorities because it is not primarily responsible for the tax and does not bear any risk. Under this approach, the amount of excise tax should be excluded from revenue and amounts collected should be reported as a liability.

Example 43 – Sales taxes: Gross accounting for export taxes

The tax authorities in Country X impose an export tax on certain commodities sold to overseas customers; an entity cannot reclaim the tax if the customer defaults. In our view, this example is similar to Example 41 in this chapter – i.e. the seller is primarily obligated for payment of the taxes, rather than collecting the amounts on behalf of the tax authorities. Therefore, the transaction price is determined on a gross basis, including any export tax recouped from customers. As a result, the export tax is included in the revenue line item and export tax incurred is included in expenses or 'cost of goods sold'.

4 Allocate the transaction price to the performance obligations in the contract (Step 4)

Overview

IFRS 15.73, 75 The transaction price is allocated to each performance obligation – generally each distinct good or service – to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

IFRS 15.74 An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met a discount or variable consideration is allocated to one or more, but not all, performance obligations.

IFRS 15.76 This step of the revenue model comprises two sub-steps that an entity performs at contract inception.

Determine stand-alone selling prices (see Section 4.1) → **Allocate the transaction price (see Section 4.2)**

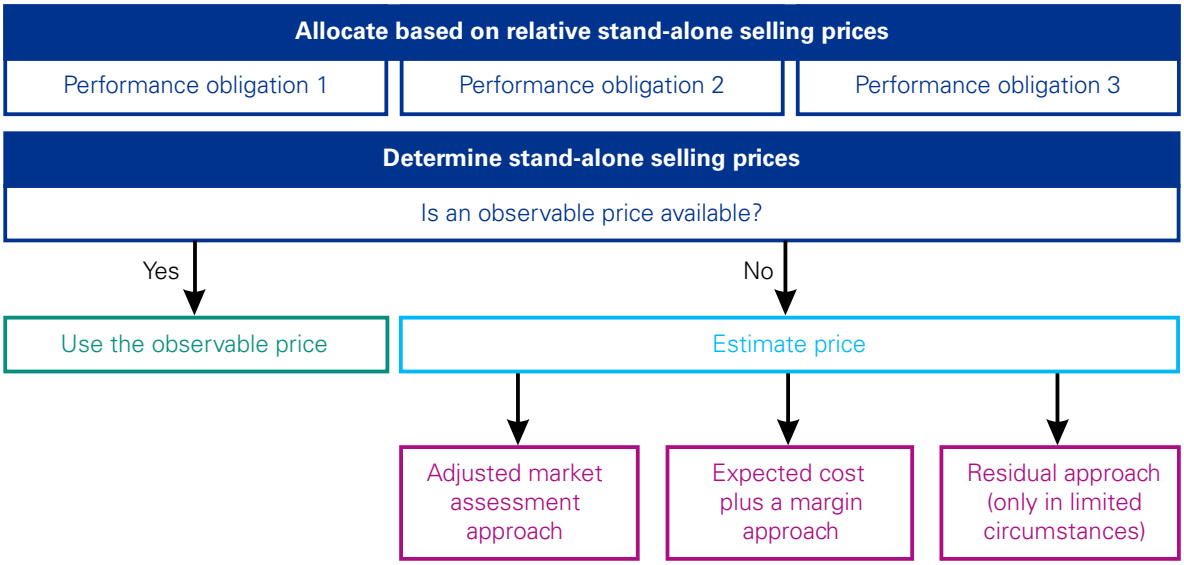
4.1 Determine stand-alone selling prices

IFRS 15.77 The 'stand-alone selling price' is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of this is an observable price from stand-alone sales of the good or service to similarly situated customers.

A contractually stated price or list price may be the stand-alone selling price of that good or service, but this is not presumed to be the case.

IFRS 15.78 If the stand-alone selling price is not directly observable, then the entity estimates the amount using a suitable method (see 4.1.1) as illustrated below. In limited circumstances, an entity may estimate the amount using the residual approach (see 4.1.2).

IFRS 15.79



The standard does not contain a reliability threshold

Under the standard, the stand-alone selling price is determined at contract inception for each performance obligation. There are no circumstances in which revenue recognition is postponed because it is difficult to determine a stand-alone selling price.

If an observable price is available, then it is used to determine the stand-alone selling price; if not, then the entity is required to estimate the amount.

The standard does not require that the amount can be 'reliably' estimated, nor does it prescribe another threshold. An entity is required to maximise the use of observable inputs, but in all circumstances will need to arrive at a stand-alone selling price and allocate the transaction price to each performance obligation in the contract.

An entity will need to apply judgement when there are observable prices but they are highly variable.

4.1.1 Estimating stand-alone selling prices

IFRS 15.78

An entity considers all information that is reasonably available when estimating a stand-alone selling price – e.g. market conditions, entity-specific factors and information about the customer or class of customer. It also maximises the use of observable inputs and applies consistent methods to estimate the stand-alone selling price of other goods or services with similar characteristics.

IFRS 15.79

The standard does not preclude or prescribe any particular method for estimating the stand-alone selling price for a good or service when observable prices are not available, but describes the following estimation methods as possible approaches.

Adjusted market assessment approach	Evaluate the market in which goods or services are sold and estimate the price that customers in the market would be willing to pay
Expected cost plus a margin approach	Forecast the expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service
Residual approach (limited circumstances)	Subtract the sum of the observable stand-alone selling prices of other goods or services promised in the contract from the total transaction price

IFRS 15.88

After contract inception, an entity does not reallocate the transaction price to reflect subsequent changes in stand-alone selling prices. For a discussion of changes in a transaction price as a result of a contract modification, see Section 8.2.

Judgement is often required to estimate stand-alone selling price

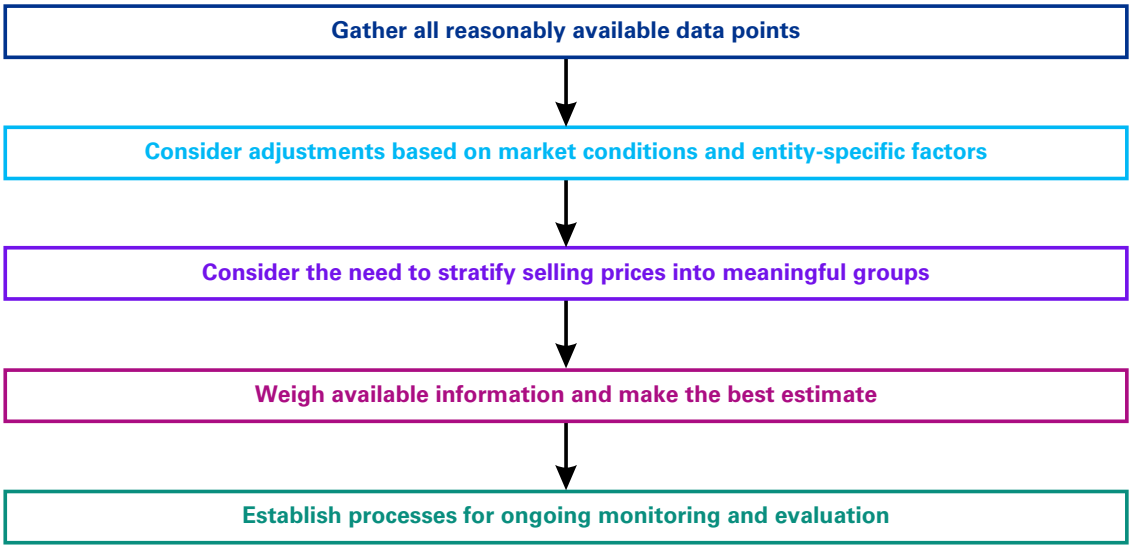
IFRS 15.BC269

Often, there is not an observable selling price for all of the goods or services in a contract with a customer. As a result, significant judgement is often involved in estimating a stand-alone selling price. To estimate stand-alone selling prices of goods or services that are not typically sold separately, an entity needs to develop processes with appropriate internal controls.

Reasonably available information that may be considered in developing these processes might include:

- *reasonably available data points:* e.g. costs incurred to manufacture or provide the good or service, profit margins, supporting documentation to establish price lists, third party or industry pricing and contractually stated prices;
- *market conditions:* e.g. market demand, competition, market constraints, awareness of the product and market trends;
- *entity-specific factors:* e.g. pricing strategies and objectives, market share and pricing practices for bundled arrangements; and
- *information about the customer or class of customer:* e.g. type of customer, geography or distribution channels.

The following framework may be a useful tool for estimating and documenting the stand-alone selling price and for establishing internal controls over the estimation process.



Estimated stand-alone selling prices for a particular good or service may change over time due to changes in market conditions and entity-specific factors. Although the estimated stand-alone selling prices for previously allocated arrangements are not revised, new arrangements should reflect current reasonably available information, including shifts in pricing, customer base or product offerings.

The extent of the monitoring process and the frequency of necessary changes in estimated stand-alone selling prices will vary based on the nature of the performance obligations, the markets in which they are being sold and various entity-specific factors. For example, a new product offering or sales in a new geographic market may require more frequent updates to the estimated stand-alone selling price as market awareness and demand change.

Single good or service may have more than one stand-alone selling price

An entity may sell a similar good or service to different groups of customers at different prices. In these cases, the good or service may have more than one stand-alone selling price. Therefore, the entity may consider stratifying stand-alone selling prices. The stratification could be based on customer type, volume of sales to customers, geography, distribution channel or other relevant groupings.

If there is a range of observable prices, then a stated contract price within the range may be an acceptable stand-alone selling price

In some cases, an entity may sell a good or service separately for a range of observable prices. When this is the case and the stated contract price is within a sufficiently narrow range of observable selling prices, it may be appropriate to use a stated contract price as the estimated stand-alone selling price of the good or service.

To determine whether this is appropriate, the entity assesses whether an allocation of the transaction price based on such an estimate would meet the allocation objective (see Section 4.2). As part of this assessment, the entity considers all information that is reasonably available (including market conditions, entity-specific factors, information about the customer or class of customer, how wide the range of observable selling prices is and where the stated price falls within the observable range).

For example, Company D sells a licence plus post-contract customer support (PCS) for 450. The stated price for PCS in the contract is 206. D regularly sells the same PCS separately for observable prices ranging from 200 to 210. In this example, the stated price is within a reasonably narrow range of observable prices and, assuming that there are no other indicators that using the stated price would not meet the allocation objective, it may be appropriate to conclude that 206 is a reasonable estimate of the stand-alone selling price for the PCS that can be used in determining how to allocate the contract consideration of 450 between the licence and PCS.

Using a range to estimate stand-alone selling prices

When estimating stand-alone selling prices, it may be acceptable to select from a range of prices, particularly when stand-alone selling prices would be expected to vary for similar types of customers. A range has to be narrow and based on an analysis that maximises observable inputs and supports an assertion that any price within that range would be a valid pricing point if the performance obligation were sold on a stand-alone basis.

It would not be appropriate to establish a range by determining an estimated stand-alone selling price and then arbitrarily adding a range of a certain percentage on either side of the point estimate to create a reasonable range of estimated selling prices.

4.1.2 Using the residual approach to estimate stand-alone selling prices

IFRS 15.79(c)

The residual approach is appropriate only if the stand-alone selling price of one or more goods or services is highly variable or uncertain and observable stand-alone selling prices can be established for the other goods or services promised in the contract.

Selling price is…	If…
Highly variable	The entity sells the same good or service to different customers at or near the same time for a broad range of prices
Uncertain	The entity has not yet established the price for a good or service and the good or service has not previously been sold on a stand-alone basis

Under the residual approach, an entity estimates the stand-alone selling price of a good or service on the basis of the difference between the total transaction price and the observable stand-alone selling prices of other goods or services in the contract.

In our view, the total transaction price used in applying the residual approach should include the estimated amount of any variable consideration before applying the constraint (see Section 3.1). This approach is consistent with the allocation objective because the estimated variable consideration is the amount of consideration to which the entity expects to be entitled.

IFRS 15.80

If two or more goods or services in a contract have highly variable or uncertain stand-alone selling prices, then an entity may need to use a combination of methods to estimate the stand-alone selling prices of the performance obligations in the contract. For example, an entity may use:

- the residual approach to estimate the aggregate stand-alone selling prices for all of the promised goods or services with highly variable or uncertain stand-alone selling prices; and then
- another technique to estimate the stand-alone selling prices of the individual goods or services relative to the estimated aggregate stand-alone selling price that was determined by the residual approach.

Example 1 – Estimating stand-alone selling price: Residual approach

Software Vendor M enters into a contract with Customer C to provide rights to use Licences S and T for three years, as well as PCS services for both licences. The contract price is 100,000.

The PCS services comprise telephone technical support for each licence. M has identified four performance obligations in the contract:

- Licence S;
- PCS services for S;
- Licence T; and
- PCS services for T.

The stand-alone observable price of 12,500 is available for the technical support for each of the licences, based on renewals that are sold separately. However, the prices at which M has sold licences similar to S and T have been in a broad range of amounts – i.e. the selling prices of the licences are highly variable and not directly observable. Also, the level of discounting in the bundled arrangements varies based on negotiations with individual customers. M estimates the stand-alone selling prices of the performance obligations in the contract as follows.

Product	Stand-alone selling price	Approach
Licences S and T	75,000	Residual approach (100,000 - 12,500 - 12,500)
PCS services for S	12,500	Directly observable price
PCS services for T	12,500	Directly observable price
Total	**100,000**	

M uses the residual approach to estimate the stand-alone selling price for the bundle of products (S and T) with highly variable selling prices. Because the licences will transfer to C at different points in time, M then estimates the stand-alone selling price of each licence. It does this by allocating the 75,000 to S and T based on the average stand-alone selling price determined using the residual approach over the past year, as follows.

Product	Average residual selling price	Ratio	Price allocation	Calculation
Licence S	40,000	40%	30,000	(75,000 × 40%)
Licence T	60,000	60%	45,000	(75,000 × 60%)
Total	**100,000**	**100%**	**75,000**	

The residual approach is an estimation technique, not an allocation method

IFRS 15.BC271

The residual approach is a technique to estimate the stand-alone selling price of a good or service, rather than an allocation method. Therefore, the timing of the transfer of control of each performance obligation is not relevant when applying the residual approach to estimate the stand-alone selling price of a promised good or service. In some cases, it may be appropriate to use a residual method to estimate the stand-alone selling price of an item that is transferred on contract commencement; in other cases, it may be appropriate to use a residual method to estimate the stand-alone selling price of an item that is transferred later in the contract.

In contracts for intellectual property or other intangible products, a residual approach may be appropriate for determining a stand-alone selling price

Determining stand-alone selling prices may be particularly challenging for contracts for intellectual property (IP) or intangible assets if they are infrequently sold separately but are often sold in a wide range of differently priced bundles. They often have little or no incremental cost to the entity providing those goods or services to a customer (so a cost plus a margin approach would be inappropriate) and may not have substantially similar market equivalents from which to derive a market assessment.

In these circumstances, the residual approach may be the most appropriate approach for estimating the stand-alone selling price.

The assessment of whether it is appropriate to use a residual approach should be made separately for each good or service

In some contracts, the price of one good or service may be calculated with reference to the price of another good or service. For example, in a contract containing IP and PCS, the price of PCS may be established as a fixed percentage of the stated contract price of the licence fee.

If this is the case and the stand-alone selling price of the IP is determined to be highly variable or uncertain, then the entity needs to consider all available data and evidence in determining the stand-alone selling price of the PCS, rather than assuming that the fixed percentage of the contract price represents the stand-alone selling price of the PCS. The entity considers, among other evidence, the price charged for actual renewals of PCS and stated renewal rates in other contracts with similar customers.

Consideration allocated is unlikely to be zero or close to zero

IFRS 15.BC273

If applying the residual approach under the standard results in no or very little consideration being allocated to a good or service, or to a bundle of goods or services, then this outcome may not be reasonable unless the contract is only partially in the scope of the standard and another standard also applies to the contract (see Section 6.3).

If an entity has determined in applying Step 2 of the model that a good or service is distinct, then by definition it has value to the customer on a stand-alone basis. In this case, an entity considers all reasonably available data and whether the stand-alone selling price of that good or service should be estimated using another method.

4.2 Allocate the transaction price

IFRS 15.76

At contract inception, the transaction price is generally allocated to each performance obligation on the basis of relative stand-alone selling prices. However, when specified criteria are met, a discount (see 4.2.1) or variable consideration (see 4.2.2) is allocated to one or more, but not all, of the performance obligations in the contract.

IFRS 15.88–89

After initial allocation, changes in the transaction price are allocated to satisfied and unsatisfied performance obligations on the same basis as at contract inception, subject to certain limited exceptions (see Section 4.3).

Example 2 – Allocating the transaction price

Telco T enters into a 12-month phone contract in which a customer is provided with a handset and a plan that includes data, calls and texts (the wireless plan) for a price of 35 per month. T has identified the handset and the wireless plan as separate performance obligations.

T sells the handset separately for a price of 200, which provides observable evidence of a stand-alone selling price. T also offers a 12-month service plan without a phone that includes the same level of data, calls and texts for a price of 25 per month. This pricing is used to determine the stand-alone selling price of the wireless plan as 300 (25 × 12 months).

T allocates the transaction price of 420 (35 × 12 months)[1] to the performance obligations based on their relative stand-alone selling prices as follows.

Performance obligation	Stand-alone selling prices	Selling price ratio	Price allocation	Calculation
Handset	200	40%	168	(420 × 40%)
Wireless plan	300	60%	252	(420 × 60%)
Total	**500**	**100%**	**420**	

Note

1. In this example, the entity does not adjust the consideration to reflect the time value of money. This could happen if the entity concludes that the transaction price does not include a significant financing component or if the entity elects to use the practical expedient (see Section 3.2).

Allocating the transaction price may be simple if stated contract prices are acceptable estimates of stand-alone selling price

In some cases, an entity may determine that a stated contract price is an acceptable estimate of the stand-alone selling price for its performance obligations – e.g. if the stated contract price is within a narrow range of observable selling prices (see 4.1.1). If this is the case for all of the performance obligations in a contract and there is no allocation of variable consideration or discounts, then this will simplify allocation of the transaction price.

For example, Medical Device Company MDC sells a medical imaging device bundled with one year of PCS and 10 days of training to a customer for a total fee of 564,900. MDC determines that the medical imaging device, PCS and training are separate performance obligations. There is no variable consideration or discounts that are required to be allocated entirely to some but not all performance obligations.

The stated contract prices for the goods and services are as follows.

Goods and services	Contract prices
Medical imaging device	505,000
One year of PCS	50,000
Training	9,900
Total	**564,900**

MDC has established a narrow range of stand-alone selling prices for each of the goods and service identified as separate performance obligations.

Performance obligation	Range of stand-alone selling prices
Medical imaging device	500,000–525,000
One year of PCS	50,000–52,500
Training	960–990 per day

Because all of the stated contract prices fall within narrow ranges, the stated contract price may be used to allocate the transaction price to the performance obligations. No further allocation is required.

Additional calculations are necessary if the stand-alone selling price of one or more performance obligations differs from its stated contract price

If the stated contract price for any of the performance obligations in the arrangement is not an appropriate estimate of stand-alone selling price, then it will be necessary for the entity to perform a relative selling price allocation of the transaction price.

This will be the case if, for example, the stated contract price falls outside the narrow range of stand-alone selling prices established for that performance obligation. When this is the case, an entity should apply a consistent policy to determine which price in the range of stand-alone selling prices should be used as the stand-alone selling price.

For example, an entity may consider a policy of using either (1) the midpoint of the range or (2) the outer limit of the range nearest to the stated contract price for that performance obligation. The appropriateness of the policy will be determined by whether the resulting allocation of the transaction price would meet the allocation objective.

This can be illustrated by varying the facts in the previous example. For example, assume that the total fee for the arrangement is 551,000, with stated contract prices of 520,000 for the medical imaging device, 26,000 for the PCS and 5,000 for the training. Medical Device Company MDC's policy is to estimate stand-alone selling prices using the midpoint of its narrow range of observable selling prices for performance obligations whose stated contract prices fall outside the established ranges when performing the relative selling price allocation.

Because the stated prices for PCS and training fall outside their respective estimated selling price ranges, consistent with its policy MDC allocates the transaction price using the midpoint of the ranges as follows.

Performance obligation	Stated price	Stand-alone selling price	Selling price ratio	Price allocation
Medical imaging device (stated price within range)	520,000	520,000[1]	89.5%	493,145
One year of PCS (midpoint of range)	26,000	51,250[2]	8.8%	48,488
Ten days of training (midpoint of range)	5,000	9,750[3]	1.7%	9,367
Total	**551,000**	**581,000**	**100.0%**	**551,000**

Notes

1. The stated contract price is used because it falls within the narrow range.
2. The midpoint of the range 50,000–52,500 is used because the stated contract price is outside the narrow range.
3. The midpoint of the range 960–990 per day × 10 days is used because the stated price is outside the narrow range.

4.2.1 Allocating a discount

IFRS 15.81

If the sum of the stand-alone selling prices of a bundle of goods or services exceeds the promised consideration in a contract, then the discount is generally allocated proportionately to all of the performance obligations in the contract. However, this does not apply if there is observable evidence that the entire discount relates to only one or more but not all of the performance obligations.

IFRS 15.82

This evidence exists, and a discount is allocated entirely to one or more, but not all, of the performance obligations, if all of the following criteria are met:

- the entity regularly sells each distinct good or service, or each bundle of distinct goods or services, in the contract on a stand-alone basis;
- the entity also regularly sells, on a stand-alone basis, a bundle (or bundles) of some of those distinct goods or services at a discount to the stand-alone selling prices of the goods or services in each bundle; and
- the discount attributable to each bundle of goods or services is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation(s) to which the entire discount in the contract belongs.

IFRS 15.83

Before using the residual approach, an entity applies the guidance on allocating a discount.

Example 3 – Allocating a discount: Transaction involving a customer loyalty programme

IFRS 15.82–85

Retailer R has a customer loyalty programme that rewards a customer with one customer loyalty point for every 10 purchases of products. Each point is redeemable for a 1 discount on any future purchases of R's products. During a reporting period, Customer C purchases products and gift cards for 1,200 and earns 100 points that are redeemable on future purchases. The consideration is fixed and the stand-alone selling price of the purchased products is 1,200 (1,000 for products and 200 for gift cards). R expects 95 points to be redeemed. R estimates a stand-alone selling price of 0.95 per point (totalling 95) on the basis of the likelihood of redemption.

The loyalty points provide a material right to C that it would not receive without entering into the contract. Therefore, R concludes that the promise to provide the loyalty points is a performance obligation.

The sum of the stand-alone prices of 1,295 (1,000 in products, 200 in gift cards and 95 in loyalty points) exceeds the promised consideration of 1,200. R needs to determine whether to allocate the discount to all or only some of the performance obligations.

R regularly sells both the gift cards and the products with loyalty points on a stand-alone basis. The amounts paid for the gift cards are equal to the stand-alone selling price. R also regularly sells, on a stand-alone basis, the products and loyalty points in a bundle at substantially the same discount as under the contract being evaluated. As a result, R has evidence that the entire discount should be allocated to the promise to transfer the products and loyalty points, and not the gift cards.

As a result, R determines that the discount relates entirely to the products and loyalty points. R allocates the transaction price to the products, gift cards and loyalty points as follows.

Performance obligation	Stand-alone selling price	Price allocation	Calculation
Gift cards	200	200	
Products	1,000	913	1,000 × (1,000 / 1,095)
Loyalty points	95	87	1,000 × (95 / 1,095)
Total	**1,295**	**1,200**	

Analysis is required when a large number of goods or services are bundled in various ways

Some arrangements involve several different goods or services that may be sold in various bundles. In this case, an entity may need to consider numerous possible combinations of products to determine whether the entire discount in the contract can be allocated to a particular bundle. This raises the question of how much analysis needs to be performed by an entity that sells a large number of goods or services that are bundled in various ways and for which the discount varies based on the particular bundle.

This analysis is required only if the entity regularly sells each good or service – or bundle of goods or services – on a stand-alone basis. Therefore, if the entity regularly sells only some of the goods or services in the contract on a stand-alone basis, then the criteria for allocating the discount entirely to one or more, but not all, of the performance obligations are not met and further analysis is not required.

Determination of 'regularly sells' is a key judgement

Under the guidance on allocating a discount entirely to one or more performance obligations, a bundle of goods or services has to be regularly sold on a stand-alone basis. An entity may need to establish a policy to define 'regularly sells'.

The entity needs processes and related controls to monitor sales transactions and determine which bundles are regularly sold.

Guidance on allocating a discount typically applies to contracts with at least three performance obligations

IFRS 15.BC283

The discount in the contract has to be substantially the same as the discount attributable to the bundle of goods or services under the guidance on allocating a discount entirely to one or more performance obligations. As a result, an entity will typically be able to demonstrate that the discount relates to two or more performance obligations, but it will be difficult to have sufficient evidence to allocate the discount entirely to a single performance obligation. Therefore, this provision is not likely to apply to arrangements with fewer than three performance obligations.

Additional application examples

Example 4 – Allocating a discount: Discount allocated entirely to one or more, but not all, performance obligations in a contract

IFRS 15.IE167–IE172

Telco C enters into a contract with a residential customer to sell phone, internet and television services for a total amount of 120. C regularly sells the products individually for the following prices.

Product	Stand-alone selling prices
Phone	40
Internet	55
Television	45
Total	**140**

C also regularly sells phone and internet services together for 75.

The contract includes a discount of 20 on the overall transaction (140 - 120), which is allocated proportionately to the three services in the contract when applying the relative stand-alone selling price method. However, because C regularly sells phone and internet services as a bundle for 75 (at a 20 discount compared with their total selling price of 95 (55 + 40)) and television services for 45, it has evidence that the entire discount should be allocated to the phone and internet services.

Performance obligation	Stand-alone selling prices	Selling price ratio	Price allocation	Calculation
Phone	40	42%	32	(75 × 42%)
Internet	55	58%	43	(75 × 58%)
Total	**95**	**100%**	**75**	

C recognises revenue of 32 for phone, 43 for internet and 45 for television services.

Example 5 – Allocating a discount: Bundle discount allocated to all performance obligations in a contract

IFRS 15.82

Telco B offers phone, internet and television services to residential customers at 20, 30 and 40 per month, respectively. If a customer contracts for either phone and internet or internet and television services, then B gives a discount of 5. If the customer takes all three services, then B gives a discount of 10. Because the discount attributable to each bundle is not the same and the analysis of the services in each bundle does not provide observable evidence that the discount relates to just one or two services, the discount of 10 is allocated to all three services as shown below.

Performance obligation	Stand-alone selling prices	Allocation of discount	Price allocation
Phone	20	10 × 20 / 90	18
Internet	30	10 × 30 / 90	27
Television	40	10 × 40 / 90	35

4.2.2 Allocating variable consideration

IFRS 15.84

Variable consideration (see Section 3.1) may be attributable to:

- all of the performance obligations in a contract;
- one or more, but not all, of the performance obligations in a contract: e.g. a bonus that is contingent on transferring a promised good or service within a specified time period; or
- one or more, but not all, of the distinct goods or services promised in a series of distinct goods or services that form part of a single performance obligation: e.g. an annual increase in the price of cleaning services linked to an inflation index within a facilities management contract.

IFRS 15.85

An entity allocates a variable amount – and subsequent changes to that amount – entirely to a performance obligation, or to a distinct good or service that forms part of a single performance obligation, only if both of the following criteria are met:

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

Judgement is required based on careful consideration of all facts and circumstances to determine whether a variable payment relates directly to a specific performance obligation, especially when variation in the price is not directly linked to a change in effort – e.g. if pricing in the contract is based on a market price or an index.

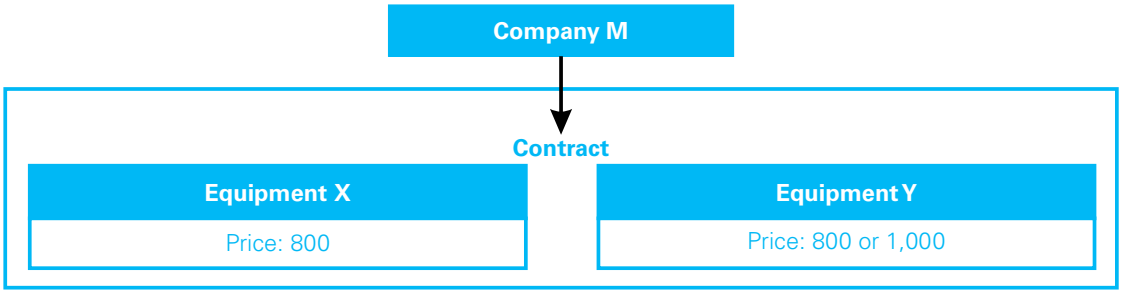
If a contract contains different types of variable consideration, then an entity applies the requirements in the standard separately to each type.

IFRS 15.BC285

In some cases, a contract that contains a series of distinct goods or services (see Section 2.3) may contain both fixed and variable consideration. In these cases, variable consideration may be attributed to one or more, but not all, distinct goods or services promised in the series. This allows an entity, in some cases, to attribute the reassessment of variable consideration to only the satisfied portion of a performance obligation if that performance obligation is a series of distinct goods or services. For an illustration, see Example 8 in this chapter.

Example 6 – Allocating variable consideration: Variable consideration allocated entirely to one performance obligation in the contract

IFRS 15.IE179–IE182



Company M enters into a contract with Customer N for two pieces of equipment, Equipment X and Equipment Y. M determines that X and Y represent two performance obligations, each satisfied at a point in time. The stand-alone selling prices of X and Y are 800 and 1,000, respectively.

The price stated in the contract for X is a fixed amount of 800. For Y, the price is 800 if the equipment is used by N to produce 1,000 products or less in Year 1 and 1,000 if it's used to produce more than 1,000 products in Year 1. M estimates that it will be entitled to variable consideration of 1,000 and that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur.

M allocates the estimated 1,000 in variable consideration entirely to Y because:

- the variable payment relates specifically to Y; and
- the estimated amount of variable consideration and the fixed amount for X approximate the stand-alone selling prices of each product.

M recognises revenue for X and Y of 800 and 1,000, respectively, when control of the good is transferred to N.

Example 7 – Allocating variable consideration: Each shipment is a distinct performance obligation

Mining Company M enters into a contract to deliver 12 monthly shipments of gold ore to Customer C. Each shipment is priced based on the spot price for gold at the date of the shipment. M determines that each shipment is a distinct performance obligation. M considers that the amount paid by C for a specific shipment of gold ore is independent of past or future shipments – i.e. the amount paid is resolved entirely as a result of delivering one specific shipment. Therefore, M concludes that the variability resulting from changes in market price relates directly to each distinct monthly shipment and that allocating this variable consideration to each shipment is consistent with the allocation objective.

Variable consideration allocation guidance is applied before the guidance on allocating discounts

IFRS 15.86

In some cases, a contract may contain both variable consideration and a discount. For example, an entity may sell products in a bundle at a discount to the aggregate stand-alone selling prices of the products in the bundle. In addition, the transaction price may include a variable element.

In these cases, an entity applies the guidance on allocating variable consideration before it applies the guidance on allocating discounts. That is, the standard includes an allocation hierarchy. When a contract contains both variable consideration and a discount, applying the allocation guidance in the reverse order may result in an incorrect allocation of the transaction price.

Some contracts contain features that may be variable consideration and/or a discount – e.g. a rebate. In these cases, an entity evaluates the nature of the feature. If the rebate causes the transaction price to be variable – e.g. the amount of the rebate depends on the number of purchases that a customer makes – then the entity follows the hierarchy and applies the guidance on allocating variable consideration first. Conversely, if a rebate is fixed and not contingent – e.g. the rebate is simply a fixed discount against the aggregate stand-alone selling prices of the items in a bundle – then an entity applies the guidance on allocating discounts and does not consider the guidance on allocating variable consideration.

Evaluating whether the allocation objective is met when allocating variable consideration to a distinct service period in a series

In some cases, a contract that contains a series of distinct goods or services may include variable consideration. In this situation, an entity needs to determine whether variable consideration can be allocated to a distinct time increment within a series – e.g. a day, month or year. For the analysis, an entity may use the following factors that may indicate that the variable pricing depicts the amount of consideration to which the entity would expect to be entitled for providing goods or services in each distinct period.

- The variable pricing is based on a per-unit amount or formula and that pricing is consistent throughout the contract.
- The entity charges a commensurate price per transaction or per user when it charges separately.
- The consideration is commensurate with the value or benefit to the customer – e.g. a hotel management fee that is based on a percentage of daily room fees.
- The consideration is commensurate with the entity's efforts to fulfil the service – e.g. reimbursement of variable labour costs.
- The pricing is consistent with the entity's customary pricing practices.

Additional application examples

Example 8 – Allocating variable consideration: Series of distinct services

Company X is an electricity provider. X enters into a contract with Customer C to supply electricity for one year on the following terms.

- The amount and timing of the electricity supply are at C's discretion: i.e. the quantity is variable.
- The fee includes a fixed and a usage-based component.
- The fixed fee is 1,200 and is payable in monthly instalments.
- The usage-based fee is a standard price of 1 per kWh and is payable at the end of each month. The price per kWh is fixed for the whole contract period.

X determines that it has a stand-ready obligation to supply electricity because the amount and timing of the supply are at C's discretion. X also determines that this stand-ready obligation is a series because:

- each increment of X's services (e.g. month, day etc) is distinct and has the same pattern of transfer to C;
- C simultaneously receives and consumes the benefits of the electricity as it is provided (see Section 5.2); and

IFRS 15.BC285

- X would use the same time-based method to measure its progress in transferring each increment of its service to C (see Section 5.3).

X allocates the fixed fee on a straight-line basis throughout the year. This is because the fixed fee relates to a stand-ready obligation. X allocates the variable fee based on the daily or monthly electricity consumption. This is because, under the terms of the contract, the variable payment relates to the amount of electricity used during a period and therefore variable consideration is allocated only to the satisfied portion of a performance obligation. This allocation is consistent with the allocation objective. The pricing is consistent throughout the contract and the rates charged are consistent with X´s standard pricing practices with similar customers.

Example 9 – Technology company: Up-front fees and allocation of variable consideration

Technology Company T enters into a contract with Customer C to provide C with access to its hosted transaction processing software application for three years. T concludes that the software licence is not distinct from the hosting services and that there is a single performance obligation satisfied over time to provide transaction processing services. It also concludes that the licence is not the predominant item in the transaction, because the hosting services have a significant value to C. Therefore, the licence guidance does not apply to this performance obligation.

T charges 0.90 per transaction throughout the contract period, billed quarterly. In addition, C is required to pay a non-refundable up-front fee of 48,000.

T determines that it should recognise the transaction-based fees in the period in which the transactions are processed, because:

- the variable amounts relate specifically to C's usage of the application that day; and
- allocating the transaction-based fees to each day is consistent with the allocation objective because each day has a similar pricing structure. When considering whether the fixed fee is allocated to all of the days in the contract, the resulting allocation of potential variable amounts and fixed fees depicts what T would expect to receive for each day of service.

The fixed fee is attributable to the entire performance obligation and recognised over the contract period.

Example 10 – Pharmaceutical company: Allocating elements of the transaction price to specific performance obligations

Biotech Company B enters into a contract with Pharma Company C for Compound X, which is under development. Under the arrangement, C will receive a licence for X and B will continue to perform the research and development (R&D) activities required to take X through to commercialisation. Under the contract, B receives an hourly rate for its R&D services and 2% of any sales of X by C. This hourly rate is consistent with the rate that B charges other entities for similar services.

B assesses the arrangement and determines that the hourly rate reflects the stand-alone selling price of the R&D services. Therefore, B concludes that it is appropriate to allocate the sales-based royalty entirely to the licence arrangement.

If, instead of an hourly rate, B received monthly fixed payments designed to cover the costs of R&D, careful consideration would be required to determine whether it was appropriate to allocate those payments in their entirety to the R&D services. If it was not appropriate, then B would be required to determine the stand-alone selling price of the licence and R&D services and allocate the fixed payments on that basis.

Allocating the transaction price will also be more complex if the consideration under the contract includes a significant non-refundable up-front payment.

Example 11 – Pharmaceutical company: Allocating variable consideration to multiple performance obligations

Company X enters into a contract with Customer C for two IP licences (Licences E and F). X determines that the promises to transfer the licences represent two distinct performance obligations, each of which is satisfied at a point in time. The prices stated in the contract are as follows:

- Licence E: a fixed fee of 2,000; and
- Licence F: 3% of C's future sales of products that use that licence.

X estimates that its sales-based royalties (i.e. the total variable consideration) will be 1,500. The stand-alone selling prices of Licences E and F are 1,800 and 1,700, respectively.

X determines that the royalty relates directly to F and that allocating all of the variable consideration to F is consistent with the allocation objective. Therefore, it allocates the total variable consideration of 1,500 entirely to F.

X allocates the fixed consideration as follows:

- 1,800[1] to E; and
- 200[1] to F.

Note

1. In this example, the entire variable consideration is allocated to F and the fixed consideration is allocated to E in an amount equal its stand-alone selling price. The remaining amount of fixed consideration of 200 (2,000 - 1,800) is allocated to F.

4.3 Changes in the transaction price

IFRS 15.87–90

After contract inception, the transaction price may change for various reasons – including the resolution of uncertain events or other changes in circumstances that affect the amount of consideration to which an entity expects to be entitled.

In most cases, these changes are allocated to performance obligations on the same basis as at contract inception; however, changes in the transaction price resulting from a contract modification are accounted for under the standard's contract modifications guidance (see Chapter 8). If a change in the transaction price occurs after a contract modification, then it is allocated to the performance obligations in the modified contract – i.e. those that were unsatisfied or partially unsatisfied immediately after the modification – unless the:

- change is attributable to an amount of variable consideration that was promised before the modification; and
- modification was accounted for as a termination of the existing contract and creation of a new contract.

IFRS 15.89

A change in the transaction price is allocated to one or more distinct goods or services only if specified criteria are met (see 4.2.2).

IFRS 15.88

Any portion of a change in transaction price that is allocated to a satisfied performance obligation is recognised as revenue – or as a reduction in revenue – in the period of the transaction price change.

Example 12 – Discretionary credit: Service quality issue

Telco F provides a customer with a credit in the current month due to a short period of service quality issues experienced in the prior month (often referred to as a 'goodwill credit'). F determines that this results in a change in the transaction price, rather than variable consideration (see Section 3.1). Because the goodwill credit relates to a satisfied performance obligation, the credit is recognised in its entirety in the month in which it is granted (i.e. when F promises to pay the consideration).

Example 13 – Discretionary credit: Retention

Telco G grants a one-time credit of 50 to a customer in Month 14 of a two-year contract. The credit is discretionary and is granted as a commercial gesture, not in response to prior service issues (often referred to as a 'retention credit'). The contract includes a subsidised handset and a voice and data plan.

G does not regularly provide these credits and therefore customers do not expect them to be granted. Therefore, G concludes that this is a change in the transaction price and not variable consideration (see Section 3.1). Because the credit does not relate to a satisfied performance obligation, the change in transaction price resulting from the credit is accounted for as a contract modification and recognised over the remaining term of the contract (see Section 8.2).

If, in this example, rather than providing a one-time credit, G granted a discount of 5 per month for the remaining contract term, then G would also conclude that it was a change in the transaction price. It would apply the contract modification guidance and recognise the credit over the remaining term of the contract (see Section 8.2).

5 Recognise revenue (Step 5)

When or as the entity satisfies a performance obligation

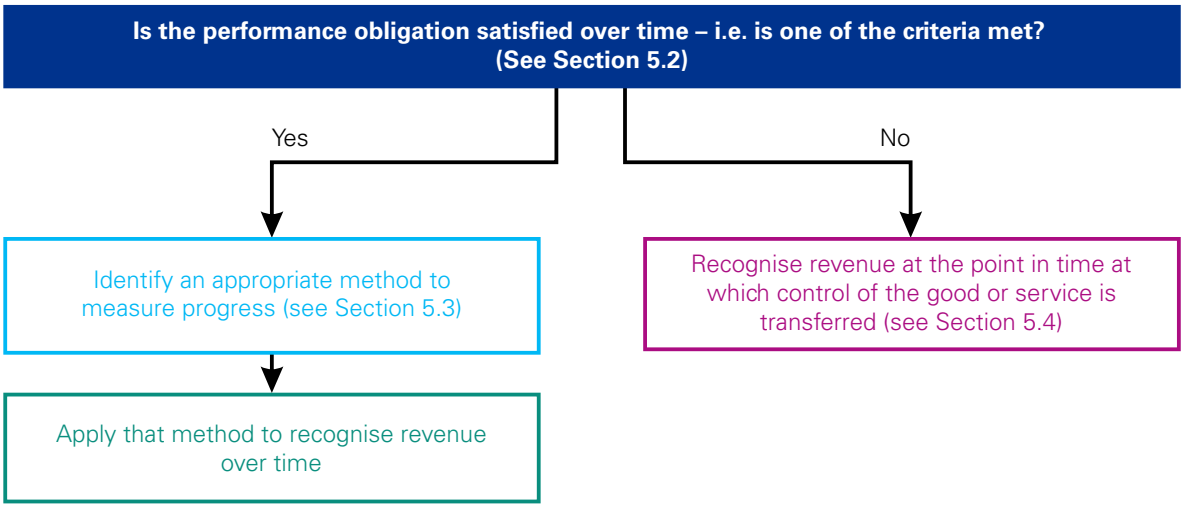
Overview

An entity recognises revenue when or as it satisfies a performance obligation by transferring a good or service to a customer, either at a point in time (when) or over time (as).

A good or service is 'transferred' when or as the customer obtains control of it.

IFRS 15.32

At contract inception, an entity first evaluates whether it transfers control of the good or service over time – if not, then it transfers control at a point in time.



IFRS 15.BC121

The analysis of when control transfers is performed primarily from the perspective of the customer.

IFRS 15.B52–B62

For a performance obligation that is a licence of intellectual property (IP), the standard provides specific application guidance on assessing whether revenue is recognised at a point in time or over time (see Chapter 9).

5.1 Transfer of control

IFRS 15.31–32

A good or service is transferred to a customer when the customer obtains control of it. 'Control' refers to the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. It also includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. Potential cash flows that are obtained either directly or indirectly – e.g. from the use, consumption, sale or exchange of an asset – are benefits of an asset.

Control is…	
the ability	• The customer has a present right
to direct the use of	• The right enables it to: - deploy the asset in its activities - allow another entity to deploy the asset in its activities - prevent another entity from deploying the asset
and obtain the remaining benefits from	• The right also enables it to obtain potential cash flows directly or indirectly – e.g. through: - use of the asset - consumption of the asset - sale or exchange of the asset - pledging the asset - holding the asset
… an asset	

Use of control concept to recognise revenue aligns with the accounting for assets

IFRS 15.BC118

The standard is a control-based model. First, an entity determines whether control of the good or service transfers to the customer over time based on the criteria in the standard and, if it does, the pattern of that transfer. If it does not, then control of the good or service transfers to the customer at a point in time (see Section 5.4).

The standard extends a control-based approach to all arrangements, including service contracts. The International Accounting Standards Board (the Board) believes that goods and services are assets – even if only momentarily – when they are received and used by the customer. The standard's use of control to determine when a good or service is transferred to a customer is consistent with the current definition of an asset under IFRS Accounting Standards, which principally uses control to determine when an asset is recognised or derecognised.

5.2 Performance obligations satisfied over time

IFRS 15.32, 35

For each performance obligation in a contract, an entity first determines whether the performance obligation is satisfied over time – i.e. control of the good or service transfers to the customer over time. It does this using the following criteria (a different approach applies if the performance obligation is a licence of IP – see Chapter 9).

	Criterion	Example
1	The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs	Routine or recurring services – e.g. cleaning services
2	The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced	Building an asset on a customer's site
3	The entity's performance does not create an asset with an alternative use to the entity (see 5.2.1) and the entity has an enforceable right to payment for performance completed to date (see 5.2.2)	Building a specialised asset that only the customer can use or building an asset to a customer's specifications

IFRS 15.35, 38–39

If one or more of these criteria are met, then the entity recognises revenue over time, using a method that depicts its performance – i.e. the pattern of transfer of control of the good or service to the customer. If none of the criteria is met, then control transfers to the customer at a point in time and the entity recognises revenue at that point in time (see Section 5.4).

Criterion 1

IFRS 15.B3–B4, BC125–BC128

A customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs and another entity would not need to substantially reperform the work that the entity has completed to date.

When determining whether another party would not need to substantially reperform, the entity also presumes that another party would not have the benefit of any asset that the entity presently controls and would continue to control if that other party took over the performance obligation.

Criterion 2

IFRS 15.B5, IU 03-18

In evaluating whether a customer controls an asset as it is created or enhanced, an entity considers the guidance on control in the standard, including the indicators of the transfer of control (see Section 5.4).

In evaluating Criterion 2 for sales of real estate, an entity focuses on the real estate unit itself, rather than on the right to sell or pledge a right to obtain the real estate in the future. This is because the latter does not provide evidence of control of the real estate unit.

Criterion 3

IFRS 15.36

In assessing whether an asset has an alternative use, at contract inception an entity considers its ability to readily direct that asset in its completed state for another use – e.g. selling it to a different customer.

Applying Criteria 1 and 3

IFRS 15.B4, B6–B8, BC127

Potential contractual restrictions or practical limitations may prevent the entity from transferring the remaining performance obligation to another entity (Criterion 1) or directing the asset for another use (Criterion 3). The standard provides guidance on whether these restrictions or possible termination affect the assessment of those criteria. It provides the following guidance on the assumptions that an entity should make when applying Criteria 1 and 3.

Determining whether…	Consider contractual restrictions?	Consider practical limitations?	Consider possible termination?
Another entity would not need to substantially reperform (Criterion 1)	No	No	Yes
The entity's performance does not create an asset with an alternative use (Criterion 3)	Yes	Yes	No

Example 1 – Assessing whether another entity would need to reperform the work completed

IFRS 15.BC126

Company M enters into a contract to transport equipment from Los Angeles to New York City. If M delivers the equipment to Denver – i.e. only part of the way – then another entity could transport the equipment the remainder of the way to New York City without reperforming M's performance to date. The other entity would not need to take the goods back to Los Angeles to deliver them to New York City. Criterion 1 is met and transportation of the equipment is a performance obligation that is satisfied over time.

Differences in assumptions used when applying Criteria 1 and 3

IFRS 15.BC139

The consideration of contractual restrictions and practical limitations differs for the assessment of Criteria 1 and 3 because they are designed to apply to different scenarios.

Criterion 1 involves a hypothetical assessment of what another entity would need to do if it took over the remaining performance obligation. Contractual restrictions or practical limitations, which would otherwise prevent the entity from transferring the performance obligation to another entity, are not relevant when assessing whether the entity has transferred control of the goods or services provided to date.

By contrast, Criterion 3 focuses on the entity's ability to direct the completed asset for an alternative use, assuming that the contract is fulfilled. This ability is directly affected by the existence of contractual restrictions and practical limitations.

However, the entity's rights on contract termination are considered when evaluating whether the entity has a right to payment under Criterion 3.

Determining whether a commodity transfers over time may depend on Criterion 1

An entity that agrees to deliver a commodity considers the nature of its promise to determine whether to recognise revenue over time or at a point in time. In many contracts to deliver commodities, an entity has promised to transfer a good and will consider the point-in-time guidance to determine when control transfers. However, there may be scenarios in which an entity has promised to provide a service of delivering a commodity that the customer immediately consumes and therefore immediately receives the benefits.

For example, a contract to deliver natural gas to temporary storage may represent a promise to deliver a good, whereas a contract to provide natural gas to the customer for on-demand consumption may represent a service that meets Criterion 1 for over-time recognition.

To determine whether the customer immediately consumes the assets and receives the benefits as the performance obligation is satisfied, the entity evaluates the:

- inherent characteristics of the commodity;
- contract terms;
- information about the infrastructure and other delivery mechanisms; and
- other relevant facts and circumstances.

Application to service concession arrangements

IFRIC 12.14

The interpretation on service concession arrangements specifies that an operator in a service concession arrangement accounts for construction and upgrade services under the revenue standard. Therefore, the operator applies the criteria in the standard to determine whether construction and upgrade services are separate performance obligations and recognises revenue as it satisfies the performance obligations over time or at a point in time.

In many situations, revenue from construction and upgrade services under service concession arrangements will be recognised over time because Criterion 2 and/or Criterion 3 will be met.

5.2.1 Performance does not create an asset with an alternative use

IFRS 15.B7

For an asset to have no alternative use to an entity, a contractual restriction on the ability to direct its use has to be substantive – i.e. an enforceable right. If an asset is largely interchangeable with other assets and could be transferred to another customer without breaching the contract or incurring significant incremental costs, then the restriction is not substantive.

IFRS 15.B8

A practical limitation on an entity's ability to direct an asset for another use – e.g. design specifications that are unique to a customer – exists if the entity would:

- incur significant costs to rework the asset; or
- be able to sell the asset only at a significant loss.

IFRS 15.36

The assessment of whether an asset has an alternative use is made at contract inception and is not subsequently updated, unless a contract modification substantially changes the performance obligation (see Chapter 8).

Example 2 – Applying the guidance on alternative use

IFRS 15.IE73–IE76

Manufacturer Y enters into a contract with a customer to build a specialised satellite. Y builds satellites for various customers; however, the design and construction of each satellite differs substantially on the basis of each customer's needs and the type of technology that is incorporated into the satellite.

At contract inception, Y assesses whether the satellite, in its completed state, will have an alternative use. Although the contract does not preclude Y from directing the completed satellite to another customer, Y would incur significant costs to rework the design and function of the satellite. In this example, the customer-specific design of the satellite restricts Y's practical ability to readily direct the satellite to another customer. Therefore, the satellite does not have an alternative use to Y.

Example 3 – Applying the guidance on alternative use: Automotive supplier

Automotive Supplier S enters into a contract with Carmaker W to build 100 steering wheels.

S builds steering wheels for various carmakers. However, the design of some of the components of W's steering wheel is W's IP. Therefore, S is not allowed to sell completed steering wheels to other carmakers. W enforces this contractual restriction by performing periodic inspections in S's warehouses. In addition, S would incur significant costs to rework the design of the steering wheel in its completed state if it replaced W's unique components with other carmakers' components.

On contract inception, S assesses whether each completed steering wheel will have an alternative use. S concludes that there are significant contractual and practical restrictions that limit its ability to direct the completed steering wheels to another carmaker. Therefore, S concludes that the steering wheels manufactured for W have no alternative use.

Many factors to consider when evaluating alternative use

IFRS 15.BC136–BC139

Under the standard, an asset may not have an alternative use due to contractual restrictions. For example, units constructed for a multi-unit residential complex may be standardised; however, an entity's contract with a customer may preclude it from transferring a specific unit to another customer.

Protective rights – e.g. a customer having legal title to the goods in a contract – may not limit the entity's practical ability to physically substitute or redirect an asset, and therefore on their own are not sufficient to establish that an asset has no alternative use to the entity.

In the absence of a contractual restriction, an entity considers:

- the characteristics of the asset that will ultimately be transferred to the customer; and
- whether the asset, in its completed form, could be redirected without a significant cost of rework.

The focus is not on whether the asset can be redirected to another customer or for another purpose during a portion of the production process – e.g. up until the point at which significant customisation begins to occur. For example, in some manufacturing contracts the basic design of an asset may be the same across many contracts, but the customisation of the finished good may be substantial. Consequently, redirecting the asset in its completed state to another customer would require significant rework.

Evaluating whether costs of rework are significant

The standard does not provide guidance to help evaluate whether the cost to rework an asset for an alternative use is significant. Therefore, judgement is required in making the evaluation and consideration is given to both quantitative and qualitative factors.

The following are some factors that an entity may consider when making this determination.

- *Level and cost of customisation:* If the customisation itself is significant, then the cost of rework may be significant. For example, if the customisation of the asset occurs over a significant period of time and involves significant development and design activities or represents a significant part of the cost of the finished product, then the cost to rework the asset for another customer may be significant. In contrast, if the customisation occurs over a short period of time and does not represent a significant portion of the overall cost, then the cost to rework may not be significant.
- *Incremental cost to rework vs the original costs:* If the cost to rework an asset and produce a finished product is commensurate with the original cost of customisation, then the cost to rework may be significant. In contrast, if the cost to rework the asset is insignificant compared with the original cost of the asset, then the rework costs may not be considered significant.
- *Activities required to rework the asset:* If the activities required to rework the asset involve design and development activities, then the cost of rework may be more significant. However, if the materials can be quickly converted into a raw material to be used in the entity's normal process, then the cost may not be as significant. For example, an entity may produce glass materials customised to the size and shape for a particular customer but could easily melt the glass to be reused as a raw material.
- *Ability to sell the reworked asset at a reasonable profit margin:* Although the profit margin would be expected to be less than if no rework occurred, if the entity expects to recover the costs plus a reasonable margin when compared with sales of similar goods then the cost of rework may not be significant. The entity should consider both the absolute monetary amount of margin to be recovered and profit margin percentage in evaluating whether it could expect to receive a reasonable profit margin. For example, if an entity produces a low-cost, low-margin product, then any incremental cost may have a significant effect on margin percentage but not a significant effect on the absolute monetary amount expected to be recovered.
- *Amount of the asset that cannot be reworked:* An entity may be unable to rework the asset or a significant portion of the component parts – e.g. if the disassembly process would significantly damage the component parts so that they cannot be reused or the raw material cannot be worked into other products. That would be considered a significant economic loss, which is a practical limitation on alternative use of the asset.

5.2.2 The entity has an enforceable right to payment for performance completed to date

IFRS 15.37, IU 03-18

An entity that is constructing an asset with no alternative use is effectively constructing the asset at the direction of the customer. The contract will often contain terms providing some economic protection against the risk of the customer terminating the contract and leaving the entity with an asset of little or no value. Therefore, to demonstrate that a customer controls an asset that has no alternative use as it is being created, an entity evaluates whether it has an enforceable right to payment for the performance completed to date.

In performing this evaluation, the entity considers whether, throughout the contract, it is entitled to compensation for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised.

The likelihood that the customer would terminate the contract or that the entity would exercise its right to payment are not relevant in making this assessment.

IFRS 15.B9–B13

To meet this part of Criterion 3, the entity's right to payment has to be for an amount that approximates the selling price of the goods or services transferred – e.g. a right to recover costs incurred plus a reasonable profit margin. The amount to which the entity is entitled does not need to equal the expected profit margin in the contract, but has to be based on either a reasonable proportion of the entity's expected profit margin or a reasonable return on the entity's cost of capital. However, if an entity would only recover its costs, then it would not have the right to payment for performance completed to date and this part of Criterion 3 would not be met.

In some cases, an entity may enter into a contract with a customer that is expected to be loss-making from the outset. This usually happens when an entity pursues a specific economic objective – e.g. to enter into a new market, an entity agrees to sell a product in that market for a price that is below cost. In our view, a contract with a negative margin may still meet Criterion 3 if the amount to which the entity is entitled from the customer on termination is reasonable in proportion to the expected margin for the contract and the performance completed to date.

Other factors to consider include the following.

Payment terms	• An unconditional right to payment is not required, but rather an enforceable right to demand or retain payment for the performance completed to date if the contract is terminated by the customer for convenience
Payment schedule	• A payment schedule does not necessarily indicate whether an entity has an enforceable right to payment for performance to date
Other contractual terms	• If a customer acts to terminate a contract without having a contractual right at that time to do so, then the contract terms may entitle the entity to continue to transfer the promised goods or services and require the customer to pay the corresponding consideration promised

IFRS 15.B11

Legislation or legal precedent	• Even if a right is not specified in the contract, jurisdictional matters such as legislation, administrative practice or legal precedent may confer a right to payment to the entity • By contrast, legal precedent may indicate that rights to payment in similar contracts have no binding legal effect or that an entity's customary business practice not to enforce a right to payment may result in that right being unenforceable in that jurisdiction
Payment in scope of the analysis	• Only payments under the existing contract with the customer are relevant for the analysis • Amounts received or to be received from a third party if the asset is resold are not payments for performance under the existing contract

IU 03-18

Example 4 – Applying the over-time criteria: Consulting contract

IFRS 15.IE69–IE72

Consulting Firm B enters into a contract to provide a professional opinion to Customer C based on C's specific facts and circumstances. If C terminates the consulting contract for reasons other than B's failure to perform as promised, then the contract requires C to compensate B for its costs incurred plus a 15% margin. The 15% margin is approximately the profit margin that B earns from similar contracts.

B assesses the contract against the over-time criteria and reaches the following conclusions.

Criterion	Conclusion	Rationale
1	Not met	If B did not issue the professional opinion and C hired another consulting firm, then the other firm would need to substantially reperform the work completed to date, because it would not have the benefit of any work in progress performed by B. Accordingly, C does not simultaneously receive and consume the benefits of its performance.
2	Not met	B is not creating or enhancing an asset of which C obtains control as it performs because the professional opinion is delivered to C only on completion.
3	Met	The development of the professional opinion does not create an asset with an alternative use to B, because it relates to facts and circumstances that are specific to C. Therefore, there is a practical limitation on B's ability to readily direct the asset to another customer. The contract's terms provide B with an enforceable right to payment for its performance completed to date and its costs incurred plus a reasonable margin.

Because one of the three criteria is met, B recognises revenue relating to the consulting services over time.

Conversely, if B determined that it did not have a legally enforceable right to payment if C terminated the consulting contract for reasons other than B's failure to perform as promised, then none of the three criteria would be met. In that situation, the revenue from the consulting service would be recognised at a point in time – probably on completion of the engagement and delivery of the professional opinion.

Example 5 – Applying the over-time criteria: Sales of real estate: No alternative use and enforceable right to payment

IFRS 15.IE81–IE90

Developer D is developing a multi-unit residential complex. Customer Y enters into a binding sales contract with D for Unit X, which is under construction. Each unit has a similar floor plan and is a similar size. The following facts are relevant.

- Y pays a non-refundable deposit on entering into the contract and will make progress payments intended to cover costs to date plus the margin percentage in the contract during construction of X.
- The contract has substantive terms that preclude D from being able to direct X to another customer.
- If Y defaults on its obligations by failing to make the promised progress payments when they are due, then D has a right to all of the consideration promised in the contract if it completes the construction of the unit.
- The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

At contract inception, D determines that because it is contractually prevented from transferring X to another customer, X does not have an alternative use. In addition, if Y were to default on its obligations then D would have an enforceable right to all of the consideration promised under the contract. Consequently, Criterion 3 is met and D recognises revenue from the construction of Unit X over time.

A right to payment may be established by relevant laws and regulations

IFRS 15.B11–B12, BC147

When a right to payment on termination is not specified in the contract with the customer, an entity may still have a right to payment under relevant laws or regulations.

The fact that the entity may sue a customer that defaults or cancels a contract for convenience does not in itself demonstrate that the entity has an enforceable right to payment. Generally, a right to payment exists only if taking legal action entitles the entity to a payment for the cost incurred plus a reasonable profit margin for the performance completed to date.

Factors to consider when determining whether an entity has a right to payment include:

- relevant laws and regulations;
- customary business practices;
- the legal environment;
- relevant legal precedents; and
- legal opinions on the enforceability of rights (see below).

Each individual factor may not be determinative on its own. An entity needs to determine which factors are relevant for its specific set of circumstances. In cases of uncertainty – e.g. when the above factors are inconclusive or provide contradictory evidence about the existence of a right to payment – an entity considers all relevant factors and applies judgement in reaching its conclusion.

Use of legal opinion when assessing enforceability of right to payment

IFRS 15.B12

In some cases, an entity may have an apparent right to payment described in its contract with the customer, or under a relevant law or regulation, but there may be uncertainty over whether the right is enforceable. This may be the case when there is no legal precedent for the enforceability of the entity's right.

For example, in a rising property market an entity may choose not to enforce its right to payment in the event of customer default, because it prefers to recover the property and resell it at a higher price. A practice of not enforcing an apparent right to payment may result in uncertainty over whether the contractual right remains enforceable.

In these cases, an entity may need a legal opinion to help it assess whether it has an enforceable right to payment. However, all facts and circumstances need to be considered in assessing how much weight (if any) to place on the legal opinion. This may include an assessment of:

- the quality of the opinion: i.e. how strong are the legal arguments that support it?;
- whether there are conflicting opinions provided by different legal experts; and
- whether there are conflicting legal precedents for similar cases.

Agreements for the construction of real estate may have different patterns of transfer of control

IFRS 15.BC150

Applying the criteria to real estate contracts may result in different conclusions on the pattern of transfer of control, depending on the relevant facts and circumstances of each contract. For example, the terms of some real estate contracts may prohibit an entity from transferring an asset to another customer and require the customer to pay for performance completed to date (therefore meeting Criterion 3). However, other real estate contracts that create an asset with no alternative use may only require a customer to make an up-front deposit, and therefore would not provide the entity with an enforceable right to payment for its performance completed to date (therefore failing to meet Criterion 3).

In practice, a detailed understanding of the terms of the contract and local laws may be required to assess whether an entity has a right to payment for performance to date. For example, in some jurisdictions customer default may be infrequent and contracts may not include extensive detail on the rights and obligations that arise in the event of termination. In these cases, expert opinion may be required to establish the legal position.

In other jurisdictions, real estate developers may have a practice of not enforcing their contractual rights if a customer defaults, preferring instead to take possession of the property so that they can sell it to a new customer. Again, evaluation of the specific facts and circumstances, including appropriate legal consultation, may be required to establish whether the contractual rights remain enforceable given an established pattern of non-enforcement.

Enforceable right to payment for standard materials used as inputs

IFRS 15.BC142

Contracts with customers to manufacture or construct goods with no alternative use to the entity may require the use of standard raw materials or components as inputs into the product being manufactured or constructed. In many cases, these inputs (including work in progress) remain interchangeable with other products until they are integrated into the customer's product – i.e. they have an alternative use. The entity will often not have an enforceable right to payment for these standard inputs until they are integrated into the customer's product.

In these circumstances, the entity treats the raw materials or work in progress as inventory until they are incorporated into the customer's product. The fact that the entity does not have an enforceable right to payment for standard materials until they are integrated into the product being manufactured does not result in the arrangement failing to meet Criterion 3. An entity's right to payment is assessed for performance completed. Standard materials are not considered completed performance until they are integrated into the production process. The assessment of an entity's right to payment is for the standard materials once they are integrated.

Termination of an over-time contract

IFRS 15.BC142

In some cases, an entity that has a contract meeting Criterion 3 for recognition of revenue over time may choose not to enforce its right to payment. For example, an entity may permit a customer to terminate a contract when no termination right exists. In these cases, an entity needs to consider carefully whether its right to payment remains enforceable such that Criterion 3 is met at contract inception for similar contracts.

If an entity chooses to waive its enforceable right to payment, then a question arises about how it should account for the termination – in particular, the revenue that has been recognised over time under Criterion 3. In our view, in these circumstances it is generally appropriate to reverse the revenue previously recognised for which the right to payment has been waived.

For example, Developer D enters into a contract to sell an apartment to Customer C for 100. The expected construction cost is 60. C is required to make an up-front payment of 30, with the remaining 70 due on completion of the apartment. C cannot terminate the contract and D has the right to complete the apartment and require C to pay the promised consideration. D has determined that this right is enforceable in its jurisdiction.

D determines that its contract with C meets Criterion 3 for the recognition of revenue over time and that a cost-to-cost input measure of progress is appropriate.

When the apartment is 80% complete, C approaches D with a request to terminate the contract. Considering C's circumstances, as an exception to its customary business practice D agrees to terminate the contract, thereby waiving its right to complete the apartment and enforce payment of 100 in cash from C. D also agrees to refund the up-front payment of 30 to C.

At the time of the termination, D had recorded the following journal entries to recognise revenue and costs over time as the apartment was constructed.

	Debit	*Credit*
Contract asset	50	
Cash	30	
Revenue (100 × 80%)		80
To recognise revenue for construction of 80% of apartment[1]		
Cost of sales	48	
Cash/individual accounts related to construction		48
To recognise cost of sales for construction of apartment performed to date[1]		

Note

1. For the purposes of this example, all journal entries recorded over time are summarised and presented as one.

We believe that it is generally appropriate for D to reverse the previously recognised revenue and cost of sales. Therefore, D should record the following entries.

	Debit	*Credit*
Revenue	80	
Contract asset		50
Cash		30
Inventories – work in progress	48	
Cost of sales		48
To reverse revenue and cost of sales on termination of contract		

D carefully considers whether its right to payment remains enforceable such that Criterion 3 is met at contract inception for similar contracts.

Modifying the example, D agrees to terminate the contract with C but retains the up-front payment of 30. In this case, we believe that it is generally appropriate for D to reverse the previously recognised revenue for which it has waived payment – i.e. 50 – and cost of sales. Therefore, D should record the following entries.

	Debit	*Credit*
Revenue	50	
Contract asset		50
Inventories – work in progress	48	
Cost of sales		48
To reverse revenue and cost of sales on termination of contract		

D carefully considers whether its right to payment remains enforceable such that Criterion 3 is met at contract inception for similar contracts.

Additional application examples

Example 6 – Applying the over-time criteria: Bottle manufacturer

Company C enters into a framework agreement to manufacture bottles for Customer B under the following terms.

- The design of the bottles is the IP of B.
- The sales price is cost plus 10%.
- There is no stated minimum purchase quantity.
- C is required to maintain a specific level of inventory of raw materials and finished goods.
- If B terminates the framework agreement, then it is required to purchase inventory of raw materials at cost and work in progress and finished goods on hand at the agreed sales price at the date of termination.
- The manufacturing process does not result in material amounts of work in progress.

C determines that the nature of the promise to B under the framework agreement is to manufacture bottles for use in B's operation.

C applies the over-time criteria and determines that it does not create an asset with an alternative use because C is legally prevented from selling the asset to another customer. The contract's termination clause provides C with an enforceable right to payment for its performance completed to date – i.e. for costs incurred plus a reasonable margin. C therefore determines that Criterion 3 is met.

Because Criterion 3 is met, C recognises revenue over time as it manufactures bottles.

Example 7A – Applying the over-time criteria: Real estate developer: Criterion 3 not met (1)

Real Estate Developer D in Country Y enters into a contract with Customer C for the sale of a real estate unit in a multi-unit residential complex. The contract contains the following terms.

- C pays a 10% deposit at contract inception and the remainder of the purchase price after construction is complete.
- D retains legal title until C has paid the full purchase price.
- C has the right to terminate the contract at any time before construction is complete.
- On termination, D is required to make reasonable efforts to resell the unit to a third party.
- If the resale price obtained from the third party is less than the original purchase price in the contract with C, then C must pay the difference to D.

IU 03-18

D applies the over-time criteria and determines that its performance does not create an asset with an alternative use under Criterion 3. However, the consideration to which D is entitled from C on termination is limited to reimbursement of any loss of profit on resale. This does not approximate to the selling price of the part-constructed real estate unit, and therefore does not compensate D for its performance completed to date. Based on its analysis, D concludes that Criterion 3 is not met.

Because Criterion 3 is not met, D recognises revenue at the point in time when control of the unit transfers to C (see Section 5.4).

Example 7B – Applying the over-time criteria: Real estate developer: Criterion 3 not met (2)

Modifying Example 7A, the contract between Real Estate Developer D and Customer C contains the following terms.

- C pays 20% of the purchase price in instalments as the unit is constructed and the remainder of the purchase price after construction is complete.
- D retains legal title to the unit during construction.
- C has the *in rem* right to the unit during construction (i.e. the legal right to the unit), which it can resell or pledge to a new buyer.

The contract cannot be terminated under Country Y's local law. However, the courts in Country Y have accepted requests to terminate similar contracts in some circumstances – e.g. when the customer becomes unemployed or ill. In these cases, the courts have allowed the developer to retain approximately 10% of the payments made as a termination penalty.

IU 03-18

D concludes that the *in rem* right to the unit does not give C the ability to direct the use of the unit itself during construction; therefore, Criterion 2 is not met.

Although the contract does not give C a termination right, D concludes that the legal precedent permits the termination of contracts for reasons other than its failure to perform as promised. Further, the termination penalty of approximately 10% of the payments that the courts have allowed the developer to retain does not compensate the developer for performance to date. Therefore, D concludes that Criterion 3 is not met.

Because none of the criteria for over-time revenue recognition is met, D recognises revenue at the point in time when control of the unit transfers to C (see Section 5.4).

Example 7C – Applying the over-time criteria: Real estate developer: Criterion 3 not met (3)

Real Estate Developer B in Country X enters into a contract with Customer M for the sale of a real estate unit in a multi-unit residential complex. The contract contains the following terms.

- M pays 100% of the purchase price at contract inception.
- B retains legal title over the unit until construction is complete.
- M has the right to terminate the contract at any point in time, even if the contract is not breached by B.
- On termination, B is required to refund 70% of the purchase price.

B applies the over-time criteria and determines that its performance does not create an asset with an alternative use under Criterion 3.

In assessing whether it has an enforceable right to payment for performance to date, B notes that the consideration to which it is entitled on termination is limited to 30% of the purchase price. For example, if M terminated the contract when it was 60% complete, then B would only have a right to 30% of the purchase price. This would not result in a payment that reflects performance at the point of termination. Based on its analysis, B concludes that Criterion 3 is not met because it does not have a right to payment for performance completed to date throughout the entire contract period.

Because Criterion 3 is not met, B recognises revenue at the point in time when control of the unit transfers to M (see Section 5.4).

Example 8 – Applying the over-time criteria: No enforceable right to payment

Bicycle Manufacturer B enters into a contract with Customer C to build 1,000 bicycles in accordance with C's specifications and branding. Under the contract, C is required to pay B on delivery of the bicycles.

The contract does not include any termination or default clauses.

The extent of customisation of the bicycles means that they do not have an alternative use; therefore, B assesses whether it has an enforceable right to payment under Criterion 3.

- There are no clauses in the contract that give B a right to payment for its performance completed to date.
- There is no local legislation or legal precedent that would indicate that B has a right to payment for its performance completed to date.

B therefore determines that it does not have an enforceable right to payment under Criterion 3 and therefore recognises revenue at the point in time when control of the bicycles transfers to C (see Section 5.4).

5.3 Measuring progress towards complete satisfaction of a performance obligation

5.3.1 Selecting a method to measure progress

IFRS 15.39–43, B15–B19

For each performance obligation that is satisfied over time, an entity applies a single method of measuring progress towards complete satisfaction of the obligation. The objective is to depict the transfer of control of the goods or services to the customer. To do this, an entity selects an appropriate output or input method. It then applies that method consistently to similar performance obligations and in similar circumstances.

Method	Description	Examples
Output	Based on direct measurements of the value to the customer of goods or services transferred to date, relative to the remaining goods or services promised under the contract	• Surveys of performance to date • Appraisals of results achieved • Milestones reached • Time elapsed
Input	Based on an entity's efforts or inputs towards satisfying a performance obligation, relative to the total expected inputs into the satisfaction of that performance obligation	• Resources consumed • Costs incurred • Time elapsed • Labour hours expended • Machine hours used

IFRS 15.B16

As a practical expedient, if an entity has a right to invoice a customer at an amount that corresponds directly with its performance to date, then it can recognise revenue at that amount. For example, in a services contract an entity may have the right to bill a fixed amount for each unit of service provided. See 5.3.4.

IFRS 15.B15, BC165

If an entity's performance has produced a material amount of work in progress or finished goods that are controlled by the customer, then output methods such as units-of-delivery or units-of-production as they have been historically applied may not faithfully depict progress. This is because not all of the work performed is included in measuring the output.

IFRS 15.B18

If an input method provides an appropriate basis to measure progress and an entity's inputs are incurred evenly over time, then it may be appropriate to recognise revenue on a straight-line basis.

IFRS 15.B19

However, there may not be a direct relationship between an entity's inputs and the transfer of control. Therefore, an entity that uses an input method considers the need to adjust the measure of progress for uninstalled goods and significant inefficiencies in the entity's performance that were not reflected in the price of the contract – e.g. wasted materials, labour or other resources (see 5.3.3). For example, if the entity transfers to the customer control of a good that is significant to the contract but will be installed later, and if certain criteria are met, then the entity recognises the revenue on that good at zero margin.

IFRS 15.44–45

An entity recognises revenue over time only if it can reasonably measure its progress towards complete satisfaction of the performance obligation. However, if the entity cannot reasonably measure the outcome but expects to recover the costs incurred in satisfying the performance obligation, then it recognises revenue to the extent of the costs incurred.

Example 9 – Time-based measure of progress: Technical support services

Company S enters into a contract to license software to Customer C and provide technical support for the three-year licence period. The terms of the support agreement specify that S's helpdesk and web support operators are available every day other than Sundays. S concludes that the software licence and the technical support services are distinct from each other and are separate performance obligations.

The distinct software licence is satisfied at a point in time (see Chapter 9). S concludes that the technical support services are satisfied over time. This is because C consumes and receives benefit from having continuous access to S's support resources throughout the three-year period. That is, the technical support is a 'stand-ready obligation'. S determines that a time-elapsed measure of progress is appropriate.

However, if S's contractual obligation in relation to technical support was instead to provide a specified number of support calls, then it would generally recognise revenue as C makes use of the specified calls.

Example 10 – Time-based measure of progress: Unspecified updates

Company U licenses software to Customer C and promises to provide unspecified updates for the full three-year licence period.

U concludes that the software licence and the unspecified updates rights are distinct from each other and are separate performance obligations. The distinct software licence is satisfied at a point in time (see Chapter 9).

U has a history of providing unspecified items to customers on a regular basis. However, the quantity and the mix of items that a customer will receive (e.g. bug fixes and updates) and the timing of releases within a given period vary. Therefore, U concludes that:

- the nature of its performance obligation to provide unspecified updates, upgrades and enhancements is a 'stand-ready obligation'; and
- it expects to expend efforts to develop and transfer unspecified items to the customer on a generally even basis throughout the three-year term. U determines that a time-based measure of progress is appropriate, resulting in straight-line revenue recognition for the performance obligation.

Determining which measure of progress to apply is not a free choice

IFRS 15.BC159

The standard requires an entity to select a method that is consistent with the objective of depicting its performance. An entity therefore does not have a free choice of which method to apply to a given performance obligation – it needs to consider the nature of the good or service that it promised to transfer to the customer.

The standard also provides examples of circumstances in which a particular method does not faithfully depict performance – e.g. it states that units-of-production may not be an appropriate method when there is a material amount of work in progress. Judgement is required when identifying an appropriate method of measuring progress.

When evaluating which method depicts the transfer of control of a good or service, the entity's ability to apply that method reliably may also be relevant. For example, the information required to use an output method may not be directly observable or may require undue cost to obtain – in these circumstances, an input method may be appropriate.

Single method of measuring progress is used for a performance obligation

IFRS 15.40

Under the standard, an entity applies a single method of measuring progress for each performance obligation. This may be difficult when a single performance obligation contains multiple promised goods or services that will be transferred over different periods of time. For example, this might occur when a performance obligation combines a licence and a service arrangement, or a sale of goods and design or installation services.

Significant judgement may be required in some circumstances, and understanding the nature of its overall promise to the customer is key for an entity to select a reasonable measure of progress.

If the determination of a single measure of progress is challenging, then an entity may need to reconsider the assessment of performance obligations and whether there are multiple distinct performance obligations. However, the fact that identifying a single measure of progress is challenging does not necessarily mean that the promised goods or services are not a single performance obligation.

Certain sales agent arrangements may be over-time

Generally, when the entity is acting as a sales agent for a customer the entity satisfies its promise at a point in time. This is because the activities performed by the agent before sale typically do not transfer a good or service to a customer. If the customer receives any benefit from the entity's activities, then that benefit is limited unless the sale is completed.

However, there may be sales agent arrangements that provide benefits to the customer over time before a sale is completed. For example, assume that an entity receives a significant non-refundable fee at the time of listing and a relatively smaller commission fee when a sale is completed. The large non-refundable up-front fee indicates that the entity is providing the customer with a listing service and the customer is benefiting from that service over time. In this example, the entity estimates the commission fee following the guidance on variable consideration.

Judgement and evaluation of the facts will be necessary to determine whether a good or service is being transferred before the sale is completed.

Virtual gaming – Time-based measure of progress may be appropriate in many cases

An entity may provide ongoing virtual gaming services to customers (players). In some arrangements, the items purchased by the players have no value outside the game. In these cases, revenue is generally recognised over time. This is because the player consumes the benefits of the services as they are provided.

In many cases, an entity may use a time-based measure of progress when recognising revenue. Judgement is required to determine the appropriate time period to use for items purchased by players. For many items, an appropriate time period may be determined based on the average expected player life or expected game life. In certain cases, a shorter time period may be considered appropriate – e.g. for an item with a limited life.

Measure of progress for stand-ready obligations is not always straight-line

IFRS 15.26(e), IE92–IE94, BC160

Judgement is required to determine an appropriate measure of progress for a stand-ready obligation. When making the judgement, an entity considers the substance of the stand-ready obligation to ensure that the measure of progress aligns with the nature of the underlying promise. In assessing the nature of the obligation, the entity considers all relevant facts and circumstances, including the timing of transfer of goods or services, and whether the entity's efforts (i.e. costs) are expended evenly throughout the period covered by the stand-ready obligation.

In many cases, a straight-line measure of progress will be appropriate for recognising revenue on a stand-ready obligation. However, a straight-line measure of progress is not always appropriate.

For example, in a contract for unspecified software upgrades (a stand-ready obligation) or a health club contract, revenue is generally recognised on a straight-line basis because the pattern of benefit to the customer as well as the entity's efforts to fulfil the contract are generally even throughout the period. In contrast, a straight-line basis of recognition would not generally be appropriate in an annual contract to provide snow removal services in an area where snowfall is highly seasonal. The pattern of benefit of these services, as well as the entity's effort to fulfil the contract, would not generally be even throughout the year, because snow is only expected in the winter.

Milestone method may not depict pattern of performance

If control transfers to the customer over time, then the measure of progress should reflect this. Although the standard lists milestones as an example of a possible measure of progress when using an output method, it remains necessary to consider whether milestones faithfully depict performance, particularly if the milestones are widely spaced. This is because control generally transfers continuously as the entity performs, rather than at discrete points in time. Normally, a milestone method would need to incorporate a measure of progress between milestone achievements to faithfully depict an entity's performance.

Work in progress for an over-time performance obligation is generally expensed as a fulfilment cost when it is incurred because control of the work in progress transfers to the customer as it is produced and not at discrete intervals. However, inventory to support multiple contracts that has an alternative use is recognised as an asset until it is dedicated to a specific contract – e.g. by being integrated into the production process.

A performance obligation may be partially satisfied before the contract is identified

IFRS 15.2, 9, 95, 99, BC48

Entities sometimes start to perform before:

- entering into a contract with a customer; or
- the contract with the customer meets the Step 1 criteria (e.g. collectability is not probable).

In these cases, if the work completed to date has no alternative use and the performance obligation meets the criteria for revenue to be recognised over time, then the entity recognises a cumulative catch-up adjustment at the date on which the Step 1 criteria are met. This is because under the standard an entity recognises revenue based on progress towards complete satisfaction of the performance obligation. Therefore, because the entity has already partially satisfied the performance obligation, it recognises revenue to reflect that performance.

For example, if a developer sells an apartment to a customer when the apartment is 20 percent complete and the contract meets the criteria to recognise revenue over time, then the developer recognises 20 percent of its revenue under the contract on the date on which the contract is signed.

Additionally, fulfilment costs incurred before the existence of the contract that are not in the scope of another standard (e.g. inventory) would be capitalised as costs to fulfil an anticipated contract when the capitalisation criteria are met (see Section 7.2). These costs are expensed immediately at the date on which the Step 1 criteria are met if they relate to progress made to date on goods or services already deemed to have transferred to the customer at that date.

Borrowing costs when revenue is recognised over time

IU 03-19

An entity may borrow funds to fulfil its contracts with customers. A question arises over whether directly attributable borrowing costs may be capitalised under the borrowing costs standard when control transfers to the customer over time – in particular, whether an entity may have a qualifying asset in these circumstances.

The IFRS Interpretations Committee discussed a scenario in which an entity incurs borrowing costs in relation to construction of a multi-unit real estate development. Units are marketed and sold to individual customers and control of each unit transfers to the customer over time. Some units are sold before construction commences and some during construction – i.e. the entity recognises work in progress for unsold units as inventory. The Committee noted that any work in progress for unsold units under construction is ready for its intended sale and therefore not a qualifying asset. This is because the entity intends to sell the part-constructed units as soon as it finds suitable customers and control of them will transfer to the customers on entering into a contract.

For example, in April 2019 Developer D undertakes a project to develop a multi-unit residential building. The construction is expected to take three years – i.e. a substantial period of time. D borrows funds to finance the development. Under applicable laws, the land on which the building is being constructed is and will continue to be owned by the government.

D starts marketing the units and commences the construction of the building. Successful marketing efforts result in entering into sales contracts with customers straight away.

D determines that revenue from the sale of individual units will be recognised over time. As a result, D does not expect to have material inventory or work in progress on its balance sheet for units sold because control over a specific unit under construction will, from the point of entering into a sales agreement, be continuously transferred to each individual customer.

At 31 December 2019, D has completed 10% of the construction work and sold 50% of the units in the building for a total consideration of 100,000. The actual costs incurred on the construction are 16,000. As a result, D recognises:

- revenue in profit or loss for the units sold of 10,000 (100,000 × 10%);
- construction costs in profit or loss for the units sold of 8,000 (16,000 × 50%); and
- inventory in the statement of financial position for the cost of the unsold units of 8,000 (16,000 × 50%).

D assesses whether the units under construction meet the definition of a qualifying asset under the borrowing costs standard.

- *Sold units:* D determines that the units sold do not meet the definition of qualifying assets, because any work in progress related to them is continuously sold in its existing condition to the customers and therefore recognised in profit or loss as costs are incurred.
- *Unsold units:* D determines that the unsold units also do not meet the definition of qualifying assets. This is because the inventory is currently being marketed, marketing efforts are intended to result in immediate sales contracts and each unit will be subject to immediate derecognition once there is a signed contract with a customer – i.e. the units are ready for their intended sale in their existing condition.

Additional application examples

Example 11 – Cost-to-cost measure of progress: Stand-ready maintenance contract

ABC Corp enters into a maintenance contract with Truck Company T for one year. ABC provides maintenance services as needed or at specified intervals for the fleet of trucks. ABC concludes that the nature of its performance obligation is to stand ready to provide the maintenance services and that the performance obligation is satisfied over time because T simultaneously receives and consumes the benefits from the assurance that ABC is available when and if needed.

Although ABC concludes that its performance obligation is to stand ready to maintain or service the trucks at any point during the annual period, the maintenance services do not necessarily occur evenly throughout the year. Therefore, ABC selects a measure of progress that more closely aligns with its actual efforts and recognises revenue on an input-based measure that reflects its performance – e.g. cost-to-cost or labour hours incurred.

Example 12 – Telco: Monthly prepaid wireless contract

Telco M enters into a monthly prepaid contract with wireless Customer B for 200 minutes per month of voice services. B pays 30 per month in advance. B can use the minutes to make calls at any time during the month. Once the 200 minutes are used, the handset remains connected to the network and can accept calls. That is, incoming calls are not included in the 200 minutes per month.

M first concludes that B simultaneously receives and consumes the benefits from the service as it is provided and therefore the performance obligation is satisfied over time. Furthermore, M determines that the nature of its promise is to provide network services to B throughout the month because incoming calls are not included in the 200 minutes. Consequently, the number of minutes used does not appear to appropriately depict the satisfaction of that promise. Instead, the more appropriate measure of progress appears to be time elapsed. M therefore recognises revenue of 30 evenly throughout the month.

Example 13 – Wireless service contract with rollover minutes

Telco N enters into a two-year wireless contract with Customer C for prepaid voice services. The voice plan allows C to use 600 minutes each month for incoming and outgoing calls. After the 600 minutes are used, the handset can no longer be used to make or receive calls during that month. If C does not use all of the minutes, then C is able to roll over the unused minutes to the subsequent month. For the purposes of this example, breakage is ignored.

N concludes that C simultaneously receives and consumes the benefits of the minutes and therefore the performance obligation is satisfied over time. Due to C's ability to roll over the unused minutes each month, progress towards complete satisfaction of the performance obligation is measured based on the number of minutes used each month.

Any minutes that are unused at the end of each month will be accounted for as a contract liability because C pays in advance for the following month's 600 minutes.

5.3.2 Limitations on applying the units-of-delivery or units-of-production methods

IFRS 15.B15

An output method may not provide a faithful depiction of performance if the method selected fails to measure some of the goods or services for which control has transferred to the customer.

For example, if at the reporting date an entity's performance has produced work in progress or finished goods that are controlled by the customer, then using an output method based on units produced or units delivered would distort the entity's performance. This is because it would not recognise revenue for the assets that are created before delivery or before production is complete but that are controlled by the customer.

Example 14 – Measure of progress for a performance obligation involving multiple goods and services

Company U enters into a contract to manufacture and deliver 10 units to Customer C for 10,000. U assesses that the contract contains a single performance obligation that is satisfied over time. The cost to manufacture and deliver the 10 units is estimated to be 8,000.

U considers whether it could apply the units-of-delivery method to measure progress and determines that it would not be appropriate because it would lead to material amounts of work in progress being recognised on the balance sheet. Instead, U determines that an input method based on costs (cost-to-cost) is an appropriate measure of progress.

The alternative effects on the financial statements are shown below. This illustration assumes that none of the units has been completed or delivered and costs of 3,200 have been incurred (i.e. 40% complete) as at the reporting date.

	Units-of-delivery method	Cost-to-cost method
Revenue	-	4,000[1]
Costs of goods sold	-	3,200[2]
Gross margin	-	800
Work in progress	3,200	-[2]

Notes

1. Calculated as 10,000 × 40%.
2. Assuming that all materials have been integrated into the units and have no alternative use.

Design and production services – A units-of-delivery method or a units-of-production method may not be appropriate

IFRS 15.BC165–BC166

A units-of-delivery or units-of-production method may not be appropriate if the contract provides both design and production services and they represent a single performance obligation, because in this case each item produced or delivered may not transfer an equal amount of value to the customer. These contracts are common, for example, in the aerospace and defence, contract manufacturing, engineering and construction industries.

The clarifications provided in the standard on when certain methods for measuring progress may not be appropriate emphasise the need for an entity to consider its facts and circumstances and select the method that depicts its performance and the transfer of control of the goods or services to the customer.

5.3.3 Adjusting the measure of progress

IFRS 15.B19

An entity applying an input method excludes the effects of any inputs that do not depict its performance in transferring control of goods or services to the customer. In particular, when using a cost-based input method – e.g. cost-to-cost – an adjustment to the measure of progress may be required when an incurred cost:

- does not contribute to an entity's progress in satisfying the performance obligation: e.g. unexpected amounts of wasted materials, labour or other resources (these costs are expensed as they are incurred); or
- is not proportionate to the entity's progress in satisfying the performance obligation: e.g. uninstalled materials.

For uninstalled materials, a faithful depiction of performance may be for the entity to recognise revenue only to the extent of the cost incurred – i.e. at a zero percent profit margin – if, at contract inception, the entity expects all of the following conditions to be met:

- the good is not distinct;
- the customer is expected to obtain control of the good significantly earlier than it receives services related to the good;
- the cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation; and
- the entity is acting as the principal, but procures the good from a third party and is not significantly involved in designing and manufacturing the good.

If an entity determines that the cost of uninstalled materials should be excluded from the measure of progress, then revenue and the related costs are recognised on transfer of control of the uninstalled materials to the customer. In determining when control transfers to the customer, in our view an entity should consider all relevant indicators, including both point-in-time and over-time indicators (see Sections 5.2 and 5.4).

IFRS 15.IE95–IE100

Example 15 – Uninstalled materials

In November 2019, Contractor P enters into a lump-sum contract with Customer Q to refurbish a three-storey building and install new lifts for total consideration of 5,000. The following facts are relevant.

- The refurbishment service, including the installation of lifts, is a single performance obligation that is satisfied over time.
- P is not involved in designing or manufacturing the lifts, but is acting as the principal. Q obtains control of the lifts when they are delivered to the site in December 2019.
- The lifts are not expected to be installed until June 2020.
- P uses an input method based on costs incurred to measure its progress towards complete satisfaction of the performance obligation.

The transaction price and expected costs are as follows.

Transaction price	**5,000**
Costs	
Lifts	1,500
Other costs	2,500
Total expected costs	**4,000**

P concludes that including the costs of procuring the lifts in the measure of progress would overstate the extent of its performance. Consequently, it adjusts its measure of progress to exclude these costs from the costs incurred and from the transaction price, and recognises revenue for the transfer of the lifts at a zero margin.

By 31 December 2019, other costs of 500 have been incurred (excluding the lifts) and P therefore determines that its performance is 20% complete (500 / 2,500). Consequently, it recognises revenue of 2,200 (20% × 3,500[1] + 1,500) and costs of 2,000 (500 + 1,500).

Note

1. Calculated as the transaction price of 5,000 less the cost of the lifts of 1,500.

No guidance on the timing and pattern of the recognition of margin on uninstalled materials

An entity may be entitled to a margin on the uninstalled goods that is clearly identified in the contract terms or forms part of the overall transaction price. The standard does not provide guidance on the timing of recognition for this margin – i.e. whether it is recognised when the materials are installed or incorporated into the revenue recognition calculation for the remainder of the contract – or whether the costs are excluded when a measure of progress based on input costs is used.

IFRS 15.BC171

The Board believes that recognising a contract-wide profit margin before the goods are installed could overstate the measure of the entity's performance and, therefore, revenue. However, requiring an entity to estimate a profit margin that is different from the contract-wide profit margin could be complex and could effectively create a performance obligation for goods that are not distinct (therefore bypassing the requirements on identifying performance obligations).

The adjustment to the cost-to-cost measure of progress for uninstalled materials is generally intended to apply to a subset of goods in a construction-type contract – i.e. only to those goods that have a significant cost relative to the contract and only if the entity is essentially providing a simple procurement service to the customer.

Judgement will be required in determining whether a customer is obtaining control of a good 'significantly' before receiving services related to the good. In Example 15 in this chapter, it is unclear whether the same guidance would apply if the lifts were expected to be installed in January 2020 instead of June 2020.

No detailed guidance on identifying inefficiencies and wasted materials

IFRS 15.BC176–BC178

Generally, some level of inefficiency, rework or overrun is assumed in a service or construction contract and an entity contemplates these in the arrangement fee. Although the standard specifies that unexpected amounts of wasted materials, labour or other resources should be excluded from a cost-to-cost measure of progress, it does not provide additional guidance on how to identify unexpected costs. Judgement is therefore required to distinguish normal wasted materials or inefficiencies from those that do not depict progress towards completion.

5.3.4 As-invoiced practical expedient

IFRS 15.B16

As a practical expedient, if an entity has a right to invoice a customer at an amount that corresponds directly with its performance to date, then it can recognise revenue at that amount. For example, in a services contract an entity may have the right to bill a fixed amount for each unit of service provided.

Example 16 – Applying 'as-invoiced' practical expedient: Cleaning services

Cleaning Firm F enters into a contract with Customer C to provide cleaning services for two years. Fees for the services are based on a fixed hourly rate.

F could elect to apply the as-invoiced practical expedient because during the contract term it has a right to invoice the customer based on its performance to date – i.e. the number of hours of cleaning services provided to date.

Consideration does not need to be a fixed amount per unit to recognise revenue at the amount that the entity has a right to invoice

The as-invoiced practical expedient can apply when the price per unit changes during the contract. The practical expedient is appropriate when the amount invoiced for goods or services reasonably represents the value to the customer of the entity's performance completed to date.

This can be illustrated using the following examples.

- *A contract to purchase electricity at prices that change each year based on the observable forward market price of electricity:* such a contract qualifies for the practical expedient if the rates per unit reflect the value of the provision of those units to the customer.
- *An IT outsourcing arrangement with a declining unit price that reflects decreasing levels of effort to complete the tasks:* this may be the case because underlying activities performed at the outset of the contract are more complex, requiring more experienced (i.e. more costly) personnel than later activities. There may also be the effect of a learning curve – i.e. in most circumstances, personnel will become more efficient at performing the same tasks over time.

Additionally, the following considerations are relevant when assessing whether the as-invoiced practical expedient can be applied when the price per unit changes during the contract:

- *whether the reasons for the change in the price per unit are substantive:* e.g. for a valid business reason, such as declining costs or changes in the relevant price index; and
- *whether the amount of the change approximates the change in value to the customer:* e.g. by the change in a forward pricing curve in the case of electricity, a change in the consumer price index (CPI) or a change in labour data that is relevant to the entity's costs of providing the goods or services.

Arrangements that include a contractual minimum

It may be unclear whether the as-invoiced practical expedient can be applied when there is a contractual minimum in an arrangement. This is because in some cases the price that an entity invoices per unit may not directly correspond with the value to the customer.

In general, a contractual minimum amount that the entity expects the customer to easily surpass is not considered a substantive minimum and does not preclude the use of the as-invoiced practical expedient. This is because the contractual minimum will not affect the price per unit invoiced because it is expected to be exceeded.

In contrast, if the contractual minimum is such that there is a reasonable possibility that the customer will not exceed that minimum, then the practical expedient does not apply. Instead, the general guidance on determining the transaction price (including the constraint on variable consideration) applies and the entity needs to select an appropriate measure of progress for that performance obligation. This is because when the contractual minimum is not exceeded, the entity will need to estimate the total number of transactions and continuously update that amount in order to apply an output method that depicts progress.

Practical expedient may not be available when a contract includes a significant up-front fee

The practical expedient is designed to apply when the transaction price varies in direct proportion to a variable quantity of goods or services transferred to the customer – i.e. when the transaction price = a fixed per-unit price × a variable quantity of units (TP = P × Q). In general, when significant fees are paid up-front, the amount invoiced typically does not correspond directly with the value to the customer of each incremental good or service that the entity transfers to the customer and therefore the practical expedient cannot be applied.

In contrast, an up-front fee that reflects the value of other distinct goods or services transferred to the customer up-front would not preclude the use of the practical expedient.

Rebates, credits and refunds generally preclude application of the practical expedient

The presence of variable pricing created by expected refunds, rebates, credits or tiered pricing generally precludes use of the as-invoiced practical expedient.

This is because the amount that the entity has a right to invoice will not, at least until the customer achieves the lowest pricing tier, generally reflect the amount to which the entity expects to be entitled.

The entity also cannot recognise the invoiced amount as revenue when there is an expectation of later price concessions, which means that the invoiced amounts do not reflect the value to the customer of the services provided.

Additional application examples

Example 17A – Applying 'as-invoiced' practical expedient: Change in rates linked to CPI

Law Firm L enters into a contract with Customer M to provide services related to a legal case that is expected to take three years to resolve. Fees for the services are based on hourly rates: starting at 500 per hour for Year 1 and then adjusting each year by an amount equal to the change in the CPI.

Even though the rate per hour will change in Years 2 and 3, L concludes that it can still apply the as-invoiced practical expedient because the change in fee results from cost of service increases commensurate with local inflation. As a result, L concludes that the fees that it will receive during each period appropriately reflect the value to the customer of the entity's performance of providing legal services in that period.

Example 17B – Applying 'as-invoiced' practical expedient: Change in unit price linked to a fixed change

Modifying Example 17A, Law Firm L charges 500 per hour for the first year and then adjusts each subsequent year by an amount equal to the greater of the change in the CPI or 7%. The CPI is currently expected to increase at 2% for the upcoming year and L's costs are not expected to increase more than the CPI.

In this example, the price is expected to increase by 7% each year, which is not consistent with inflation or L's historical pricing or cost trends. Therefore, L concludes that it cannot use the as-invoiced practical expedient because the change is not supported by valid business reasons – e.g. being commensurate with the increase in costs of providing the service or changes in the CPI.

Example 17C – Applying 'as-invoiced' practical expedient: Different per-unit rates within a performance obligation

Modifying Example 17A, Law Firm L charges different rates per hour over the contract term based on the type and experience of the professional providing the service.

For example, the contract provides the following rate card:

- 750 per hour for a partner;
- 500 per hour for a senior associate;
- 300 per hour for an associate; and
- 100 per hour for a paralegal.

These rates reflect observable hourly rates that L charges similar customers for its professional services on a stand-alone basis. Despite the legal services being a single performance obligation, L will bill Customer M a different hourly rate depending on which professional is performing the task generating the billing.

L concludes that it can apply the practical expedient to recognise revenue because it has the right to bill at an amount that corresponds directly with its performance to date. The practical expedient is available despite the different rates because the differences reflect substantive differences between the value that each professional provides.

Example 18 – Applying 'as-invoiced' practical expedient: Enterprise service contract with usage fee treated as variable consideration

Telco T enters into a contract with enterprise Customer C to provide call centre services. These services include providing dedicated infrastructure and staff to stand ready to answer calls. T receives consideration of 0.50 per minute for each call answered.

T has separately concluded that its performance obligation is the overall service of standing ready to provide call centre services each day, rather than each call answered. Because C simultaneously receives and consumes the benefits of the service of standing ready each day the service is provided, the performance obligation is satisfied over time. T also observes that the arrangement meets the series guidance because each time increment of standing ready to provide call centre services is distinct, is essentially the same and has the same pattern of transfer.

Furthermore, T has concluded that the per-minute fee is variable consideration. In assessing the appropriate pattern of transfer (i.e. measure of progress in satisfying the performance obligation), T considers whether the variable consideration needs to be estimated at contract inception.

T expects its performance to be fairly consistent during the contract and observes that the pricing in this contract is consistent with pricing in similar contracts with similar customers. T also observes that the variable consideration for each day (i.e. the per-minute fee) relates to the entity's effort to satisfy the promise of standing ready each day. Furthermore, T observes that it has a right to consideration from C for each minute used (for practical reasons these amounts may be invoiced on a monthly basis). In addition, T concludes that the per-minute usage corresponds directly with the value to C of the service provided by T (i.e. the service of standing ready). Therefore, T concludes that revenue can be recognised based on the contractual right to bill.

Example 19 – Applying 'as-invoiced' practical expedient: Up-front fees

Technology Company T enters into a contract with Customer C to provide C with access to its hosted transaction processing application for three years. T concludes that the software licence is not distinct from the hosting services and that there is a single performance obligation satisfied over time to provide transaction processing services. T further concludes that the licence is not the predominant item in the transaction because the hosting services have a significant value to C. Therefore, the licence-specific guidance does not apply to this performance obligation.

T charges C 0.90 per transaction throughout the contract period, billed quarterly. In addition, C is required to pay a non-refundable up-front fee of 48,000. T expects transaction-based fees from the arrangement of approximately 480,000.

Judgement is needed to determine whether T can apply the 'as-invoiced' practical expedient. If T determines that the up-front fee is significant, then this suggests that the fees for which T has a right to invoice each period do not reflect the value of T's performance for that period and that the practical expedient does not apply.

If the practical expedient does not apply, then T considers whether it is appropriate to allocate the transaction processing fees to each period of service. See Section 4.2.

Example 20 – Applying 'as-invoiced' practical expedient: Non-substantive contractual minimum

Outsourcer Y and Customer C execute a two-year payroll processing arrangement in which Y processes C's payroll each week.

The total weekly invoice is calculated based on the number of employee payments processed each week. C pays 1.00 per transaction throughout the two years, subject to an annual minimum of 50,000.

Y has a number of contracts similar to the one with C and relevant experience suggests that it will process more than 150,000 payroll transactions each year for C. Y includes an annual minimum requirement in its contracts to ensure a minimum recovery of its fixed costs if all of its customers pay only their contractual minima annually.

Because Y expects to significantly exceed the annual minimum each year of the contract, it concludes that the annual minimum is not substantive. Therefore, Y concludes that the contractual minimum does not preclude use of the as-invoiced practical expedient.

5.4 Performance obligations satisfied at a point in time

IFRS 15.32–33

If a performance obligation is not satisfied over time, then an entity recognises revenue at the point in time at which it transfers control of the good or service to the customer. An entity has 'control' of a good or service when it has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service.

The 'benefits' of an asset are the potential cash flows – inflows or savings in outflows – that can be obtained directly or indirectly, including by:

- using the asset to:
  - produce goods or provide services (including public services);
  - enhance the value of other assets; and
  - settle liabilities or reduce expenses;
- selling or exchanging the asset;
- pledging the asset to secure a loan; and
- holding the asset.

IFRS 15.38

The standard includes indicators of when the transfer of control occurs.

Relevant considerations include the following.

- In some cases, possession of legal title is a protective right and may not coincide with the transfer of control of the goods or services to a customer – e.g. when a seller retains title solely as protection against the customer's failure to pay.
- In consignment arrangements (see Section 5.6) and some repurchase arrangements (see Section 5.5), an entity may have transferred physical possession but still retain control. Conversely, in bill-and-hold arrangements (see Section 5.7) an entity may have physical possession of an asset that the customer controls.
- In some arrangements, a customer may obtain control of an asset before it has physical possession – e.g. a bank purchasing a fixed amount of gold from a mine may be able to sell the gold for immediate physical settlement before the refinement process is completed.
- When evaluating the risks and rewards of ownership, an entity excludes any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. In some cases, the customer may have the rewards of ownership, but not the risks. This does not necessarily preclude the customer from having control. An entity considers whether the other indicators are more relevant and the customer's ability to direct the use of and obtain substantially all of the benefits from the asset.
- An entity needs to assess whether it can objectively determine that a good or service provided to a customer conforms to the specifications agreed in a contract (see Section 5.8).

Judgement may be required to determine the point in time at which control transfers

IFRS 15.BC155

The indicators of transfer of control are factors that are often present if a customer has control of an asset; however, they are not individually determinative, nor are they a list of conditions that have to be met. The standard does not suggest that certain indicators should be weighted more heavily than others, nor does it establish a hierarchy that applies if only some of the indicators are present. However, it remains possible that in some facts and circumstances certain indicators will be more relevant than others and so carry greater weight in the analysis.

Judgement may be required to determine the point in time at which control transfers. This determination may be particularly challenging when there are indicators that control has transferred alongside 'negative' indicators suggesting that the entity has not satisfied its performance obligation.

Potential challenges may exist in determining the accounting for some delivery arrangements

When evaluating at which point in time control transfers to the customer, the shipping terms of the arrangement are a relevant consideration. Shipping terms alone do not determine when control transfers – i.e. an entity considers them along with other indicators of control to assess when the customer has the ability to direct the use of, and obtain substantially all of the benefits from, the asset. However, shipping terms often indicate the point in time when the customer has legal title, the risks and rewards of ownership and a present obligation to pay – all of which are indicators that control has transferred.

The Incoterms of the International Chamber of Commerce are used frequently in international purchase-and-sales contracts. They include standard trade terms such as 'free on board' (FOB), 'cost, insurance and freight' (CIF) and 'ex works' (EXW). In the case of FOB, when the goods are loaded onto the ship the customer usually receives the bill of lading and takes over the risk of loss or damage to the goods. This may indicate that the customer obtains control when the goods are loaded onto the ship and the bill of lading has been transferred to the customer.

If control of the goods transfers to the customer before delivery to the final destination, then an entity considers whether the transportation service is a distinct performance obligation and, if so, whether it acts as a principal or an agent for the shipping service (see Section 10.3).

When goods are shipped, the risk of loss may often be transferred to a third party while the goods are in transit. The fact that the seller transfers its risk of loss to another party (i.e. the third party shipping company or insurance company) does not mean that the customer has the ability to direct the use or obtain substantially all of the benefits from the goods or services. An entity needs to consider this when assessing at which point in time control transfers to the customer.

If the entity concludes that transfer of control has occurred when the product is shipped, then it also considers whether its business practices give rise to a separate performance obligation in addition to the performance obligation to transfer the product itself – i.e. a stand-ready obligation to cover the risk of loss if goods are damaged in transit. If a separate performance obligation is identified, then only the revenue allocated to the sale of the goods is recognised at the shipping date.

Indirect channels and sell-in vs sell-through

Many entities sell through distributors and resellers. These transactions will require judgement to determine if the transfer of control occurs on delivery to the intermediary (sell-in model) or when the good is resold to the end customer (sell-through model). Entities need to consider the guidance on consignment sales (see Section 5.6) and variable consideration (see Section 3.1) to determine which model is appropriate.

5.5 Repurchase agreements

Overview

An entity has executed a repurchase agreement if it sells an asset to a customer and promises, or has the option, to repurchase it. If the repurchase agreement meets the definition of a financial instrument, then it is outside the scope of the standard. If not, then the repurchase agreement is in the scope of the standard and the accounting for it depends on its type – e.g. a forward, call option or put option – and on the repurchase price.

IFRS 15.10, B64

The option to repurchase the asset may be in the same contract or in another contract. A contract creates enforceable rights and obligations and can be written, oral or implied by an entity's customary business practices (see Section 1.1).

The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.

IFRS 15.BC423

If an entity does not have a contractual right to repurchase a good, but decides to do so after transferring control of that good to a customer, then this does not constitute a repurchase arrangement. This is because the customer is not obliged to resell that good to the entity under the original contract.

A forward or a call option

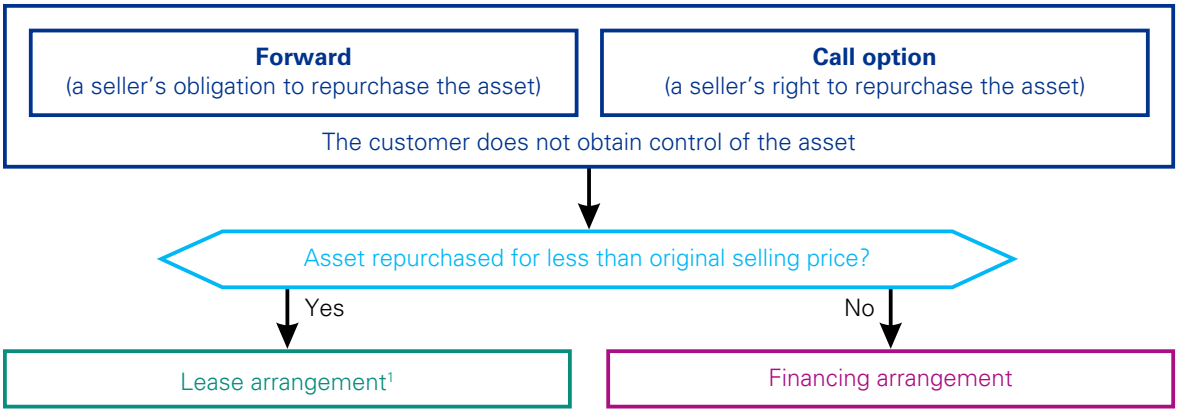
IFRS 15.B66–B67

If an entity has an obligation (a forward) or a right (a call option) to repurchase an asset, then a customer does not have control of the asset. This is because the customer is limited in its ability to direct the use of, and obtain the benefits from, the asset despite its physical possession. If the entity has an obligation or a right to repurchase the asset for less than its original sales price, then it accounts for the entire agreement as a lease, unless the contract is part of a sale-and-leaseback transaction. Conversely, if the entity has an obligation or a right to repurchase the asset for an amount that is greater than or equal to the original sales price, then it accounts for the transaction as a financing arrangement. When comparing the repurchase price with the selling price, the entity considers the time value of money.

If a repurchase arrangement that would otherwise be accounted for as a lease is part of a sale-and-leaseback transaction, then the entity continues to recognise the asset and recognises a financial liability for any consideration received. The entity accounts for the financial liability under the financial instruments standard.

IFRS 15.B68–B69, B75

In a financing arrangement, the entity continues to recognise the asset and recognises a financial liability for any consideration received. The difference between the consideration received from the customer and the amount of consideration to be paid to the customer is recognised as interest, and processing or holding costs if applicable. If the option expires unexercised, then the entity derecognises the liability and the related asset and recognises revenue.



1. Unless the contract is part of a sale-and-leaseback transaction.

A put option

IFRS 15.B70–B71

If a customer has a right to require the entity to repurchase the asset (a put option) at a price that is lower than the original selling price, then at contract inception the entity assesses whether the customer has a significant economic incentive to exercise the right. To make this assessment, an entity considers factors including the:

- relationship of the repurchase price to the expected market value of the asset at the date of repurchase; and
- amount of time until the right expires.

IFRS 15.B70, B72

If the customer has a significant economic incentive to exercise the put option, then the entity accounts for the agreement as a lease, unless the contract is part of a sale-and-leaseback transaction. Conversely, if the customer does not have a significant economic incentive, then the entity accounts for the agreement as the sale of a product with a right of return (see Section 10.1).

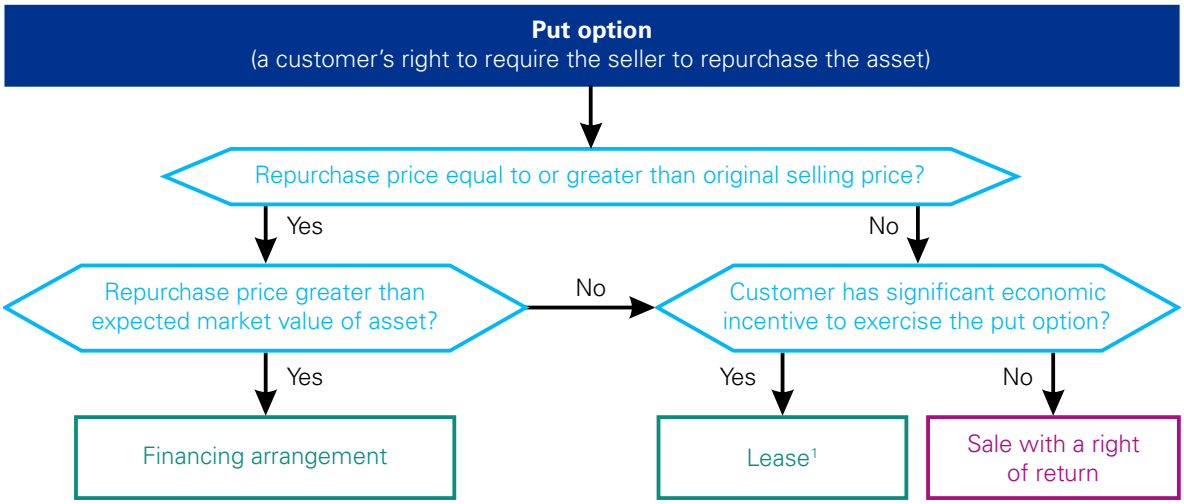
If a repurchase arrangement that would otherwise be accounted for as a lease is part of a sale-and-leaseback transaction, then the entity continues to recognise the asset and recognises a financial liability for any consideration received. The entity accounts for the financial liability under the financial instruments standard.

IFRS 15.B73, B76

If the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset, then the entity accounts for the contract as a financing arrangement. In this case, if the option expires unexercised, then the entity derecognises the liability and the related asset and recognises revenue at the date on which the option expires.

IFRS 15.B75

When comparing the repurchase price with the selling price, the entity considers the time value of money.



1. Unless the contract is part of a sale-and-leaseback transaction.

Example 21 – Handset trade-in

Telco T enters into a 24-month wireless service contract with Customer C. At contract inception, T transfers to C a handset for 600, together with a right to trade in that handset for 100 at the end of the service contract. The stand-alone selling price of the handset at contract inception is 600. T expects the handset market value to be 150 in 24 months.

T's obligation to repurchase the handset at the customer's option is a put option. T assesses, at contract inception, whether C has a significant economic incentive to exercise the put option, to determine the accounting for the transfer of the handset.

T concludes that C does not have a significant economic incentive to exercise the put option because the repurchase price of 100 is lower than the expected market value of 150. Additionally, customers usually have easy access to the second-hand market to resell similar phones. T determines that there are no other relevant factors to consider when assessing whether C has a significant economic incentive to exercise the put option. Consequently, T concludes that control of the handset transfers to C because C is not limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the handset.

T therefore accounts for the transaction as a sale with a right of return (see Section 10.1).

An approach that focuses on the repurchase price

The standard includes guidance on the nature of the repurchase right or obligation and the repurchase price relative to the original selling price.

Judgement will be required to determine whether a customer with a put option has a significant economic incentive to exercise its right. This determination is made at contract inception and is not updated for subsequent changes in asset prices. Historical customer behaviour in similar arrangements will be relevant to this determination.

Requirements for repurchase agreements not applicable to arrangements with a guaranteed resale amount

IFRS 15.BC431

The Board observed that although the cash flows of an agreement with a guaranteed minimum resale value may be similar to those of an agreement with a put option, the customer's ability to control the asset is different and therefore the recognition of revenue may differ. This is because if a customer has a significant economic incentive to exercise a put option, then it is restricted in its ability to consume, modify or sell the asset. This would not be the case if the entity had instead guaranteed a minimum amount of resale proceeds.

This could result in different accounting for arrangements with similar expected cash flows.

Conditional forwards or call options

IFRS 15.BC424

In some cases, a forward contract or a call option may be conditional on a future event. Although all of the facts and circumstances need to be evaluated for each arrangement, treating certain conditional forwards or call options as rights of return (see Section 10.1) may be more consistent with the economics of these transactions. In these cases, it is appropriate to apply the principles for recognising and measuring variable consideration from a right-of-return provision, rather than accounting for the arrangement as a lease or a financing transaction.

For example, some perishable goods manufacturers include provisions in their agreements with customers under which they have the right to remove and replace out-of-date products to ensure that the end consumers receive the product quality and freshness that they expect. Under these circumstances, the manufacturer does not have the unconditional right to repurchase the products at any time. The product must be past its sell-by date for the manufacturer to apply this right.

In this example, the existence of a conditional call option does not restrict the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset unless and until the conditional event occurs, because the manufacturer has no right to repurchase the product if the sell-by date has not passed. Consequently, the customer has control over the asset until the contingent event occurs. Therefore, in this example the manufacturer accounts for the arrangement as a sale with a right of return.

Guidance on repurchase arrangements applies to conditional call options

IFRS 15.BC427

In some cases, a forward contract or a call option may be conditional on a future event. The standard does not distinguish between conditional and unconditional repurchase rights. In our view, an entity should apply the repurchase guidance to both conditional and unconditional repurchase rights that are substantive.

If the condition that makes the right exercisable is in the control of the entity (the seller), then we believe that the repurchase right should be viewed as being unconditional.

If the entity's ability to exercise the repurchase right is conditional on a future event that is outside the control of the entity, then we believe that this conditionality should be taken into account when assessing whether the repurchase right restricts the customer's ability to direct the use or obtain substantially all of the benefits of the asset. In making this assessment, an entity should determine whether it is more than remote that the repurchase right will become exercisable. To do so, the entity may use the following factors.

- If the condition that makes the right exercisable is within the control of the customer, then the entity may consider:
  - any economic incentive the customer has to act in a way that will make the entity's right to repurchase the asset exercisable; and
  - the reasons other than economic incentive for the customer to act in a way that will make the repurchase right exercisable and the likelihood of the customer using those reasons to make the repurchase right exercisable.
- If the condition that makes the right exercisable is outside the control of the entity or the customer, then the entity may consider the likelihood of the contingency occurring. For example, a contingency related to a natural disaster would generally not preclude the entity from transferring control.

As part of the assessment an entity may consider whether other facts and circumstances indicate that the repurchase arrangement should be treated as a right of return. For example, the seller has the right to remove and replace out-of-date products. See observation below for further discussion.

Right of first refusal

IFRS 15.B66, BC423

A seller may retain a right of a first refusal for future sale of the purchased asset by the customer. This allows the seller to repurchase the asset at the same price as a third party agrees to pay to the customer for the sale of the asset.

This right is not a call or a put option because it does not prevent the customer from controlling the asset. Accordingly, it does not generally constitute a repurchase agreement and therefore does not affect revenue recognition by the seller. Additionally, the customer has no right to return the asset to the seller so the returns are not estimated.

Additional example

Example 22 – Conditional forward or call option controlled by the customer

Company M owns two investment properties, P1 and P2, which are adjacent buildings leased fully to the same lessee. In April 2022, M signs a sales contract with Customer X in respect of P1 and P2. Under the terms of the contract, X agrees to purchase P1 for a fixed price in April 2022 and receives an option to purchase P2 for a fixed price in January 2027. In addition, M has the right to repurchase P1 at fair value if X does not purchase P2 in January 2027 – i.e. M holds a conditional call option over P1.

The following facts are also relevant to this example.

- Lease payments received for P1 and P2 are distinguishable.
- X cannot sell P1 without approval from M until P2 is purchased.
- M cannot sell P2 during the option period without approval from X.
- Until the option is exercised, any decision about the lease contract requires joint agreement.

M applies the repurchase guidance to its conditional repurchase option to determine whether it can recognise revenue for the sale of P1 in April 2022. M notes that it does not control the condition under which the repurchase option becomes exercisable.

M evaluates the facts and circumstances of the arrangement considering all relevant factors and determines that there is more than a remote possibility of the option becoming exercisable. Therefore, M concludes that the conditional call option is in the scope of the repurchase guidance. As a result, M is precluded from recognising revenue for the transfer of P1 until the option expires.

M then assesses whether to treat the arrangement as a lease or financing arrangement.

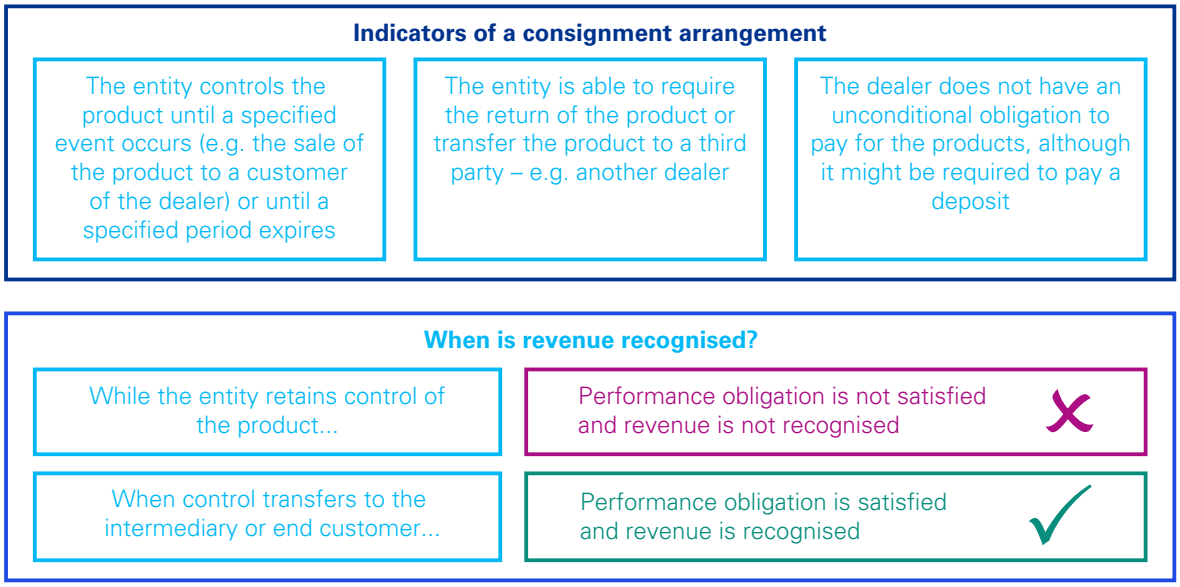
5.6 Consignment arrangements

IFRS 15.B77

An entity may deliver goods to another party but retain control of the goods – e.g. it may deliver a product to a dealer or distributor for sale to an end customer. These types of arrangements are called 'consignment arrangements' and do not allow the entity to recognise revenue on delivery of the products to the intermediary.

IFRS 15.B78

The standard provides indicators that an arrangement is a consignment arrangement as follows.



Example 23 – Retail: Consignment arrangement

Manufacturer M enters into a 60-day consignment contract to ship 1,000 dresses to Retailer R's stores. R is obliged to pay M 20 per dress when the dress is sold to an end customer. During the consignment period, M has the contractual right to require R to either return the dresses or transfer them to another retailer. M is also required to accept the return of the inventory.

M determines that control has not transferred to R on delivery, for the following reasons:

- R does not have an unconditional obligation to pay for the dresses until they have been sold to an end customer;
- M is able to require that the dresses be transferred to another retailer at any time before R sells them to an end customer; and
- M is able to require the return of the dresses or transfer them to another retailer.

M determines that control of the dresses transfers when they are sold to an end customer – i.e. when R has an unconditional obligation to pay M and can no longer return or otherwise transfer the dresses. M recognises revenue as the dresses are sold to the end customer.

Example 24 – Automotive: Consignment arrangement

Carmaker C requires Automotive Supplier S to deliver a predetermined number of brake lightbulbs to C's warehouse based on a forecast production plan. However, legal title over the lightbulbs and a right to payment arise only when the parts are retrieved from the warehouse and moved to C's assembly line.

Brake lightbulbs produced by S can also be sold to other carmakers and S has the contractual right to require C to return the parts or deliver them to another carmaker. S is also required to accept any excess lightbulbs returned by C.

S determines that control over the lightbulbs has not transferred to C on delivery to C's warehouse because:

- C does not have an unconditional obligation to pay for the lightbulbs until they have been moved to its assembly line; and
- S is able to require that the lightbulbs be transferred to another carmaker any time before C installs them in its cars.

S determines that control of the lightbulbs transfers when they are moved to C's assembly line – i.e. when C has an unconditional obligation to pay S and can no longer be asked to return or transfer the goods.

Example 25 – Automotive: Not a consignment arrangement

Carmaker D enters into a contract with Automotive Supplier S to deliver windscreens for D's cars. According to the contract, S is required to maintain a minimum number of windscreens in D's warehouse during the contract term. Once they have been delivered, S cannot access the windscreens (other than for stocktaking). It also has no right to require the windscreens to be returned or redirected to another carmaker.

The price of the windscreens is determined when they are delivered to D's warehouse. S has a right to payment for the windscreens either when they are moved to D's assembly line or within six weeks of delivery, whichever is earlier.

While they are stored at D's warehouse, D bears any insurance fees and storage costs. In addition, it is liable for the risk of loss, theft or damage. However, S retains legal title to the windscreens until payment is received.

According to the relevant legal framework in D's jurisdiction, goods are deemed to be accepted if D does not claim otherwise without an undue delay.

S concludes that the arrangement with D is not a consignment arrangement, because:

- it is unable to require D to return the windscreens or to transfer them to a third party; and
- S has an unconditional right to payment for the windscreens once they are delivered that is dependent only on the passage of time. D's actions can only influence the timing of the payment.

Judgement is required to determine the point in time at which control over the windscreens is transferred to D. Under this fact pattern, S notes that:

- it is unable to direct the windscreens to another use once they have been delivered;
- it has an unconditional right to payment for windscreens (see above);
- even though it retains legal title to the windscreens, this is a protective measure against D's failure to pay;

- it has transferred physical possession of the windscreens to D;
- it has transferred the significant risks and rewards of ownership of the windscreens – i.e. the price risk, demand risk and inventory risk; and
- under the local law, D is deemed to accept the windscreens delivered to its warehouse if it does not claim otherwise shortly after delivery.

Therefore, S concludes that control over the parts has been transferred to D on delivery to its warehouse.

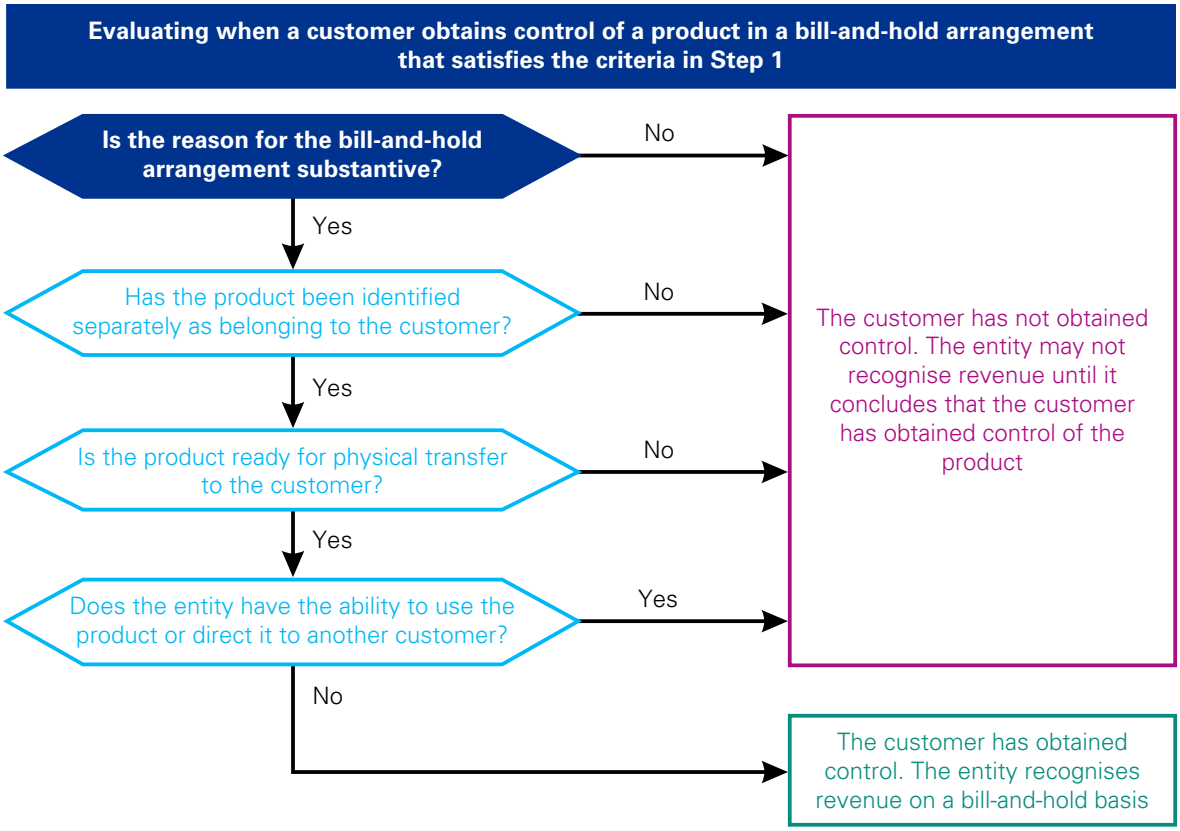
5.7 Bill-and-hold arrangements

IFRS 15.B79

Bill-and-hold arrangements occur when an entity bills a customer for a product that it transfers at a point in time, but retains physical possession of the product until it is transferred to the customer at a future point in time. This might occur to accommodate a customer's lack of available space for the product or delays in production schedules.

IFRS 15.B80–B81

To determine when to recognise revenue, an entity needs to determine when the customer obtains control of the product. Generally, this occurs at shipment or delivery to the customer, depending on the contract terms (for discussion of the indicators for transfer of control at a point in time, see Section 5.4). The standard provides criteria that have to be met for a customer to obtain control of a product in a bill-and-hold arrangement. These are illustrated below.



IFRS 15.B82

If an entity concludes that it is appropriate to recognise revenue for a bill-and-hold arrangement, then it is also providing a custodial service to the customer, which may constitute a separate performance obligation to which a portion of the transaction price is allocated.

Example 26 – Bill-and-hold arrangement

Company C enters into a contract to sell equipment to Customer D, who is awaiting completion of a manufacturing facility and requests that C hold the equipment until the manufacturing facility is completed.

C bills and collects the non-refundable transaction price from D and agrees to hold the equipment until D requests delivery. The transaction price includes appropriate consideration for C to hold the equipment indefinitely. The equipment is complete and segregated from C's inventory and is ready for shipment. C cannot use the equipment or sell it to another customer. D has requested that the delivery be delayed, with no specified delivery date.

C concludes that D's request for the bill-and-hold basis is substantive. It also concludes that control of the equipment has transferred to D and that it will recognise revenue on a bill-and-hold basis even though D has not specified a delivery date.

The obligation to warehouse the goods on behalf of D represents a separate performance obligation. C needs to estimate the stand-alone selling price of the warehousing performance obligation based on its estimate of how long the warehousing service will be provided. C defers the amount of the transaction price allocated to the warehousing obligation and recognises it over time as the warehousing services are provided.

5.8 Customer acceptance

IFRS 15.38(e)

To determine the point in time at which a customer obtains control for point-in-time performance obligations (and therefore the performance obligations are satisfied), an entity considers several indicators of the transfer of control, including whether the customer has accepted the goods or services.

IFRS 15.B83

The customer acceptance clauses included in some contracts are intended to ensure the customer's satisfaction with the goods or services promised in the contract. The table below illustrates examples of customer acceptance clauses.

If the entity…	Then…	For example…
Can objectively verify that the goods or services comply with the specifications underlying acceptance	Customer acceptance would be a formality, and revenue could be recognised before explicit acceptance	The customer acceptance clause is based on meeting objective size and weight specifications
Cannot objectively determine whether the specifications have been met	It is unlikely that the entity would be able to conclude that the customer has obtained control before formal customer acceptance	The customer acceptance clause is based on a modified product functioning in the customer's new production line
Delivers products for trial or evaluation purposes and the customer is not committed to paying any consideration until the trial period lapses	Control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses	The customer acceptance clause specifies that the customer may use prototype equipment for a specified period of time

IFRS 15.B84

IFRS 15.B85

IFRS 15.B86

IFRS 15.B84

An entity's experience with similar contracts may provide evidence that goods or services transferred to the customer are based on the agreed specifications.

For further discussion on the accounting for consignment arrangements that may have attributes similar to customer acceptance clauses, see Section 5.6.

6 Scope

Overview

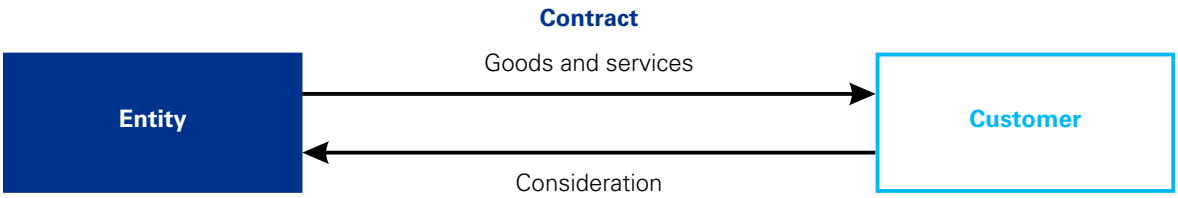
The standard applies to contracts to deliver goods or services to a customer. Its guidance applies to contracts with customers in all industries. However, a contract with a customer is outside the scope of the revenue standard if it falls in the scope of other specific requirements.

In some cases, the revenue standard is applied to part of a contract or, in certain circumstances, to a portfolio of contracts.

6.1 In scope

IFRS 15.6

A 'customer' is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.



Example 1 – Identifying in-scope contracts

Company X is in the business of buying and selling commercial property. It sells a property to Purchaser Y. This transaction is in the scope of the revenue standard because Y has entered into a contract to purchase an output of X's ordinary activities and is therefore considered a customer of X.

Conversely, if X was a manufacturing entity selling its corporate headquarters to Y, then the transaction would not be a contract with a customer because selling real estate is not an ordinary activity of X. For further discussion on which parts of the model apply to contracts with a non-customer, see Section 10.7.

Determining whether an activity is 'ordinary' may require judgement

IFRS 15.BC52–BC53

The definition of a customer focuses on an entity's ordinary activities. However, 'ordinary activities' are not defined. In some cases, the assessment of whether a good or service is an output of the entity's ordinary activity may be straightforward – e.g. a retailer selling goods to its customers. However, in other cases the assessment may require judgement – e.g. if a retailer enters into a co-branding arrangement with a bank and provides marketing services, judgement may be required to assess whether the bank is the customer of the retailer for the marketing services.

Sales of by-products may be in the scope of the standard

An entity may produce by-products as part of its operations. In these cases, an entity needs to evaluate all facts and circumstances to determine the appropriate guidance to apply.

If a by-product is a routine output of the primary manufacturing process and its sales are part of ongoing operations, then the transaction is often in the scope of the revenue standard – i.e. the sale is accounted for and presented as revenue.

Conversely, if on rare occasions an entity sells scrap or a by-product that is not an output of its primary manufacturing process, then these transactions may be outside the scope of the revenue standard – i.e. the transactions would be accounted for and presented as other income.

Utility tokens may be in the scope of the standard

Entities may issue digital tokens (commonly referred to as 'utility tokens') for cash that can be redeemed by the holder for goods or services provided by the entity. Utility tokens are not goods or services in themselves, but are akin to vouchers or gift cards issued for cash that can be redeemed for goods or services.

In some cases, utility tokens can be traded on exchanges and the value of the token on redemption may also vary. For example, the token may be redeemable at the market price on the redemption date and if the market price goes up, then the holder can receive more goods or services on redemption.

There is no specific guidance in the Accounting Standards on how to account for utility tokens. The accounting needs to reflect the rights and obligations conveyed by the specific tokens. If the predominant feature of a utility token is to permit the holder to redeem it in exchange for goods and/or services from the entity and the good or service is part of the entity's ordinary activities, then the utility token is in the scope of the revenue standard. This is the case even if the token can be traded or its value varies as long as the holder's principal claim is the right to redeem the tokens for goods and services provided by the entity as part of its ordinary activities.

For guidance on accounting for customers' unexercised rights (breakage), see Section 10.5.

Example 2 – Accounting for utility tokens

Company X operates a trading platform that allows users to trade 'digital assets' like crypto, stocks and precious metals. As part of its business model, X issues tokens for cash, which the holder can use to pay for trading services on X's platform. The tokens can also be traded on the marketplaces operated by X (broker platform and exchange platform) or on third party exchanges, though trading volumes are low. X has no legal obligation to repurchase the tokens. When the tokens are exchanged for services, they are redeemed at the market price on the redemption date.

X evaluates the nature of the tokens and determines that their predominant feature is to permit the holder to redeem them as a payment for services provided by X. This assessment is consistent with the terms and conditions and the pricing of the tokens on initial issuance. Although the holder is also able to trade the tokens, the holder's principal claim is the right to redeem the tokens for services provided by X in the ordinary course of its activities. Therefore, X concludes that the tokens are in the scope of the revenue standard.

In accounting for the cash received for issuing tokens, X considers whether it represents a non-refundable prepayment from a customer. If so, then X recognises a contract liability, which is not remeasured after the initial recognition for fluctuations in the market price of the tokens. X also considers guidance on customers' unexercised rights (breakage) (see Section 10.5).

6.2 Out of scope

IFRS 15.5

The standard does not apply to:

- lease contracts;
- insurance contracts;
- financial instruments and other contractual rights or obligations in the scope of other specific guidance;
- guarantees (other than product or service warranties); and
- non-monetary exchanges between entities in the same line of business that facilitate sales to customers other than the parties to the exchange.

Example 3 – Non-monetary exchanges between telecom companies

Telco T and Telco B provide wireless services such as voice, data and text to their customers. However, they maintain and operate networks in different regions. T and B have agreed to exchange airtime and network capacity to ensure that their customers always have access to wireless services. The exchange is expected to be approximately equal and the contract requires no payment between the entities. Also, T and B have concluded that the exchange does not include a sale of property, plant and equipment or a lease.

This transaction is outside the scope of the revenue standard because T and B have entered into an agreement that is a non-monetary exchange between entities in the same line of business to facilitate sales to their customers. Because this transaction is outside the scope of the revenue standard for both T and B, it is excluded from the disclosures required by the revenue standard, including the presentation of revenue from contracts with customers.

Product and service warranties – Revenue vs provisions standard

IFRS 15.B28–B33

Entities with product or service warranties apply the guidance in the revenue standard (see Section 10.2) to determine whether to account for them under the revenue or the provisions standard.

Contributions in non-exchange transactions are outside the scope of the standard

CF4.68, IFRS 15.BC28

A 'contribution' is a non-reciprocal transfer of cash or other assets, rather than an exchange transaction – i.e. it is not given in exchange for goods or services that are an output of the entity's ordinary activities. Accordingly, contributions are not transactions with a customer, because a customer is defined in the standard as a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. Therefore, non-reciprocal contributions are not in the scope of the standard.

A not-for-profit entity may enter into some transactions that are contributions and others that are not. A not-for-profit entity therefore needs to evaluate which, if any, of its transactions are either fully or partially in the scope of the standard.

Settlement of imbalances in non-monetary exchanges

IFRS 15.5(d), BC58

Some exchanges between entities in the same line of business that facilitate sales to customers may involve similar goods or services of unequal value – e.g. there may be a time gap that affects the pricing of the good or the goods may differ in specification. In these cases, entities may settle the accumulated imbalances in cash periodically – e.g. on a quarterly or annual basis. The imbalance settled in cash often represents a small proportion of the gross exchange under the arrangement.

The fact that the imbalances may be settled in cash does not necessarily cause the exchange to become 'monetary' and result in the transaction being in the scope of the standard.

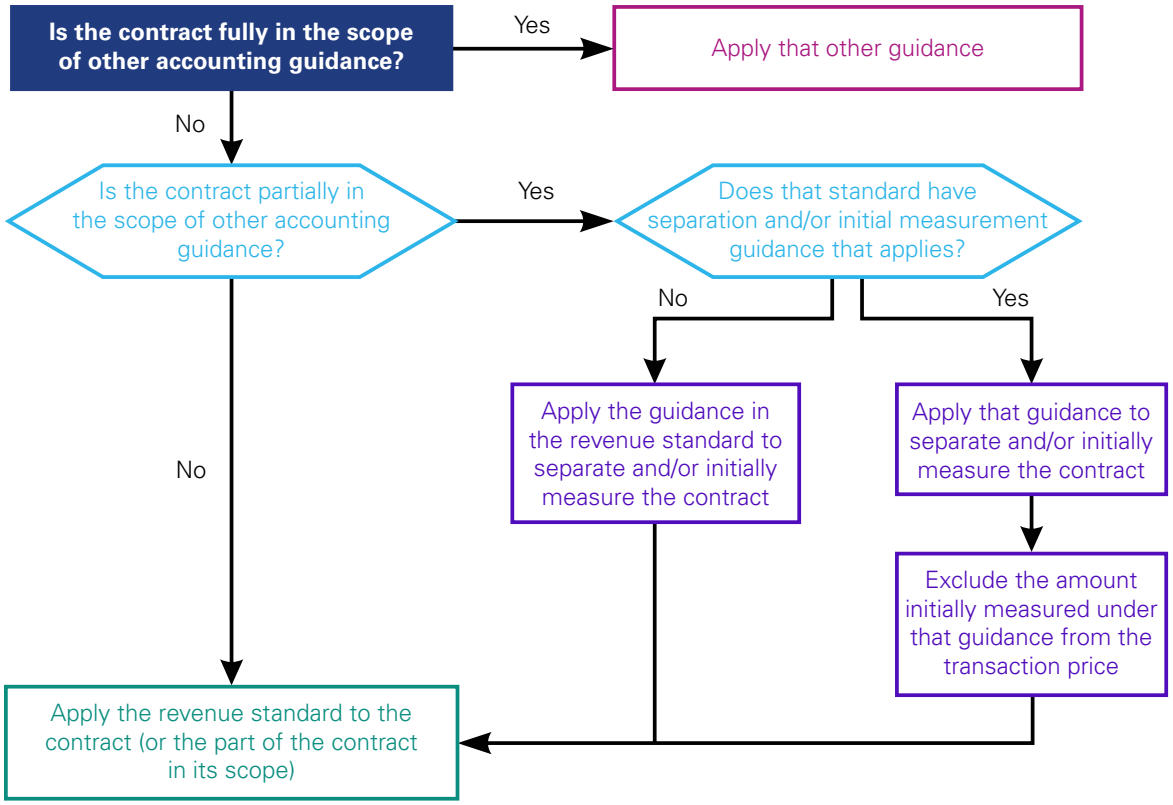
An entity needs to evaluate all facts and circumstances of the transaction, including the nature and the objective of the exchange, in determining whether it falls in the scope of the standard. In making this assessment, the entity also considers the relevance of the resulting information to the users of the financial statements.

6.3 Partially in scope

IFRS 15.7

A contract with a customer may be partially in the scope of the revenue standard and partially in the scope of other accounting guidance. If the other accounting guidance specifies how to separate and/or initially measure one or more parts of a contract, then an entity first applies those requirements. Otherwise, the entity applies the revenue standard to separate and/or initially measure the separately identified parts of the contract.

The following flowchart highlights the key considerations when determining the accounting for a contract that is partially in the scope of the revenue standard.



IFRS 15.6

The revenue standard excludes from its scope contracts with a collaborator or a partner that are not customers, but rather share with the entity the risks and rewards of participating in an activity or process. However, a contract with a collaborator or a partner is in the scope of the revenue standard if the counterparty meets the definition of a customer for part or all of the arrangement. Accordingly, a contract with a customer may be part of an overall collaborative arrangement and the revenue standard is applied to that part.

Example 4 – Zero residual amount after applying other accounting requirements

IFRS 9.B5.4.3

Bank B enters into a contract with a customer in which it receives a cash deposit and provides associated deposit services and treasury services for no additional charge. The cash deposit is a liability in the scope of the financial instruments standard. B first applies the initial recognition and measurement requirements in the financial instruments standard to measure the cash deposit. B then allocates the residual amount to the associated deposit services and treasury services and accounts for it under the revenue standard. Because the amount received for the cash deposit is recognised as a deposit liability, there are no remaining amounts to allocate to the associated deposit services and treasury services.

Modifying the fact pattern, if the arrangement included a periodic service fee, then a similar analysis would be performed. However, depending on the facts and circumstances, all or part of an ongoing fee that is charged on a monthly or annual basis is likely to be in the scope of the revenue standard.

Example 5 – Collaborative agreement

Biotech X has an arrangement with Pharma Y to research, develop and commercialise a drug candidate. X is responsible for the research and development (R&D) activities and Y is responsible for the commercialisation of the drug candidate. Both X and Y agree to participate equally in the results of the R&D and commercialisation activities.

Because the parties are active participants and share in the risks and rewards of the end product – i.e. the drug – this is a collaborative arrangement. However, there may be a revenue contract within the overall collaborative arrangement.

In some cases, there will be little or no residual amount remaining to allocate

For some arrangements, as illustrated in Example 4 in this chapter, after applying the other accounting guidance on separation and/or initial measurement, there may be little or no amount left to allocate to components of the contract that are in the scope of the revenue standard.

A counterparty may be both a collaborator and a customer

IFRS 15.BC55

The counterparty may be a collaborator for certain parts of the arrangement and a customer for other parts of it. It will be important for an entity that engages in collaborative arrangements to analyse whether the other parties to these arrangements are customers for some activities, and therefore whether these activities are revenue-generating. Making this assessment will require judgement and consideration of all applicable facts and circumstances of the arrangement.

Rate-regulated entities applying specific requirements do not apply the standard to movements in regulatory deferral account balances

IFRS 14

The revenue standard applies to the normal operations of rate-regulated entities – e.g. the sale of electricity, gas or water to customers in the course of the entity's ordinary activities.

Some entities that are subject to rate regulation may be eligible to apply the standard on regulatory deferral accounts. If so, then they apply that standard – rather than the revenue standard – to the movements in the regulatory account balances.

Parts of the standard apply to sales of non-financial assets

IFRS 15.BC57

Parts of the revenue standard also apply to sales of intangible assets, property, plant and equipment and investment property, including real estate in transactions outside the ordinary course of business. For further discussion on sales of non-financial assets outside the ordinary course of business, see Section 10.7.

Financial services fees – Revenue vs financial instruments standard

IFRS 9.B5.4.2–B5.4.3

The financial instruments standard includes guidance that specifies which types of financial services fees are included in the measurement of a financial instrument and which types of fees are accounted for under the revenue standard.

Fees that are an integral part of the effective interest rate of a financial instrument and fees on an instrument measured at fair value through profit or loss (FVTPL) are in the scope of the financial instruments standard. Examples of financial service fees that are not an integral part of the effective yield of an associated financial instrument and are therefore recognised under the revenue standard include:

- fees charged for servicing a loan;
- commitment fees to originate loans when it is unlikely that a specific lending arrangement will be entered into and the loan commitment is not measured at FVTPL;
- loan syndication fees received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants);
- a commission earned on the allotment of shares to a client;
- placement fees for arranging a loan; and
- investment management fees.

Determining the contract term when a contract contains lease and non-lease components

IFRS 15.7

When a contract contains lease and non-lease components, under the leases standard a lessor allocates the consideration in the contract applying Step 4 of the revenue standard (see Chapter 4). A question may arise over whether to allocate the consideration based on the lease term as determined under the leases standard (i.e. including optional renewal periods over which the lessee is reasonably certain to extend) or based on the contract term as determined under the revenue standard (i.e. only including periods during which the parties have presently enforceable rights and obligations (see Section 1.2)). In our view, in these cases an entity should allocate the consideration to each component based on the lease term determined under the leases standard.

We believe that an entity should also consider whether any renewal options for the non-lease component give rise to a material right (see Section 10.4).

Additional application examples

Example 6 – Telco: Partially in-scope transaction

IFRS 15.7(a), 16.17

Telco T enters into a contract that includes a promise to provide telecom equipment and services to Customer C. T first applies the leasing standard to assess whether the arrangement contains a lease.

If T concludes that the use of the equipment represents a lease, then the equipment will be accounted for under the leasing standard. Because the leasing standard contains guidance on how to identify a lease component and allocate the transaction price between lease and non-lease components, T first applies that guidance.

If T concludes that the equipment is not leased, then the entire contract will be accounted for under the revenue standard. In applying the revenue standard, T would follow all of the relevant revenue guidance, including the requirement to determine whether the equipment is distinct from the service (see Chapter 2).

Example 7 – Investment contracts that are not insurance contracts

Insurer X enters into an investment contract with a customer. Under the terms of the contract, X is obliged to return the underlying investment to the customer, net of management services fees. The management fee is set as a fixed percentage of the investment value.

IFRS 4.A, IAS 32.11

X concludes that the contract does not transfer significant insurance risk and is therefore not an insurance contract. X also identifies that the contract includes two components: a financial liability to the customer for the return of the underlying investment amount and an investment management service component.

Because the contract includes a financial liability, X first applies the initial recognition and measurement requirements in the financial instruments standard to measure it. X then allocates the residual amount to the investment management services. X determines that the initial investment received is the fair value of the financial liability. Therefore, there is no remaining amount to allocate to the investment management services at inception of the contract.

Subsequently, X measures the financial liability in accordance with the financial instruments standard and accounts for all of the management service fee charged under the contract in accordance with the revenue standard.

Example 8 – Media: Collaborative arrangement

Studio B and Television Channel C enter into an arrangement to develop a new television show. Under the agreement, B and C will jointly decide on the script, budget and number of episodes. C receives the licence to the show for its jurisdiction and B is able to sell the rights to television channels in other jurisdictions. C will reimburse B for 50% of the costs incurred during production and make a fixed payment of 5,000 to B when the television series is complete.

In this example, B needs to analyse carefully whether all or any part of the arrangement with C is in the scope of the revenue standard. For example, B considers whether the final fixed payment is part of a collaborative arrangement or represents a payment for a licence in the scope of the standard.

Example 9 – Automotive: Collaborative agreement

Automotive Supplier S enters into an arrangement with Carmaker D to develop a new technology for D's cars. Both S and D agree to participate equally in the costs and results of the engineering and development activities. Under the arrangement, S will also produce 100 units of the part developed for payment of 10,000. Because the parties are active participants and share in the risks and rewards of the engineering and development activities – i.e. the technology – part of the contract related to the engineering and development could be a collaborative arrangement. However, there is also a revenue contract to produce a series of parts within the overall agreement, which is accounted for under the revenue standard.

6.4 Portfolio approach

IFRS 15.4

The standard is generally applied to an individual contract with a customer. However, as a practical expedient an entity may apply the revenue model to a portfolio of contracts with similar characteristics if the entity reasonably expects that the financial statement effects of applying the revenue standard to the individual contracts within that portfolio would not differ materially.

Example 10 – Portfolio approach applied to costs

In April 2019, Cable Store C sold 100 cable television contracts. C employs several sales agents who receive a bonus of 10 for each contract that they obtain. C determines that each bonus constitutes a cost of obtaining a contract (see Section 7.1) and should be capitalised and amortised over the life of that underlying contract and any related anticipated renewal (see Section 7.3).

C determines that the portfolio approach is appropriate because the costs are all related to obtaining a contract and the characteristics of the contracts are similar. The amortisation period for the asset recognised related to these costs is expected to be similar for the 100 contracts (see Section 7.3). Additionally, C documents that the portfolio approach does not materially differ from the contract-by-contract approach. Instead of recording and monitoring 100 assets of 10 each, C records a portfolio asset of 1,000 for the month of April 2019.

Entities need to consider costs vs benefits of portfolio approach

Although the portfolio approach may be more cost effective than applying the standard on an individual contract basis, it is not clear how much effort may be needed to:

- evaluate which similar characteristics constitute a portfolio: e.g. the effect of different offerings, periods of time or geographic locations;
- assess when the portfolio approach may be appropriate; and
- develop the process and controls needed to account for the portfolio.

No specific guidance on assessing whether portfolio approach can be used

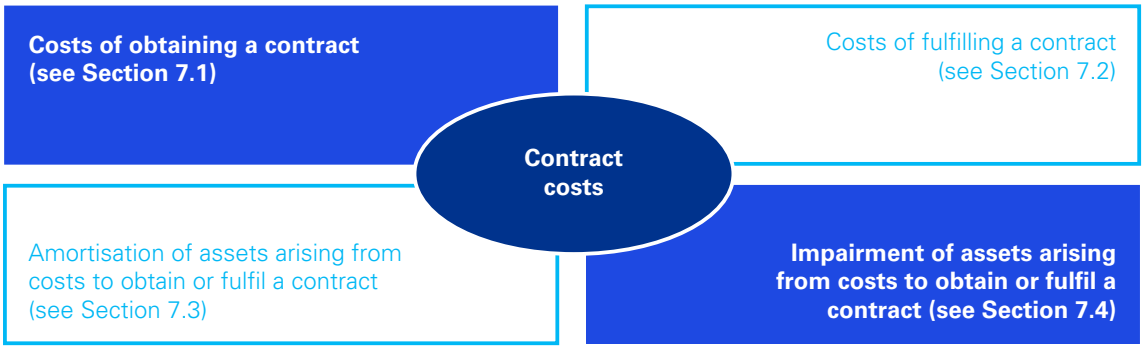
IFRS 15.IE110–IE115, IE267–IE270

The portfolio approach can be applied to both contract revenues and costs. The standard includes illustrative examples in which the portfolio approach is applied, including for rights of return and breakage. However, it does not provide specific guidance on how an entity should assess whether the results of a portfolio approach would differ materially from applying the standard on a contract-by-contract basis.

7 Contract costs

Overview

The standard does not seek to provide comprehensive guidance on the accounting for contract costs. In many cases, entities apply the cost guidance under other standards – e.g. the inventory standard. However, the revenue standard does include specific guidance on the following areas.



7.1 Costs of obtaining a contract

IFRS 15.91–92

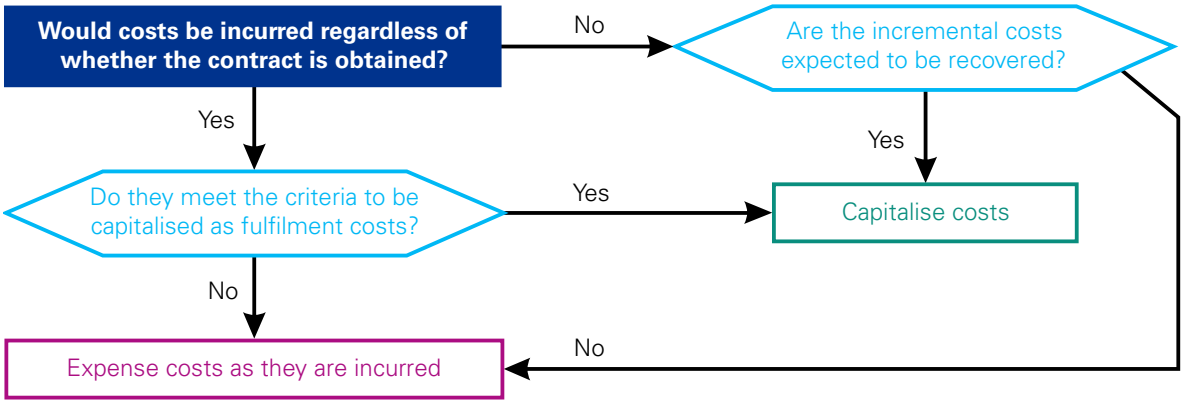
An entity capitalises incremental costs to obtain a contract with a customer – e.g. sales commissions – if it expects to recover those costs.

IFRS 15.94

However, as a practical expedient an entity is not required to capitalise the incremental costs to obtain a contract if the amortisation period for the asset is one year or less.

IFRS 15.93

Costs that will be incurred regardless of whether the contract is obtained – including costs that are incremental to *trying* to obtain a contract – are expensed as they are incurred, unless they meet the criteria to be capitalised as fulfilment costs (see Section 7.2). An example is costs to prepare a bid, which are incurred even if the entity does not obtain the contract.



Example 1 – Costs incurred to obtain a contract: Sales commissions to employees

IFRS 15.IE189–IE191

Consulting Company E provides consulting services to customers. Following a competitive tender process, E wins a contract to provide consulting services to Customer C. E incurs the following costs to obtain the contract.

External legal fees for due diligence	15
Travel costs to deliver proposal	25
Commissions to sales employees and related payroll taxes	10
Total costs incurred	**50**

The commissions payable to sales employees and related payroll taxes are an incremental cost to obtain the contract, because they are payable only on successfully obtaining the contract. E therefore recognises an asset for the sales commissions of 10, subject to recoverability.

By contrast, although the external legal fees and travel costs are incremental costs, they are costs associated with *trying* to obtain the contract. Therefore, they are incurred even if the contract is not obtained. Consequently, E expenses the legal fees and travel costs as they are incurred.

Practical expedient applies if the amortisation period is less than one year

IFRS 15.94

The practical expedient allowing entities not to capitalise the incremental costs to obtain a contract offers potential relief for an entity that enters into contracts of relatively short duration without a significant expectation of renewals. However, it may reduce comparability between entities.

Whether to use the practical expedient is an accounting policy choice, which can be made when the amortisation period associated with the asset that would otherwise have been recognised is one year or less. It is important to note that the amortisation period may be longer than the initial contract period because the entity is required to take into account expected renewals when determining the amortisation period. Determining the amortisation period can be particularly challenging when the entity also pays commissions for renewal contracts. For discussion of the amortisation period, see Section 7.3.

Consistent with other accounting policy choices for which the relevant standard does not specify the level at which the accounting policy choice is applied, the practical expedient related to contract costs is applied on an entity-wide basis across all of its business units or segments.

The assessment of whether the practical expedient applies is made at the contract level. If a contract includes multiple performance obligations, and one or more of them will be satisfied beyond one year, then the practical expedient will not usually apply. This will be the case when the asset relates to all of the goods and services in the contract and more than one performance obligation is present, which means that the amortisation period of the capitalised costs will be longer than a year.

For discussion of the amortisation period, see Section 7.3.

Capitalising commission when associated liability is accrued

In some cases, an additional commission may be payable, or the original commission amount adjusted, at a future date. Examples include commissions:

- paid for renewal of the contract;
- earned on contract modifications;
- contingent on future events;
- subject to claw-back; and
- that are tiered, subject to a threshold.

In these cases, an entity considers the enforceable rights and obligations created by the arrangement to determine when the liability is accrued and whether to capitalise a commission, and in what amount. Consider these examples.

- If an entity pays commission of 100 on commencement of a contract with a non-cancellable two-year term, and agrees to pay further commission of 100 if the customer renews the contract at the end of two years, then the entity generally capitalises only the initial commission of 100 on contract commencement. The entity capitalises the second commission of 100 only when the customer renews the contract. This is because the contract creates enforceable rights and obligations for both parties only for the initial contract period of two years and the entity does not accrue the second commission payment until it has a present obligation.
- If an entity pays commission of 100 on commencement of a contract with a non-cancellable two-year term and agrees to pay additional commission of 100 on the first anniversary of the contract, then the entity generally capitalises 200 on contract commencement. This is because the contract creates enforceable rights and obligations for both parties for the contract period of two years. Also, the entity accrues the second payment because it has a present obligation and its payment depends only on the passage of time.

In more complex scenarios, an entity focuses on whether its obligation to pay a commission meets the definition of a liability. This will be particularly important when considering commission structures that include thresholds – e.g. a commission amount is payable only if cumulative sales within a given period exceed a specified amount or the commission rate varies with cumulative sales. In general, if an entity recognises a liability to pay commission that qualifies for recognition as the cost of obtaining a contract, then the entity recognises an asset at the same time.

Judgement required for multiple-tier commissions

Some entities pay sales commissions on a multiple-tier system, in which the salesperson receives commission on all contracts executed with customers, and their direct supervisor receives commission based on the sales of the employees who report to them. An entity uses judgement when determining whether the supervisor's commission is incremental to obtaining a specific contract or contracts. The incremental cost is the amount of acquisition cost that can be directly attributable to an identified contract or contracts.

Additional application examples

Example 2 – Costs incurred to obtain a contract: Sales commissions to employees vs advertising

Telco E enters into a two-year wireless contract with Customer C that includes voice and data services. The contract is signed at one of E's stores and Sales Employee S receives a commission of 30 when C signs the contract. E has also incurred costs related to a two-week advertising campaign. On signing the contract, C indicates that he came into the store in response to this advertising campaign.

The commission paid to S is an incremental cost to obtain the contract with C because it is payable only on successfully obtaining the contract. Because the contract term is more than 12 months, the practical expedient does not apply. E therefore capitalises the sales commission of 30 as a cost of obtaining the contract, subject to recoverability. For discussion of the amortisation period, see Section 7.3.

In contrast, the advertising costs, although they are associated with *trying* to obtain the contract, are not incremental costs of obtaining the contract. That is, the advertising costs would have been incurred even if no new customer contracts were acquired. Consequently, E expenses the advertising costs as they are incurred.

Example 3 – Costs incurred to obtain a contract: Sales commissions vs wages to sales staff

During the development of a new advisory service line of business, Bank B incurred the following costs.

- External consultant and legal costs for developing a standard contract.
- Wages for sales staff who were assigned the task of signing new customers.
- Sales commissions paid to sales staff when a customer signs a contract.

B determines that the sales commissions paid to staff are costs of obtaining a contract because they are payable only when the contract is secured. B recognises an asset for the sales commissions, subject to recoverability.

In contrast, the wages for sales staff are not incremental costs because they are incurred regardless of whether the contract is obtained. Consequently, wages for sales staff are expensed as they are incurred.

The external consultant costs and legal costs also fail to meet the definition of costs to obtain a contract because they are incurred regardless of whether a contract is secured.

Example 4 – Commission paid on renewals after the initial contract is obtained

Telco T pays its sales employees a commission of 30 for each new two-year wireless contract entered into with a customer. T also pays 10 to sales employees each time a customer renews a contract for an additional two years. T needs to assess if and when these commissions should be capitalised as costs to obtain a contract, subject to recoverability.

At contract inception, T concludes that the commission of 30 is an incremental cost of obtaining the initial contract because the cost would not have been incurred if the contract had not been obtained. The contract between T and the customer creates no enforceable rights and obligations beyond the initial two-year period. Because there is no contract beyond the two-year period, T does not capitalise at contract inception future commissions that may be payable on renewal (i.e. the renewal commission of 10).

On contract renewal, T incurs an additional commission of 10. This commission of 10 is an incremental cost of obtaining the second contract because the cost would not have been incurred if the contract had not been renewed.

T therefore capitalises both commissions when they are incurred. For discussion of the amortisation period, see Section 7.3.

Example 5 – Dealer commission with claw-back provision

Telco E enters into a month-to-month wireless contract with Customer C that includes voice and data services. The contract is obtained through Dealer D, who is entitled to a commission of 20 from E. The commission is paid on contract commencement but is clawed back and refunded to E if C cancels the service within the first three months.

E concludes that D has completed its obligation, which is to sign C up for the service, even though C must continue to receive the service until the end of Month 3 for the commission to be fully earned. D's commission is an incremental cost to obtain the contract with C. Therefore, E recognises the commission of 20 as an asset at contract inception, subject to recoverability. For discussion of the amortisation period, see Section 7.3.

E assesses the contract cost asset for impairment together with its right to a refund on the commission paid to D.

Example 6 – Commission plan with tiered thresholds: Cumulative effect

Company B has a commission plan whereby once a cumulative threshold based on a number of contracts is reached, a commission is paid as a percentage of the cumulative value of that contract and the preceding contracts, taking into account any commission already paid.

Number of contracts	Commission
1–10 contracts	1% of value of contracts
11–20 contracts	4% of value of contracts 1–20
21+ contracts	7% of value of contracts 1–21+

As contracts 1–10 are obtained, B owes the salesperson only 1% of the contract value, which would be the minimum incremental cost of obtaining each of those contracts. In addition, B assesses whether it needs to accrue additional commissions related to those contracts that may become payable if other expected contracts are obtained. B also capitalises those additional amounts as incremental costs of obtaining customer contracts, if the one-year practical expedient does not apply or has not been elected.

Assume that B initially accrues 1% when it enters into Contracts 1–4. However, by the time B enters into Contract 5 it expects that it will enter into at least 11 contracts. At that point, B adjusts its expectations and on entering into Contract 5 capitalises a 4% commission related to Contract 5 and an additional 3% commission related to Contracts 1–4 because 1% was already capitalised.

7.2 Costs of fulfilling a contract

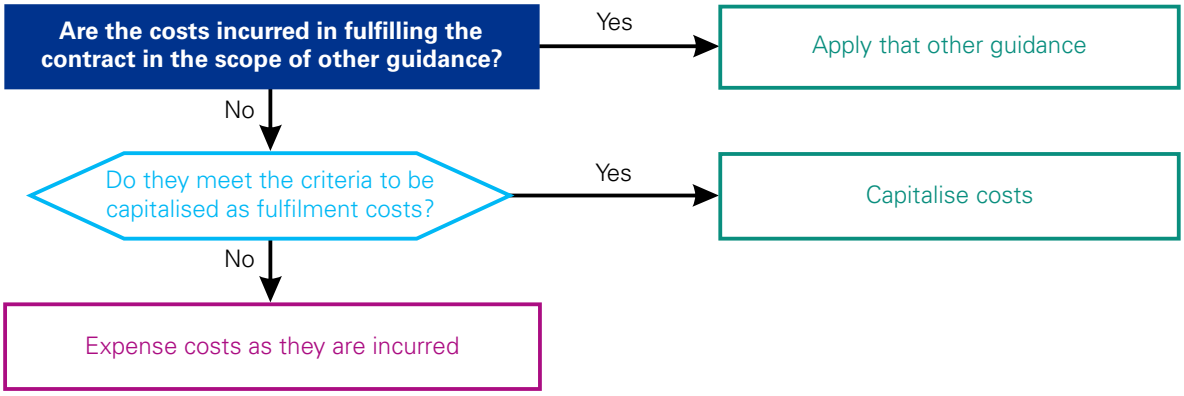
IFRS 15.95, BC308

If the costs incurred in fulfilling a contract with a customer are not in the scope of other guidance – e.g. inventory, intangibles or property, plant and equipment – then an entity recognises an asset only if the fulfilment costs meet the following criteria:

- they relate directly to an existing contract or specific anticipated contract;
- they generate or enhance resources of the entity that will be used to satisfy performance obligations in the future; and
- they are expected to be recovered.

IFRS 15.96, BC307

If the costs incurred to fulfil a contract are in the scope of other guidance, then the entity accounts for them using the other guidance. If other applicable guidance precludes capitalisation, then the costs cannot be capitalised under the revenue standard.



IFRS 15.97–98

When costs are not in the scope of other guidance, an entity considers whether they are directly related to a contract or an anticipated contract. The following are examples of costs that are capitalised when the specified criteria are met and of costs that cannot be capitalised.

Direct costs that are eligible for capitalisation if other criteria are met ✓	**Costs required to be expensed when they are incurred** ✗
• **Direct labour**: e.g. employee wages • **Direct materials**: e.g. supplies • **Allocation of costs that relate directly to the contract**: e.g. depreciation and amortisation • **Costs that are explicitly chargeable to the customer under the contract** • **Other costs that were incurred only because the entity entered into the contract**: e.g. subcontractor costs	• **General and administrative costs**: unless they are explicitly chargeable under the contract • **Costs that relate to satisfied (or partially satisfied) performance obligations** • **Costs of wasted materials, labour or other contract costs**[1] • **Costs that do not clearly relate to unsatisfied or partially satisfied performance obligations**

1. For the effects that these costs have on the measure of progress, see 5.3.3.

Example 7 – Set-up costs: Managed data centre

IFRS 15.IE192–IE196

Managed Services Company M enters into a contract to manage Customer Y's IT data centre for five years, for a fixed monthly fee. Before providing the services, M designs and builds a technology platform to migrate and test Y's data. This platform is not transferred to Y and is not considered a separate performance obligation. The initial costs incurred to set up the platform are as follows.

Design services	40
Hardware and software	210
Migration and testing	100
Total	**350**

These set-up costs relate primarily to activities to fulfil the contract, but do not transfer goods or services to the customer. M accounts for them as follows.

Type of cost	Accounting treatment
Hardware	Accounted for under guidance for property, plant and equipment
Software	Accounted for under guidance for internal-use software development/intangible assets
Design, migration and testing of the data centre	Capitalised under the standard because they: • relate directly to the contract • generate or enhance resources of the entity that will be used to satisfy performance obligations in the future • are expected to be recovered over the five-year contract period

The capitalised hardware and software costs are subsequently measured using other applicable guidance. The costs capitalised under the standard are subject to its amortisation and impairment requirements (see Sections 7.3 and 7.4).

Applicability of the cost capitalisation guidance in the revenue standard

For many contracts under which performance obligations are satisfied at a point in time, an entity usually accounts for the costs of satisfying these performance obligations under other standards – e.g. the inventory standard. This is because, under such contracts, an entity is often creating an asset in the scope of other guidance (e.g. inventory).

In contrast, when a performance obligation is satisfied over time, costs are typically expensed as they are incurred because control of the work in progress transfers continuously to the customer as it is produced and not at discrete intervals – i.e. there is no asset created by the entity's performance.

Output method – Contract to construct a building

IFRS 15.95, 98, IU 06-19

The IFRS Interpretations Committee discussed a scenario in which an entity enters into a contract to construct a building. There is one performance obligation, which is satisfied over time, and the entity uses an output method to measure progress. The Committee noted that the costs to construct the building – e.g. cost of the foundation, walls, floors and roof structures – are costs that relate to the partially satisfied performance obligation. These costs relate to past performance and do not generate or enhance resources that will be used to satisfy the performance obligation in the future. Therefore, these costs do not meet the criteria for capitalisation. Instead, these costs are expensed when they are incurred.

Judgement needed in determining whether cost capitalisation criteria are met

IFRS 15.BC308, CF 4.20

Only costs that meet the definition of an asset – i.e. a present economic resource controlled by the entity as a result of past events – are capitalised under the standard. Judgement may be required to determine whether costs enhance a resource that the entity controls. For example, in our view training costs generally do not meet all of the criteria for capitalisation because employees are not a resource controlled by an entity.

Judgement needed in determining whether to capitalise learning curve costs

IFRS 15.BC312–BC316

The standard may affect the accounting for contracts that have significant learning curve costs that decrease over time as process and knowledge efficiencies are gained. The Board noted that the standard addresses the accounting for the effect of learning curve costs when two conditions exist:

- an entity has a single performance obligation to deliver a specified number of units; and
- the performance obligation is satisfied over time.

The International Accounting Standards Board (the Board) noted that in these cases an entity is likely to select a method for measuring progress (e.g. cost-to-cost method) that would result in more revenue and expense recognised earlier in the contract when the first units are produced, because this is when more of the costs are incurred. The Board believed that this effect is appropriate because of the greater value of the entity's performance in the earlier part of the contract, and if only one unit was sold then the entity would sell it for a higher price. Further, when control passes to the customer as costs are incurred, it would be inappropriate to capitalise those costs because they relate to past performance. Therefore, if these conditions exist and the cost-to-cost method is used, then generally learning curve costs will not be capitalised.

IAS 2

In other cases, if the contract is for multiple performance obligations (e.g. selling multiple goods or products, such as multiple pieces of equipment or machinery) that are each satisfied at a point in time (e.g. on transfer of control of the good), then an entity will principally account for the costs of these performance obligations under other standards, such as inventory guidance. This is because an entity incurring costs to fulfil a contract without also satisfying a performance obligation over time is probably creating an asset in the scope of other guidance (e.g. inventory).

Costs in excess of constrained transaction price

IFRS 15.IE110–IE115

In certain circumstances, an up-front loss may arise because the revenue from a transaction is constrained or the allocation of transaction price to a performance obligation is limited to an amount that is lower than the cost of the goods transferred to the customer. In these cases, it is not appropriate for an entity to defer the up-front loss unless other specific guidance requires deferral.

For example, an entity sells goods with a cost basis of 100,000 for stated consideration of 120,000. However, the total consideration is subject to a risk of price concession in the future. The entity determines that the contract is not onerous and a loss accrual is not required under other applicable guidance. The entity constrains the transaction price and concludes that 90,000 is highly probable of not resulting in a significant revenue reversal. When control transfers, the entity recognises revenue of 90,000 and costs of 100,000. This accounting entry results in an up-front loss until the uncertainty associated with the variable consideration is resolved. For discussion of variable consideration and the constraint, see Section 3.1.

Transportation services and costs

In some arrangements, an entity delivers goods to a location specified by its customer and incurs transport costs. To determine how to account for these costs, an entity considers whether the transportation service is a distinct performance obligation (see Chapter 2) and when control of the goods transfers to the customer.

If control of the goods transfers to the customer on delivery to the final destination – i.e. transport and distribution costs form part of a single performance obligation for the sale of goods – then the entity recognises revenue when the goods are delivered and applies the guidance in the inventory standard on accounting for transport costs (see Chapter 3.8 in our publication Insights into IFRS).

If control of the goods transfers to the customer before the goods are transported, then this may indicate that the transportation service is a separate performance obligation and that the entity needs to determine whether it is a principal or an agent in relation to it (see Section 10.3).

- If the entity acts as a principal for the transportation service, then it recognises the gross revenue as the service is provided and applies the guidance in the revenue standard on fulfilment costs.
- If the entity acts as an agent for the transportation service, then it recognises the net revenue when the service is arranged.

Back-end-loaded costs

IFRS 15.39

In some arrangements, a significant portion of the costs may be incurred at the end of the contract. If an entity uses an output method to measure progress, then the margin in the period in which the back-end-loaded costs are incurred may be lower than in other periods. Depending on the facts and circumstances, the margin in a particular period may be negative.

Variability in margins is a potential outcome under the standard whenever an entity uses an output measure of progress for an over-time contract. An entity carefully considers whether it has determined the appropriate measure of progress that depicts its performance in transferring control of goods or services promised to the customer.

Additional application examples

Example 8 – Training costs expensed as incurred

Company D enters into a contract with Customer E to provide maintenance services for E's manufacturing plant for five years. Before beginning the maintenance services, D needs to train its employees on the specifics of E's plant in order to provide the service. The costs incurred by D related to this training include the labour hours (salaries and wages) of the employees participating in the training sessions.

D determines that these labour costs relate directly to the contract with E and are expected to be recovered. However, D concludes that the costs do not meet all of the criteria for capitalisation under the standard. This is because the employees are not a resource that is controlled by D and therefore the definition of an asset is not met. D therefore recognises the training costs as an expense as they are incurred.

Example 9 – Set-up costs: Customised part for carmaker

Automotive Supplier S undertakes a large-scale project to produce a highly customised part for Carmaker L. The contract with L guarantees a minimum amount of parts to be ordered throughout the life of the project. Before producing the parts, S:

- develops a new enterprise resource planning (ERP) system that enables it to manage large-scale projects such as the one with L;
- trains its employees to use the new ERP system; and
- builds a technology platform that migrates and tests some of L's databases that contain information necessary for the production of the parts.

The ERP system is considered S's intellectual property and can be used to manage future projects. The technology platform is not transferred to L and is not considered a separate performance obligation. Therefore, S concludes that these set-up costs relate primarily to activities to fulfil the contract, but do not transfer goods or services to L. S accounts for them as follows.

Type of cost	Accounting treatment
ERP system	Capitalised under the intangibles standard.
Training of employees	S determines that it has insufficient control over the economic benefits arising from its employees and therefore it cannot capitalise these costs.
Migration and testing technology platform	Capitalised as fulfilment costs because the costs: • relate directly to the contract with L • generate or enhance resources of S that will be used to satisfy performance obligations in the future – i.e. the production of parts • are expected to be recovered over the life of the project.

The capitalised software costs are subsequently accounted for under the intangibles standard. Costs capitalised under the revenue standard are subject to its amortisation and impairment requirements; see Sections 7.3 and 7.4.

Example 10 – Mobilisation costs

Company E enters into a contract with Customer F to construct an office building. E determines that there is one performance obligation in the contract (construction of the building), which is satisfied over time.

E incurs mobilisation costs to bring heavy equipment to the building site. E first determines that these costs are not in the scope of another standard, noting that the costs are not part of the cost of property, plant and equipment and no inventory will be recognised related to the work in progress because control transfers to the customer as the building is constructed. E also incurs costs in relocating employees to the building site.

E determines that the mobilisation costs related to bringing the heavy equipment to the building site meet the capitalisation criteria because they:

- are directly related to the contract with the customer;
- enhance a resource controlled by E (i.e. the heavy equipment), which will be used to satisfy E's performance obligation, which is construction of the building; and
- are expected to be recovered.

E therefore capitalises the mobilisation costs related to the heavy equipment.

In contrast, the costs that E incurs to relocate employees are not capitalised. These costs do not meet the definition of an asset because E cannot control the resource enhanced by the cost, which is its employees.

Example 11 – Reconfiguration costs

Company F enters into a contract with Customer G to build a customised item. To fulfil the contract, F incurs up-front costs to reconfigure its production facility to create the specialised item. These costs consist primarily of direct labour hours (salaries and wages) of employees. After the specialised asset is completed, F expects to incur similar costs to restore its production facility to its original state. The costs to initially reconfigure the facility and the costs to return the facility to its original state are explicitly chargeable to G under the contract.

F determines that the up-front and back-end reconfiguration activities do not transfer a good or service to the customer and there is only one performance obligation in the contract – i.e. building the specialised asset. F determines that it will recognise revenue over time using an output measure of progress.

Up-front reconfiguration

F determines that the up-front reconfiguration costs meet the capitalisation criteria because they are directly related to the contract, are expected to be recovered and enhance the entity's resources that will be used to satisfy the performance obligation – i.e. its manufacturing facility that it will use to produce the specialised asset for the customer. F therefore capitalises the up-front reconfiguration costs and amortises the asset over time consistent with the transfer of control of the specialised asset.

Back-end reconfiguration

F determines that the back-end reconfiguration costs cannot be capitalised because they do not enhance a resource that will be used to satisfy the performance obligation in the contract because the reconfiguration occurs after the specialised asset has been produced. These costs are therefore expensed as they are incurred.

In this case, F determines that the latter expenses are incurred when the back-end reconfiguration occurs. Although it is probable that F will incur the costs, the costs are avoidable up to the date they are incurred – i.e. F can choose not to reconfigure its production facility. This analysis is similar to repair and maintenance costs that are essential to the operation of the production facility but are recognised only when the repair and maintenance activities take place.

7.3 Amortisation

IFRS 15.99

An entity amortises the asset recognised for the costs to obtain and/or fulfil a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates. This can include the goods or services in an existing contract, as well as those to be transferred under a specific anticipated contract – e.g. goods or services to be provided following the renewal of an existing contract.

Example 12 – Amortisation: Specifically anticipated contracts

Company X enters into a contract with Customer Z to manage its payroll processing for five years. X incurs initial set-up costs of 500. These set-up activities do not transfer goods or services to Z. Based on historical experience and customer analysis, X expects Z to renew the contract for an additional five years, making a total of 10 years.

X recognises an asset of 500 for the set-up costs associated with the payroll processing and amortises that asset over the 10-year period – i.e. on a systematic basis consistent with the pattern of satisfaction of the performance obligation, and including specifically anticipated renewal period performance obligations.

Example 13 – Amortisation: Acquisition costs for month-to-month contracts

Telco E enters into a month-to-month wireless contract with Customer C that includes voice and data services. Dealer D is paid a commission of 20 at the time of sale. E does not pay commissions on renewals of month-to-month contracts. Based on historical experience and customer analysis, E expects C to renew the contract for 36 months (i.e. three years).

E recognises an asset of 20 for the commission paid and amortises that asset over the three-year period – i.e. on a systematic basis consistent with the pattern of satisfaction of the performance obligation, and including specifically anticipated renewals.

Amortisation period may need to include anticipated contracts

Under the standard, a capitalised contract cost asset is amortised based on the transfer of goods or services to which the asset relates. In making this determination, the standard notes that those goods or services could be provided under an anticipated contract that the entity can specifically identify.

The standard does not prescribe how an entity should determine whether one or more anticipated contracts are specifically identifiable, so practice is likely to develop over time. Relevant factors to consider may include the entity's history with that customer class and predictive evidence derived from substantially similar contracts. In addition, an entity may consider the available information about the market for its goods or services beyond the initial contract term – e.g. whether it expects the service still to be in demand when renewal would otherwise be anticipated. Judgement will be involved in determining the amortisation period of contract cost assets, but an entity should apply consistent estimates and judgements across similar contracts, based on relevant experience and other objective evidence.

Anticipated contracts included when determining whether practical expedient applies

Under the standard, an entity assesses the amortisation period to determine whether it is eligible to apply the practical expedient not to recognise an asset for the incremental costs to obtain a contract (costs to fulfil a contract are not eligible for the practical expedient). For example, a cable television company incurs incremental costs to obtain contracts with customers that have an initial term of one year. However, a significant proportion of customers renew the contracts at the end of the initial term. In this case, the company cannot assume that it is eligible for the practical expedient, but instead has to determine the amortisation period.

Judgement is required when contracts include recurring commissions

Some entities pay sales commissions on all contracts executed with customers, including new contracts – i.e. new services and/or new customers – and renewal or extension contracts. If the commission paid by an entity on a new contract will be followed by corresponding commissions for each renewal period – i.e. the salesperson will receive an incremental commission each time the customer renews the contract or does not cancel it – then the entity applies judgement to determine whether the original commission on the new contract should be amortised only over the initial contract term or over a longer period.

The capitalised asset is generally amortised over the period covered by the commission. If the renewal commission is commensurate with the initial commission, then the initial commission is amortised over the original contract term and the renewal commission is amortised over the renewal period. Commissions are generally considered commensurate with each other when they are reasonably proportional to the respective contract value.

When making the 'commensurate' evaluation, an entity considers whether the economic benefits that it expects to obtain from payment of the commission – i.e. the margin that it expects to earn from providing the good or service – is commensurate with the commission paid. Therefore, when an entity's expected economic benefits from providing services during a renewal period are commensurate with those from providing the same services during the initial period, the renewal and initial commissions that will be paid should be roughly equal to be considered commensurate with each other.

When the renewal commission is not commensurate, there are two acceptable approaches to amortise the capitalised asset, as long as the approaches are consistently applied to substantially similar circumstances.

- The entire capitalised asset is amortised over the period that includes the specifically anticipated renewal periods.
- Only the portion of the capitalised asset that is incremental to the renewal commission that the entity would normally pay is amortised over the period that includes the specifically anticipated renewal periods.

Systematic amortisation for contract assets related to multiple performance obligations

The standard requires the asset to be amortised on a systematic basis (which might not be on a straight-line basis) that is consistent with the transfer to the customer of the goods or services to which the asset relates. When the contract contains multiple performance obligations satisfied at different points in time, the entity takes this into account when determining the appropriate amortisation period and pattern.

An entity may allocate a contract cost asset among the distinct goods or services to which it relates or it may amortise the contract cost asset using a single measure of progress considering all of the distinct goods or services to which the asset relates.

If an entity chooses to allocate contract cost assets, then there may be multiple acceptable approaches to doing so. For example, an entity may allocate the contract cost asset on a relative stand-alone selling price basis. Alternatively, depending on the facts and circumstances, other approaches may be acceptable, including the following.

- Allocate the contract cost asset on the basis of the economic benefits (i.e. the margin) that the entity expects to obtain from transferring the good or service.
- When the entity determines that the contract cost asset relates specifically to one or more distinct goods or services in a contract, but not all, it may be reasonable to allocate the contract cost asset entirely to that (or those) goods or services.

If an entity uses the single measure of progress approach to amortise contract cost assets, then judgement may be required to determine a single measure of progress that is consistent with the transfer to the customer of the goods or services to which the contract relates.

No correlation with the accounting for non-refundable up-front fees

The amortisation pattern for capitalised contract costs (i.e. including the term of specific anticipated contracts) and the revenue recognition pattern for non-refundable up-front fees (see Section 10.6) (i.e. the existing contract plus any renewals for which the initial payment of the up-front fee provides a material right to the customer) are not symmetrical under the standard. Therefore, there is no requirement under the standard for the recognition pattern of these two periods to align, even if contract costs and non-refundable up-front fees on the same contract are both deferred.

Presentation of amortisation costs may often depend on the nature of the entity and its industry

If an entity chooses to present its expenses by nature, then judgement will be required to determine the nature of the expenses arising from the amortisation of capitalised contract costs. The appropriate classification may often depend on the nature of the entity and the industry in which it operates. In all cases, an entity is subject to the general requirement to ensure that its presentation is not misleading and is relevant to an understanding of its financial statements.

Additional application examples

Example 14 – Amortisation: Renewal commissions

Cloud Service Provider H agrees to provide hosting services for a one-year term to Customer C for 100,000. C has the option to renew the services at the end of each year for 100,000 per year. Based on its compensation plan, H pays a salesperson 5,000 for securing the initial contract and will pay 1,000 to a salesperson who secures each renewal contract. H determines that the payments to salespeople represent incremental costs of obtaining contracts.

Securing an initial contract generally requires a significant amount of effort from the sales staff. Less effort is generally required to secure the renewal, which may only involve making a few phone calls or sending an email to confirm that the customer wants to renew.

	Initial contract	Expected renewal 1	Expected renewal 2
Revenue	100,000	100,000	100,000
Costs of service	(30,000)	(30,000)	(30,000)
Gross margin (exclusive of commission costs)	**70,000**	**70,000**	**70,000**
Commission paid	**(5,000)**	**(1,000)**	**(1,000)**

H concludes that the renewal commission is not commensurate with the initial commission. This is because the commission paid initially is five times greater than the renewal commission, but the economic benefits – i.e. the margin that H expects to obtain from the renewal – equal those that it expects to obtain from the initial contract.

Therefore, the initial commission is a partial prepayment for the economic benefits that H expects to receive from subsequent renewal periods – i.e. the amortisation period includes renewal periods. This cost is therefore not subject to the practical expedient and is capitalised as an incremental cost of obtaining the contract, subject to recoverability.

Example 15 – Amortisation: Commission paid on renewals after the initial contract is obtained

Telco T pays its sales employees a commission of 30 for each new two-year wireless contract entered into with a customer. T also pays 10 to sales employees each time a customer renews a contract for an additional two years. T previously concluded that both commissions qualify as a cost to obtain a contract and are capitalised when they are incurred.

Based on historical experience and customer analysis, T expects the customer to renew for an additional two years, making a total of four years. T further observes that the 10 renewal commission is not commensurate with the 30 paid at inception of the contract.

T concludes that the first commission relates to a longer period than the initial two-year contract term. In this example, T determines that the commission should therefore be amortised over four years – i.e. on a systematic basis consistent with the pattern of satisfaction of the performance obligation and including the specifically anticipated renewal period. The renewal commission, however, is amortised over two years, being the period to which the commission relates. In this example, the amortisation expense would therefore be higher during the renewal period than during the initial contract period.

7.4 Impairment

IFRS 15.101

An entity recognises an impairment loss to the extent that the carrying amount of the asset exceeds the recoverable amount. The 'recoverable amount' is defined as the:

- remaining expected amount of consideration to be received in exchange for the goods or services to which the asset relates; *less*
- costs that relate directly to providing those goods or services and that have not been recognised as expenses.

IFRS 15.102

When assessing an asset for impairment, the amount of consideration included in the impairment test is based on an estimate of the amounts that the entity expects to receive. To estimate this amount, the entity uses the principles for determining the transaction price, with two key differences:

- it does not constrain its estimate of variable consideration: i.e. it includes its estimate of variable consideration, regardless of whether the inclusion of this amount could result in a significant revenue reversal if it is adjusted; and
- it adjusts the amount to reflect the effects of the customer's credit risk.

IFRS 15.104

An entity recognises a reversal of any impairment recorded when impairment conditions improve. However, following the reversal of an impairment, the carrying amount of the asset cannot exceed the carrying amount that would have been determined if no impairment had been recognised and the asset had continued to be amortised.

Impairment model specifically for capitalised contract costs

IAS 2, 36

The standard includes an impairment model that applies specifically to assets that are recognised for the costs to obtain and/or fulfil a contract. An entity applies this model in addition to the impairment models in other standards – e.g. the inventory standard and the impairment standard.

IAS 36.22, IFRS 15.103

The entity applies, in the following order:

- any existing asset-specific impairment guidance (e.g. for inventory);
- the impairment guidance on contract costs under the standard; and
- the impairment model for cash-generating units.

For example, if an entity recognises an impairment loss under the standard, then it is still required to include the impaired amount of the asset in the carrying amount of the relevant cash-generating unit if it also performs an impairment test under the impairment standard.

Specific anticipated contracts are considered in impairment test

The standard specifies that an asset is impaired if its carrying amount exceeds the remaining amount of consideration that an entity expects to receive, less the costs that relate directly to providing those goods or services that have not been recognised as expenses.

Under the standard, an entity considers specific anticipated contracts when capitalising contract costs. Consequently, the entity includes cash flows from both existing contracts and specific anticipated contracts when determining the consideration expected to be received in the contract costs impairment analysis. However, the entity excludes from the amount of consideration the portion that it does not expect to collect, based on an assessment of the customer's credit risk.

Discounting may be relevant for long-term contracts

IAS 36

For certain long-term contracts that have a significant financing component, the estimated transaction price may be discounted. In this case, the standard does not prescribe whether to discount the estimated remaining contract costs when performing the impairment test, even though the contract cost asset is not presented on a discounted basis in the entity's statement of financial position. Under IFRS Accounting Standards, an entity discounts the contract costs for impairment test purposes consistently with the standard on impairment of assets, which requires it to take into account the time value of money when determining value in use.

8 Contract modifications

Overview

A 'contract modification' occurs when the parties to a contract approve a change in its scope, price or both. The accounting for a contract modification depends on whether distinct goods or services are added to the arrangement and on the related pricing in the modified arrangement. This section discusses both identifying and accounting for a contract modification.

8.1 Identifying a contract modification

IFRS 15.18

A contract modification is a change in the scope or price of a contract, or both. This may be described as a change order, a variation or an amendment. When a contract modification is approved, it creates or changes the enforceable rights and obligations of the parties to the contract. Consistent with the determination of whether a contract exists in Step 1 of the model, this approval may be written, oral or implied by customary business practices and should be legally enforceable.

If the parties have not approved a contract modification, then an entity continues to apply the requirements of the standard to the existing contract until approval is obtained.

IFRS 15.19

If the parties have approved a change in scope, but have not yet determined the corresponding change in price – i.e. an unpriced change order – then the entity estimates the change to the transaction price by applying the guidance on estimating variable consideration and constraining the transaction price (see Section 3.1).

Example 1 – Assessing whether a contract modification is approved

Shipbuilder S is an experienced shipbuilder. One of its largest customers is CruiseLines C, for whom S has previously built 11 cruise ships. S agrees to build a 12th cruise ship for C and begins work on 1 January Year 1.

On 1 January Year 3, C informs S that it wishes to amend the specifications of the new cruise ship to accommodate 50 additional staterooms. S determines that in order to meet the request it would need to redesign three of the decks and procure additional materials. S and C discuss these changes and start preparing an amendment to the contract.

To determine whether to account for the contract modification, S assesses whether it has created new, or changed existing, enforceable rights and obligations under the contract.

In making this determination, S notes the following.

- Although S and C have not executed a contract amendment or formal change order for the additional materials, design services or the construction labour necessary to complete the requested redesign and construction, changes of this nature are common.
- When changes resulting from redesign have occurred in previous projects, C has compensated S for the incremental costs along with a margin, as long as S has been able to demonstrate that the additional costs were reasonable.
- Despite the fact that there has been no formal written agreement on the change in scope or price, after consultation with its legal counsel S determines that there is legal precedent for enforceability of similar types of arrangements in the jurisdiction.
- S has significant, relevant history with C through 11 previous shipbuilding contracts, which supports a conclusion that C will agree to pay S for additional costs along with a reasonable margin.
- S fully expects that C will agree to, and be able to pay, the incremental fees in this specific case.
- Considering all relevant facts and circumstances, S has the necessary documentation to support its conclusion that enforceable rights and obligations have been established.

S therefore concludes that the contract modification has been approved.

Conversely, if the facts and circumstances had been different, then the following factors may have indicated that the contract modification had not been approved.

- There was no legal precedent in the jurisdiction related to oral agreements of this nature or S's counsel could not determine whether the unpriced change order would be enforceable.
- This was S's first project with C, so S did not have relevant history or an established business practice with C to support a conclusion that there was an agreement between the parties that C would pay S for additional costs along with a reasonable margin to create enforceable rights and obligations in the contract.
- Previous experience with C had shown it to be reluctant or even unwilling to pay for incremental costs and related margin on any scope changes before their formal approval, which has usually been given only after extensive negotiations.
- At the time of the contract modification, it was not probable that C would be able to pay any incremental fees resulting from the scope changes.

Example 2 – Contract claim for delays caused by the customer

Construction Company B enters into a contract with Customer C to build an office block on C's land for 500,000. The contract specifies the construction start date – 1 March – but B is not able to start its work until 15 March because the site is not ready. The contract does not include specific terms that apply if C fails to provide access to the land on time. Based on the advice of its legal counsel, B raises a claim under the general disputes clause in the contract for costs incurred as a result of the delay in the amount of 10,000. C disagrees with the claim and the parties enter into negotiations.

B determines that the claim does not represent variable consideration because it is not a contractual penalty. Instead, B accounts for the claim as a contract modification.

Assessment focuses on enforceability

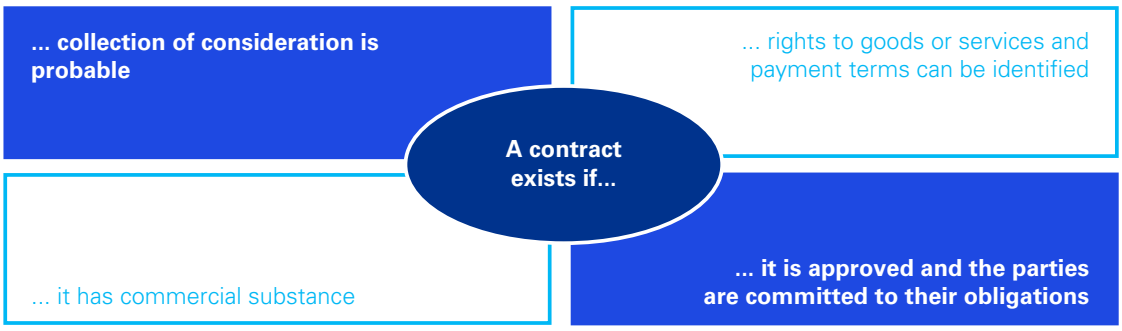
The assessment of whether a contract modification exists focuses on whether the new or amended rights and obligations that arise under the modification are enforceable. This determination requires an entity to consider all related facts and circumstances, including the terms of the contract and relevant laws and regulations. This may require significant judgement in some jurisdictions or for some modifications, particularly if the parties to the contract have a dispute about the scope or the price. In cases of significant uncertainty about enforceability, written approval and legal representation may be required to support a conclusion that the parties to the contract have approved the modification.

Criteria to determine when a modification is approved

IFRS 15.13

The standard's guidance on contract modifications does not explicitly address whether the entity should assess the collectability of consideration when determining that a modification has been approved. However, the objective of the guidance and its focus on whether the modification creates enforceable rights and obligations are consistent with the guidance on identifying a contract in Step 1 of the model (see Chapter 1).

Also, in many cases a modification of the contract will be a 'significant change in facts and circumstances' and therefore will require the entity to reassess whether the Step 1 criteria for a contract are met. Under that guidance, the following criteria are used to determine whether a contract exists and to help assess whether a modification exists.



IFRS 15.IE14–IE17

Relevant considerations when assessing whether the parties are committed to performing their respective obligations, and whether they intend to enforce their respective contract rights, may include whether:

- the contractual terms and conditions are commensurate with the uncertainty, if there is any, about the customer or the entity performing in accordance with the modification;
- there is a history of the customer (or class of customer) not fulfilling its obligations in similar modifications under similar circumstances; and
- the entity has previously chosen not to enforce its rights in similar modifications with the customer (or class of customer) under similar circumstances.

Contract claims are evaluated using the guidance on contract modifications

A contract claim is typically described as an amount in excess of the agreed contract price that a contractor seeks to collect from customers or other parties. Claims may arise from customer-caused delays, errors in specifications or design, contract terminations, change orders that are in dispute or unapproved on both scope and price, or other causes of unanticipated additional costs. Contract claims are evaluated using the guidance on contract modifications.

IFRS 15.18–19, BC39, BC81

Assessing whether a contract modification related to a claim exists may require a detailed understanding of the legal position, including third party legal advice, even when a framework agreement or other governing document prescribes the claim resolution process under the contract.

The assessment may be more straightforward if an objective framework for resolution exists – e.g. if the contract includes a defined list of cost overruns that will be eligible for reimbursement and a price list or rate schedule. Conversely, the mere presence of a resolution framework – e.g. a requirement to enter into binding arbitration instead of litigation – will generally not negate an entity's need to obtain legal advice to determine whether its claim is enforceable. If enforceable rights do not exist for a contract claim, then a contract modification has not occurred and no additional contract revenue is recognised until either approval or legal enforceability is established.

An entity's accounting for any costs incurred before approval of a contract modification will depend on the nature of the costs. In some circumstances, those costs will be expensed as they are incurred. In other circumstances, an entity will need to consider whether the expectation of costs without a corresponding increase in the transaction price requires the recognition of an onerous contract provision. Or, a contract modification may be considered a specifically anticipated contract such that the costs incurred before approval of the contract modification – i.e. pre-contract costs – may be considered for capitalisation based on the standard's fulfilment cost guidance (see Section 7.2).

Partial contract terminations are accounted for as contract modifications

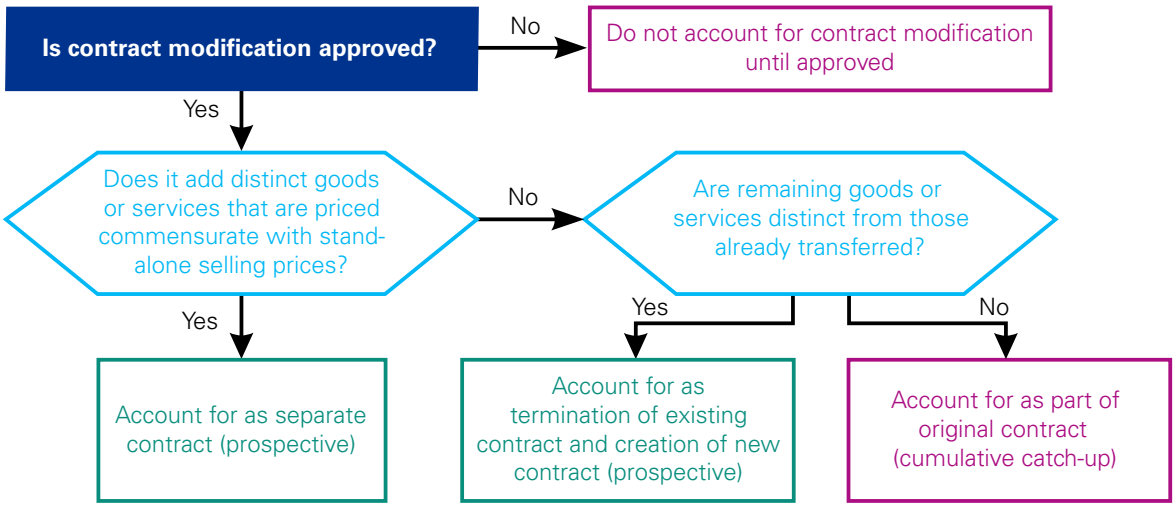
Termination clauses are evaluated in Step 1 of the model to determine the contract term for which enforceable rights and obligations exist. A substantive termination penalty is evidence that rights and obligations exist throughout the term to which the penalty applies. Once the contract term is established, the entity accounts for the contract on that basis – i.e. if the contract term is established on the basis that the customer will not terminate it, then the termination penalty is not included. On termination, any penalties, whether they are included in the original contract or negotiated when the parties agree to the partial termination, are accounted for as a contract modification.

For example, Company B enters into a contract with Customer C to provide a monthly service for a three-year period. C has the right to cancel the service in Year 3 by paying a substantive termination penalty. Therefore, B determines that it has a three-year contract to provide a series of distinct services (i.e. a single performance obligation satisfied over time).

At the end of Year1, C decides to cancel Year 3 of the contract and pay the termination penalty. B accounts for this partial termination as a contract modification because the existing enforceable rights and obligations under the contract have been changed – i.e. there is now only a two-year contract (one remaining year). C's termination payment is accounted for as consideration under the modified contract and recognised prospectively (see Section 8.2).

8.2 Accounting for a contract modification

An entity accounts for a contract modification either as a separate contract (i.e. on a prospective basis) or as part of the original contract (i.e. on a cumulative catch-up basis). The following flowchart illustrates the key decision points to consider when determining whether a contract modification should be accounted for as part of the original contract or a separate contract.



IFRS 15.20

A contract modification is treated as a separate contract (prospective treatment) if it results in:

- a promise to deliver additional goods or services that are distinct (see Section 2.1); and
- an increase in the price of the contract by an amount of consideration that reflects the entity's stand-alone selling price for those goods or services adjusted to reflect the circumstances of the contract.

IFRS 15.21

If these criteria are not met, then the entity's accounting for the modification is based on whether the remaining goods or services under the modified contract are distinct from those goods or services transferred to the customer before the modification.

If they are distinct, then the entity accounts for the modification as if it were a termination of the existing contract and the creation of a new contract. In this case, the entity does not reallocate the change in the transaction price to performance obligations that are completely or partially satisfied on or before the date of the contract modification. Instead, it accounts for the modification prospectively and the amount of consideration allocated to the remaining performance obligations (or to the remaining distinct goods or services in a series treated as a single performance obligation) is equal to the:

- consideration included in the estimate of the transaction price of the original contract that has not been recognised as revenue; plus or minus the
- increase or decrease in the consideration promised by the contract modification.

If the modification to the contract does not add distinct goods or services, then the entity accounts for it on a combined basis with the original contract, as if the additional goods or services were part of the initial contract – i.e. as a cumulative catch-up adjustment. The modification is recognised as either an increase or reduction in revenue at the date of the modification.

IFRS 15.90

If the transaction price changes after a contract modification, then an entity applies the guidance on changes in the transaction price (see Section 4.3).

The following table provides examples of contract modifications, as well as how to account for these modifications.

	Account for the contract modification as...		
	A separate contract	**A termination of an existing contract and creation of a new contract**	**Part of the original contract**
Example 1	Addition of a distinct good or service at an undiscounted price (e.g. a customer adds a text messaging package to an existing mobile phone service package and pays the standard price offered to customers for that additional package)	Addition of a distinct good or service at a price that is discounted from its stand-alone selling price (e.g. a customer receives free premium channel cable service); all remaining services provided under the original contract are distinct	Addition of a good or service to a contract that consists of a single, integrated performance obligation where that additional good or service is highly inter-related with the single performance obligation (e.g. changing the floor plan of a partially constructed house)
Example 2		Modification of the contract price, with no change in the contracted goods or services and the remaining goods and services are distinct from those already delivered (e.g. a change in the unit price for the remaining quantity of homogeneous items)	Modification of the contract price, with no change in the contracted goods or services *and* the remaining goods and services are not distinct from those already delivered (e.g. a change in the contract price of a highly customised piece of software)

Example 3 – Contract modification: Additional goods or services

Construction Company G enters into a contract with Customer M to build a road for a contract price of 1,000. During construction of the road, M requests that a section of the road be widened to include two additional lanes. G and M agree that the price will increase by 200.

In evaluating how to account for the contract modification, G first needs to determine whether the modification adds distinct goods or services.

- If the road widening is not distinct from the construction of the road, then it becomes part of a single performance obligation that is partially satisfied at the date of the contract modification, and the measure of progress is updated using a cumulative catch-up method.
- If the road widening is distinct, then G needs to determine whether the additional 200 is commensurate with the stand-alone selling price of the distinct good.
  - If the 200 reflects its stand-alone selling price, then construction of the additional two lanes is accounted for separately from the original contract for construction of the road. This will result in prospective accounting for the modification as if it were a separate contract for the additional two lanes.
  - If the 200 does not reflect its stand-alone selling price, then the agreement to construct the additional two lanes is combined with the original agreement to build the road and the unrecognised consideration is allocated to the remaining performance obligations. Revenue is recognised when or as the remaining performance obligations are satisfied – i.e. prospectively.

Example 4 – Contract modification: An unpriced change order

Company M enters into a contract with Customer B to build a specialised asset (Product S) for 1 million. M determines that building S is a single performance obligation and that revenue for the contract should be recognised over time using the cost-to-cost method. M estimates that the total cost of S will be 800,000 and incurs 600,000 in the first two years of the contract.

At the end of Year 2, B asks M to make a complex change to S. M agrees and begins the work immediately. However, the corresponding change in transaction price will be determined subsequently. M estimates that the costs of S will increase by 200,000 and the consideration will increase by 300,000.

M assesses that the modification has created enforceable rights and obligations and that B will pay for the incremental efforts. M therefore concludes that the contract has been modified.

Because the contract includes only one performance obligation, which is being satisfied over time, M accounts for the modification as part of the original contract. However, before including the estimated consideration in the transaction price, M considers whether the amount should be constrained.

M assesses all relevant factors and determines that it has sufficient experience in fulfilling similar change orders on similar contracts and past experience with B such that it is highly probable that a reversal of revenue will not occur on resolution of the uncertainty (i.e. agreement with B on a price for the change order). Therefore, M updates its measure of progress and adjusts revenue for the modification as follows.

At end of Year 2	Before modification	After modification
Cumulative revenue	750,000[1]	780,000[2]
Adjustment to revenue		30,000[3]

Notes

1. Calculated as 1,000,000 × 600,000 / 800,000.
2. Calculated as (1,000,000 + 300,000) × 600,000 / (800,000 + 200,000).
3. Calculated as 780,000 - 750,000.

M therefore increases the cumulative amount of revenue recognised at the end of Year 2 by 30,000 to 780,000.

Example 5 – Contract modification: Partially satisfied performance obligation and additional distinct goods or services

Company Z enters into a contract with Customer C for a specialised asset (Product S) for consideration of 1 million. Z has determined that the revenue should be recognised over time using the cost-to-cost method.

At the end of Year 1, Z has satisfied 30% of its performance obligation. Therefore, Z has recognised 300,000 of revenue up to the end of Year 1.

At the beginning of Year 2, the parties agree to change the specification of S and increase the consideration by 100,000. Additionally, Z agrees with C to deliver Product X for 120,000 along with S.

S and X are distinct goods and therefore represent separate performance obligations. The price of X is significantly discounted from its stand-alone selling price of 150,000.

Because the price of X is not commensurate with its stand-alone selling price, X cannot be accounted for as a separate contract. Therefore, both S and X are considered part of the same contract when accounting for the modification.

Z accounts for the modification as follows.

Step (i) – Calculate the remaining consideration

Remaining consideration on original contract not yet recognised as revenue	700,000
Change order	100,000
Product X	120,000
Total remaining consideration	**920,000**

Step (ii) – Allocate the remaining consideration between Products S and X

Z allocates the remaining consideration of 920,000 to S and X under the general guidance in Step 4 of the model as follows.

	Stand-alone selling prices	Percent allocated	Allocated amounts
Remaining for Product S	900,000	85.7%	788,571
Product X	150,000	14.3%	131,429
Total	**1,050,000**	**100.0%**	**920,000**

Step (iii) – Record a cumulative catch-up adjustment for the partially satisfied performance obligation

For the partially satisfied performance obligation (S), Z accounts for the contract modification as part of the original contract. Therefore, Z updates its measure of progress and estimates that it has satisfied 27.4% of its performance obligation after revising its cost-to-cost measure of progress for the revised expected costs. As a consequence, Z calculates the following adjustment to reduce revenue previously recognised:

1,732 = 27.4% complete × 1,088,571[1] modified transaction price allocable to S - 300,000 revenue recognised to date.

When Z transfers control of X, it recognises revenue in the amount of 131,429.

Note

1. Calculated as 300,000 + 788,571.

Different approaches for common types of contract modifications

To determine the appropriate accounting, an entity needs to evaluate whether the modification adds distinct goods or services and, if so, whether the prices of those distinct goods or services are commensurate with their stand-alone selling prices. This determination will depend on the specific facts and circumstances of the contract and the modification, and may require significant judgement.

Entities entering into construction-type contracts or project-based service contracts (e.g. a service contract with a defined deliverable such as a valuation report) may often account for contract modifications on a combined basis with the original contract. However, modifications to other types of contracts for goods (e.g. a sale of a number of distinct products) or services (e.g. residential television or internet services, or hardware/software maintenance services) may often result in prospective accounting. For discussion on modifications of licences of intellectual property, including renewals and extensions of licences, see Section 9.4.

Distinct goods or services in a series that are treated as a single performance obligation are considered separately

IFRS 15.BC115

Sometimes an entity needs to apply the contract modification guidance to a series of distinct goods or services that is accounted for as a single performance obligation. In this case, the entity considers the distinct goods or services in the contract, rather than the single performance obligation.

Interaction of new contracts with pre-existing contracts needs to be considered

Any agreement with a customer involving a pre-existing contract with an unfulfilled performance obligation may need to be evaluated to determine whether it is a modification of the pre-existing contract.

Accounting for contract asset on termination of an existing contract and creation of a new one

IFRS 15.107

In some cases, an entity may have a contract asset at the time when a contract is modified. If a modification of the contract results in a termination of the existing contract and creation of a new one, then the entity does not write off the existing contract asset but carries it forward to the new contract, subject to impairment. This is because a write-off of the contract asset would result in a reversal of previously recognised revenue and would be inconsistent with the prospective accounting for the modification.

Additional application example

Example 6 – Contract modification: Additional goods or services: Car supply agreement

On 1 January, Carmaker G enters into a framework agreement with Automotive Supplier S to perform engineering and design (E&D) activities and produce parts. The agreement between G and S does not specify a separate price for E&D services, but the price of each part includes a mark-up to compensate S for those services. The agreement does not state a minimum quantity of parts to be ordered by G, but it contains a termination clause under which S will be reimbursed for any costs incurred for the E&D services if G terminates the agreement. Therefore, on 1 January S concludes that a contract exists for the E&D activities but not for the production of parts.

On 1 April, S completes the E&D activities and recognises revenue for the services provided.

On 1 December, G orders the first batch of parts.

S assesses whether the purchase order for the parts should be treated as a modification of the contract to provide E&D services.

S notes that the consideration for the parts does not reflect their stand-alone selling price, because the price of the parts is meant to compensate S for the lower margin on the E&D services. Therefore, S concludes that it may be appropriate to consider the modification guidance.

S concludes that the parts ordered are distinct from the E&D activities, because, among other considerations, they are produced after the E&D activities are completed and their production cannot affect the way the E&D activities are performed.

Under the modification guidance, S would account for G's purchase order together with any remaining performance obligations. However, S notes that no remaining obligations are left under the E&D contract – i.e. it is completely satisfied. Therefore, it does not allocate any consideration payable for the parts to the E&D services, and accounts for the purchase order as a separate contract.

9 Licensing

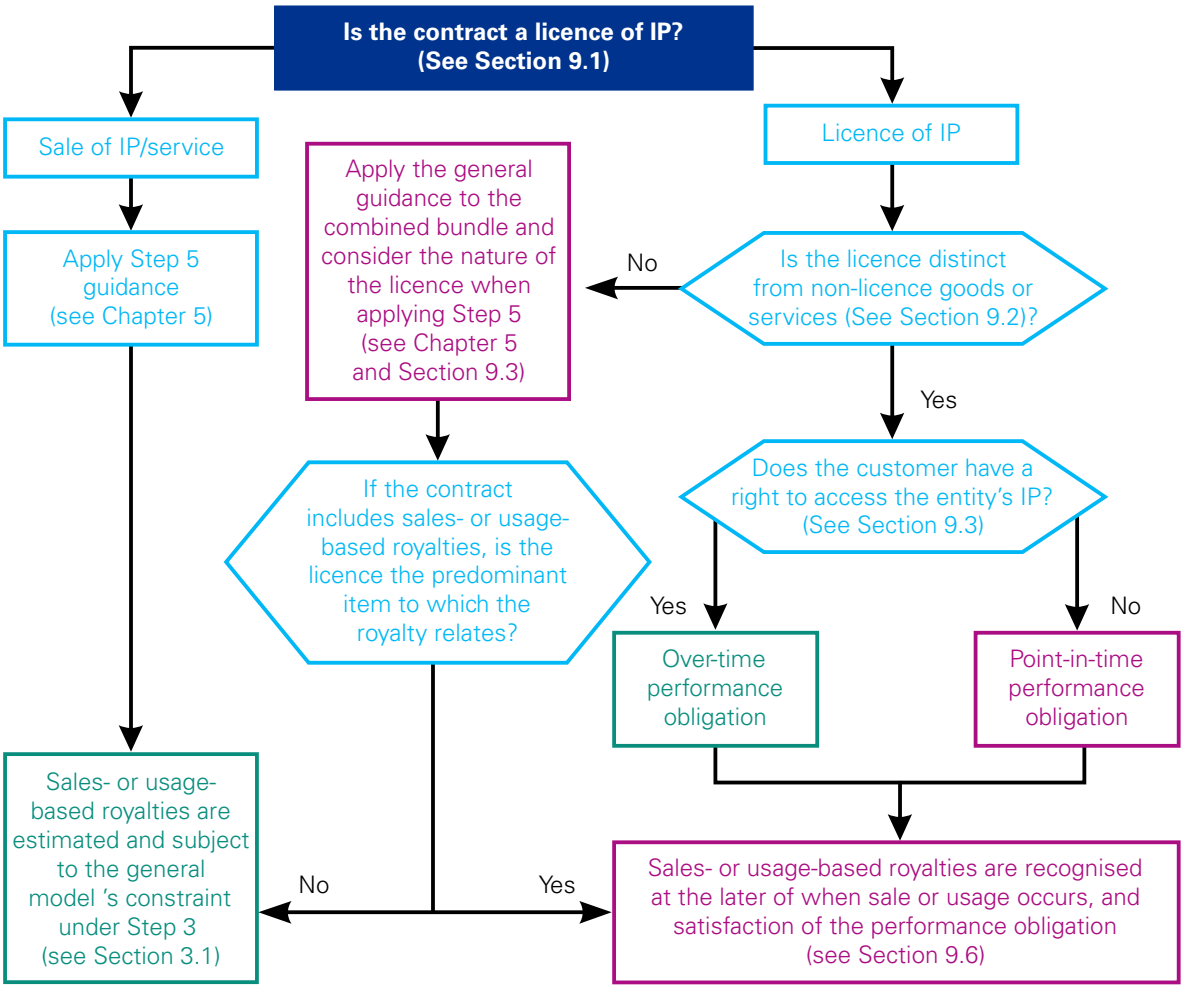
Overview

The standard provides application guidance for the recognition of revenue attributable to a distinct licence of intellectual property (IP).

If the licence is distinct from the other goods or services, then an entity assesses its nature to determine whether to recognise revenue allocated to the licence at a point in time or over time.

The standard also contains guidance, separate from the general model for estimating variable consideration, on the recognition of sales- or usage-based royalties on licences of IP when the licence is the sole or predominant item to which the royalty relates.

The following flowchart summarises how the standard applies to licences of IP.



9.1 Licences of intellectual property

IFRS 15.B52

A licence of IP establishes a customer's rights to the IP of another entity. Examples of IP licences include:

- software and technology;
- franchises;
- patents, trademarks and copyrights;
- films, music and video games; and
- scientific compounds.

Example 1 – Promise is a service not a licence

Streaming Service S provides a music streaming service to customers. S enters into a one-year contract that grants Customer C a licence to access the music content via the internet on C's personal devices. However, C does not have the ability to download the music content during the contract term and it can listen to the music only through the internet.

S evaluates whether it is providing C with a service or a licence to its content. S concludes that the contract does not include a licence because C does not have the ability to download the music during the contract term and use it without accessing S's site. As a result, the licence guidance does not apply.

Example 2 – Promise is a licence

Production Company P produces music content. P enters into a three-year licence agreement to provide an initial music library and rights to future content to Customer C. The terms of the licence allow C to play, stream and broadcast the content to other parties.

P evaluates whether it is providing C with a service or a licence to its content. P concludes that the contract includes a licence of IP because C takes delivery of the music library that it can use without further services from P.

As a result, the licensing guidance applies and P needs to evaluate whether the licence related to the initial music library is distinct from the rights to future content.

Different accounting for a licence and sale of IP

A licence establishes a customer's rights to a licensor's IP and the licensor's obligations to provide those rights. Specific application guidance is provided for measuring and recognising revenue from licensing transactions, including guidance for recognising revenue from sales- or usage-based royalties (see Section 9.6).

The accounting depends on the legal distinction between a sale and a licence of IP. If a transaction is a legal sale of IP, then it is subject to the general model in the same way as the sale of any good or other non-financial asset. Sales- or usage-based royalties on a sale of IP are subject to the guidance on measuring variable consideration, including the constraint, and not the specific recognition guidance applicable to sales- or usage-based royalties from a licence of IP.

No definition of intellectual property

The term 'intellectual property' is not defined in the standard, nor elsewhere in IFRS Accounting Standards. In some cases, it will be clear that an arrangement includes a licence of IP – e.g. a trademark. In other cases – e.g. when content is being made available to a customer over the internet – it may be less clear and the accounting may be different depending on that determination. Therefore, an entity may need to apply judgement to determine whether the guidance on licences applies to an arrangement.

IP that forms part of tangible asset

IP may be included in tangible products such as DVDs, hard-copy books or CDs. The first-sale doctrine, which exists in US copyright law, provides that the individual who purchases a copyrighted work from the copyright holder is the owner of that individual copy and receives the right to sell or lease that particular copy.

Generally, when IP is embedded in the tangible product the licensing guidance does not apply to the sale of goods subject to the first-sale doctrine. Instead, an entity applies the general guidance in the revenue standard to determine the transaction price and when control of the goods transfers to the customer. Non-US entities would consider similar laws and concepts to the first-sale doctrine.

Distinguishing between a licence and service

Even if a contract states that the arrangement is a licence, the nature of the promise to the customer may be that of providing a service. The evaluation of whether the arrangement is a licence or a service requires judgement based on the identification of the performance obligations in the arrangement – i.e. Step 2 of the model (see Chapter 2). The guidance on determining whether a licence is distinct (see Section 9.2) also applies in the determination.

9.2 Determining whether a licence is distinct

IFRS 15.B53

A contract to transfer a licence to a customer may include promises to deliver other goods or services in addition to the promised licence. These promises may be specified in the contract or implied by an entity's customary business practices.

Consistent with other types of contracts, an entity applies Step 2 of the model (see Chapter 2) to identify each of the performance obligations in a contract that includes a promise to grant a licence in addition to other promised goods or services. This includes an assessment of whether the:

- customer can benefit from the licence on its own or together with other resources that are readily available; and
- licence is separately identifiable from other goods or services in the contract.

IFRS 15.BC414X

The basis for conclusions states that:

- in some cases it may be necessary to consider the nature of the entity's promise in granting a licence, even when the licence is not distinct; and
- an entity considers the nature of its promise in granting a licence that is the primary or dominant component of a combined performance obligation.

IFRS 15.B54–B55

If the licence is not distinct, then the entity recognises revenue for the single performance obligation when or as the combined goods or services are transferred to the customer. It generally applies Step 5 of the revenue model (see Chapter 5) to determine whether the performance obligation containing the licence is satisfied over time or at a point in time.

IFRS 15.B54

The following are examples of licences that are not distinct.

Type of licence	Example
Licence that forms part of a tangible good and is integral to the functionality of the good	• Software embedded in the operating system of a car
Licence that the customer can benefit from only in conjunction with a related service	• Media content that the customer can access only via an online service • Drug compound that requires proprietary research and development (R&D) services from the entity

Example 3 – IP licence in combined performance obligation

Company X enters into a five-year patent licence with Customer Z for a fixed fee. X also provides essential consulting services for two years.

X determines that there are two promises in the contract – the patent licence and the consulting service component. However, the licence is not distinct from the service component in the contract because the services are essential and highly inter-related.

Assume that the combined performance obligation is satisfied over time – e.g. because the patent is being created for Z and will have no alternative use to X, and X has an enforceable right to payment for performance completed to date. X considers the nature of the licence to determine the period over which the combined performance obligation will be satisfied and the appropriate measure of progress to apply.

If the licence provides a *right to use* the IP, then the combined performance obligation is satisfied over the two-year consulting service period. In contrast, if the licence provides a *right to access* X's IP, then the performance obligation will not be completely satisfied until the end of the licence term (and revenue will be recognised over the five-year licence period). In both cases, X has to determine an appropriate measure of progress to apply over the two- or five-year performance period (e.g. time elapsed, costs incurred). For discussion of measuring progress, see Section 5.3.

Example 4 – Customer's option to purchase additional licences

Software Vendor S enters into a five-year software arrangement with Customer C. As part of the arrangement, S provides access to download copies of the software from its website. C pays a fixed fee of 300,000 for up to 200 software downloads. Each downloaded copy can have only a single user. C pays an additional 1,000 per copy downloaded in addition to the 200, pro-rated based on the remaining licence period at the time of download (e.g. 1,000 for copies downloaded in Year 1; 800 for copies downloaded in Year 2).

C receives access codes for 200 downloads on commencement of the contract. C has to request access codes for each additional download, which S will provide. S measures the number of downloads and C pays for any additional downloads each quarter.

The initial arrangement is generally a multiple licence scenario (i.e. C has been granted 200 software licences) that can be accounted for as a single performance obligation because the licences are transferred to C at the same point in time. Therefore, the option for additional downloads represents an option to acquire additional user licences to the software for 1,000 per licence.

Because the 1,000 per copy option price is less than the initial per-user licence fee of 1,500 per licence (300,000 / 200 users), S needs to evaluate whether the option provides C with a material right (see Section 10.4).

Assessing whether a licence is distinct may require significant judgement

Licences of IP are frequently included in arrangements that include promises for other goods or services. The evaluation of whether a licence is distinct is often complex and requires assessment of the specific facts and circumstances of the contract. The standard provides the following illustrative examples that may be helpful in evaluating different fact patterns.

IFRS 15.IE49–IE58D

Type of contract	Description	Observations
Example 11A and 11B – Technology		
Contract to transfer a software licence, installation services, unspecified software updates and technical support	Two cases are provided to illustrate differences in identifying performance obligations depending on whether the software will be significantly customised or modified as part of professional services also promised to the customer in the contract.	Installation services involving the customisation or modification of a software licence may result in a conclusion that the licence is not distinct from the services. Determining whether professional services involve significant customisation or modification of the software may require significant judgement.

Type of contract	Description	Observations
Example 55 – Technology		
Contract to license IP related to the design and production processes for a good, including updates to that IP	The customer is entitled to all updates for new designs or production processes. The updates are essential to the customer's ability to derive benefit from the licence. The example concludes that the licence and the updates are inputs into a combined item for which the customer contracted and that the promises to grant the licence and the updates are not distinct. The entity's overall promise to the customer is to provide ongoing access to the entity's IP.	There may be diversity in views about the kinds of technology to which the fact pattern, analysis and outcome may apply in practice. An entity considers the nature of the promise in these fact patterns. For example, this promise is a service rather than a licence of IP with upgrades.
Example 56A and 56B – Life sciences		
Contract to licence patent rights to an approved drug, which is a mature product, and to manufacture the drug for the customer	Two cases are provided to illustrate differences in identifying performance obligations depending on whether the manufacturing process is unique or specialised, whether the licence can be purchased separately or whether other entities can also manufacture the drug.	Manufacturing services that can be provided by another entity are an indication that the customer can benefit from a licence on its own.

IFRS 15.IE278–IE280

IFRS 15.IE281–IE288

These examples highlight the potential difficulty of determining whether services and IP are, in effect, inputs into a combined item and, therefore, not separately identifiable from each other. For example, an entity may license a video game and provide additional online hosting services that are not sold on a stand-alone basis. The entity will need to determine the degree to which the service is integral to the customer's ability to derive benefit from its rights to the video game. The entire arrangement may be a single performance obligation or, alternatively, if the customer can derive substantial functionality from using the video game on a stand-alone basis without the additional online hosting services, then they may be separate performance obligations.

Customer's option to purchase additional licences

In some contracts, an entity charges fees for additional copies or usage of software. The entity determines whether the contract is for a single licence or multiple licences. Depending on the facts of the arrangement, the contract might contain options to purchase additional software licences that will need to be evaluated to determine whether they convey a material right to the customer or a single licence with a usage-based fee. Judgement will be needed to determine whether an entity should apply the guidance on customer options or usage-based fees to these types of arrangements (see Example 4 in this chapter).

Although this type of arrangement is common for software, the same considerations apply to similar arrangements for licences of other types of IP.

Additional application examples

Example 5 – Licence for drug compound and related service: Separate performance obligations

Pharma Company P enters into an arrangement with Customer C. Under the arrangement, C receives a licence for exclusive worldwide rights to Compound B. B has shown promising results in early testing but still requires further R&D before it can be commercialised. P will perform the R&D services required to get B approved for commercial sale, which primarily relate to testing and validating its efficacy. The R&D services required to develop B further could be performed by another pharma company.

P considers whether the licence and the R&D services are distinct and determines that:

- the R&D services required to take B through to commercialisation are not unique or specialised – i.e. other entities could perform them;
- the required R&D services do not have a transformative effect on the licence; and
- P's services do not change the nature of B.

Therefore, P concludes that the licence and the R&D services are distinct and the contract includes two performance obligations:

- a licence; and
- an R&D service.

However, if the nature of the R&D services provided were different such that only P could perform those services – e.g. the R&D work is highly specialised or would significantly modify B – then P may conclude that the licence for B and the R&D services were not distinct in the context of the contract and should be treated as a single performance obligation.

Example 6 – Licence for drug compound and related service: Single performance obligation

IFRS 15.IE281–IE288

Pharma Company P licenses its patent rights to an approved drug compound to Customer C for 10 years and promises to manufacture the drug for C. The drug is a mature product; therefore, P will not undertake any activities to support the drug, which is consistent with its customary business practices. In this case, no other entity can manufacture the drug because of the highly specialised nature of the manufacturing process. As a result, the licence cannot be purchased separately from the manufacturing service – i.e. the licence is not capable of being distinct.

P determines that C cannot benefit from the licence without the manufacturing service. Therefore, the licence and the manufacturing service are not distinct and P accounts for them as a single performance obligation.

Conversely, if the manufacturing process used to produce the drug were not unique or specialised and other entities could also manufacture the drug for C, then P might instead conclude that C could benefit from the licence on its own and that the licence and manufacturing service were separate performance obligations.

9.3 Determining the nature of a distinct licence

IFRS 15.B56

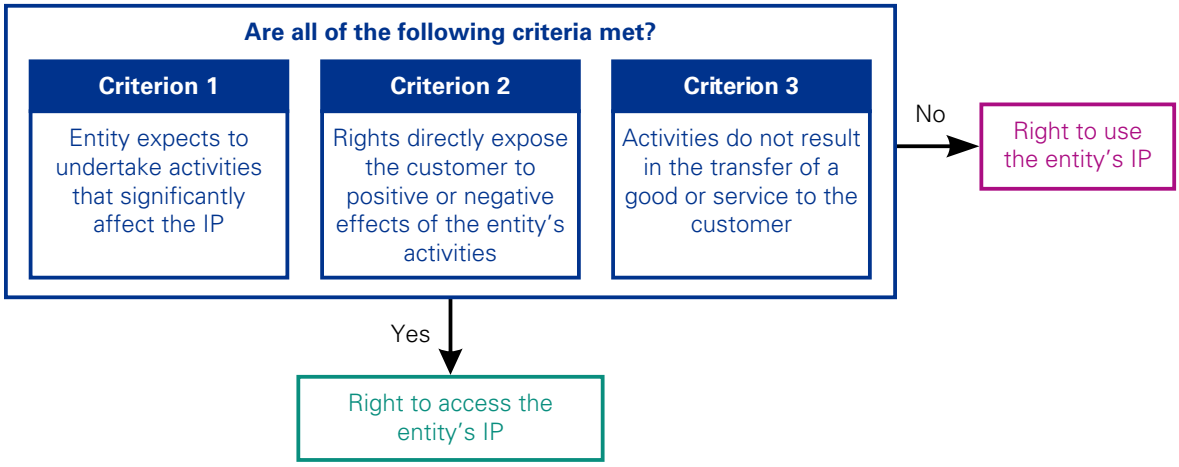
A licence for IP that is distinct from other goods or services in the contract is a separate performance obligation. To determine whether the performance obligation is satisfied at a point in time or over time, the entity considers whether the nature of its promise is to provide the customer with a right to:

- access the entity's IP throughout the licence period; or
- use the entity's IP as it exists at the point in time at which the licence is granted.

The revenue from a right-to-access licence is recognised over time and the revenue from a right-to-use licence is recognised at a point in time.

IFRS 15.B58

The nature of an entity's promise in granting a licence is a promise to provide a right to access the entity's IP if all of the following criteria are met.



IFRS 15.B59

To determine whether a customer could reasonably expect the entity to undertake activities that do not result in the transfer of a good or service to the customer that significantly affect the IP, the entity considers its customary business practices, published policies and specific statements, and whether there is a shared economic interest between the entity and the customer.

IFRS 15.B59A

Under Criterion 1, an entity 'significantly affects' the IP when either the:

- activities are expected to change the form (e.g. the design or content) or functionality (e.g. the ability to perform a function or task) of the IP; or
- ability to obtain benefit from the IP is substantially derived from, or dependent on, those activities (e.g. the ability to benefit from a brand is often dependent on the entity's ongoing activities to support or maintain the value of that brand).

An entity's ongoing activities do not significantly affect the IP when the IP has significant stand-alone functionality, unless they change that functionality. IP that often has significant stand-alone functionality includes software, biological compounds or drug formulas, and completed media content (e.g. films, television shows and music recordings).

IFRS 15.B61

If the criteria are not met, then the nature of the licence is a right to use the entity's IP as that IP exists at the date the licence is granted. This is because in this case the customer can direct the use of, and obtain substantially all of the remaining benefits from, the licence at the point in time when it transfers. When the nature of the licence is a right to use the entity's IP, it is accounted for as a performance obligation satisfied at a point in time.

IFRS 15.B62

Contractual provisions relating to time, geographic region or use could represent:

- additional licences if they create a right to use or access IP that the customer does not already control; or
- only attributes of a promised licence to IP that the customer controls.

If these provisions do not represent multiple licences, then they are not considered when determining the nature of the entity's promise in granting a licence (i.e. whether a right-to-use or right-to-access licence).

A guarantee provided by the licensor that it has a valid patent to the underlying IP and that it will maintain and defend that patent is also not considered when determining whether the licence provides a right to access or a right to use the entity's IP.

Example 7 – Assessing the nature of a software licence with unspecified upgrades

Software Company X licenses its software application to Customer Y. Under the agreement, X will provide updates or upgrades on a when-and-if-available basis; Y can choose whether to install them. Y expects that X will undertake no other activities that will change the functionality of the software.

Although the updates and upgrades will change the functionality of the software, they are not activities considered in determining the nature of the entity's promise in granting the licence. The activities of X to provide updates or upgrades are not considered because they transfer a promised good or service to Y – i.e. updates or upgrades are distinct from the licence. Therefore, the software licence provides a right to use the IP that is satisfied at a point in time.

Example 8 – Assessing the nature of a film licence and the effect of marketing activities

Film Studio C grants a licence to Customer D to show a completed film. C plans to undertake significant marketing activities that it expects will affect box office receipts for the film. The marketing activities will not change the functionality of the film, but they could affect its value.

C would probably conclude that the licence provides a right to use its IP and, therefore, is transferred at a point in time. There is no expectation that C will undertake activities to change the form or functionality of the film. Because the IP has significant stand-alone functionality, C's marketing activities do not significantly affect D's ability to obtain benefit from the film, nor do they affect the IP available to D.

IFRS 15.IE289–IE296

Franchise licences generally provide a right to access IP

Franchise rights generally provide a right to access the underlying IP. This is because the franchise right is typically affected to some degree by the licensor's activities of maintaining and building its brand. For example, the licensor generally undertakes activities to analyse changing customer preferences and enact product improvements and the customer has the right to exploit and benefit from those product improvements.

Example 57 in the standard illustrates a 10-year franchise arrangement in which the entity concludes that the licence provides access to its IP throughout the licence period.

IFRS 15.B58, BC410

Only consider licensor's activities that do not transfer a good or service to the customer

When evaluating the nature of its promise to provide a licence of IP, a licensor considers only activities that do not transfer a good or service to the customer.

The third criterion for a licence to be a right to access the entity's IP is that the licensor's activities do not transfer a good or service to the customer. If all of the activities that may significantly affect the IP transfer goods or services to the customer, then this criterion will not generally be met, resulting in point-in-time recognition.

For example, a contract that includes a software licence and a promise to provide updates to the customer's software does not result in a conclusion that the licensor is undertaking activities that significantly affect the IP to which the customer has rights. This is because the provision of updates constitutes the transfer of an additional good or service to the customer – i.e. updates are distinct from the licence.

IFRS 15.B62, BC414O–BC414R, IE303–IE306

Effect of different attributes of a licence on determining the nature of the entity's promise

A licence is, by its nature, a bundle of rights conveyed to a customer. The various attributes of a licence (e.g. restrictions on time, geography or use) do not affect whether the licence provides a right to use or a right to access the entity's IP.

IFRS 15.IE303–IE306

For example, Example 59 in the standard discusses a licence to a symphony recording that includes restrictions on time, geography and use (i.e. the licence is limited to two years in duration, permits use only in Country A and limits the customer to use of the recorded symphony only in commercials). These restrictions are attributes of the single licence in the contract and do not affect the conclusion that the licence provides a right to use the entity's IP. However, in certain fact patterns contractual provisions characterised as restrictions on time, geography or use may result in a conclusion that the entity has promised to grant multiple licences to the customer (see Section 9.5).

Entity's activities that significantly affect the IP

IFRS 15.B58, B59A

An entity's activities that do not transfer a good or service to the customer can significantly affect the IP to which the customer has rights when the customer's ability to obtain benefits from the IP is substantially derived from, or dependent on, those activities. This is one of the three criteria that have to be met under IFRS Accounting Standards to recognise revenue for a licence of IP over time.

When classifying a licence as a right to use or a right to access IP, an entity focuses on whether its ongoing activities are expected to change the licence's form or functionality, or whether the customer's ability to obtain benefit from the licence substantially depends on other activities of the entity that are not expected to change the form or functionality of the IP (e.g. advertising or other activities to support or maintain the value of the IP).

Recognition timing	Rationale	Examples
Point in time	Revenue is recognised at a point in time because there is no explicit or implicit obligation for the entity to undertake activities during the licence period to (a) change the form or functionality of the IP or (b) support or maintain the value of the IP during the licence period.	• Software • Biological compounds • Drug formulas • Copies of media content: e.g. films, television shows, music
Over time	Revenue is recognised over time because the IP's design or functionality changes over time or because the customer's ability to obtain benefits from the IP is substantially derived from, or dependent on, the company's ongoing activities that will be performed over the licence period.	• Brand names • Franchise rights • Logos and team names

IFRS 15.IE297–IE302, BC409

Cost and effort to undertake activities are not the focus of the analysis

A licence is not satisfied over time solely because the entity is expected to undertake activities that significantly affect the licensed IP (the first criterion). Those activities also have to directly expose the customer to their effects (the second criterion). When the activities do not affect the customer, the entity is merely changing its own asset – and although this may affect the entity's ability to grant future licences, it does not affect the determination of what the current licence provides to the customer or what the customer controls.

Example 58 in the standard illustrates that, when determining the nature of its promise, an entity focuses on whether its activities directly affect the IP already licensed to the customer – e.g. updated character images in a licensed comic strip – rather than the significance of the cost and effort of the entity's ongoing activities. An entity also focuses on whether the customer's ability to obtain benefit from the IP is substantially derived from, or dependent on, the entity's activities (i.e. the publishing of the comic strip).

Similarly, a media company licensing completed seasons of television programmes and simultaneously working on subsequent seasons would generally conclude that the subsequent seasons do not significantly affect the IP associated with the licensed seasons, and would not focus merely on the significance of the cost or efforts involved in developing the subsequent seasons.

Additional application examples

Example 9A – Assessing the nature of a team name and logo licence: Active sports team

Sports Team D enters into a three-year agreement to license its team name and logo to Apparel Maker M. The licence permits M to use the team name and logo on its products, including display products, and in its advertising or marketing materials.

The nature of D's promise in this contract is to provide M with the right to access the sports team's IP and, accordingly, revenue from the licence will be recognised over time. In reaching this conclusion, D considers all of the following facts.

- M reasonably expects D to continue to undertake activities that support and maintain the value of the team name and logo by continuing to play games and field a competitive team throughout the licence period. These activities significantly affect the IP's ability to provide benefit to M because the value of the team name and logo is substantially derived from, or dependent on, those ongoing activities.
- The activities directly expose M to positive or negative effects (i.e. whether D plays games and fields a competitive team will have a direct effect on how successful M is in selling clothing featuring the team's name and logo).
- D's ongoing activities do not result in the transfer of a good or a service to M as they occur (i.e. the team playing games does not transfer a good or service to M).

Example 9B – Assessing the nature of a team name and logo licence: Sports team that is no longer active

Modifying Example 9A, Sports Team D has not played games in many years and the licensor is Brand Collector B, an entity that acquires IP such as old team or brand names and logos from defunct entities or those in financial distress. B's business model is to license the IP, or obtain settlements from entities that use the IP without permission, without undertaking any ongoing activities to promote or support the IP.

Based on B's customary business practices, Apparel Maker M probably does not reasonably expect B to undertake any activities to change the form of the IP or to support or maintain the IP. Therefore, B would probably conclude that the nature of its promise is to provide M with a right to use its IP as it exists at the point in time at which the licence is granted.

Example 10 – Licence for right to access IP

Franchisor Y licenses the right to operate a store in a specified location to Franchisee F. The store bears Y's trade name and F will have a right to sell Y's products for 10 years. F pays an up-front fixed fee.

The franchise contract also requires Y to maintain the brand through product improvements, marketing campaigns etc.

The licence provides F access to the IP as it exists at any point in time in the licence period. This is because:

- Y is required to maintain the brand, which will significantly affect the IP by affecting F's ability to obtain benefit from the brand;
- any action by Y may have a direct positive or negative effect on F; and
- these activities do not transfer a good or service to F.

Therefore, Y recognises the up-front fee over the 10-year franchise period.

9.4 Timing and pattern of revenue recognition

IFRS 15.B56, B60–B61

The nature of an entity's promise in granting a licence to a customer is to provide the customer with either a right to:

- access the entity's IP; or
- use the entity's IP.

A promise to provide the customer with a right to access the entity's IP is satisfied over time because the customer simultaneously consumes and receives benefit from the entity's performance of providing access to its IP as that performance occurs. The entity applies the general guidance for measuring progress towards the complete satisfaction of a performance obligation satisfied over time in selecting an appropriate measure of progress.

A promise to provide the customer with a right to use the entity's IP is satisfied at a point in time. The entity applies the general guidance on performance obligations satisfied at a point in time to determine the point in time at which the licence transfers to the customer. However, revenue cannot be recognised before the beginning of the period during which the customer can use and benefit from the licence (i.e. before the start of the licence period).

An entity may enter into a contract with a customer to renew or extend an existing licence to use the entity's IP. If the renewal is agreed before the start of the renewal period, then a question arises about when to recognise revenue for the renewal. In our view, an entity should choose an accounting policy, to be applied consistently, to recognise revenue for the renewal when:

- *the renewal is agreed:* on the basis that the renewal is regarded as a modification of an existing contract in which the licence has already been delivered; or
- *the renewal period starts:* on the basis that this is the date from which the customer can use and benefit from the renewal.

Example 11A – Right-to-access licence

Company S enters into a contract with Customer C on 15 November Year 0 to grant C a five-year licence to its IP, with the licence period beginning on 1 January Year 1 and ending on 31 December Year 5. S provides C with a copy of the IP on 1 December Year 0. S determines that the licence provides a right to access.

Because the licence provides C with a right to access S's IP, S will recognise the revenue from the licence over the five-year term (from 1 January Year 1 until 31 December Year 5) as it satisfies its performance obligation to provide C with access to the IP. S cannot begin to recognise revenue until 1 January Year 1 when C can begin to use and benefit from the licence.

Example 11B – Right-to-use licence

Modifying Example 11A, assume that the licence provides Customer C with a right to use Company S's IP.

Because the licence provides a right to use its IP, S recognises the revenue from the licence at a point in time on 1 January Year 1. This date is the first point in time at which C:

- has obtained control of the licence based on an evaluation of the general guidance on performance obligations satisfied at a point in time; and
- is able to use and benefit from the licence.

Example 12 – Renewal of a right-to-use licence

Company S enters into a contract with Customer C on 1 January Year 0 to grant C a three-year licence to its IP for consideration of 100. The licence period is from 1 January Year 1 to 31 December Year 3. S determines that the licence provides a right to use and recognises the revenue from the licence at a point in time on 1 January Year 1, when C obtains control of the licence and is able to use and benefit from the licence.

On 1 January Year 3, S and C agree and approve a renewal of the licence for a further three-year period for consideration of 100 payable at the date of the agreement. There are no other changes to the licence (i.e. the other terms and conditions of the licence and the IP remain the same). The renewal period is from 1 January Year 4 to 31 December Year 6.

We believe that S should choose an accounting policy, to be applied consistently, to recognise 100 revenue for the renewal on 1 January Year 3 (i.e. when the renewal is agreed) or 1 January Year 4 (i.e. when the renewal period starts).

Application of the general guidance on performance obligations satisfied at a point in time

IFRS 15.38

The standard states that a right-of-use licence is satisfied at a point in time and that the indicators for determining when control transfers generally apply (see Section 5.4). However, for licences of IP that are a right of use, the standard adds an additional requirement that revenue cannot be recognised before the beginning of the period in which the customer can begin to use and benefit from the licence.

Although the point at which the customer can begin to use and benefit from the licence will typically be readily determinable, the point-in-time transfer of control indicators may not be applied to licences as easily as they might be to physical goods. For example, there may not be 'legal title' to a licence and it may be difficult to assess whether the customer has the significant risks and rewards of a licence. However, the contract can be viewed as analogous to title to a licence and availability of a copy of the IP (when applicable) as the equivalent of 'physical possession'. Assessing the entity's right to payment in a licence contract should not be significantly different from that assessment in other scenarios.

Consequently, control of a licence will generally transfer to the customer when:

- there is a valid contract between the parties;
- the customer has a copy or the ability to obtain a copy of the IP; and
- the customer can begin to use and benefit from the licence.

9.5 Contractual restrictions and attributes of licences

IFRS 15.B62

The following factors are not considered when determining the nature of the entity's promise in granting a licence:

- restrictions of time, geography or use of the licence; and
- guarantees provided by the licensor that it has a valid patent to the underlying IP and that it will maintain and defend that patent.

Example 13A – Licence of IP: Hold-back period

On 1 January Year 1, Film Studio F enters into a three-year contract to grant Broadcaster B the exclusive right to air Film M in the US and Canada during the contract term. B has the right to air M in the US immediately but, due to an overlapping contract with a Canadian competitor, the rights to air the film in Canada do not begin until 1 July Year 1 – i.e. there is a six-month hold-back period.

F considers whether the contract grants B a single licence that is subject to a use restriction (i.e. a single licence to show the film in the US from 1 January Year 1 and in Canada from 1 July Year 1), or two licences (i.e. one licence to show the film in the US and one licence to show the film in Canada).

F determines that the contract includes two promised licences based on the following:

- the term of the contract preventing B from airing the film in Canada for the first six months of the contract term leads to the rights to show the film in Canada being a separate and additional right transferred on 1 July Year 1; and
- B does not control the additional right at 1 January Year 1 because it cannot use and benefit from it in Canada before 1 July Year 1. This differentiates it from the right to show the film in the US.

Therefore, the right to air the film in Canada represents a separate promise that F has not yet transferred to B.

Example 13B – Licence of IP: Usage limitations

Modifying Example 13A, the rights to air Film M in the US and Canada both start on 1 January Year 1. However, the terms of B's rights to air the film extend only to eight broadcasts in each territory during the three-year period and, as part of the contract, B agrees not to air certain types of adverts during the film.

In this case, F determines that the contract is for a single licence because B can begin to use and benefit from the rights conveyed in both the US and Canada from 1 January Year 1. There are no additional rights transferred after 1 January Year 1.

The term of the licence (three years), the geographic scope of the licence (B's US and Canadian networks only) and the usage limitations (limited to eight showings per territory and restrictions on adverts during the film) are all attributes of the licence.

No explicit guidance on distinguishing attributes of a licence from additional licences

IFRS 15.IE304, BC414O–BC414R

The standard does not include explicit guidance on distinguishing attributes of a licence from additional licences, so judgement is required to determine when a restriction creates multiple licences and when it is an attribute of the licence.

The basis for conclusions notes that an entity considers all of the terms in a contract when considering whether promised rights result in the transfer of one or more licences to the customer. This judgement is necessary to distinguish between contractual provisions that create promises to transfer rights to use the entity's IP from contractual provisions that establish when, where and how those rights may be used.

Example 59 of the standard illustrates that restrictions of time, geography and use are considered as attributes of a single licence in a contract.

Distinguishing attributes of a single licence from additional promises to transfer licences

A provision in a contract that requires the entity to transfer additional rights to use or access IP that the customer does not already control generally describes an additional promise for the entity to fulfil. In Example 13A in this chapter, the provision restricting the customer's ability to use the IP in Canada initially means that, until those rights start, the entity has a remaining obligation to transfer those rights that the customer does not already control. Because of that provision, the contract in Example 13A could easily have been written as a contract to grant two distinct licences (one to air Film M in the US and a second licence to air M in Canada). The accounting outcome in a scenario such as Example 13A does not depend on how the contract is written.

In contrast, Example 13B in this chapter illustrates that licences are, by nature, a bundle of rights to IP that are often limited in duration and scope (geographic and usage). The provisions describing the duration and scope of the customer's rights in Example 13B are distinguished from the requirement in Example 13A that the entity transfer additional rights after some other rights have been transferred (i.e. to fulfil a remaining promise to transfer those additional rights).

Substantial break between periods during which a customer is able to use (or access) IP

In some cases, a substantial break between periods during which a customer is able to use (or access) IP might suggest that those two separate periods of time represent separate licences, even if the rights conveyed during each period are the same. This scenario arises principally in the media industry and is often referred to as a 'broken windows' scenario. The facts and circumstances will need to be considered when deciding whether broken windows should be accounted for as a single licence or multiple licences.

9.6 Sales- or usage-based royalties

IFRS 15.B63

For sales- or usage-based royalties that are attributable to a licence of IP, the amount is recognised at the later of:

- when the subsequent sale or usage occurs; and
- the satisfaction or partial satisfaction of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.

IFRS 15.B63A–B63B

This is an exception to the general requirements and it applies when the:

- royalty relates only to a licence of IP; or
- licence is the predominant item to which the royalty relates (e.g. when the customer would ascribe significantly more value to the licence than to the other goods or services to which the royalty relates).

An entity does not split a royalty into a portion that is subject to the exception and a portion that is subject to the guidance on variable consideration, including the constraint (see Section 3.1).

If the exception does not apply, then the entity applies the general guidance on variable consideration, including the constraint, to the royalty arrangement and includes its estimate in the transaction price.

Example 14 – Royalty: Licence of IP is the predominant item

Film Distributor D licenses the right to show a film in cinemas for six weeks to Film Company T. D has agreed to provide memorabilia to T for display at cinemas and to sponsor radio adverts. In exchange, D will receive a royalty equal to 30% of the ticket sales.

D has a reasonable expectation that T would ascribe significantly more value to the licence than to the related promotional activities, and therefore D concludes that the licence to show the film is the predominant item to which the sales-based royalty relates.

D applies the royalties exception to the entire sales-based royalty and therefore cannot recognise revenue when the promotional activities are provided based on an estimate of the expected royalty amount.

If the licence, the memorabilia and the advertising activities were separate performance obligations, then D would allocate the sales-based royalties to each performance obligation when or as the subsequent sales occurred. Then it would recognise the royalties allocated to each performance obligation based on whether that performance obligation has been satisfied – e.g. whether the licence, which is a right to use IP in this example, has been transferred to the customer or whether the advertising services are complete.

Exception for sales- or usage-based royalties aligns the accounting for different licence types

A key practical effect of the exception for sales- or usage-based royalties is that it may reduce the significance of the distinction between the two types of licences in certain circumstances. In particular, if the consideration for a licence consists solely of a flat sales- or usage-based royalty for a distinct licence, then an entity is likely to recognise it in the same, or a substantially similar, pattern, irrespective of whether the licence provides the customer with a right to access IP or a right to use IP.

Judgement is required to assess when a licence of IP is 'predominant'

IFRS 15.B63A

An entity may be entitled to a sales-based or usage-based royalty in exchange for a licence and other goods or services in the contract, which may or may not be distinct from the licence. Licences of IP are often bundled with other goods or services, with the consideration taking the form of a sales- or usage-based royalty for all goods or services in the contract. For example:

- software licences are commonly sold with PCs and other services (e.g. implementation services) or hardware where there is a single consideration in the form of a sales- or usage-based royalty;
- franchise licences are frequently sold with consulting or training services or equipment, with ongoing consideration in the form of a sales-based royalty;

- biotechnology and pharmaceutical licences are often sold with R&D services and/or a promise to manufacture the drug for the customer, with a single consideration in the form of a sales-based royalty; or
- licences for digital media and a promise for promotional activities may be sold with a single consideration in the form of a sales-based royalty.

The guidance specifies that the royalties exception applies when the licence is the predominant item to which the royalty relates. 'Predominant' is not defined. However, the standard says that "this may be the case when the customer would ascribe significantly more value to the licence than to the other goods or services to which the royalty relates".

Significant judgement may be required to determine whether a licence is the predominant item in an arrangement. For example, an entity may determine that a licence of IP is the predominant item when it represents the major part or substantially all of the value or utility of the bundle. Another entity may conclude that the exception would apply when a licence of IP is the largest single item in a bundle of goods or services. These different interpretations could result in differences in practice and may give rise to differences in the transaction price and timing of revenue recognition, because they could affect the conclusion on whether the royalties exception applies to an arrangement.

Application of royalties exception to milestone payments

Company X enters into a contract to licence IP to Company Y. In exchange for the licence, X is entitled to a 5 million milestone payment after Y has reached 50 million in sales.

The royalties exception generally applies to the milestone payment because the payment is based on Y's subsequent sales. Consequently, X does not recognise any revenue for the variable amount until the subsequent sales occur. However, this view does not extend to milestone payments that are determined with reference to other events or indicators – e.g. regulatory approval or enrolment in clinical trials.

For example, arrangements in the life sciences industry often include a licence of IP of a drug and an obligation to perform R&D services, with a substantial portion of the fee being contingent on achieving milestones such as regulatory approval of the drug.

Guaranteed minimum payment – Right-to-use licence

For a right-to-use licence, any guaranteed minimum payment represents fixed consideration – i.e. it is an amount payable by the customer that will not vary based on sales, usage or any other metric. This fixed amount is recognised as revenue at the point in time when the customer obtains control of the licence.

Royalties earned in excess of the guaranteed minimum are recognised as and when the related sales or usage occurs.

Guaranteed minimum payment – Right-to-access licence

The standard does not prescribe a single approach for recognising revenue for a right-to-access licence when the contract includes royalties with a minimum guarantee. Instead, an entity chooses an approach that appropriately considers all of the principles in the standard, including the royalty exception, selecting measures of progress and the variable consideration allocation exception.

One acceptable approach is illustrated in Example 15B in this chapter.

Variable royalty rates – Right-to-use licence

An entity recognises revenue from a sales- or usage-based royalty when (or as) the customer's subsequent sales or usage occurs unless this method would accelerate the recognition ahead of the entity's performance in completing the performance obligations. Therefore, when the royalty relates to a right-to-use licence, it is generally recognised as and when sales or usage occur because performance is complete.

One exception to this approach is when a declining rate is applied on a retrospective basis – e.g. customers receive a refund or credit on previous payments when the customer reaches a lower royalty rate. In these cases, the entity estimates the ultimate royalty rate that it expects to be entitled to and applies that to the sales or usage. The entity updates that estimate over the licence term.

Variable royalty rates – Right-to-access licence

An entity recognises revenue from a sales- or usage-based royalty when (or as) the customer's subsequent sales or usage occur unless this method would accelerate the recognition ahead of the entity's performance in completing the performance obligations. Therefore, when the royalty decreases over the licence term an entity evaluates whether a portion of the royalty rate needs to be deferred to ensure that the entity does not recognise revenue ahead of its performance. Conversely, when the royalty rate increases over the licence term the entity generally recognises revenue at the current royalty rate because an entity cannot recognise revenue before sales or usage occurs.

Allocating sales- or usage-based royalties to multiple performance obligations

An entity may enter into a contract with multiple performance obligations that consist of a licence of IP and another good or service that is transferred over a different time period. If the requirements to allocate variable consideration entirely to one performance obligation are not met, then an entity allocates the sales- or usage-based royalties to multiple performance obligations.

The standard is not clear about how an entity allocates the consideration to its performance obligations when the contract includes sales- or usage-based royalties predominantly associated with a licence of IP and a guaranteed minimum. Multiple approaches could be acceptable if they are consistent with the allocation objective and application of the royalty exception. We believe that the following are examples of acceptable approaches.

- *Approach 1:* Allocate the fixed consideration and variable consideration separately based on relative stand-alone selling prices.
- *Approach 2:* Estimate the total transaction price (including royalties) and allocate that amount to each performance obligation subject to a cumulative recognition constraint.

Additional application examples

Example 15A – Software licence with a guaranteed minimum (1)

Company M enters into a five-year arrangement to license software to Customer C. The software licence provides C with the right to use M's software – i.e. revenue is recognised at a point in time. The consideration for the licence is a sales-based royalty of 5% of C's gross sales of products that include M's software, with a minimum guaranteed amount of 5,000.

The 5,000 guaranteed royalty amount is fixed consideration and is recognised in the same manner as any other fixed consideration – i.e. as revenue when the customer obtains control of the licence. Any royalties in excess of the minimum guaranteed amount are recognised when C's subsequent sales – i.e. those above the minimum – occur.

Example 15B – Software licence with a guaranteed minimum (2)

Modifying Example 15A, the software licence provides C with a right to access M's IP and revenue is recognised over time.

M determines that the guaranteed minimum is substantive and that it is appropriate to recognise the guaranteed minimum amount on a straight-line basis over the licence period. M recognises any royalty amounts above the guaranteed minimum only after the guaranteed minimum of 5,000 has been exceeded. However, other methods may also be appropriate, as long as a single measure of progress is used for the performance obligation.

Conversely, if the guaranteed minimum is considered non-substantive then M recognises revenue as and when sales occur.

Example 16 – Allocation of guaranteed minimum among multiple performance obligations

Tech Company T enters into a three-year arrangement to license its technology to Customer C along with a promise to provide when-and-if-available upgrades developed during the licence term.

T concludes that the licence and promise to provide when-and-if-available upgrades are two distinct performance obligations.

- The licence provides C with a right to use the technology, which is a performance obligation satisfied at a point in time.
- The right to when-and-if-available upgrades is a performance obligation satisfied over time because C simultaneously receives and consumes the benefits of having access to when-and-if-available upgrades continuously throughout the contract term.

T receives a royalty of 10% of C's sales subject to a minimum guaranteed amount of 10,000. T estimates that the total consideration (fixed plus variable) will be 50,000.

T estimates the stand-alone selling price of the licence and when-and-if-available upgrades to be 15,000 and 35,000, respectively. T concludes that the royalty is predominantly associated with a licence of IP because both performance obligations are related to providing IP.

C's gross sales and the related royalties earned each year are as follows. This information is not known at the beginning of the contract.

	Year 1	Year 2	Year 3	Total
Gross sales	150,000	250,000	100,000	500,000
Royalties	15,000	25,000	10,000	50,000

Approach 1: Allocate fixed and variable consideration separately

T allocates the fixed fee (guaranteed minimum) of 10,000 on a relative stand-alone selling price basis.

Performance obligation	Stand-alone selling price	%	Allocation of guaranteed minimum
Licence	15,000	30%	3,000
Upgrades	35,000	70%	7,000
Total	**50,000**	**100%**	**10,000**

T allocates the estimated variable royalty (in excess of the minimum) of 40,000 between the two performance obligations on a relative stand-alone selling price basis as future usage and sales occur.

T recognises the variable amounts allocated to the when-and-if-available upgrades in the period the amounts are earned because the performance obligation is a series of distinct time periods and T meets the criteria to allocate the fees directly to the distinct periods in which the sales occur as follows:

- the fees relate to the customer's past usage and the licence and when-and-if-available upgrades; and
- the allocation is consistent with the allocation objective because the fee is consistent from period to period and C's greater usage reflects additional value to C (see 4.2.2).

The following table summarises the allocation and recognition for each performance obligation during the three-year contract term.

	Inception	End of Year 1	End of Year 2	End of Year 3	Total
Fixed					
Licence	3,000[1]	-	-	-	3,000
Upgrades	-	2,333[2]	2,333[2]	2,333[2]	7,000
Variable					
Licence	-	1,500[3]	7,500[5]	3,000[7]	12,000
Upgrades	-	3,500[4]	17,500[6]	7,000[8]	28,000

	Inception	End of Year 1	End of Year 2	End of Year 3	Total
Cumulative revenue					
Licence	3,000	4,500	12,000	15,000	15,000
Upgrades	-	5,833	25,666	35,000	35,000

Notes

1. 10,000 minimum × 30% allocation. This amount is recognised immediately on transfer of the licence because it is a right-to-use licence recognised at a point in time.
2. 10,000 minimum × 70% allocation × 1/3 complete. Only a portion is recognised each period because this amount is recognised over time.
3. 5,000 royalty above the minimum (15,000 - 10,000) × 30% allocation.
4. 5,000 royalty above the minimum (15,000 - 10,000) × 70% allocation.
5. 25,000 additional royalty × 30% allocation.
6. 25,000 additional royalty × 70% allocation.
7. 10,000 additional royalty × 30% allocation.
8. 10,000 additional royalty × 70% allocation.

Approach 2: Allocate fixed and variable consideration together

T allocates the 50,000 estimated transaction price on a relative stand-alone selling price basis as follows:

- 15,000 to the licence; and
- 35,000 to the when-and-if-available upgrades.

When (or as) the performance obligations are satisfied, T recognises as revenue the lesser of the amount allocated to the performance obligations satisfied or the amount that is no longer subject to the royalty constraint.

	Inception	Year 1	Year 2	Year 3	Total
Allocated to (A):					
Licence	15,000[1]	-	-	-	15,000
Upgrade	-	11,667[3]	11,667[3]	11,667[3]	35,000
Cumulative	15,000	26,667	38,333	50,000	N/A
Royalty due (B):					
Annual	10,000[2]	5,000[4]	25,000[5]	10,000[6]	40,000
Cumulative	10,000	15,000	40,000	50,000	N/A
Lesser of A and B	10,000	15,000	38,333	50,000	N/A
Less: previously recognised	-	(10,000)	(15,000)	(38,333)	N/A
Revenue recognised	10,000	5,000	23,333	11,667	50,000

Notes

1. The right-to-use licence is transferred at a point in time. As such, the performance obligation is satisfied on transfer and the amount allocated to that performance obligation is 15,000.
2. There is a guaranteed minimum of10,000 in the contract.
3. 35,000 allocated to the upgrades / 3 years.
4. 15,000 in royalties earned during Year 1 - 10,000 minimum already recorded.
5. 25,000 additional royalties earned during Year 2.
6. 10,000 additional royalties earned during Year 3.

10 Other application issues

10.1 Sale with a right of return

Overview

Under the standard, when an entity makes a sale with a right of return it recognises revenue at the amount to which it expects to be entitled by applying the variable consideration and constraint guidance set out in Step 3 of the model (see Chapter 3). The entity also recognises a refund liability and an asset for any goods or services that it expects to be returned.

IFRS 15.B20

An entity applies the accounting guidance for a sale with a right of return when a customer has a right to:

- 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 entity; or
- another product in exchange (unless it is another product of the same type, quality, condition and price – e.g. exchanging a red sweater for a white sweater).

IFRS 15.B21–B22

An entity does not account for its stand-ready obligation to accept returns as a performance obligation.

In addition to product returns, the guidance also applies to services that are provided subject to a refund.

IFRS 15.B26–B27

The guidance does not apply to:

- exchanges by customers of one product for another of the same type, quality, condition and price; and
- returns of faulty goods or replacements, which are instead evaluated under the guidance on warranties (see Section 10.2).

IFRS 15.B21, B23, B25

When an entity makes a sale with a right of return, it initially recognises the following.

Item	Measurement
Revenue	Measured at the gross transaction price, less the expected level of returns calculated using the guidance on estimating variable consideration and the constraint (see Section 3.1)
Refund liability	Measured at the expected level of returns – i.e. the difference between the cash or receivable amount and the revenue as measured above The nature of such a refund liability is different from contract liabilities and therefore it is not presented as such
Return asset	Measured with reference to the carrying amount of the products expected to be returned less the expected recovery costs, including potential decreases in the value to the entity of returned products The nature of this return asset is different from trade and other receivables and therefore it is not presented as such

Item	Measurement
Cost of goods sold	Measured as the carrying amount of the products sold less the return asset as measured above
Reduction of inventory	Measured as the carrying amount of the products transferred to the customer

IFRS 15.B24–B25

The entity updates its measurement of the refund liability and return asset at each reporting date for changes in expectations about the amount of the refunds. It recognises adjustments to the:

- refund liability as revenue; and
- return asset as an expense.

Example 1 – Sale with a right of return

Retailer B sells 100 products at a price of 100 each and receives a payment of 10,000. The sales contract allows the customer to return any undamaged products within 30 days and receive a full refund in cash. The cost of each product is 60. B estimates that three products will be returned and a subsequent change in the estimate will not result in a significant revenue reversal.

B estimates that the costs of recovering the products will not be significant and expects that the products can be resold at a profit.

Within 30 days, two products are returned.

B records the following entries on:

- transfer of the products to the customer to reflect its expectation that three products will be returned;
- return of the two products; and
- expiry of the right to return products.

	Debit	*Credit*
Sale		
Cash	10,000	
Refund liability		300[1]
Revenue		9,700
To recognise sale excluding revenue on products expected to be returned		
Return asset	180[2]	
Cost of sales	5,820	
Inventory		6,000
To recognise cost of sales and right to recover products from customers		
Two products returned		
Refund liability	200[3]	
Cash		200[3]
To recognise the refund for product returned		

	Debit	*Credit*
Two products returned		
Inventory	120[4]	
Return asset		120[4]
To recognise product returned as inventory		
Right of return expires		
Refund liability	100	
Revenue		100
To recognise revenue on expiry of right of return		
Cost of sales	60	
Return asset		60
To recognise cost of sales on expiry of right to recover products from customers		

Notes

1. 100 × 3 (the price of the products expected to be returned).
2. 60 × 3 (the cost of the products expected to be returned).
3. 100 × 2 (the price of the products returned).
4. 60 × 2 (the cost of the products returned).

Partial refunds are measured based on the portion expected to be refunded

IFRS 15.55, B23–B25

The measurement of a refund liability reflects the amount expected to be refunded to the customer. Therefore, when a right of return allows the customer to return a product for a partial refund (e.g. 95 percent of the sales price), the refund liability (and the corresponding change in the transaction price) is measured based on the portion of the transaction price expected to be refunded. For example, this would be the number of products expected to be returned multiplied by 95 percent of the selling price.

Restocking fees and costs

IFRS 15.55, B23–B25

An entity sometimes charges a customer a restocking fee when a product is returned. The restocking fee is generally intended to compensate the entity for costs associated with the product return (e.g. shipping and repacking costs) or the reduction in the selling price that an entity may achieve when reselling the product to another customer.

A right of return with a restocking fee is similar to a right of return for a partial refund. Therefore, a restocking fee is included as part of the estimated transaction price when control transfers – i.e. the refund liability is based on the transaction price less the restocking fee.

Similarly, the entity's expected costs related to restocking are reflected in the measurement of the return asset when control of the product transfers. This is consistent with the guidance in the standard that any expected costs to recover returned products should be included by reducing the carrying amount of the return asset recorded for the right to recover those products.

For example, assume that an entity sells 20 widgets to a customer for 30 each and the cost of each widget is 15. The customer has the right to return a widget but is charged a 10% restocking fee. The entity expects to incur restocking costs of 2 per widget returned. The entity estimates returns to be 5%.

When control of the widgets transfers to the customer, the entity recognises the following.

Item	What to include	Amount	Calculation
Revenue	Widgets not to be returned plus restocking fee	573	$(19^{1} \times 30) + (1 \times 3^{2})$
Refund liability	Widget expected to be returned less restocking fee	27	$(1 \times 30) - 3^{2}$
Return asset	Cost of widget expected to be returned less restocking cost	13	$(1 \times 15) - 2$

Notes

1. Widgets not expected to be returned, calculated as 20 widgets sold less one ($20 \times 5\%$) expected to be returned.
2. Restocking fee, calculated as $30 \times 10\%$.

Conditional right of return

IFRS 15.55, B23, B70–B75

The standard does not distinguish between conditional and unconditional rights of return and both are accounted for similarly. However, for a conditional right of return the probability that the return condition would be met is considered in determining the expected level of returns. For example, a food production company only accepts returns of its products that are past a sell-by date. Based on historical experience, the company assesses the probability that the products will become past their sell-by date and estimates their return rate.

Historical experience may be a source of evidence for estimating returns

When estimating the amount of consideration expected to be received from a sales contract with a right of return, an entity may consider historical experience with similar contracts to make estimates and judgements. Using a group of similar transactions as a source of evidence is not itself an application of the portfolio approach (see Section 6.4 and 3.1.1).

When the entity elects to estimate the transaction price using the expected value method and uses a portfolio of data to determine the expected value of an individual contract, the estimated amount might not be a possible outcome for an individual contract (see 3.1.1). Because a sale with a right of return represents variable consideration, an entity is also required to apply the constraint to its estimate.

IFRS 15.IE110–IE115

The standard includes Example 22 illustrating how to determine the transaction price for a portfolio of 100 individual sales with a right of return. In the example, the entity concludes that the contracts meet the conditions to be accounted for at a portfolio level and determines the transaction price for the portfolio using an expected value approach to estimate returns. However, as explained above the entity could achieve the same accounting outcome by using the portfolio as a source of data, rather than assessing whether the contracts meet the conditions to be accounted for at a portfolio level.

10.2 Warranties

Overview

Under the standard, an entity accounts for a warranty (or part of a warranty) as a performance obligation if the warranty is distinct, including:

- the customer has an option to purchase the warranty separately; or
- additional services are provided as part of the warranty.

Otherwise, warranties are accounted for under the provisions standard.

10.2.1 Applying guidance on warranties

IFRS 15.B29

Under the standard, a warranty is considered a performance obligation if it is distinct under the Step 2 criteria (see Chapter 2). If the customer has an option to purchase the good or service with or without the warranty, then the warranty is a distinct service. If the warranty includes a service beyond assuring that the good complies with agreed specifications, then it is distinct.

IFRS 15.B29–B30, IAS 37

When a warranty is not sold separately, the warranty or a portion of it may still be a performance obligation if it provides the customer with a service in addition to the assurance that the product complies with agreed specifications. A warranty that covers only a product's compliance with agreed specifications (an 'assurance warranty') is accounted for under the provisions standard. For further discussion of how to distinguish between an assurance- and service-type warranty, see 10.2.2.

IFRS 15.B29

If the warranty – or part of it – is considered to be a performance obligation, then the entity allocates a portion of the transaction price to the service performance obligation by applying the requirements in Step 4 of the model (see Chapter 4).

IFRS 15.B32

If an entity provides a warranty that includes both an assurance element and a service element and the entity cannot reasonably account for them separately, then it accounts for both of the warranties together as a single performance obligation.

IFRS 15.B33, IAS 37

A legal requirement to pay compensation or other damages if products cause damage is not a performance obligation and is accounted for under the provisions standard.

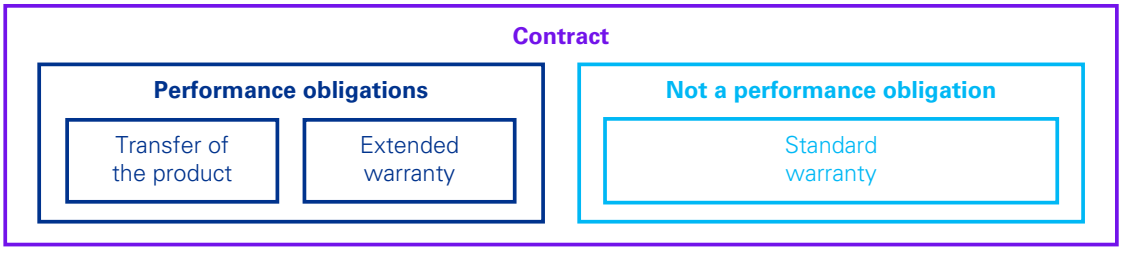
Example 1 – Sale of a product with a warranty

IFRS 15.IE223–IE229

Manufacturer M grants its customers a standard warranty with the purchase of its product. Under the warranty, M provides assurance that the product complies with agreed specifications and will operate as promised for three years from the date of purchase.

Customer C also chooses to purchase an extended warranty for two additional years.

In this example, M concludes that there are two performance obligations in the contract.



The extended warranty is a performance obligation because it can be purchased separately and is distinct based on the Step 2 criteria (see Chapter 2).

The component of the standard warranty that provides assurance that the product complies with stated specifications is an assurance-type warranty, and therefore is not a performance obligation. As a consequence, M accounts for the standard warranty under the provisions standard when control of the product transfers to the customer.

A refund for defective services may be variable consideration rather than a warranty

IFRS 15.B20–B27

The guidance in the standard on warranties is intended to apply to services as well as goods. However, it does not further explain how the concept should be applied to services.

In a contract for the delivery of services, an entity may offer to 'make good' or offer a refund. If an entity offers to 'make good' – e.g. to repaint an area that a customer was not pleased with – then it considers this in determining the timing of the transfer of control and revenue recognition.

If an entity offers a refund to customers who are dissatisfied with the service provided, then it applies the guidance on a sale with a right of return (see Section 10.1) and follows the guidance on estimating variable consideration in determining the transaction price for the service being provided (see Section 3.1).

Defective product returns in exchange for compensation

IFRS 15.B20–B27

An entity may offer compensation in the form of cash or credit to a customer, rather than repairing or replacing the defective product. Unlike returns of faulty goods or replacements, this refund is generally accounted for using the right of return guidance (see Section 10.1) and not the guidance on warranties.

Liquidated damages and similar types of contractual terms

IFRS 15.51

Many contracts contain terms providing for liquidated damages and similar compensation to the customer on the occurrence or non-occurrence of certain events. These terms may be considered variable consideration, given that the standard identifies penalties as variable consideration.

However, in some circumstances the terms may be similar to a warranty provision. For example, if a third party fixes a defective product sold by an entity and the entity reimburses the customer for costs incurred, then that term may be similar to a warranty provision.

Amounts considered closer in nature to a warranty provision are accounted for as an assurance- or service-type warranty.

Judgement is required to distinguish those terms that are accounted for as warranties from the more common scenarios in which the terms give rise to variable consideration.

Some warranty arrangements may be in the scope of the insurance standard

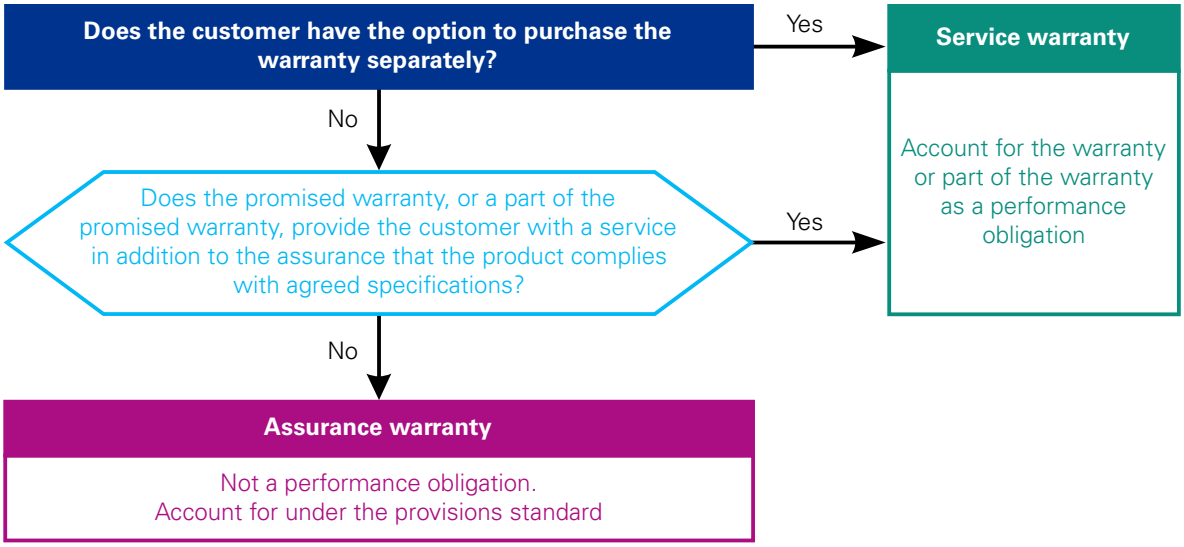
IFRS 15.BC373, 4.4(a)

Product warranties issued directly by a manufacturer, dealer or retailer are in the scope of the warranty guidance in the revenue standard. Warranties issued directly by a third party are in the scope of the insurance standard.

In more complex cases, an entity sells a warranty separately but the arrangement involves a third party or multiple covers. In these cases, the entity may need to apply judgement to determine which party issues the warranty and whether the arrangement, or a component of it, is in the scope of the insurance standard.

10.2.2 Distinguishing between an assurance- and a service-type warranty

An entity distinguishes between the types of distinct product warranties as follows.



IFRS 15.B31

To assess whether a warranty provides a customer with an additional service, an entity considers factors such as:

- *whether the warranty is required by law:* because such requirements typically exist to protect customers from the risk of purchasing defective products;
- *the length of the warranty coverage period:* because the longer the coverage period, the more likely it is that the entity is providing a service, rather than just guaranteeing compliance with an agreed specification; and
- *the nature of the tasks* that the entity promises to perform.

Example 2 – Lifetime warranty

IFRS 15.B31

Luggage Company L is a leading manufacturer in the luggage industry. L provides a lifetime warranty on all suitcases. If a suitcase is broken or damaged, then L will repair or replace it free of charge.

There are currently no regulations in the luggage industry on warranties.

L assesses whether the lifetime warranty is a service-type warranty as follows.

Factor	Rationale
No legal requirement	In this example, there is no law that requires L to make a promise for the lifetime of the product. Therefore, this factor suggests that the warranty is a separate performance obligation.
Longer coverage period	In this example, the length of the warranty is for the life of the suitcase, as compared with other manufacturers that offer warranties for a specific period. Therefore, this factor suggests that the warranty is a separate performance obligation.
Promises beyond agreed specifications	In this example, the nature of the tasks not only includes repairing or replacing a suitcase that does not meet the promised specifications, but also includes repairing damage that occurs after the customer obtains control of a suitcase. Therefore, the warranty goes beyond the promise that the suitcase complies with agreed specifications, which suggests that the warranty is a separate performance obligation.

Based on its analysis, L concludes that the lifetime warranty is a service in addition to the assurance that the product complies with agreed specifications. It therefore accounts for the service as a separate performance obligation.

'Reasonably account' threshold is undefined

The standard requires an entity that cannot reasonably account for a service-type warranty and an assurance-type warranty separately to account for them together as a single performance obligation. Because the 'reasonably account' threshold is not defined in the standard, entities will need to exercise judgement in applying this guidance.

Length of the warranty period is an indicator of the type of warranty, but is not always determinative

IFRS 15.B31

The standard lists the length of the warranty period as a factor to consider when assessing whether the warranty provides a customer with a service. However, it is only one of the factors. An entity usually considers the length of the warranty in the context of the specific market, including geography and product line. In addition to the length of the warranty period, the nature of costs incurred in performing the warranty work may provide evidence of the nature of the warranty promise.

Repairs outside the warranty period as a customary practice

IFRS 15.B28

An entity may have a customary business practice of providing repairs outside the warranty period – i.e. an 'implied warranty'. In some cases, it may not be clear if the repairs provided during the implied warranty period are an assurance- or service-type warranty.

For example, if an entity determines that the repairs made during the implied warranty period generally involve correcting defects that existed at the time of sale, then the repairs could be an assurance-type warranty. Conversely, if the entity determines that the repairs made during the implied warranty period provide a service to the customer beyond fixing defects that existed at the time of sale, then the repairs could be a service-type warranty.

An entity considers all facts and circumstances in making an assessment of whether an implied warranty is an assurance- or service-type warranty.

An 'extended warranty' may be a service-type warranty or an assurance-type warranty

A warranty that is marketed as being an 'extended warranty' may be a service-type warranty, but the facts will need to be evaluated to determine whether it provides service beyond the assurance that the product meets the agreed specifications. The mere labelling of a warranty as 'extended' or 'enhanced' is not determinative.

An entity considers all facts and circumstances and the factors included in the standard in making that determination. This includes, but is not limited to, considering the length of the coverage period.

10.3 Principal vs agent considerations

Overview

When another party is involved in providing goods or services to a customer, an entity evaluates the nature of its promise to the customer. If an entity obtains control of another party's goods or services before transferring control to the customer, then the entity's promise is to provide the goods or services itself. Therefore, the entity is acting as a principal.

However, if the entity does not control the good or service before it is transferred to the customer, then the entity is acting as an agent and arranges for that good or service to be provided by another party.

An entity identifies each specified good or service to be transferred to the customer and determines whether it is a principal or agent for each one. An entity may be a principal for some goods and services and an agent for others in a contract to transfer multiple goods or services.

10.3.1 Unit of account

IFRS 15.B34–B34A

When other parties are involved in providing goods or services to a customer, the entity determines whether the nature of its promise is a performance obligation to provide the specified goods or services itself or to arrange for them to be provided by another party – i.e. whether it is a principal or an agent. It makes this determination by identifying each specified good or service promised to the customer in the contract and evaluating whether the entity obtains control of the specified good or service before it is transferred to the customer – i.e. the unit of account is the specified good or service.

A 'specified good or service' is the distinct good or service (or distinct bundle of goods or services) to be provided to the customer specified in Step 2 (see Chapter 2).

Because an entity evaluates whether it is a principal or an agent for each specified good or service to be transferred to the customer, it is possible for the entity to be a principal for one or more specified goods or services and an agent for others in the same contract.

The specified good or service to be transferred to the customer may in some cases be a right to an underlying good or service that will be provided by another party.

Example 1 – Specified good or service is the underlying product ordered

Company V operates a website from which it sells Company T's products. Customers place orders directly on the website. V passes orders on to T, which ships the products directly to customers.

In this case, the specified good or service is the underlying product ordered rather than a right to that product.

Example 2 – Specified good or service is a right to a specified good or service

Company Y is a ticket-selling agent that sells airline tickets. The tickets give customers the right to travel with a specific airline.

In this case, the specified good or service is the right to the flight. As such, the principal-agent assessment focuses on who controls that right rather than the underlying flight itself. In these cases, the fact that Y will not provide the underlying service is not determinative.

Unit of account is the specific good or service

IFRS 15.B34, BC385Q

The evaluation focuses on the promise to the customer and the unit of account is the specified good or service. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer. That is, the analysis of whether an entity acts as a principal or an agent is performed at the performance obligation level. If individual goods and services are not distinct from one another, then they represent inputs into a combined promise that is the specified good or service that the entity assesses.

The specified good or service may be a right

IFRS 15.B35A(b)

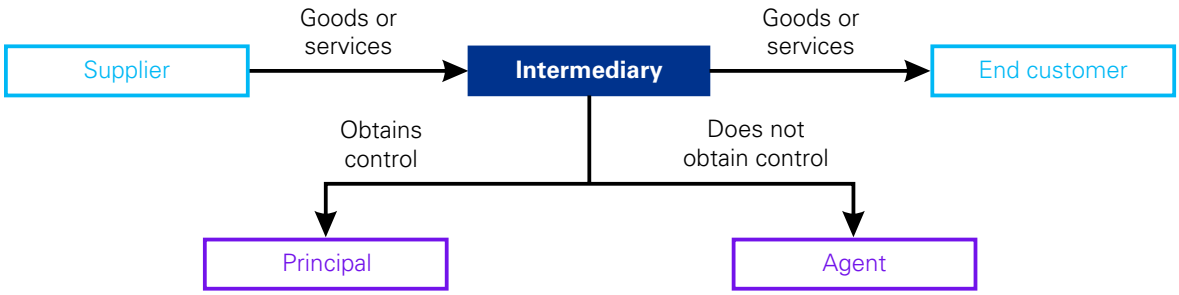
The specified good or service to be transferred to the customer may in some cases be a right to an underlying good or service that will be provided by another party. For example, a travel website may sell an airline ticket that gives the customer the right to fly on a particular airline or an entity may provide a voucher that gives the holder the right to a meal at a specified restaurant.

In these cases, the principal vs agent assessment is analysed based on who controls the right to the underlying good or service. That is, an entity may be a principal in a transaction relating to a right (e.g. sale of an airline ticket or a voucher that gives the customer the right to a flight or a meal) even if another party controls and transfers the underlying good or service (e.g. the flight or the meal) to the end customer.

IFRS 15.IE239–IE248F

An entity may be a principal in a transaction relating to a right if it has the ability to direct the use of the right to the underlying service because it has committed itself to purchasing the right and has inventory risk. The entity's ability to establish the price that the customer would pay for the right may also be a relevant indicator to consider.

10.3.2 Control assessment



IFRS 15.B35

If an entity obtains control of a good or a right to services in advance of transferring those goods or services to the customer, then the entity is a principal. Otherwise, it is an agent.

IFRS 15.33

'Control' is the ability to direct the use of, and obtain substantially all of the remaining benefits from, the goods or services (or prevent others from doing so).

IFRS 15.B35A

When another party is involved, an entity that is a principal obtains control of:

- a good from another party that it then transfers to the customer;
- a right to a service that will be performed by another party, which gives the entity the ability to direct that party to provide the service on the entity's behalf; or
- a good or a service from another party that it combines with other goods or services to produce the specified good or service promised to the customer.

IFRS 15.B77–B78, B81

To determine whether it controls a specified good or service before it is transferred to the customer, the entity acting as an intermediary applies the general guidance on transfer of control (see Section 5.4).

IFRS 15.B34A, B37

If the assessment based on the general guidance on transfer of control is not conclusive, then an entity also considers the specific indicators of whether it acts as a principal. These indicators include, but are not limited to, the following.

Indicator	Relevant considerations
The entity is primarily responsible for providing specified goods or services	The entity: • is responsible for acceptability of the specified good or service • has discretion with respect to accepting and rejecting orders from customers • can source the good or service ordered by the customer from more than one supplier • is responsible for delivery and any loss or damage between pick up from the supplier and delivery to the end customer • is responsible for the sales strategy • is the party the customer believes is responsible for fulfilling the promise
The entity has inventory risk	The entity: • obtains, or commits itself to obtaining, the specified good or service before obtaining a contract with a customer • is liable for damage and product loss for inventory in its possession before sale to the end customer, including loss in inventory value • is liable for customer returns • commits to a minimum order quantity • has no right to return unsold inventory to the supplier
The entity has discretion in establishing prices for specified goods or services	The amount paid to the supplier is: • a fixed price per unit • not a commission or fee basis, which is fixed in terms of either an amount of currency or a percentage of the value of the underlying goods or services

IFRS 15.B37A

The above indicators and considerations are not exhaustive. To assess whether it obtains control, an entity needs to carefully assess its facts and circumstances, including the nature of the specified goods or services and the terms and conditions of the contracts. The indicators and conditions may be more or less relevant to the assessment of control, depending on the nature of the specified goods or services and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.

IFRS 15.B35, B38

An entity that is a principal in a contract may satisfy a performance obligation by itself or it may engage another party – e.g. a subcontractor – to satisfy some or all of a performance obligation on its behalf. However, if another party assumes an entity's performance obligation so that the entity is no longer obliged to satisfy the performance obligation, then the entity is no longer acting as the principal and therefore does not recognise revenue for that performance obligation. Instead, the entity evaluates whether to recognise revenue for satisfying a performance obligation to obtain a contract for the other party – i.e. whether the entity is acting as an agent.

IFRS 15.IE231–IE233

Example 3 – Entity arranges for the provision of goods or services

Internet Retailer B operates a website that enables Customer E to buy goods from a range of specific suppliers that deliver the goods directly to E. The website facilitates payment between the supplier and E at prices set by the supplier, and B is entitled to commission of 10% of the sales price. E pays in advance and all orders are non-refundable.

B notes that each supplier delivers its goods directly to E and that B itself does not control the goods. In reaching the conclusion that it does not control the goods before they are transferred to E, B makes these observations.

- The supplier is primarily responsible for fulfilling the promise to provide the goods to E (i.e. by shipping the goods to E). B is not obliged to provide the goods to E if the supplier fails to deliver and is also not responsible for the acceptability of the goods delivered by the supplier.
- B does not take inventory risk at any time before or after the goods are transferred to E (because the goods are shipped directly by the supplier to E), B does not commit to obtain the goods from the supplier before they are purchased by E and B is not responsible for any damaged or returned goods.
- B does not have discretion in establishing prices for the goods because the sales price is set by the supplier.

Consequently, B concludes that it is an agent and that its performance obligation is to arrange for the supplier to provide the goods. When B satisfies its promise to arrange for the supplier to provide the goods to E – which, in this example, is when the goods are purchased by E – B recognises revenue at the amount of the commission to which it is entitled.

IFRS 15.IE248A–IE248F

Example 4 – Entity is an agent and a principal for sales of virtual or intangible goods

Company H contracts to provide recruiting services. As part of the contract, Customer J agrees to obtain a licence to access a third party's database of information on potential recruits. H arranges for this licence and collects payment from J on behalf of the third party database provider. However, the database provider sets the price to J for the licence and is responsible for providing technical support.

H concludes that the recruitment services and the database access are distinct. H considers the control principle and indicators to determine whether it controls the specified goods and services before they are transferred to J.

H concludes that it is the principal in relation to the recruitment services because it performs those services itself. In contrast, H concludes that it is an agent in relation to the promise to provide access to the third party's database because H does not control access to the database before it is transferred to J for the following reasons.

- H is not responsible for fulfilling the promise to provide access to the database access.
- H does not have inventory risk because it does not purchase, or commit to purchasing, the database access from the database provider.
- H does not have discretion in setting the price for the database access.

Principal-agent indicators support application of the general control principle, but cannot override it

When evaluating whether an entity obtains control of the specified good or service, an entity first applies the general definition of control and relevant indicators. To help it make this assessment, the entity may also use the principal-agent indicators.

The principal-agent indicators are helpful when the overall assessment of control is unclear or highly judgemental. However, the key consideration remains whether the entity obtains control; if the conclusion of the control evaluation is clear, then the principal-agent indicators cannot override this conclusion.

Certain conditions may help with control determination

When assessing whether the entity acting as intermediary has obtained control of the specified good or service before it transfers to the end customer, the following general control considerations may be helpful.

- *Intermediary does not obtain control: agent.* The supplier has a substantive unconditional right to recall the inventory before sale to an end customer, or the supplier and the intermediary enter into a consignment arrangement and control passes only on sale to the end customer.
- *Intermediary obtains control: principal.* The supplier and the intermediary enter into a bill-and-hold arrangement and all of the criteria for the transfer of control are met (see Section 5.7).

No individual indicator is generally determinative

IFRS 15.B37

There is no specific hierarchy for the indicators and an entity considers all of the indicators in making the assessment. The assessment of whether the entity controls the specified good or service before it is transferred to the customer does not depend on whether one or more of the indicators are met or on a majority evaluation of the indicators. For instance, meeting two of the three indicators, or not meeting two of the three indicators, does not in itself determine the conclusion of the control evaluation.

The indicators are intended to inform the control evaluation and, depending on the facts and circumstances, provide more or less relevant evidence in that evaluation. Therefore, meeting one (or more) of the indicators cannot override other more relevant evidence of whether the entity controls the specified good or service before it is transferred to the customer in accordance with the control principle.

Assessing the relevance of the indicators may be challenging when it is unclear whether the entity or other party bears the responsibility, or when there are shared responsibilities between the entity and other party. For example, an entity that does not have primary responsibility for providing the specified good or service or inventory risk may have discretion to set prices. In this case, the entity makes an overall assessment of all of the facts and circumstances. This may include assessing whether the discretion to set prices is merely a way for the entity to generate additional revenue while arranging for another entity to provide the specified goods or services, or evidence that the entity is acting as a principal.

Providing a significant integration service is determinative

IFRS 15.B35A(c), BC385R

When a customer contracts for a combined output of significantly integrated goods or services and the entity is the party that provides the significant integration service, the entity is the principal for the combined output. In these cases, the entity controls the specified good or service (the combined output) before it transfers control to the customer because it controls the inputs necessary to perform the significant integration service.

Entity obtains only flash title before transfer to the customer

IFRS 15.B35

A 'flash title' scenario is common in the retail and commodity industries, in which a retailer or a commodity dealer does not take title to the goods or services until the point of sale to a customer and the end customer immediately takes control after that.

Although taking title may indicate that an entity can direct the use of and obtain substantially all of the remaining benefits of a good, it is not determinative that control has transferred. For example, taking title to a good only momentarily does not in and of itself mean that an entity controls the specified good or service before it is transferred to the customer. In contrast, an entity could control a good before obtaining title.

When an entity obtains only flash title to the specified good, the principal-agent evaluation will focus on whether it obtains control of the specified good or service before obtaining flash title and a consideration of the entity's and supplier's rights before the transfer of the good to the end customer. All facts and circumstances will need to be considered when evaluating the control principle circumstances.

Entity may still be principal for tangible asset even if it does not take physical possession

Although physical possession is an indicator that the entity has the ability to direct the use of and can obtain substantially all of the remaining benefits of an asset, it is not determinative.

If an entity does not take physical possession of the asset – e.g. in arrangements when goods are shipped directly from the supplier to the customer – it might still control the specified good or service when it:

- has the ability to direct or redirect the asset for other uses (for its own use or to other customers); or
- can restrict the ability of the customer or supplier to direct the use of the asset.

Judgement is required in assessing whether a software reseller is acting as principal or agent in the sale of standard software licences

The IFRS Interpretations Committee discussed whether a software reseller was a principal or an agent in the sale of standard software licences. The Committee noted that if, after applying the general principles and requirements on control in the revenue standard, it is unclear whether the reseller is a principal or an agent, then the reseller also considers the indicators in 10.3.2 in assessing whether it obtains control of the standard software licences before they are transferred to the customer. The Committee also noted that a reseller needs to apply judgement, based on the specific facts and circumstances, including the terms and conditions of the relevant contract, to determine whether it is a principal or an agent in a specific transaction. For a discussion of pre-sale advice by software resellers, see Section 2.1.

Additional application examples

Example 5 – Entity is a principal for advertising services provided by a subcontractor

Company D provides advertising services to customers. D enters into a subcontract with a multinational online video sharing company, F. Under the subcontract, F places all of D's customers' adverts.

D notes the following.

- D works directly with customers to understand their advertising needs before placing adverts.
- D is responsible for ensuring that the advert meets the customer's needs after the advert is placed.
- D directs F over which advert to place and when to place it.
- D does not bear inventory risk because there is no minimum purchase requirement with F.
- D does not have discretion in setting the price because fees are charged based on F's scheduled rates.

D considers that it is primarily responsible for fulfilling the promise to provide advertising services. Although F delivers the placement service, D directly works with customers to ensure that the services are performed to their requirements. Although D does not bear inventory risk and does not have discretion in setting the price, D considers that it controls the advertising services before they are provided to the customer. Therefore, D concludes that it acts as a principal.

Example 6 – Entity is a principal for consulting services provided by a subcontractor

Investment Management Company P is the fund manager of Fund F.

P engages Advisory Company S to provide it with consulting services in implementing F's investment management policy.

P notes that:

- it independently selected S to help it with fulfilling its obligations under its contract with F;
- it entered into a contract with F before selecting and engaging S;

- it is the counterparty to the consulting services contract, rather than F; and
- it has a contractual right to direct how S provides the services and also to suspend S's services.

P concludes that these factors indicate that it is using S as a subcontractor and that it is a principal directing S to provide services on its behalf. In reaching this decision, P also considers the indicators of control provided by the standard.

- P is considered by F as the company with the primary responsibility for fulfilling the investment management services contract and the entity responsible for the acceptability of those services.
- P determined the price of the investment management services before it signed a contract with S.

Example 7 – Entity is a principal even though it does not take physical possession of goods

Carmaker M contracts with Supplier S to manufacture the bumper for its vehicle model. M owns the intellectual property (IP) rights for that bumper technology, which is specifically designed to fit its vehicles. Further, M owns the machinery, equipment and moulds used by S to produce the bumpers at S's facilities. S may not use that machinery, equipment or moulds to produce bumpers for any other entities besides M. S only produces bumpers based on M's orders. M uses the same bumpers from S in its own production facilities and for after-market sales.

Body Shop B orders a new bumper directly from M for an existing vehicle (e.g. for a repair). M then submits a purchase order to S and instructs S to ship the new bumper directly to B. S makes the bumper and ships it to B and then invoices M.

In evaluating whether it is the principal for the sale of the bumper to B, M evaluates whether it controls the bumper before it is transferred to B. Even though the bumper is shipped directly to B from S, M concludes that it controls the bumper before it is transferred to B and therefore that it is the principal.

M's conclusion that it controls the bumper is based on the following factors.

- M has the ability to direct the use of the bumper. M owns and controls the use of the IP and the equipment used to manufacture the bumper; no bumpers are produced other than from M's orders. M decides whether to direct a particular unit to its own facilities (e.g. to install in a new vehicle) or to another customer (e.g. a different repair shop or auto parts retailer). S cannot sell the bumper to a customer not permitted by M or use it at its discretion (because S does not manufacture cars); it can only direct the bumper as instructed by M.
- M has the ability to obtain substantially all of the remaining benefits from the bumper. M is entitled to all of the proceeds (the amount of which it determines) from the sale of the bumper to B or it could use the bumper to produce a new vehicle. As a result, M is able to obtain substantially all of the remaining benefits from each bumper.

M does not need to consider the principal-agent indicators because it is apparent based on applying the general control requirements that M controls the bumper before it is transferred to B and therefore is the principal in the transaction.

Example 8 – Entity is an agent when goods and services delivered directly to customer by third parties

Company X markets itself as a leading provider of end-to-end IT security solutions. X aims to operate as a specialist extension of its customers by having its experts match the customers' needs to available solutions.

X helps a customer evaluate available technologies and determine which combination of technology solutions will best meet its specific needs. This assistance generally leads to the purchase of an enterprise-wide solution by the customer. The products typically consist of hardware and software licences, as well as related support, maintenance and training.

X has concluded that each hardware product and each software licence is typically a specified good.

Hardware

X does not maintain an inventory of hardware; all hardware purchased by X's customers is delivered directly to the customer by one of X's vendor partners.

X's terms with its vendor partners typically mirror its terms with its customers. For example, title typically transfers to X at the same time as it transfers to the customer (typically, at the vendor partner's location), and return rights from the customer to X are typically mirrored by the return terms from X to its vendor partner.

In addition to the above terms, X considers the following facts when determining whether it is a principal or agent in the arrangement.

- X sets the price of the hardware to the customer, but its discretion to set that price is effectively constrained by market pressures – i.e. it cannot price goods too expensively because X's customers generally have alternative supply options.
- Any vendor warranties and end-user agreements or documentation are between the third party vendor and the customer – X is not a party thereto. Therefore, the third party vendors are clearly not invisible to the customer.
- X frequently serves as a contact point for its customers, but does not maintain a call centre or helpdesk. When customers contact it, X generally just facilitates the customer's contact with the appropriate personnel from the third party vendor.
- X generally does not accept returns from customers that will not be accepted by the third party vendor.

X concludes that it is an agent for sales of hardware. Important to X's conclusion is that at no point before control is transferred to the customer can X direct a specified unit of hardware to anyone or prevent the third party vendor from directing (e.g. selling, giving or leasing) it to any other customer the vendor chooses. X has no rights to any hardware units before a customer places an order with X and X, in turn, places an order with the third party vendor. In addition, X does not maintain any hardware inventory of its own, has no pre-customer order purchase commitments with the third party vendors and does not have any arrangements with its vendor partners for them to hold units for X.

Moreover, X concludes that its vendor partners do not perform on X's behalf in these arrangements. Although X establishes the price of the hardware with its customers, the weight of relevant evidence supports a conclusion that the third party vendors are not acting on X's behalf. X notes that:

- the third party vendors have primary responsibility for fulfilment. They pick and are responsible for shipping the requested hardware;

- the warranties and end-user agreements generally ensure that the third party vendors are known to the customer and establish their responsibility for the acceptability of the hardware; and
- X has no return or other back-end inventory risk. Even though X's customers will frequently initiate and send returns to X, substantially all of X's return terms with its customers are mirrored in the contracts between X and its vendor partners.

Third party software licences

X similarly concludes that it does not control the third party software licences before they are transferred to its customers and therefore that it is an agent for those specified licences.

X's conclusion is based on the following factors.

- X does not have a pre-purchased pool of licences that it can resell.
- X does not obtain a master copy of the licensed software and cannot generate or grant licences or keys for a customer independently of the third party software vendor. It is the third party software vendor that transfers a copy of the software to the customer, provides the key necessary to register the licence directly to the customer and enters into an end-user licence agreement with the customer that grants the licence to the customer.

X further concludes that the software licences in its contracts do not exist until customers issue a purchase order and execute the applicable end-user licence agreement with the third party software vendor. Therefore, X concludes that it does not control the software licences before they are transferred to its customers.

Example 9 – Entity is a principal in website sales

Company Y operates a website on which it advertises and showcases for sale a wide variety of consumer products. For a significant portion of its sales, customers' orders placed with Y are shipped directly from the supplier to the customer. Y does not take title to or possess any inventory of these consumer products at any point.

When a customer places an order, Y notifies the vendor and provides it with the appropriate customer shipping information – i.e. where to deliver the product. Y charges the customer the advertised price of the product (which Y established) and then pays the vendor the specified unit price under the vendor partner agreement.

At least a few days before products are offered for sale on Y's website, Y issues a purchase order to the vendor that 'reserves' a specified number of units, at a fixed price, that reflects its estimate of the number of units that it expects to sell to customers. The purchase orders are cancellable, meaning that Y does not have inventory risk – i.e. if it cannot sell the goods to its customers, then Y can cancel the purchase order without recourse or penalty.

Despite the purchase orders being cancellable by Y, Y concludes that they convey control over the specified products in these arrangements before the products are transferred to customers. Therefore, Y is acting as principal.

Y's conclusion is based on the following regarding the purchase orders.

- Before Y's customers buy one of the specified products, the vendor cannot direct the use of the reserved units subject to the purchase order to another customer (or for its own use) and cannot obtain substantially all of its remaining benefits. Specifically, the vendor cannot obtain the remaining benefits in terms of cash flows from sale because the vendor cannot sell the product to another party while it is being held for Y. Also, the vendor cannot realise any beneficial change in value during the hold period because the price to Y for the products is defined in the purchase order.

- From the time Y issues the purchase order until it either sells the product to one of its customers or cancels the purchase order (i.e. releasing the hold), Y has the sole ability to direct the product to one of its customers and obtain substantially all of its remaining benefits, including by adjusting the price that it charges for the product on the website.

The control evaluation is further supported by the fact that Y's reserved unit count 'depletes' as it completes sales to customers. Each unit sold and shipped to a Y customer is a unit that Y (1) controlled before it was transferred to the customer and (2) directed the vendor to pick and ship at Y's direction.

Based on its evaluation, Y concludes that it has the ability to direct the use of and obtain substantially all of the remaining benefits from the products (and can prevent others from doing so). Therefore, Y concludes that it is the principal in its arrangements with the vendor. Y notes that the principal-agent indicators do not provide any disconfirming evidence to this conclusion because these indicators are mixed. Specifically, Y controls the price to the customer but it does not have inventory risk with respect to the products and it shares responsibility with the vendor for fulfilment to the customer.

Example 10 – Entity is an agent in providing a service

Company C contracts with consumer products companies and content developers to create video content (published on the internet) that promotes products sold by the consumer products companies.

C enters into a contract with Customer D (a consumer products company) to provide the services of Provider P (a content developer) to create videos that promote the use of D's products. The contract with D specifies that C is entering into the agreement on behalf of P (identified in the contract).

C is not involved in developing the specifications for what P will produce. C is not responsible if D is unsatisfied with P's end product. D has no recourse against C, unless C has not satisfied its obligations in the contract – generally limited to the responsibility for co-ordination between the content developer and the consumer products company.

C has contracts with multiple content developers, including P, to create video content. C separately negotiates a fee with each content developer for creating the content. C and D set the price for the content development and P does not have visibility into that price. However, D must pay P for costs incurred plus a reasonable margin if it terminates the contract for reasons other than P's failure to perform.

C concludes that there is only a single specified service in this contract, which is the service to produce the video content that promotes D's consumer products. C considered the following in evaluating whether it controls the specified service.

1. Is the service combined with other goods or services into a combined output that is the specified good or service?

   No. There are no other promised goods or services in the contract.

2. Does C direct P to provide services on its behalf?

   No. C did not first enter into a contract with D and then engage P. D and C entered into a contract that specified P's involvement, so P was engaged concurrently with C and D concluding their contract. Furthermore, C does not control the services because it does not define the services to be performed by P and is not involved with the fulfilment of the product.

3. Does C control a right to the specified service before it is provided to D?

   No. C did not obtain the rights to the content, the content itself or commit to purchasing the finished content before entering into the contract with D. Therefore, C cannot direct the use of or benefit from P's finished content because it cannot use, resell or consume the content on its own.

Furthermore, C cannot benefit from the service in the contract for its own purposes.

C observes that its agent conclusion is further supported by the control indicators.

- *Primary responsibility for fulfilment:* P is primarily responsible for providing the content to D. C is only responsible for co-ordinating between P and D.
- *Price discretion:* C sets the price and contract with D and P. However, this does not change the conclusion based on the other evidence provided.
- *Inventory risk:* C does not have inventory risk, which supports a conclusion that it does not obtain control of the content before it is transferred to D.

Based on the above, C concludes that it is the agent for the specified service and recognises revenue on a net basis.

Example 11 – Specified good or service is an input into a combined output

Company C Corp partners with third parties that own and operate web-based platforms. C creates IT environments for its customers on these platforms, secures the platform processing capacity for its customers and provides software to monitor and manage the cloud consumption on the platforms. C is an authorised reseller of three different cloud platforms and provides customer support on each cloud platform to ensure that customer applications have maximum up-time (i.e. are always available on the cloud).

C enters into a contract with Customer D to implement a cloud-based solution and provide cloud capacity management. The services under the contract include identification and procurement of cloud computing capacity, a software interface to help customers monitor their cloud computing use, and customer support and maintenance. D selects Platform Provider P's product to be used in the services. However, D and P do not enter into a contractual relationship and C accepts responsibility for the cloud platform.

C sets the price charged to D for the services and P is not involved in the negotiations and does not have visibility into the contract. However, given market competition for the cloud platform and rates at which P sells separately, C is practically limited in the amount that it can charge D for the platform.

C's separate contract with P requires it to pay P even if D does not pay C for the services. C also prepays for reserved instances on the various provider platforms that it will resell to its customers. C does this to ensure that services are able to be provided uninterrupted.

C concludes that it is providing a single specified service to D because it is performing a significant service of integrating the platform, software, support and maintenance into a single performance obligation.

The specified cloud services are a single, integrated offering and C provides the significant service to D of integrating all items, including the third party cloud platform, into the combined output (i.e. the integrated cloud services) for which D contracted. The third party web platform is merely one input into C's integrated cloud offering, which C controls and makes use of in fulfilling the specified service. That the third party cloud platform is an input into a single, integrated offering provided by C is determinative. C controls that cloud platform service along with all of the other inputs into the specified service (i.e. the single, integrated cloud offering). No further analysis is performed.

10.3.3 Recognition

IFRS 15.B35B If the entity is a principal, then it recognises revenue and the related costs on a gross basis – corresponding to the consideration to which the entity expects to be entitled.

IFRS 15.B36 If the entity acts as an agent, then its performance obligation is to arrange for the provision of the specified goods or service. Therefore, it recognises revenue on a net basis corresponding to any fee or commission to which the entity expects to be entitled. An entity recognises revenue when its obligation to arrange for the provision of the specified good or service is fulfilled, which may be before it is provided to the customer by the principal.

IFRS 15.47, B35B–B36 Amounts collected by an agent on behalf of a third party are accounted for as a payable in the statement of financial position until they are settled and do not gross up revenue and expenses. Similarly, amounts prepaid by an agent to a third party on behalf of customers are recognised as a receivable until they are recovered and do not gross up revenues and expenses. For discussion of sales taxes, see Section 3.5.

Example 12 – Revenue recognition by a principal

Company S is providing restructuring advice to Customer C and has determined that it is acting as principal in providing the service to C.

S billed C 100 for the services performed and incurred costs of 50 to deliver the service, which included costs of 30 paid to external lawyers.

Because S is acting as a principal, it reports revenue and costs, including the legal fees paid to the external lawyers, on a gross basis. As such, it recognises revenue of 100 and costs of 50.

Example 13 – Revenue recognition by an agent

Company V operates a website from which it sells Company T's products. Customers place orders directly on the website and provide credit card details for payment. V receives the order and authorisation from the credit card company and passes the order on to T, which ships the product directly to the customer. V does not take title to the product and has no risk of loss or other responsibility for the function or delivery of the product. T is responsible for all product returns and defects. T sets the price of the product at 175, from which V receives a commission of 25.

V considers that it does not take title to the product, is not primarily responsible for providing the product, does not have inventory risk and does not have discretion in establishing prices. Therefore, V determines that it does not control the product before it is transferred to the customer and acts as an agent. As a result, V recognises its fee of 25 as revenue when it passes the order to T.

No specific guidance on allocating a discount when an entity is a principal for part of the arrangement and an agent for the other part

The standard does not include specific guidance on how an entity allocates a discount in an arrangement in which it is a principal for some goods or services and an agent for others. To achieve the allocation principle in these situations, judgement will be needed in determining the discount to allocate to the performance obligation related to acting as an agent in arranging for goods or services on a customer's behalf.

For further discussion on allocating the transaction price, including discounts, see Section 4.2.

Estimating gross revenue as a principal

In some arrangements, the entity may be the principal even though it does not know the price paid by the end customer to the intermediary that is an agent because it receives a fixed amount per unit regardless of the price paid. The standard does not address these fact patterns, but the International Accounting Standards Board (the Board) provided its views in the basis for conclusions. The Board noted that an entity that is a principal would generally be expected to be able to apply judgement and determine the consideration to which it is entitled using all relevant facts and circumstances that are available to it.

IFRS 15.BC385X–BC385Z

Although a principal may be unaware of the specific amount charged by an intermediary that is an agent, it may have information that could be used to estimate the transaction price. An entity that is a principal should carefully consider the facts and circumstances and available information when estimating the transaction price.

Example 14 – Estimating gross revenue as a principal: Discount attributed to the company

Company C is a principal that is entitled to receive 3 from Intermediary D for each good sold to end customers. D may sell the good to the end customer for a range of prices from 2 to 5, but the amount remitted by D to C will be 3 for each good sold to end customers on C's behalf.

C does not know and will not know the specific price charged by D to the end customer. However, it should consider what information is available in assessing whether it could estimate the transaction price (e.g. estimated transaction price of 4 resulting in revenue of 4 and commission expense of 1).

Example 15 – Estimating gross revenue as a principal: Discount attributed to the intermediary

Company B is a principal that is entitled to receive 80% of the 10 list price for each good sold by Intermediary D to end customers. Regardless of whether D sells the good for 7, 1 or another amount, the amount remitted by D will be 8 for each good sold to end customers on B's behalf.

B knows the list price, which is the product's stand-alone selling price. Therefore, any incremental discount offered to the end customer by D is attributed to the intermediary. B's transaction price for each good is 10.

10.3.4 Transporting goods to customers

IFRS 15.B34, BC116S

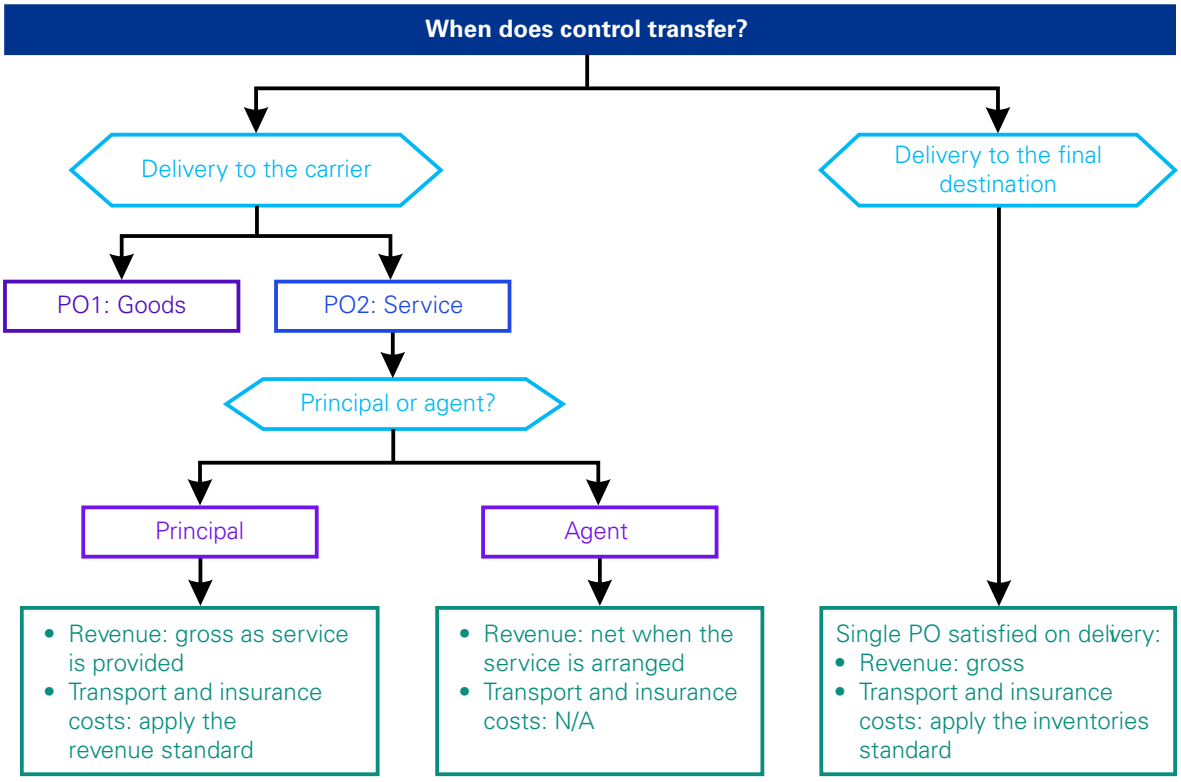
In some arrangements, an entity delivers goods to a location specified by its customer and incurs transport and insurance costs. To determine how to account for these costs, an entity needs to consider whether the transportation and/or insurance service is a distinct performance obligation (see Chapter 2) and when control of the goods transfers to the customer.

If control of the goods transfers to the customer on delivery to the final destination – i.e. transport and distribution costs form part of a single performance obligation for the sale of goods – then the entity recognises revenue when the goods are delivered and applies the guidance on inventory in the inventories standard on accounting for transport costs.

If control of the goods transfers to the customer before the goods are transported, then this may indicate that the transportation service is a separate performance obligation and the entity needs to determine whether it is a principal or an agent in relation to it (see 10.3.1).

- If the entity acts as a principal for the transportation service, then it recognises the gross revenue as the service is provided and applies the guidance in the revenue standard on fulfilment costs.
- If the entity acts as an agent for the transportation service, then it recognises the net revenue when the service is arranged.

An analysis similar to that discussed above applies to insurance costs. In our experience, the entity often acts as an agent for insurance services. The following flowchart summarises how an entity may analyse transport and insurance costs.



Example 16A – Accounting for transportation costs: Entity is a principal

Retailer B enters into a contract with Customer C that involves the following two performance obligations:

- transfer of Product P; and
- a delivery service.

Based on its evaluation of whether it controls the goods and services before transfer to C, B concludes that it is a principal for both performance obligations. B allocates the total transaction price between the two performance obligations and recognises revenue and costs for each performance obligation as follows.

- *Product P:* Revenue is recognised when control transfers to C when P leaves B's premises. The cost of the inventory as determined under the inventories standard is derecognised at the same point in time.
- *Delivery service:* Revenue is recognised over time as the shipping service is performed. B considers that the shipping costs are not in the scope of another standard and that they do not generate or enhance a resource controlled by B that will be used to satisfy a performance obligation in the future. Therefore, B expenses the shipping costs as they are incurred.

Example 16B – Accounting for transportation costs: Entity is an agent

Modifying Example 16A, Retailer B instead determines that it acts as an agent for the shipping service, which is provided by a third party shipping company (see Section 10.3).

The accounting for Product P is the same as above.

However, when B is an agent for the delivery service, revenue for arranging the delivery service is recognised on a net basis – i.e. net of the amount payable to the third party shipping company – when B satisfies its obligation of arranging for the delivery service.

10.4 Customer options for additional goods or services

Overview

An entity accounts for a customer option to acquire additional goods or services as a performance obligation if the option provides the customer with a material right. The standard provides guidance on calculating the stand-alone selling price of a customer option when it is a material right.

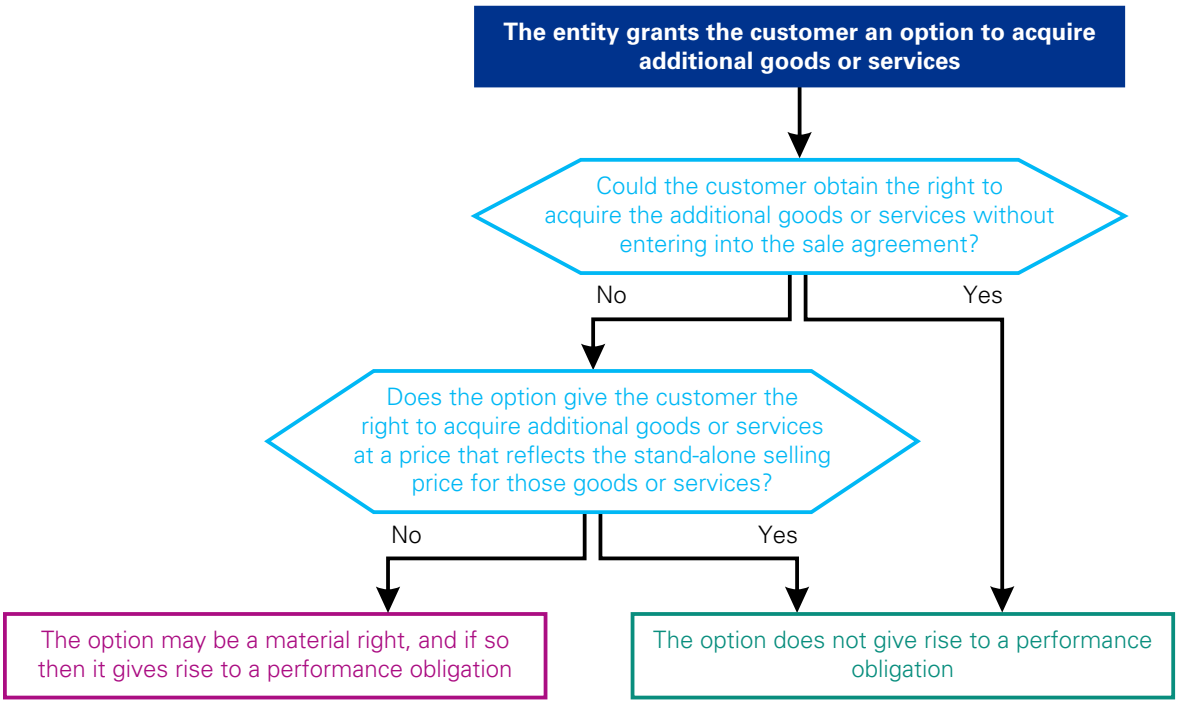
10.4.1 General requirements

IFRS 15.B40

When an entity grants the customer an option to acquire additional goods or services, that option is a performance obligation under the contract if it provides a material right that the customer would not receive without entering into that contract.

IFRS 15.B40–B41

The following flowchart helps analyse whether a customer option is a performance obligation.



IFRS 15.B42

If the stand-alone selling price for a customer's option to acquire additional goods or services that is a material right is not directly observable, then an entity will need to estimate it. This estimate reflects the discount that the customer would obtain when exercising the option, adjusted for:

- any discount that the customer would receive without exercising the option; and
- the likelihood that the option will be exercised.

IFRS 15.B40, B46

Revenue for material rights is recognised when the future goods or services are transferred or when the option expires. If the option is a single right with a binary outcome – i.e. it will either be exercised in full or expire unexercised – then there is nothing to recognise before the option is exercised or expires. Conversely, if the option represents multiple rights or does not expire, then in our view an entity may apply the guidance on unexercised rights – i.e. breakage (see Section 10.5).

Example 1 – Cable television service and additional premium channels

Cable Company B contracts with Customer D to provide television services for a fixed monthly fee for 24 months. The base television services package gives D the right to purchase additional premium channels. In Month 3, D adds a premium sports channel for an additional 5 per month, which is the price that all customers pay for the premium sports channel (i.e. it is priced at its stand-alone selling price).

The premium channel can be added or dropped by D without affecting the base cable television service. Therefore, the ability to add the premium channel to the package represents an option to purchase additional goods or services.

At contract inception, B concludes that because the option to purchase the premium channel is priced at its stand-alone selling price, the option is not a material right. Therefore, the option is not identified as a performance obligation at contract inception. B recognises revenue for the premium channel in Month 3 when it provides the services.

Example 2 – Product sold with a discount voucher

IFRS 15.IE250–IE253

Retailer R sells a computer to Customer C for 2,000. As part of this arrangement, R gives C a voucher. The voucher entitles C to a 25% discount on any purchases up to 1,000 in R's store during the next 60 days. R intends to offer a 10% discount on all sales to other customers during the next 60 days as its seasonal promotion. R regularly sells this model of computer for 2,000 without the voucher.

R notes that the discount voucher provides a material right that C would not receive without entering into the original sales transaction. This is because C receives a 15% incremental discount compared with the discount expected to be offered to other customers (25% discount voucher – 10% discount for all customers). Therefore, the discount voucher is a separate performance obligation.

R estimates that there is an 80% likelihood that C will redeem the voucher and will purchase additional products with an undiscounted price of 500.

R allocates the transaction price between the computer and the voucher on a relative selling price basis as follows.

Performance obligation	Stand-alone selling prices	Selling price ratio	Price allocation	Calculation
Computer	2,000	97.1%	1,942	(2,000 × 97.1%)
Voucher	60[1]	2.9%	58	(2,000 × 2.9%)
Total	**2,060**	**100.0%**	**2,000**	

Note

1. Stand-alone selling price for the voucher calculated as 500 estimated purchase of products × 15% incremental discount × 80% likelihood of exercise.

C purchases 200 of additional products (pre-discount) within 30 days of the original purchase for 150 cash payment.

C makes no additional purchases before the voucher expires. Therefore, at the expiry date R recognises the remaining amount allocated to the voucher as revenue.

R records the following journal entries.

	Debit	*Credit*
Cash	2,000	
Revenue		1,942
Contract liability		58
To recognise initial sale of computer and voucher		
Cash	150[1]	
Contract liability	23[2]	
Revenue		173
To recognise subsequent purchase		
Contract liability	35[3]	
Revenue		35
To recognise expiry of voucher		

Notes

1. Discounted sale price of additional products purchased: 200 - (200 × 25%).
2. Partial satisfaction of performance obligation 58 × (200 purchases / 500 total expected purchases).
3. Settlement of performance obligation on expiry (58 - 23).

Determining whether a material right exists requires an evaluation of both quantitative and qualitative factors

An entity considers whether a customer option for additional goods or services is a material right at contract inception based on both quantitative and qualitative factors. Although the evaluation is judgemental, an entity considers whether the option would be likely to impact the customer's decision to buy the entity's product or service in the future. This is consistent with the notion that an entity considers valid expectations of the customer when identifying promised goods or services (see Chapter 2).

Customers' options that provide accumulating rights are assessed in aggregate

In many cases, the rights that an entity grants to its customers accumulate as the customer makes additional purchases. For example, in a customer loyalty programme the points granted in an initial transaction are typically used in conjunction with points granted in subsequent transactions. Further, the value of the points granted in a single transaction may be low, but the combined value of points granted over an accumulation of transactions may be much higher. In these cases, the accumulating nature of the right is an essential part of the arrangement.

When assessing whether these customer options represent a material right, an entity considers the cumulative value of the rights received in the transaction, the rights that have accumulated from past transactions and additional rights expected from future transactions.

An entity considers all relevant quantitative and qualitative factors.

Exercise of a material right

When a customer exercises a material right for additional goods or services, an entity may account for it using one of the following approaches.

- *Continuation of the original contract:* Under this approach, an entity treats the consideration allocated to the material right as an addition to the consideration for the goods or services under the contract option – i.e. as a change in the transaction price.

  For example, Service Provider S enters into a contract with Customer M to provide Service D for two years for 100 and an option to purchase Service E for two years for 300, which is typically priced at 400. S determines that the option is a material right and therefore a separate performance obligation. Assume that S initially allocates the transaction price of 100 as follows: 75 to D and 25 to the option to purchase E. Six months into the contract, M exercises the option to purchase E.

On exercise of the option, S recognises revenue of 325 (25 + 300) for E over two years. There are no changes to the amount or timing of revenue recognition for D – i.e. 75 continues to be recognised over two years from contract inception.

- *Contract modification:* Under this approach, an entity applies the contract modification guidance to evaluate whether the goods or services transferred on exercise of the option are distinct from the other goods or services in the contract. The outcome of this evaluation will determine whether the modification is accounted for prospectively or with a cumulative catch-up adjustment. See Chapter 8 for further guidance on contract modifications.

Estimate of the likelihood of exercise of an option is not revised

IFRS 15.88

When determining the stand-alone selling price of a customer option for additional goods or services, an entity estimates the likelihood that the customer will exercise the option. This initial estimate is not subsequently revised because it is an input into the estimate of the stand-alone selling price of the option. Under the standard, an entity does not reallocate the transaction price to reflect changes in stand-alone selling prices after contract inception.

The customer's decision to exercise the option or allow the option to expire affects the timing of recognition of the amount allocated to the option, but it does not result in reallocation of the transaction price.

Estimating the stand-alone selling price of 'free' gift cards and coupons

IFRS 15.42

In some cases, an entity may sell gift cards or coupons in stand-alone transactions with customers. In addition, the entity may grant gift cards or coupons in the same denomination in transactions in which customers purchase other goods and services. In the latter case, the gift cards or coupons may be identified as conveying a material right to the customer – e.g. an entity offers a free gift card or coupon with a value of 15 with every 100 of goods purchased.

In these cases, the stand-alone selling price of the gift card or coupon identified as a material right may differ from the stand-alone selling price of a separately sold gift card or coupon. This is because customers who receive the gift card or coupon as a material right may be significantly less likely to redeem them than customers who purchase a gift card or coupon in a separate transaction.

Therefore, an entity may conclude that there is no directly observable stand-alone selling price for a free gift card or coupon provided to a customer in connection with the purchase of another good or service. In this case, the entity estimates the stand-alone selling price using the guidance in Step 4 of the model (see Chapter 4).

Coupons issued at the point of sale

Retail stores often print coupons at the register after a purchase is completed (sometimes referred to as 'Catalina coupons' or 'bounce-back coupons' that can be redeemed for a short period of time). The coupons are handed to customers at the point of sale or packaged with the goods that customers have contracted to purchase. Often, customers are not aware that they will receive these coupons.

Customers can often access similar discounts without making a purchase – e.g. if coupons are printed in a newspaper or freely available in-store or online. This type of general marketing offer may indicate that the coupon does not provide a material right because the discount is available to the customer independently of a prior purchase. As a result, the coupons are often recognised as a reduction in revenue on redemption.

Conversely, if there is no general marketing offer then the entity assesses whether the coupon conveys a material right. This assessment includes consideration of the likelihood of redemption, which will often be low and therefore reduces the likelihood that the coupon will be identified as a material right.

Volume discounts and rebates

Prospective volume discounts (or rebates) that are earned once a customer has completed a specified volume of optional purchases are evaluated for the presence of a material right and do not give rise to variable consideration.

To evaluate whether an option represents a material right, an entity evaluates whether a similar class of customer could receive the discount independently of a contract with the entity. This analysis involves comparing the discount in the current transaction with discounts provided to similar customers in transactions that were not dependent on prior purchases – i.e. discounts not offered through options embedded in similar contracts with other customers. The fact that discounts given to similar customers in stand-alone transactions are similar to the discount offered in the current contract indicates that the customer could obtain the discount without entering into the current contract.

For example, a prospective rebate arrangement would not give rise to a material right if the discounted price after the threshold is consistent with the unit price offered to other customers that are expected to make purchases at or above the volume target. However, if other customers can receive the discounted price only through a prospective rebate arrangement then this suggests that all customers receive future discounts as a result of prior purchases. In these cases, a prospective rebate arrangement may give rise to a material right.

Evaluating optional purchases at a discount compared with the original contract

In many cases, an option to purchase additional goods or services at a discount from the price in the original contract will give rise to a material right. However, in some scenarios it may be challenging to determine whether the discounted price gives rise to a material right – e.g. when an entity uses the cost plus a margin pricing model and the decrease in price relates to a decrease in costs passed to the customer. In our view, in these cases an entity should consider the following indicators to determine whether the discounted price for the optional purchases reflects the stand-alone selling price for those goods or services – i.e. whether there is a material right.

Indicators – No material right	Indicators – Material right
Decrease in price reflects the expected decrease in costs	Decrease in price is incremental to the expected decrease in costs
Decrease in price is consistent with price decreases for other similar mature goods or services	Decrease in price is incremental to price decreases for other similar mature goods or services

Indicators – No material right	Indicators – Material right
Discounted price is consistent with reduced price offered to other customers, including new customers – i.e. all current and potential customers benefit from the decrease in costs	Discounted price is lower than the price offered to other customers – i.e. not all customers benefit from the decrease in costs
The right to the discounted price does not accumulate in a manner that incentivises the customer to make future purchases	The right to the discounted price accumulates in a manner that incentivises the customer to make future purchases

Renewal options consistent with the initial fee may give rise to a material right

In some cases, an entity grants an option to purchase additional goods or services in the future at the same price at which it sells those goods and services at contract inception. For example, in a service contract the customer may have an option to renew the service for an additional period at the same price as the customer pays in the initial period. In our view, an option to purchase additional goods or services at the same price as at contract inception may give rise to a material right. We believe that to determine whether such an option gives rise to a material right, an entity should make an assessment based on its specific facts and circumstances, including whether:

- it expects the stand-alone selling price to increase in the future; and
- the expected discount is likely to impact the customer's behaviour.

A cancellable contract may contain a material right

When a contract is cancellable without significant penalty, a material right may exist for the cancellable period of the contract. This is because a contract that can be cancelled without a substantive termination penalty is economically similar to a contract with a renewal right. For example, a three-year contract that allows the customer to cancel at the end of each year without a substantive termination penalty is no different from a one-year contract with two one-year renewal options. Therefore, an entity considers whether the optional renewal periods give rise to a material right.

Additional application examples

Example 3A – Custom product with learning curve effect: No material right

Automotive Supplier S enters into a two-year framework agreement with Carmaker M to manufacture a custom part. M is committed to purchasing a minimum of 500 parts for 200 per part. Each part is a distinct good that is transferred at a point in time. If M purchases between 500 and 700 parts, then the price per part for those parts decreases to 180. For purchases above 700 parts, the price per part decreases to 150.

The decreases in the price per part are consistent with the expected reduction in S's costs along its learning curve. The price reductions are also consistent with S's typical decrease in price for other mature parts of a similar size and complexity.

S considers that there is some level of accumulation because M achieves the discounted price of 150 only if it purchases more than 700 parts. However, because M is committed to purchasing 500 parts under the contract, S determines that this indicator is not significant to its analysis.

In the absence of any other quantitative or qualitative factors, S concludes that the discounted prices on the optional purchases reflect the stand-alone selling price for those parts and the contract does not include a material right.

Example 3B – Custom product with learning curve effect: Material right

Modifying Example 3A, the decreases in the price per part are incremental to the expected reduction in Automotive Supplier S's costs along its learning curve. The price reductions are also incremental to S's typical decrease in price for other mature parts of a similar size and complexity.

Considering these quantitative and qualitative factors, S concludes that the discounted prices on the optional purchases do not reflect the stand-alone selling price for those parts and the contract includes a material right.

Example 4 – Custom production line: No material right

Shipbuilder B enters into a contract with Customer C to manufacture a highly customised ship. To manufacture this custom ship, B needs to set up a unique production line, which it plans to run for one year. C commits to purchasing five ships at a price of 1,000 per ship. C has the option to purchase additional ships at a price of 500 per ship as long as the order is placed three months before the end of the one-year period during which the production line will be in place.

B estimates the stand-alone selling price of the ship using an expected cost plus a margin approach. The decrease in the price per ship after the first five ships reflects the expected reduction in B's costs once the production line is configured.

The pricing of the committed volume of ships reflects B's expected margin, including the costs to set up the custom production line. Once the production line is set up, B's costs are limited to the incremental costs for that specific ship. Therefore, the stand-alone selling price estimated using the expected cost plus a margin approach is lower. Additionally, B considers that the right does not accumulate because there is a committed volume of ships and any optional orders have the same discounted price. Therefore, in the absence of any other quantitative or qualitative factors B concludes that the reduced price for the optional ship orders represents their stand-alone selling price and there is no material right.

Example 5 – Prospective volume rebate: Material right

Food Company F enters into an arrangement with Customer C to supply Product A. The arrangement includes a fixed price of 1 per unit and an annual rebate. The rebate is paid only for purchases in excess of 501 units. The arrangement includes no minimum purchase quantities but F expects that C will purchase approximately 1,000 units annually.

Purchases	Rebate
0–500	-
501+	0.10

C makes an initial purchase of 100 units. Because the rebate arrangement is prospective, F evaluates whether the sale gives rise to a material right that needs to be accounted for as a separate performance obligation.

F determines that the arrangement contains a material right. Therefore, F recognises revenue for the initial purchase net of the amount of consideration allocated to the material right liability. F recognises revenue allocated to the material right when the right is exercised in the future – i.e. C purchases in excess of 501 units.

Alternatively, if it is considered that all of the goods to be delivered are substantially the same, then under the alternative approach F may elect to recognise revenue at the average price per unit based on total expected purchases, rather than calculating the value of the material right – i.e. at 0.95 per unit (500 × 1 + 500 × (1 - 0.10)) / 1,000.

Example 6 – Prospective discounts: No material right vs material right

Scenario 1 – Prospective discounts do not provide a material right

Automotive Supplier X produces standard, non-customised parts that are used by various carmakers. X enters into a two-year framework agreement with Carmaker M, a new customer, to manufacture parts for 200 per part. Each part is a distinct good that is transferred at a point in time.

M is committed to purchasing a minimum quantity of 500 parts per year. If M purchases more than 1,000 parts, then the price of future purchase orders is decreased prospectively to 150 per part.

X prices parts of a similar size and complexity consistently, based on expected annual sales volumes to a specific carmaker:

- carmakers expected to order fewer than 1,000 parts usually pay 200 per part; and
- carmakers expected to order more than 1,000 parts in total usually pay 150 per part for *all* purchases. That is, prices usually do not decrease prospectively as those carmakers purchase additional volumes.

X notes that other carmakers could order similar volumes of parts of similar size and complexity for a price of 150 without a similar prospective price reduction. Therefore, in the absence of any other quantitative or qualitative factors indicating otherwise, X concludes that the pricing on future purchases does not provide M with a material right.

Scenario 2 – Prospective discounts provide a material right

Modifying Scenario 1, X provides the same prospective price reductions to *all* carmakers similar to M – i.e. no carmaker can buy parts for 150 per part before buying more than 1,000 parts.

In evaluating whether the price reduction provides M with a material right, X notes that:

- it is not appropriate to compare the pricing with price reductions provided to other carmakers because they all receive future discounts as a result of prior purchases; and
- the right for reduced prices accumulates and incentivises M to make future purchases. This is a qualitative indicator that M pays for the option to purchase future parts at a discount on its previous purchases.

Therefore, in the absence of any other quantitative or qualitative factors indicating otherwise, X concludes that the prospective price reduction conveys a material right to M.

M places an order for 500 parts in the first year. X expects that M will purchase 1,200 parts in total – i.e. it will receive a discount on 200 parts. This is based on X's historical experience with framework agreements with similar payment mechanisms.

X concludes that M has, in substance, paid for 50% of the right for future discounted parts because M purchased 500 of the 1,000 parts required for it to be entitled to a price reduction.

X allocates the transaction price between the parts ordered and the material right for a future discount on a relative selling price basis as follows.

Performance obligation	Stand-alone selling prices	Selling price ratio	Price allocation	Calculation
Parts[1]	100,000[2]	95.2%	95,238	(100,000 × 95.2%)
Material right	5,000[3]	4.8%	4,762	(100,000 × 4.8%)
Total	**105,000**	**100.0%**	**100,000**	

Notes

1. Each part is a separate performance obligation but for simplicity they are presented as a single item in this table.
2. 500 parts × 200.
3. The stand-alone selling price for the material right is calculated as the expected volume of parts to be sold at a discount (200) × the discount of 50 (200 - 150) × 50% of the quantity required to receive future discounts (500 / 1,000).

Example 7 – Periodic price decreases in a framework agreement: No material right

Automotive Supplier Y enters into a three-year framework agreement with Carmaker T to supply highly complex parts. Each part is a distinct good that is transferred at a point in time.

Under the framework agreement, T is not obliged to purchase a minimum quantity of parts. The price per part set out in the framework agreement declines each year as follows, independently of the quantity of parts purchased.

- Year 1: 700 per part.
- Year 2: 660 per part.
- Year 3: 600 per part.

This declining unit price reflects the expected reduction in Y's learning curve costs.

Shortly after the framework agreement is signed, T orders 50 parts. Y notes that:

- price reductions are dependent only on the passage of time and not on previous purchase orders. Therefore, the purchase order does not provide T with a material right; and
- the purchase order fixes the price for the parts to be delivered. Therefore, the consideration in the contract is not variable.

When T submits subsequent purchase orders, Y assess whether they should be combined with the first one (see Section 1.4) and whether the contract modification guidance should be applied (see Section 8.1).

Example 8 – Fixed-price renewal: Material right

Company L enters into a one-year service contract with Customer M for 100 per month, which is the stand-alone selling price of one year of service at contract inception. The contract gives M the option to renew the service for an additional year for 100 per month.

L expects that the stand-alone selling price charged to customers in the same class will increase to 115 in the next year. This increase reflects L's expectation about the market prices for similar services. Based on its assessment of data related to customers' behaviour, L estimates that 75% of its customers will renew their contracts to benefit from the discount.

In these specific circumstances, based on quantitative and qualitative factors, L concludes that the renewal option gives rise to a material right because the expected discount on renewal is sufficient to influence M's behaviour and M is likely to renew. L considers whether to apply the alternative approach in 10.4.2 to allocate the transaction price to the optional renewal periods.

10.4.2 Practical alternative for similar goods or services

IFRS 15.B43

If the goods or services that the customer has a material right to acquire are similar to the original goods or services in the contract – e.g. when the customer has an option to renew the contract – then an entity may allocate the transaction price to the optional goods or services with reference to the goods or services expected to be provided and the corresponding consideration expected to be received.

Example 9 – Applying the practical alternative

Company B enters into a contract with Customer C to transfer two units of Product P for 2,000 (1,000 per unit, which is the stand-alone selling price) with an option to purchase up to two more units of P at 500 per unit (i.e. 50% discount). B concludes that each unit of P is distinct and satisfied at a point in time.

B concludes that the option for up to two additional units of P is a material right because the discount is incremental to discounts provided to other customers in this class of customers and does not exist independently from the current contract. B also concludes that the stand-alone selling price for the two additional units of P is 1,000.

The options allow C to acquire additional units of P, which are the same as the goods purchased in the original contract, and the purchases would be made in accordance with the original terms of the contract; therefore, B uses the alternative approach to allocate the transaction price to the options.

B expects that there is a high likelihood of the customer exercising each option because of the significant discount provided. As such, B does not expect breakage and includes all of the options in the expected number of goods that it expects to provide. Therefore, B allocates the expected transaction price to the units expected to be transferred.

Expected transaction price	3,000	2,000 (price of original 2 units purchased) + 500 (price of third unit) + 500 (price of fourth unit)
Number of units expected to be transferred	4	2 original units purchased + option for 1 unit + option for 1 unit
Price allocated to each unit	750	3,000 / 4 units

Therefore, in effect 1,500 of the total consideration in the original contract of 2,000 is allocated to the purchase of the original two units and the remaining 500 is allocated to the two options.

Alternative approach not limited to renewal options

IFRS 15.B43

We believe that the alternative approach is not limited to contract renewals (e.g. a right to renew a service contract on the same terms for an additional period). It may also be applied to other types of material rights – e.g. options to purchase additional goods or services at a discounted price when the optional goods or services are similar to those offered in the contract.

For example, we believe that an entity could apply the alternative approach to a prospective volume rebate arrangement. Under the alternative approach, the entity would allocate the transaction price with reference to the total number of goods that it expects the customer to purchase under the agreement and the corresponding expected total consideration from those purchases – i.e. revenue would be recognised at the average price per unit based on total expected purchases.

More than one acceptable approach to determine the expected goods or services to be provided

The standard does not provide detailed guidance on how to determine the amount of expected goods or services to be provided. The following are acceptable approaches to determining this amount.

- *Contract-by-contract basis:* Under this approach, an entity considers each option that provides the customer with a material right to be a 'good or service that is expected to be provided' unless it expects the customer's right to expire unexercised. For example, if an entity includes a renewal option with a contract price of 100 and a 60 percent probability of being exercised, then the entity includes 100 in the hypothetical transaction price rather than 60. This is because 100 is the 'corresponding expected consideration' for the additional good or service. The entity would then allocate the hypothetical transaction price (which includes 100) to all of the expected goods or services, including the renewal option on a relative stand-alone selling price basis.
- *Portfolio approach:* Under this approach, an entity estimates the number of goods or services expected to be provided based on historical data for a portfolio of similar transactions. For example, an entity enters into 100 similar annual contracts with two optional renewal periods around the same time. The entity estimates the number of expected renewals for the portfolio to estimate the transaction price and allocate consideration to the initial and renewal contracts.

Under both approaches, if the actual number of options exercised is different from what the entity expected, then the entity updates the transaction price and revenue recognised accordingly. We believe that it is acceptable to adjust the number of expected goods or services during the period(s) for which a material right exists, on either a cumulative catch-up or prospective basis, as long as the entity establishes a policy for the approach that it uses and applies it consistently.

Additional application examples

Example 10A – Applying the practical alternative: Contract-by-contract basis

ABC Corp enters into 100 contracts to provide equipment for 10,000 and one year of maintenance for 2,000 – both prices are equal to their stand-alone selling price. Each contract provides the customer with the option to renew the maintenance for two additional years for 1,000 per year.

ABC concludes that:

- the equipment and maintenance are separate performance obligations; and
- each renewal option provides a material right that the customer would not receive without entering into the contract because the discount is significant compared with what ABC charges other similar customers.

ABC does not expect the rights to go unexercised. Although it has experience with similar customers and has data that suggests there will be some breakage, historical evidence suggests that on a customer-by-customer basis neither of the options will expire unexercised. ABC therefore allocates the expected transaction price to the renewal options expected to be exercised.

Performance obligation	Contract price	Expected consideration	Stand-alone selling price	Selling price ratio	Price allocation
Equipment	10,000	10,000	10,000	62.5%	8,750
Maintenance Year 1	2,000	2,000	2,000	12.5%	1,750
Renewal option 1	1,000	1,000	2,000	12.5%	1,750
Renewal option 2	1,000	1,000	2,000	12.5%	1,750
Total	**14,000**	**14,000**	**16,000**	**100.0%**	**14,000**

In Year 1, ABC recognises 8,750 when it transfers control of the equipment to the customer and 1,750 as it satisfies the related maintenance performance obligation. The difference between the amount recognised as revenue and consideration received of 1,500 (12,000 - 8,750 - 1,750) is recognised as a contract liability. The amounts allocated to the renewal options will be recognised as the performance obligations are satisfied.

If the customer does not exercise its options, then ABC recognises as revenue the amounts allocated to all remaining options.

Example 10B – Applying the practical alternative: Portfolio approach

Modifying Example 10A, ABC Corp estimates the total number of expected goods or services for the 100 contracts based on expectations for similar customers. It estimates the number of renewals and corresponding expected transaction price. It also concludes that the stand-alone selling price for each maintenance period is the same.

Based on its expectations, it allocates the transaction price to each performance obligation as follows.

Performance obligation	Contract price	Expected renewals	Expected consideration	Stand-alone selling price	Selling price ratio	Price allocation
Equipment	10,000	N/A	10,000	10,000	65.0%	8,911
Maintenance Year 1	2,000	N/A	2,000	2,000	13.0%	1,782
Renewal option 1	1,000	90%	900	1,800[1]	11.5%	1,577
Renewal option 2	1,000	81%	810	1,620[2]	10.5%	1,440
Total	**14,000**		**13,710**	**15,420**	**100.0%**	**13,710**

Notes

1. 2,000 × 90%.
2. 2,000 × 81%.

In Year 1, ABC recognises 891,100 (8,911 × 100) when it transfers control of the equipment to the customer and 178,200 (1,782 × 100) as it satisfies the related maintenance performance obligation. The difference between the amount recognised as revenue and consideration received of 130,700 (1,200,000 - 891,100 - 178,200) is recognised as a contract liability. The amounts allocated to the renewal options will be recognised as the performance obligations are satisfied.

If the actual number of renewals is different from what was expected, then ABC's policy is to update the transaction price and recognise revenue with a cumulative catch-up adjustment.

10.4.3 Customer loyalty programmes

Applying the option guidance to customer loyalty programmes

IFRS 15.B40

Customer loyalty programmes are often in the scope of the customer option guidance and the requirements discussed in 10.4.1 apply. A customer loyalty programme that provides a customer with a material right is accounted for as a separate performance obligation.

Under some loyalty programmes, points expire, whereas under others they do not. In our view, an entity may apply the breakage guidance (see Section 10.5) to both types of programme to determine when to recognise revenue for points that are not expected to be exercised. This is because the points represent multiple material rights rather than a single right with a binary outcome.

Example 11A – Customer loyalty points programme: Increase in estimated redemptions

IFRS 15.IE267–IE270

Retailer C offers a customer loyalty programme at its store. Under the programme, for every 10 that customers spend on goods they are rewarded with one point. Each point is redeemable for a cash discount of 1 on future purchases. C expects 97% of customers' points to be redeemed. This estimate is based on C's historical experience, which is assessed as being predictive of the amount of consideration to which it will be entitled. During Year 1, customers purchase products for 100,000 and earn 10,000 points. The stand-alone selling price of the products to customers without points is 100,000.

The customer loyalty programme provides the customers with a material right, because the customers would not receive the discount on future purchases without making the original purchase. Additionally, the price that they will pay on exercise of the points on future purchases is not the stand-alone selling price of those items.

Because the points provide a material right to the customers, C concludes that the points are a performance obligation in each sales contract – i.e. the customers paid for the points when purchasing products. C determines the stand-alone selling price of the loyalty points based on the likelihood of redemption.

C allocates the transaction price between the products and the points on a relative selling price basis as follows.

Performance obligation	Stand-alone selling prices	Selling price ratio	Price allocation	Calculation
Products	100,000[1]	91%	91,000	(100,000 × 91%)
Points	9,700[2]	9%	9,000	(100,000 × 9%)
Total	**109,700**	**100%**	**100,000**	

Notes

1. Stand-alone selling price for the products.
2. Stand-alone selling price for the points (10,000 × 1 × 97%).

During Year 2, 4,500 of the points are redeemed and C continues to expect that 9,700 points will be redeemed in total. C calculates the revenue to be recognised and the corresponding reduction in the contract liability as follows.

4,175 = 9,000 × 4,500 / 9,700 – i.e. price allocated to points multiplied by points redeemed in Year 2 divided by total points expected to be redeemed.

During Year 3, a further 4,000 points are redeemed. C updates its estimate, because it now expects 9,900 rather than 9,700 points to be redeemed. C calculates the revenue to be recognised and the corresponding reduction in the contract liability as follows.

3,552 = (9,000 × (4,500 + 4,000) / 9,900) - 4,175 – i.e. price allocated to points multiplied by points redeemed in Year 2 and Year 3 divided by total points expected to be redeemed minus revenue recognised in Year 2.

Example 11B – Customer loyalty points programme: Decrease in estimated redemptions

Modifying Example 11A, assume that during Year 3 Retailer C updates its estimate and now expects 9,200 rather than 9,700 points to be redeemed. C calculates revenue to be recognised and the corresponding reduction in the contract liability as follows.

4,140 = (9,000 × (4,500 + 4,000) / 9,200) - 4,175 – i.e. price allocated to points multiplied by points redeemed in Year 2 and Year 3 divided by total points expected to be redeemed minus revenue recognised in Year 2.

Example 12 – Airline customer loyalty points programme

Airline B offers the following customer loyalty programme.

- Programme members earn one point for every 10 that they spend with B.
- Each point is redeemable for future goods and services with a value of 1: e.g. flights or consumer goods.
- Loyalty points expire after 24 months if a programme member is inactive: i.e. if there is no increase or decrease in the member's loyalty point balance.
- B estimates the redemption rate of loyalty points at each reporting date based on its historical experience, which is assessed as being predictive of the amount of consideration to which B will be entitled. B's current estimate is that 90% of loyalty points will be redeemed.

B sells Customer C a ticket to fly from Singapore to Hong Kong for 1,000. C is a member of B's customer loyalty programme.

The customer loyalty programme provides C with a material right because C would not receive the discount on future purchases by redeeming the points without buying the original air travel. Additionally, the price that C will pay on exercise of the points on its future purchases is not the stand-alone selling price of those items.

Because the points provide a material right to C, B concludes that the points are a performance obligation – i.e. C paid for the points when purchasing the air ticket. In determining the stand-alone selling price of the loyalty points, B considers the likelihood of redemption.

B allocates the transaction price between the air ticket and the points on a relative stand-alone selling price basis as follows.

Performance obligation	Stand-alone selling prices	Selling price ratio	Price allocation	Calculation
Air ticket	1,000[1]	91.7%	917	(1,000 × 91.7%)
Points	90[2]	8.3%	83	(1,000 × 8.3%)
Total	**1,090**	**100.0%**	**1,000**	

Notes

1. Stand-alone selling price for the air ticket.
2. Stand-alone selling price for the points (1,000 / 10 × 90%).

B recognises revenue for the air ticket of 917 on the flight date and revenue of 83 for the points in proportion to the pattern of rights exercised by C.

B expects 90 points to be redeemed and recognises 0.92 (83 / 90 points) on each point when it is redeemed.

No significant financing component in most customer loyalty programmes

IFRS 15.62, BC233

Customer loyalty programmes generally do not include a significant financing component even though the time period between when the customer loyalty points are earned and redeemed may be greater than one year. This is because the transfer of the related goods or services to the customer – i.e. use of the loyalty points – occurs at the discretion of the customer.

Cancellable customer loyalty programmes may be implicit performance obligations

Many customer loyalty programmes can be cancelled or changed by the issuer at any time. However, if the entity has a past practice that creates a valid expectation for its customers that it will fulfil its promises under the loyalty programme, then it accounts for the customer loyalty programme as a separate performance obligation. That is, the entity has made an implicit promise to operate the customer loyalty programme.

Treatment of customer credit card arrangements

Credit card arrangements often include loyalty programmes that earn card holders certain benefits based on the use of their credit card.

These arrangements require careful analysis to determine the appropriate accounting.

When all or part of a credit card arrangement is in the scope of the standard, the bank determines whether the loyalty programme gives rise to a separate performance obligation and what the nature of that performance obligation is. Customer loyalty programmes that give the customer accumulated rights, which can be used to purchase goods or services in the future at discounted prices, are generally accounted for as material rights under the standard. Under this approach, a portion of the consideration received for a transaction that earns the card holder these rights is deferred and recognised when the rights are exercised.

The challenge when accounting for these arrangements is identifying the revenue transaction that gives rise to the rights and, therefore, the transaction for which the bank defers a portion of the revenue. Entities may need to consider any annual card fees and also any interchange fees received when the customer enters into a transaction with a retailer that earns them their rights. The basis for potentially deferring a portion of interchange fees is that the entity may consider that, in substance, the interchange fee is paid by the customer. The other entities in the transaction remit the interchange fee to the bank and, therefore, are acting only as agents for the bank in the transaction.

When the arrangement is considered outside the scope of the standard, entities treat the costs of operating these programmes as a marketing expense and provide for any liabilities arising from the arrangements in accordance with the provisions standard.

Residual approach generally not appropriate for determining stand-alone selling price of loyalty points

Generally, the residual approach will not be available for determining the stand-alone selling price of loyalty points because this approach is available only in limited circumstances – i.e. when the stand-alone selling price is highly variable and uncertain. See Section 4.1 for further discussion on determining stand-alone selling prices.

Awards supplied by a third party

IFRS 15.BC383–BC385

Some customer loyalty programmes may involve multiple parties. If another party is involved in the customer loyalty programme, then an entity needs to assess whether it acts as an agent or as a principal with respect to the loyalty points and, if relevant, the goods or services to be delivered in exchange for the points (see Section 10.3).

Loyalty programmes may be structured in different ways. Typical arrangements include the following.

- *Points are issued by the entity and can be redeemed only for goods or services provided by the entity:* In these arrangements, the entity is usually a principal with respect to the loyalty points and the goods or services to be delivered in exchange for the points because it does not satisfy its performance obligation until the goods or services are transferred to the customer.
- *Points are issued by the entity and can be redeemed for goods or services provided by the entity or by a third party at the customer's discretion:* In these arrangements, the entity is usually a principal with respect to the loyalty points because it is obliged to 'stand ready' until the customer has made its choice. The entity satisfies its performance obligation and recognises revenue only when the customer redeems the points, either from the entity or from the third party. An entity assesses whether it acts as an agent or as a principal with respect to the goods or services to be delivered in exchange for the points.
- *Points can be redeemed for goods or services provided only by a third party:* In these arrangements, the entity assesses whether it acts as an agent or as a principal with respect to the points (i.e. does it control the points before they are transferred to the customer?). In some cases, this assessment may be challenging. For example, a bank may offer its credit card customers a loyalty programme under which the customers earn points to be redeemed with a specific airline. Judgement is required to determine whether the bank controls the points before they are transferred to customers (see Section 10.3). Under this type of arrangement, the entity typically satisfies its obligation when the points are transferred to the customer.

IFRS 15.B36, BC383–BC385

If the entity acts as an agent, then the net amount retained is recognised as revenue – i.e. the difference between the revenue allocated to the points and the amount that the entity pays to the third party.

Example 13A – Third party customer loyalty programme (1)

Company L participates in a customer loyalty programme operated by a third party. Under the programme, members earn points for purchases made in L's stores. Programme members redeem the accumulated award points for goods supplied by the third party. At the end of 2018, L has granted points with an allocated transaction price of 1,000 and owes the third party 700. The amount of revenue to be recognised depends on whether L acts as an agent or a principal with respect to the points.

L is an agent

If L is acting as an agent with respect to the points, then it recognises revenue of 300 in relation to the award points when its products are sold to customers and L has satisfied its obligation to arrange for the points to be provided to the customer. L records the following entry.

	Debit	*Credit*
Cash	1,000	
Revenue (1,000 - 700)		300
Payable to third party		700
To recognise revenue when acting as agent for issuance of points		

L is a principal

If L is acting as a principal with respect to the points, then it recognises revenue of 1,000 and an expense of 700 when its products are sold to customers and the points are transferred to the customer. L records the following entry.

	Debit	*Credit*
Cash	1,000	
Expense	700	
Revenue		1,000
Payable to third party		700
To recognise revenue when acting as principal for issuance of points		

Example 13B – Third party customer loyalty programme (2)

Company M participates in a customer loyalty programme operated by a third party. Programme members earn points for purchases made in 2018 in M's stores and can redeem the accumulated points for goods supplied by either M or the third party until 31 December 2019.

At the end of 2018, M has recognised contract liabilities of 2,000, representing 1,000 awards expected to be redeemed. In 2019, 500 awards are redeemed with the third party, 400 awards are redeemed directly with M and 100 awards expire without being redeemed. The third party invoices M 1.75 for each award redeemed by members and M determines that it acts as an agent when the third party supplies the awards. The cost of the inventory for the goods supplied for points redeemed directly with M is 600.

In 2019, M recognises a liability of 875 (500 × 1.75), derecognises the contract liabilities of 2,000 and recognises revenue of 1,125, which represents revenue of 800 (400 × 2) for awards redeemed directly, 125 (500 × 0.25) for awards redeemed through the third party and 200 (100 × 2) for lapsed awards.

	Debit	*Credit*
Contract liabilities	2,000	
Cost of goods sold	600	
Revenue		1,125
Payable to third party		875
Inventory		600
To recognise revenue from loyalty programme in 2019		

Amounts payable to third party loyalty programme operators

When an entity participates in a loyalty programme operated by a third party, it may be required to pay the third party for:

- carrying out administrative tasks with respect to the programme; and
- assuming the obligation to supply the awards.

In our view, it is appropriate for the entity to recognise amounts payable to the third party for carrying out administrative tasks in profit or loss as an expense over the period in which the loyalty programme is in effect.

In our view, it is appropriate for the entity to recognise amounts payable to the third party for assuming the obligation to supply the awards when the third party becomes obliged to supply the awards, by analogy to the principle for recognising revenue in the standard. In Example 13B in this chapter, this occurs when a customer chooses to redeem its awards from the third party in 2019.

10.5 Customers' unexercised rights (breakage)

Overview

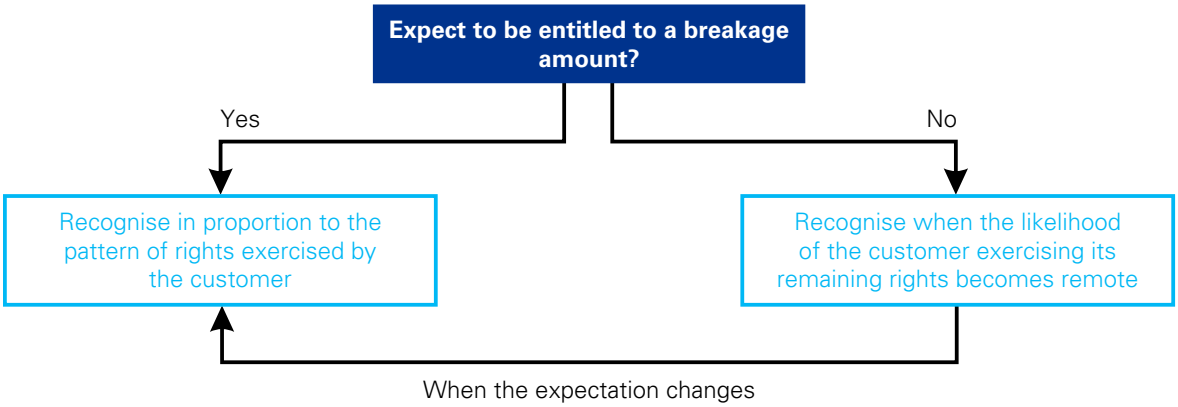
An entity may receive a non-refundable prepayment from a customer that gives the customer the right to receive goods or services in the future. Common examples include gift cards, vouchers and non-refundable tickets. Typically, some customers do not exercise their right – this is referred to as 'breakage'.

IFRS 15.B44–B45

An entity recognises a prepayment received from a customer as a contract liability and recognises revenue when the promised goods or services are transferred in the future. However, a portion of the contract liability recognised may relate to contractual rights that the entity does not expect to be exercised – i.e. a breakage amount.

IFRS 15.B46

The timing of revenue recognition related to breakage depends on whether the entity expects to be entitled to a breakage amount – i.e. if it is highly probable that recognising breakage will not result in a significant reversal of the cumulative revenue recognised.



IFRS 15.B46

An entity considers the variable consideration guidance to determine whether – and to what extent – the constraint applies (see 3.1.2). It determines the amount of breakage to which it is entitled as the amount for which it is considered highly probable that a significant reversal will not occur in the future. This amount is recognised as revenue in proportion to the pattern of rights exercised by the customer (proportional method) when the entity expects to be entitled to breakage. Otherwise, the entity recognises breakage when the likelihood of the customer exercising its remaining rights becomes remote (remote method).

IFRS 15.B47

If an entity is required to remit to a government entity an amount that is attributable to customers' unexercised rights – e.g. under applicable unclaimed property or escheatment laws – then it recognises a financial liability until the rights are extinguished, rather than revenue.

Example 1 – Sale of a prepaid phone card: Entity expects to be entitled to breakage

Retailer R sells a prepaid phone card to Customer C for 100. On the basis of historical experience with similar prepaid phone cards, R estimates that 10% of the prepaid phone card balance will remain unredeemed and that the unredeemed amount will not be subject to escheatment. Because R can reasonably estimate the amount of breakage expected and it is highly probable that including the amount in the transaction price will not result in a significant revenue reversal, R recognises the breakage revenue of 10 in proportion to the pattern of exercise of C's rights.

Specifically, when it sells the prepaid phone card R recognises a contract liability of 100, because C prepaid for a non-refundable card. No breakage revenue is recognised at this time.

If C redeems an amount of 45 in 30 days, then half of the expected redemption has occurred (45 / (100 - 10) = 50%). Therefore, half of the breakage – i.e. (10 × 50% = 5) – is also recognised.

On this initial prepaid phone card redemption, R recognises revenue of 50 – i.e. revenue from transferring goods or services of 45 plus breakage of 5.

Example 2 – Sale of a prepaid phone card: Entity does not expect to be entitled to breakage

Retailer C implements a new prepaid phone card programme. C sells Customer D a prepaid phone card for 50. C does not have an obligation to remit the value of unredeemed cards to any government authority or other entity – i.e. the unredeemed amount will not be subject to escheatment. The prepaid phone card expires two years from the date of issue.

Because this is a new programme, C has very little historical information. Specifically, C does not have sufficient entity-specific information, nor does it have knowledge of the experience of other service providers. Therefore, C concludes that it does not have the ability to estimate the amount of breakage that, if it were included in the transaction price, would be highly probable of not resulting in a significant revenue reversal.

C therefore recognises the breakage when the likelihood of D exercising its remaining rights becomes remote. This may occur at expiry of the prepaid phone card or earlier if there is evidence to indicate that the probability has become remote that D will redeem any remaining amount on the prepaid phone card.

Example 3 – Airline expects ticket breakage and can estimate it reliably

Airline B sells 100 non-refundable, flexible tickets for a flight from London to Melbourne. The price of each ticket is 1,000. If a customer does not fly on the scheduled flight date, then it can reschedule the flight within 12 months at no additional charge. B's historical data indicates that:

- 5% of customers purchasing tickets with similar terms do not fly on the scheduled flight date;
- 20% of these customers (i.e. 1% of total sales) book an alternative flight within the 12-month period; and
- 80% of these customers (i.e. 4% of total sales) never exercise their rights before expiry.

Based on this historical data, B estimates that for these 100 tickets 95 customers will fly on the scheduled date, one will reschedule the flight and four will not take their flight – i.e. the estimated breakage is 4,000 (4% × (100 × 1,000)).

B can reasonably estimate the amount of breakage expected and it is highly probable that including the amount in the transaction price will not result in a significant revenue reversal. Therefore, B recognises the estimated ticket breakage of 4,000 in proportion to the pattern of exercise of the rights by the customers as follows.

- On the date of the flight: 3,958 ((95 × 1,000) / (96 × 1,000) × 4,000).
- When one customer takes the rescheduled flight: 42 (4,000 - 3,958).

Constraint applies even though consideration amount is known

If an entity does not have a basis for estimating breakage – i.e. the estimate is fully constrained – then it recognises the breakage as revenue only when the likelihood becomes remote that the customer will exercise its rights.

When the entity concludes that it is able to determine the amount of breakage to which it expects to be entitled, it estimates the breakage. To determine the breakage amount, the entity assesses whether it is highly probable that including revenue for the unexercised rights in the transaction price will not result in a significant revenue reversal. Applying the guidance on the constraint in this context is unique – the amount of consideration is known and has already been received, but there is uncertainty over whether and when the customer will redeem the amount paid by requiring the entity to transfer goods or services in the future. Conversely, in other situations to which the constraint applies – e.g. variable consideration – the total amount of consideration is unknown.

Breakage does not constitute variable consideration

IFRS 15.B46

Although an entity considers the variable consideration guidance to determine the amount of breakage, breakage itself is not a form of variable consideration because it does not affect the transaction price. It is a recognition rather than a measurement concept in the standard. For example, the transaction price for a sale of a 50 gift card is fixed at 50; the possibility of breakage does not make the transaction price variable. However, the expected breakage affects the timing of revenue recognition.

Prepaid stored-value products may be financial liabilities

IAS 32.11, IFRS 9, IU 03-16

A prepaid stored-value product is a card with a monetary value stored on the card itself – e.g. a gift card. The guidance under the standard on the recognition of breakage excludes prepaid stored-value products that meet the definition of financial liabilities.

These are instead accounted for using the applicable guidance under the financial instruments standard.

Portfolio of data can be used for estimating expected breakage

An entity can use a portfolio of similar transactions as a source of data to estimate expected breakage for an individual contract if the entity has a sufficiently large number of similar transactions or other history. Doing so is not using the portfolio approach (see Section 6.4).

10.6 Non-refundable up-front fees

Overview

Some contracts include non-refundable up-front fees that are paid at or near contract inception – e.g. joining fees for health club membership, activation fees for telecommunication contracts and set-up fees for outsourcing contracts. The standard provides guidance on determining the timing of recognition for these fees.

IFRS 15.B40, B48–B51

An entity assesses whether the non-refundable up-front fee relates to the transfer of a promised good or service to the customer.

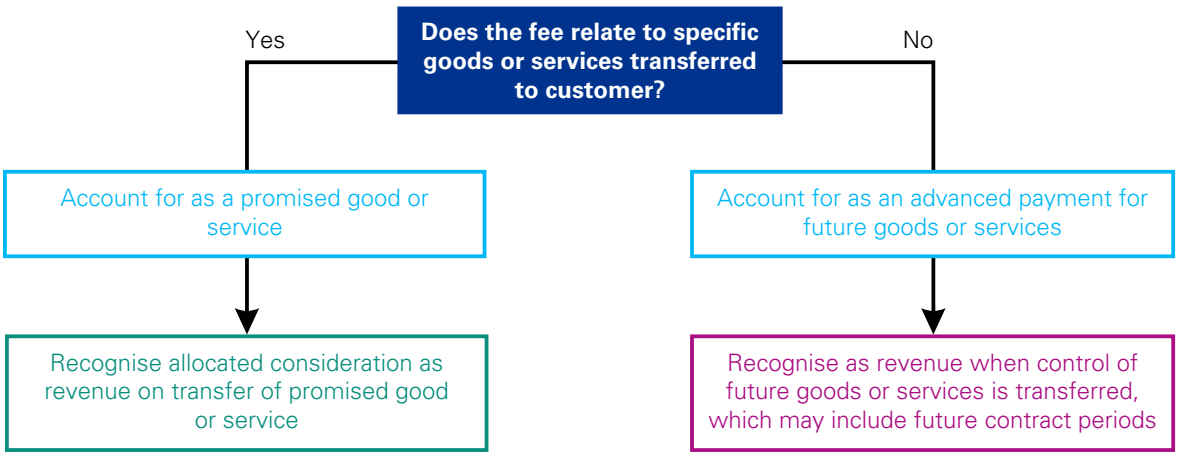
In many cases, even though a non-refundable up-front fee relates to an activity that the entity is required to undertake to fulfil the contract, that activity does not result in the transfer of a promised good or service to the customer. Instead, it is an administrative task. For further discussion on identifying performance obligations, see Chapter 2.

If the activity does not result in the transfer of a promised good or service to the customer, then the up-front fee is an advance payment for performance obligations to be satisfied in the future and is recognised as revenue when those future goods or services are provided.

If the up-front fee gives rise to a material right for future goods or services, then the entity attributes all of it to the goods and services to be transferred, including the material right associated with the up-front payment. For further discussion on allocating the transaction price and customer options, see Sections 4.2 and 10.4, respectively.

IFRS 15.BC387

The non-refundable up-front fee results in a contract that includes a customer option that is a material right if it would probably impact the customer's decision on whether to exercise the option to continue buying the entity's product or service (e.g. to renew a membership or service contract or order an additional product).



Example 1 – Non-refundable up-front fees: Annual contract

Cable Company C enters into a one-year contract to provide cable television to Customer Z. In addition to a monthly service fee of 100, C charges a one-time up-front fee of 50. C has determined that its set-up activity does not transfer a promised good or service to Z, but is instead an administrative task.

At the end of the year, Z can renew the contract on a month-to-month basis at the then-current monthly rate or can commit to another one-year contract at the then-current annual rate. In either case, Z will not be charged another fee on renewal. The average customer life for customers entering into similar contracts is three years.

C considers both quantitative and qualitative factors to determine whether the up-front fee provides an incentive for Z to renew the contract beyond the stated contract term to avoid the up-front fee. If the incentive is important to Z's decision to enter into the contract, then there is a material right.

First, C compares the up-front fee of 50 with the total transaction price of 1,250 (the up-front fee of 50 plus the service fee of 1,200 (12 × 100)). It concludes that the non-refundable up-front fee is not quantitatively material.

Second, C considers the qualitative reasons that Z might renew. These include, but are not limited to, the overall quality of the service provided, the services and related pricing provided by competitors and the inconvenience to Z of changing service providers (e.g. returning equipment to C, scheduling installation by the new provider).

C concludes that although avoidance of the up-front fee on renewal is a consideration to Z, this factor alone does not influence Z's decision over whether to renew the service. C concludes based on its customer satisfaction research data that the quality of service provided and its competitive pricing are the key factors underpinning the average customer life of three years.

Overall, C concludes that the up-front fee of 50 does not convey a material right to Z.

As a result, C treats the up-front fee as an advance payment on the contracted one-year cable services and recognises it as revenue over the one-year contract term. This results in monthly revenue of 104 (1,250 / 12) for the one-year contract.

Conversely, if C determined that the up-front fee results in a contract that includes a customer option that is a material right, then it would allocate the total transaction price including the up-front fee between the one-year cable service and the material right to renew the contract (see Section 10.4).

Quantitative and qualitative indicators are considered when assessing up-front fees

An entity considers both quantitative and qualitative factors when assessing whether a non-refundable up-front fee results in a contract that includes a customer option that is a material right, because it would probably impact the customer's decision on whether to exercise the option to continue buying the entity's product or service. This is consistent with the notion that an entity considers valid expectations of the customer when identifying promised goods or services. Therefore, a customer's perspective on what constitutes a 'material right' includes consideration of qualitative factors as well as quantitative factors.

The following factors may be helpful in the assessment:

- the renewal price compared with the price in the initial contract with the up-front fee;
- the availability and pricing of service alternatives; and
- the history of renewals.

Some factors that could influence a customer's decision to renew the contract may not be determinative on their own – e.g. the quality of service or convenience of not changing providers.

An entity needs to consider all quantitative and qualitative factors and exercise judgement in determining whether a non-refundable up-front fee results in a contract that includes a customer option that is a material right.

Determining whether a non-refundable up-front fee relates to the transfer of a promised good or service

In many cases, even though a non-refundable up-front fee relates to an activity that the entity is required to undertake at or near contract inception to fulfil the contract, that activity does not result in the transfer of a promised good or service to the customer.

When assessing whether the up-front fee relates to the transfer of a promised good or service, an entity considers all relevant facts and circumstances, including whether:

- a good or service is transferred to the customer in exchange for the up-front fee and the customer is able to realise a benefit from the good or service received. If no good or service is received by the customer or if the good or service is of little or no value to the customer without obtaining other goods or services from the entity, then the up-front fee is likely to represent an advance payment for future goods or services; and
- if the entity does not separately price and sell the initiation right or activities covered by the up front-payment, then the payment may not relate to the transfer of a promised good or service.

Up-front fee may need to be allocated

Even when a non-refundable up-front fee relates to a promised good or service, the amount of the fee may not equal the relative stand-alone selling price of that promised good or service; therefore, some of the non-refundable up-front fee needs to be allocated to other performance obligations. For further discussion on allocation, see Section 4.2.

Deferral period for non-refundable up-front fee depends on whether the fee provides a material right

A non-refundable up-front fee may provide the customer with a material right if the fee is significant enough that it is likely to impact the customer's decision on whether to reorder a product or service – e.g. to renew a membership or service contract, or order an additional product.

If the payment of an up-front fee results in a contract that includes a customer option that is a material right, then the fee is recognised over the period during which the customer consumes the good or service that gives rise to the material right. Determining that period will require significant judgement, because it may not align with the stated contractual term or other information historically maintained by the entity – e.g. the average customer relationship period.

When the up-front fee is not deemed to provide a material right and the cost amortisation period is determined to be longer than the stated contract period, the period over which a non-refundable up-front fee is recognised as revenue differs from the amortisation period for contract costs.

Consideration of whether a non-refundable up-front fee gives rise to a significant financing component

IFRS 15.60

An entity will need to consider whether the receipt of an up-front payment gives rise to a significant financing component within the contract. All relevant facts and circumstances will need to be evaluated, and an entity may need to apply significant judgement in determining whether a significant financing component exists (see Section 3.2).

Up-front fees in the funds and insurance industries

In the funds industry, there may be two separate contracts:

- the first between the investor and the fund's manager (brokerage or sales contract, whereby the fund manager acts as an agent for the fund); and
- the second between the fund's manager and the fund itself (investment management contract).

The fund manager assesses whether the up-front fee receivable for the sale of units of a (retail) fund relates to the transfer of a promised service (i.e. a brokerage service) or if it is an advance payment for an investment management service to be satisfied in the future.

By contrast in the insurance industry, in our view there is generally no distinct brokerage service because insurers enter into a single contract with policyholders (investors) and the contract is sold as a net package.

Additional application examples

IU 01-19

Example 2 – Non-refundable up-front fees: Activity does not transfer a good or service

Stock Exchange S enters into a contract with Customer C to be listed on S's exchange. S charges C a non-refundable up-front fee on the initial listing of 50 and an ongoing annual listing fee of 100. The initial listing fee compensates S for activities that it needs to undertake to enable admission to the exchange – e.g. due diligence and reviewing the listing application.

S determines that the performance of the activities at contract inception does not transfer a good or service to C – i.e. there is no promise in the contract other than the service of being listed on the exchange.

S concludes that the non-refundable up-front fee is an advance payment for the ongoing listing service.

Example 3 – Non-refundable up-front fees: Investment management services

Investment Management Company U enters into a one-year contract to provide investment management services to Investor X.

In addition to a monthly fee of 1% of the managed assets, U charges a one-time subscription fee of 50. U determines that this is a set-up activity that does not transfer a service to X, but instead is an administrative task. U expects to earn a monthly fee of 10 from the contract.

At the end of the year, X can renew the contract on a month-to-month basis, at a similar monthly rate. X will not be charged another fee on renewal.

U considers both quantitative and qualitative factors when determining whether the up-front fee provides an incentive for X to renew the contract beyond the stated contract term:

- U compares the up-front fee of 50 with the total transaction price of 170 – i.e. the variable fee of 120 plus the up-front fee of 50. It concludes that the non-refundable up-front fee is quantitatively material; and
- U considers the qualitative reasons why X might renew the contract. It notes that competitors charge similar management fees and subscription fees to investors for similar contracts.

These factors are also reflected in a strong history of renewals and an average customer life that is longer than one year.

U concludes that the up-front fee results in a contract that includes a customer option that is a material right. Therefore, it allocates the up-front fee between the one-year investment management services and the material right to renew the contract. U recognises the consideration allocated to the material right over the renewal periods that give rise to the material right. This period may be shorter than the average customer life.

Example 4 – Activation fee in a month-to-month telco wireless contract

Telco B charges a one-time activation fee of 25 when Customer D enters into a month-to-month contract for a voice and data plan that costs 50 per month. D has no obligation to renew the contract in the subsequent month. If D does renew, then no activation fee will be charged in the second or subsequent months. B's average customer life for month-to-month contracts is two years.

IFRS 15.B49

B concludes that there are no goods or services transferred to D on activation. Therefore, the up-front fee does not relate to a good or service and the only performance obligation in the arrangement is the voice and data plan. The activation is merely an administrative activity that B needs to perform to allow D to access its network.

The activation fee is considered an advance payment for future goods or services and included in the transaction price in Month 1.

IFRS 15.B40

B then assesses whether the option to renew the contract without paying the activation fee on renewal represents a material right for D. B considers both qualitative and quantitative factors in determining whether D has a material right to renew at a discount.

D pays 75 in Month 1 and would pay 50 in each subsequent month for which it renews. Therefore, the 'discount' on the renewal rate is quantitatively material. B also notes that D is likely to renew the contract beyond the first month based on the average customer life, and that D's decision to renew is likely to be significantly affected by the up-front fee.

Therefore, B concludes that the activation fee is a prepayment for future goods and services and represents a material right. B recognises the activation fee over the period for which D consumes the services that give rise to the material right. This period may be shorter than the average customer life.

10.7 Sales outside ordinary activities

Overview

Certain aspects of the standard apply to the sale or transfer of non-financial assets – e.g. intangible assets and property, plant and equipment – that are not an output of the entity's ordinary activities.

IAS 16, 38, 40

Under the standard, the guidance on measurement and derecognition applies to the transfer of a non-financial asset that is not an output of the entity's ordinary activities, including:

- property, plant and equipment in the scope of IAS 16;
- intangible assets in the scope of IAS 38; and
- investment property in the scope of IAS 40.

IAS 16, 38, 40

When an entity sells or transfers a non-financial asset that is not an output of its ordinary activities, it derecognises the asset when control transfers to the recipient, using the guidance on transfer of control in the standard (see Section 5.1).

The resulting gain or loss is the difference between the transaction price measured under the standard (using the guidance in Step 3 of the model) and the asset's carrying amount. In determining the transaction price (and any subsequent changes to the transaction price), an entity considers the guidance on measuring variable consideration – including the constraint, the existence of a significant financing component, non-cash consideration and consideration payable to a customer (see Chapter 3).

The resulting gain or loss is not presented as revenue. Likewise, any subsequent adjustments to the gain or loss – e.g. as a result of changes in the measurement of variable consideration – are not presented as revenue.

IFRS 10, IAS 28

When calculating the gain or loss on the sale or transfer of a subsidiary or associate, an entity will continue to refer to the guidance in the consolidation standards, respectively.

IFRS 16.98–103

If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and then leases it back, then both entities apply the guidance in the revenue standard to assess whether the transfer of the asset should be accounted for as a sale.

- If the transfer leg qualifies as a sale, then the seller-lessee derecognises the asset and calculates any gain or loss under the leases standard.
- If the transfer leg does not qualify as a sale, then the seller-lessee does not derecognise the asset.

Example 1 – Sale of a single-property real estate

IFRS 3, 10, IAS 40

Consulting Company X decides to sell an office building to Buyer Y. X owns the building through a wholly owned subsidiary whose only asset is the building. The transaction is outside its ordinary consulting activities.

Title transfers to Y at closing and X has no continuing involvement in the operations of the property, including through a leaseback, property management services or seller-provided financing.

The arrangement consideration includes a fixed amount paid in cash at closing plus an additional 5% contingent on obtaining a permit to re-zone the property as a commercial property. X believes that there is a 50% chance that the re-zoning effort will be successful.

When the sale is undertaken as a sale of the subsidiary X applies the deconsolidation guidance in the consolidation standard and measures the contract consideration at fair value.

Conversely, when the sale is undertaken as an asset sale, X applies the derecognition guidance in the property, plant and equipment standard and as part of determining the gain or loss from the transaction measures the consideration to be received in accordance with the requirements set out in Step 3 of the model.

Judgement required to identify ordinary activities

IFRS 15.BC53

Under the standard, a 'customer' is defined as a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. Because 'ordinary activities' is not defined, evaluating whether the asset transferred is an output of the entity's ordinary activities may require judgement.

In many cases, this judgement will be informed by the classification of a non-financial asset – e.g. an entity that purchases a tangible asset may assess on initial recognition whether to classify the asset as property, plant and equipment or as inventory. Typically, the sale or transfer of an item that is classified as property, plant and equipment will result in a gain or loss that is presented outside revenue, whereas the sale or transfer of inventory will result in the recognition of revenue.

Accounting for a non-current non-financial asset held for sale may result in a gain or loss on transfer of control because consideration may differ from fair value

IFRS 5

When the carrying amount of a non-current non-financial asset is expected to be recovered principally through a sale (rather than from continuing use), the asset is classified as held-for-sale if certain criteria are met.

The standard does not override the measurement and presentation guidance for non-current assets that are held for sale. Under this guidance, assets that are held for sale are measured at the lower of fair value less costs to sell and the carrying amount, which may differ from the expected transaction price as determined under the standard. If the sale or transfer includes variable consideration that is constrained under the standard, then the resulting transaction price that can be recognised could be less than the fair value. This could result in the recognition of a loss when control of the asset transfers to the counterparty, even though the carrying amount may be recoverable through subsequent adjustments to the transaction price. In these situations, an entity may consider providing an early warning disclosure about the potential consequences of these accounting requirements.

Applying transaction price guidance on measuring consideration received or receivable

IFRS 5

Under the standard, an entity applies the guidance on the transaction price, including variable consideration and the constraint. This may result in the consideration initially being measured at a lower amount, with a corresponding decrease in any gain – particularly if the constraint applies. In extreme cases, an entity may recognise a loss on disposal even when the fair value of the consideration exceeds the carrying amount of the item immediately before disposal.

Little difference in accounting for sales of real estate to customers and non-customers

IAS 16, 40

Because an entity applies the guidance on measuring the transaction price for both customer and non-customer transactions, the difference in accounting for an ordinary (customer) vs a non-ordinary (non-customer) sale of real estate is generally limited to the presentation in the statement of comprehensive income (revenue and cost of sales, or gain or loss).

Transfers to inventory are still possible if specific criteria are met

IAS 16.68A, 40.58

If an entity sells or transfers an item of property, plant and equipment or an investment property, then it recognises a gain or loss on disposal outside revenue. However, in limited circumstances it remains possible that an item may be transferred to inventory before sale, in which case the entity recognises revenue on disposal – for example:

- an entity that, in the course of its ordinary activities, routinely sells items of property, plant and equipment that it has held for rental to others transfers these assets to inventory when they cease to be rented and become held for sale; and
- an entity transfers investment property to inventory when, and only when, there is a change of use – e.g. the start of development with a view to sale.

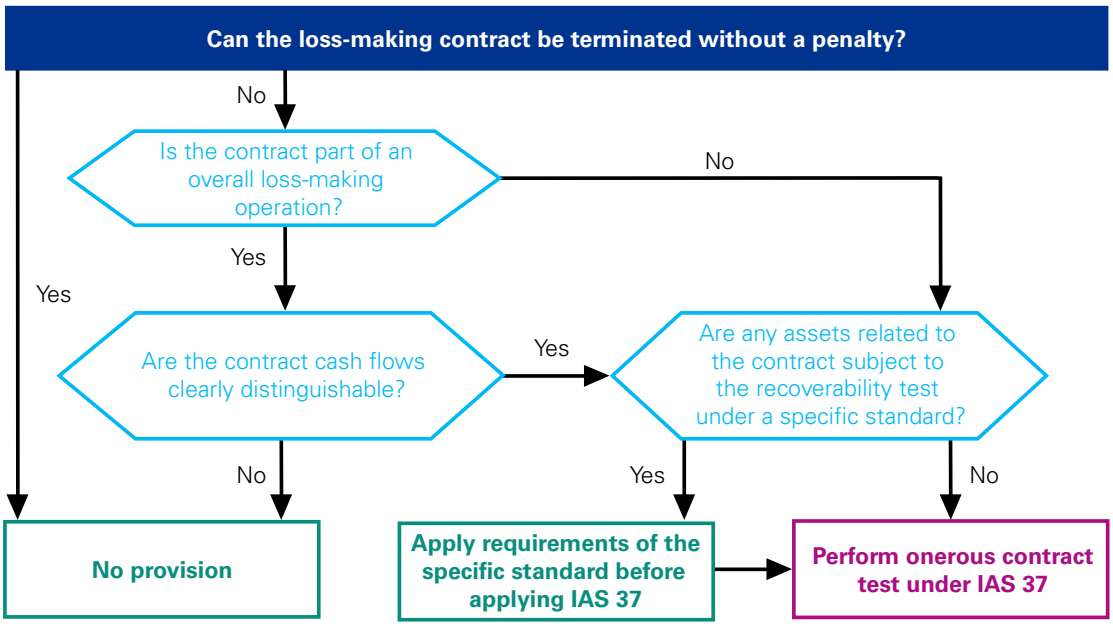
10.8 Onerous contracts

Overview

IAS 37.5

Some sales contracts entered into by an entity may be loss-making from the outset or become loss-making during their life cycle. To determine how to account for a loss-making contract, an entity first considers which standard to apply. If a contract in whole or in part is subject to the requirements in a specific standard, then in our view an entity should apply those requirements to the relevant part(s) of the contract and the onerous contracts guidance in the provisions standard to the remaining part.

The following flowchart explains when to test a loss-making contract applying the onerous contracts requirements in the provisions standard.



IAS 37.67

If a contract can be terminated without incurring a penalty, then it is not onerous.

A contract on unfavourable terms is not necessarily onerous. Similarly, a contract that is not performing as well as anticipated, or as well as possible, is not onerous unless the costs of fulfilling the obligations under the contract exceed the benefits to be derived.

Example 1 – Maintenance service in a lease contract

IFRS 16.15–16

Company M leases a retail outlet under a lease contract with Lessor L, which includes a non-lease component for maintenance services provided by L. If M decides to vacate the leased property during the lease term, then it continues to apply the requirements in the leases standard to the lease component – e.g. it needs to assess the right-of-use asset for impairment under the impairment of assets standard and continue to account for the lease liability.

In addition, we believe that M should apply the onerous contracts guidance in the provisions standard to the non-lease component, unless it applies the practical expedient in the leases standard to account for the lease and associated non-lease component as a single lease component.

10.8.1 Overall loss-making operations

Some contracts may be part of an overall loss-making operation. In our view, if the cash flows related to the contract are clearly distinguishable from the operations as a whole and the contract falls in the scope of the onerous contracts requirements in the provisions standard, then the entity should test that contract to determine whether it is onerous. Conversely, if the cash flows related to the contract are not clearly distinguishable from the operations as a whole, then we believe that no provision should be recognised. This is because a provision would effectively be recognised for future operating losses, which is prohibited by the provisions standards.

Example 2 – Overall loss-making operation vs onerous contract

Tour Operator T offers cruises on a lake to customers, among its other services. For this purpose, T charters a cruise ship for a period of nine months. T accounts for the charter as a short-term lease. Because of increased competition for cruises, the costs to charter the cruise ship exceed the income that T generates from its cruise operations. Given that the charter contract relates only to T's cruise operations, and the cash flows related to these operations are separately identifiable, we believe that T should assess whether the charter contract is onerous. In performing this analysis, T should consider the costs of terminating the charter contract and alternative uses for the ship.

However, if T sold package tours to customers, which included a cruise on the lake, and T's overall operations were loss-making, then the losses would relate to the business as a whole rather than specifically to the charter contract. In addition, it is likely that the cash inflows related to the cruise operations would not be clearly distinguishable from those related to the other operations. Therefore, in this case we believe that a provision for an onerous contract should not be recognised. However, T should consider whether the related recognised assets are impaired.

10.8.2 Determining whether a contract is onerous

IAS 37.10

An 'onerous contract' is one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under the contract.

In assessing whether a contract is onerous, it is necessary to consider:

- the unavoidable costs of meeting the contractual obligations, which is the lower of the net costs of fulfilling the contract and the cost of terminating it; and
- the economic benefits expected to be received.

IAS 37.68

In determining the costs of fulfilling a contract, an entity considers the payments due in the period in which the contract cannot be cancelled. If there is an option to cancel the contract and pay a penalty, then the entity also considers the present value of the amount to be paid on cancellation of the contract, and measures the contract at the lowest net cost to exit.

IAS 37.68A

In determining whether the contract is onerous, an entity considers the costs that relate directly to the contract, including:

- the incremental costs of fulfilling the contract – e.g. direct labour and materials; and
- an allocation of other costs that relate directly to fulfilling the contract – e.g. an allocation of the depreciation charge for property, plant and equipment used in fulfilling the contract.

The expected benefit under a contract is the net present value of the future inflows related to the contract. Estimating the future benefits to be derived may require judgement, possibly based on past experience or expert advice.

IAS 37.69

Before a separate provision for an onerous contract is recognised, an entity recognises any impairment loss that has occurred on assets used in fulfilling the contract.

Example 3 – Determining whether a contract is onerous: Cancellation option

IAS 37.68

Company F has a warehouse management service contract and pays an annual maintenance fee of 20. The remaining contract term is five years, although after two years F has an option to cancel the contract and pay the service provider a penalty of 25. The cost of fulfilling the contract is 85 (the present value of 20 x 5). The cost of terminating the contract is 60 (the present value of (20 x 2 + 25)). F uses the alternative that results in the lowest cost in determining whether the contract is onerous – i.e. 60.

Example 4 – Determining whether a contract is onerous: Unavoidable costs

Company Y provides data transmission services to customers using an external carriers' network infrastructure under network capacity contracts. The network capacity contracts are non-cancellable and are on fixed payment terms regardless of the volume or number of customers serviced by Y using the network.

The full cost of operating the network includes depreciation of owned equipment, fees for the use of network infrastructure and personnel costs.

In determining whether an individual contract with its customer is onerous, Y includes in its analysis an allocation of all costs that relate directly to fulfilling that contract – i.e. an allocation of depreciation of entity-owned equipment, fees for the use of network infrastructure and personnel costs.

Example 5 – Determining whether a contract is onerous: Assessing expected benefits

Company B, a commercial bakery, has a forward contract to buy 100 tonnes of wheat at a price of 13,000 per tonne. The forward contract will be settled by physical delivery of the wheat and meets the own-use exemption. At the reporting date, the market price of wheat has dropped to 10,000 per tonne.

In considering the expected benefits under a contract, B needs to evaluate its expected use of a product. B notes that it still expects to make a profit on the sale of the bread that will be made from the wheat delivered on settlement of the forward contract.

Therefore, the forward contract is not onerous and B does not recognise a provision for the above-market price. Instead, B measures the cost of the wheat at 13,000 per tonne when control of the wheat transfers to B.

Onerous contract assessment – To be performed at a contract level

IFRS 15.BC294–BC296, BC315

If an entity is assessing whether a contract for the sale of goods or services is an onerous contract, then in our view this assessment should be made based on the contract as a whole rather than on an item-by-item basis or on a performance obligation-by-performance obligation basis. This may be relevant when there are 'learning curve' costs that mean that inefficiencies are expected in the production of early units.

However, entities should also consider the requirement for inventory to be tested for impairment generally on an item-by-item basis. If the contractual selling price is less than the unit cost, then a write-down to net realisable value may be required. Because this net realisable value test is applied to items of inventory, we believe that a write-down to net realisable value may be required for items produced under a contract that, taken as a whole, is not onerous.

Onerous contracts assessment – Future inflows may include anticipated contracts with the same counterparty

In our view, the future inflows related to the contract may include future inflows from anticipated contracts with the same counterparty. In addition, we believe that if a contract includes future inflows falling in the scope of multiple standards – e.g. revenue from contracts with customers, financing income and lease income – then all inflows under the contract should be considered in assessing whether the contract is onerous.

Onerous contracts assessment – Derivative to hedge risk exposures arising from a sales contract

An entity may enter into a derivative transaction to hedge its risk exposures arising from a sales contract. In our view, if an entity designates a derivative as a hedging instrument to hedge cash flows related to fulfilment of a sales contract, then in estimating the future benefits expected under the contract it should consider benefits arising from the derivative. However, if hedge accounting is not applied, then we believe that benefits from a derivative should not be included in the assessment in determining whether a contract is onerous.

Onerous contracts – Timing of recognition

Usually, a decision to terminate a contract at some date in the future does not result in a legal or constructive obligation at the date of the decision. Therefore, in our view the costs of cancelling or terminating a contract should not be recognised until the contract is actually terminated, unless the contract becomes onerous.

Additional application examples

Example 6 – Contract not onerous: Learning curve costs

Company G enters into a contract with Train Company T to build three trains for a rail system. G concludes that it transfers control over trains to the customer at a point in time (see Section 5.4). The contract with the rail system is expected to be profitable overall. However, because of the customisation that requires use of a new technology, learning curve costs on the first of the three trains are expected to create a loss as detailed below, when considering costs to fulfil the contract.

	First	Second	Third
Revenue per train	100	100	100
Projected costs to fulfil the contract per train	(110)	(95)	(70)
Projected margin over costs to fulfil the contract	(10)	5	30

Because the contract as a whole is profitable – i.e. the expected margin in excess of costs to fulfil the contract is 25 – in our view it is not onerous. However, because costs are being incurred to build the earlier units, G should consider whether any of the learning curve costs can effectively be deferred in the cost of inventory. G should also consider whether assets used to fulfil the contract are impaired.

Example 7 – Determining whether a contract is onerous: Expected benefits from anticipated contract

On 1 December 2022, Company B enters into a framework agreement with Customer C. Under the agreement, B will deliver an item of machinery for consideration of 150 and consumables priced at 5 per unit. Although the framework agreement includes the price for consumables, C has no obligation to purchase consumables until it places an order – i.e. future purchase orders in combination with the framework agreement will create enforceable rights and obligations in respect of consumables (see 1.1.1).

B estimates the unavoidable costs of delivering the machinery to be 170. B also expects to make future sales of consumables for total consideration of 200 and incur related unavoidable costs of 160.

We believe that in assessing whether the existing contract with C is onerous, it is appropriate for B to consider future net inflows from sales of consumables. This is because future purchase orders for consumables placed under the framework agreement are anticipated contracts. In this example, total inflows of 350 (150 + 200) will be higher than estimated unavoidable costs of 330 (170 + 160). Therefore, B's contract with C is not onerous.

Example 8 – Determining whether a contract is onerous: Hedging expected cash flows

IAS 37.68, IFRS 9.2.4

Company J is in the business of sourcing and supplying cocoa beans and providing related services to its customers – e.g. shipping, distribution and repackaging. J is not a broker-trader. The sales contracts with customers can be settled only by physical delivery and meet the 'own-use' exemption – i.e. these contracts are not accounted for at fair value through profit or loss. On 1 August 2022, J enters into a non-cancellable contract with Company Z to sell cocoa beans at 1,000 per tonne for delivery in 12 months.

To fulfil the sales contract with Z, J will need to purchase cocoa beans. To hedge the price risk of the expected purchase of inventory that will later be sold to Z, on 2 August 2022 J enters into a forward contract with Company B to purchase cocoa beans for 900 per tonne that will be settled net. The contract is designated as a hedging instrument in a cash flow hedge of a highly probable forecast purchase of inventory.

On 31 December 2022, the market price for cocoa beans is 1,200 per tonne and J determines that the hedging relationship continues to meet the hedge accounting criteria.

We believe that in determining whether the sales contract with Z is onerous, J should take the hedging instrument into account when estimating the costs to fulfil its obligation – i.e. as if the costs to purchase cocoa were fixed at the derivative's strike price of 900 per tonne.

10.8.3 Measuring the provision

IAS 37.66, 69

The present value of the obligation under an onerous contract is recognised as a provision. Before the onerous contract provision is calculated, all assets used in fulfilling the contract are tested for impairment.

The amount of the provision is the lower of the cost of terminating the contract and the net cost of continuing with the contract after taking into account revenues directly related to a contract – i.e. the lowest net cost to exit. In our view, the lower of the cost of fulfilling the contract and of terminating the contract should be considered in measuring the provision, regardless of the entity's intention.

If a contract for the sale of goods is onerous, then the provision for the contract is used as the contract is fulfilled – e.g. to write down inventory that is acquired or produced at a cost that is greater than the revenue under the onerous contract.

Example 9 – Provision for onerous contract: Measurement (Revenue directly related to contract)

IAS 37.69

Airline S owns a number of aircraft and has entered into a non-cancellable agreement under which it charters out one of its aircraft for 20 days for a fee of 10 per day. S incurs unavoidable costs of 15 a day to service the aircraft on any day that the aircraft is flown. The unavoidable costs of servicing the aircraft exceed the revenues. The anticipated loss on the contract is 5 per day for the 20 days – i.e. 100 (5 x 20).

If S is able to cancel the charter arrangement by paying a penalty of 40, then we believe that a provision of 40 rather than 100 should be recognised, regardless of whether S intends to cancel the contract.

In addition, before recognising a provision for the onerous contract, S should test the aircraft for impairment. The fact that the operating costs exceed the revenues to be derived from the aircraft is an impairment indicator.

Onerous contracts – Principles for measuring a provision are consistent with those used for assessing whether a contract is onerous

IAS 37.68

In our view, an onerous contract should be measured using the same principles as those used for determining whether that contract is onerous. For example, an entity may have a choice either to produce goods itself or to buy them on the market in order to fulfil a contract with a customer. In our view, if the entity-specific costs of producing the goods are lower than the cost of buying them on the market, then the entity-specific costs should be used rather than the fair value of the goods on the market. This is consistent with the requirement to measure an onerous contract at the lowest net cost to exit.

Additional application examples

Example 10 – Provision for onerous contract: Measurement (Market price vs cost to produce)

Company T has a non-cancellable fixed-price contract with a customer to deliver electricity. T has a variety of electricity-generating facilities, including nuclear, thermal hydro and wind power plants. If there is insufficient capacity to meet customer demand, then T can buy electricity on the market. The market price for buying electricity is higher than T's costs of producing electricity and both of these measures are higher than the revenue under the contract. We believe that T should measure the onerous contract provision based on the costs of producing electricity, less the revenue to be earned from the customer. This is consistent with the requirement to measure an onerous contract at the lowest net cost to exit.

Example 11 – Using provision for an onerous contract: Write-down of inventory

Modifying Example 6, assume that the revenue per train is 80, not 100. Company G enters into the agreement in the first quarter of 2022 and will produce and deliver one train in each of the next three quarters. G has the following projected revenues and costs measured on a net present value basis for the purpose of calculating the onerous contract provision.

	Q2	Q3	Q4	TOTAL
Revenue per train	80	80	80	240
Projected costs to fulfil the contract per train	(110)	(95)	(70)	(275)
Projected margin over costs to fulfil the contract	(30)	(15)	10	(35)

An onerous contract provision of 35 is recognised in the first quarter of 2022 when G enters into the contract because the contract is onerous overall. In our view, this provision is available for use as and when it becomes necessary in the second and third quarters to write down to net realisable value the individual trains whose unit cost exceeds the contractual selling price. The provision is used as follows.

	Q2	Q3	Q4
Movement in the onerous contract provision			
Opening balance	(35)	(5)	-
Use of provision to write down inventory	30	5	-
Closing balance	(5)	-	-

Therefore, in respect of this contract, G would recognise a loss of 35 in the first quarter of 2022, no gain or loss in the second quarter, a loss of 10 in the third quarter and a profit of 10 in the fourth quarter.

10.9 Tooling

Overview

Tooling arrangements are typically contracts or master service agreements (MSA) in which an entity builds or receives a tool that is used for the production of customised parts ordered by the customer. Such arrangements are common, for example, in the automotive and aerospace and defence industries. The tools are usually unique and cannot be used for another customer. These tooling arrangements vary widely.

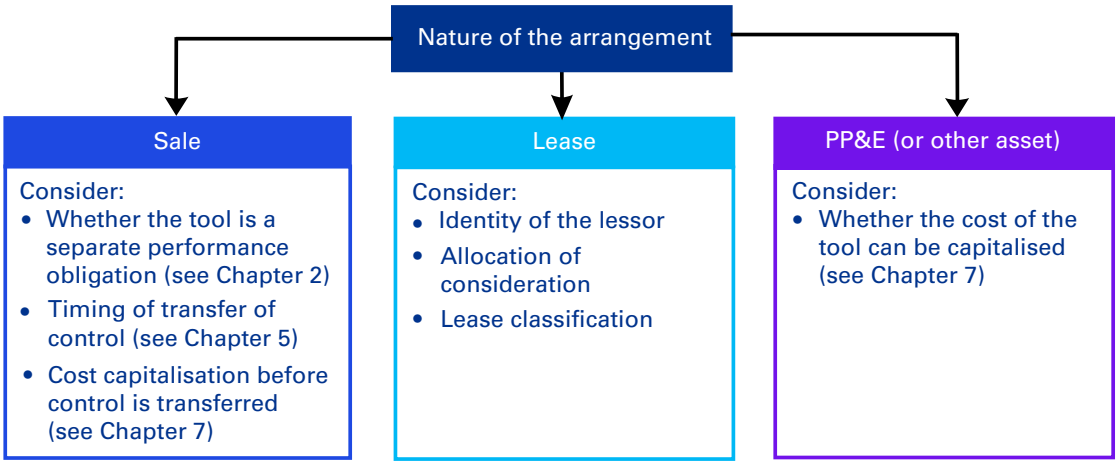
- *Development:* In some cases, the tool is developed by the entity (either on its own or by a tooling subcontractor). In other cases, it is developed by the customer.
- *Payment terms:* In some arrangements, the customer provides specific consideration for the tool, separate from the consideration for parts. In other arrangements, the cost of the tool is recovered through the price charged for the parts that are subsequently ordered. In the latter case, the recovery may be implicit or stated explicitly as a per-unit amount in the contract.
- *Title:* If the entity develops the tool, then it may transfer the title to the tool or ownership of the related intellectual property to the customer or retain it. Ownership rights may be merely a protective measure or may grant the customer substantive rights over the tool.

The entity is usually responsible for maintaining the tool, which remains physically with it for use in the production process. Generally, the tool is used for its entire useful life, or otherwise has no significant residual value. This is because another entity is unlikely to use the same tool in its production process, due to the customised nature of the tool.

Nature of a tooling arrangement

To determine the appropriate accounting for a tooling arrangement, an entity first assesses the nature of the arrangement – i.e. whether it is a sale, a lease or development of its own property, plant and equipment (or other asset) to be used in the production process. This assessment requires judgement. The legal form of the arrangement may not indicate its substance.

The following diagram illustrates the key considerations depending on the nature of the arrangement.



If control over a tool is transferred to a customer, then the arrangement is in the scope of the revenue standard. Conversely, the arrangement could be a lease in the scope of the leases standard, or the development of the entity's own asset in the scope of the property, plant and equipment standard.

Tools produced by an entity – Sale

In some tooling arrangements, legal ownership of the tool is transferred from an entity to a customer. Transfer of legal ownership, together with other facts and circumstances, may indicate that an entity transfers control of the tool to a customer and a sale has occurred.

For example, when a tool can be used only to produce parts for that customer, whether due to contractual restrictions (such as exclusivity arrangements) or technical constraints, and the contract establishes a right for the entity to be reimbursed for developing the tool, either directly or indirectly – e.g. through sufficient minimum quantities of parts to be ordered or through termination penalties.

If an entity determines that a tooling arrangement constitutes a sale of a good, then it applies the revenue standard. In these cases, the entity applies judgement to determine:

- whether the activity transfers a good or a service to the customer;
- whether the production of a tool is a separate performance obligation (see Section 2.1);
- the timing of transfer of control over the tool (see Section 5.1); and
- whether any costs incurred in developing and producing the tool before control over it is transferred to the customer (if applicable) can be capitalised in accordance with the inventory standard, revenue standard or other guidance.

Tools produced by an entity – Lease

To determine whether a tooling arrangement contains a lease, an entity considers the following factors.

Factor	Description
Right to obtain substantially all of the economic benefits from use for a period of time	When a tool can be used only to produce parts for a single customer, either due to contractual restrictions (such as exclusivity arrangements) or technical constraints, this may indicate that the customer has the right to obtain substantially all of the economic benefits from the use of the tool throughout the arrangement period.
Right to direct the use of the tool	Judgement is required to determine who controls how and for what purpose the customised tool will be used. Examples of relevant decisions – i.e. decisions that significantly affect the economic benefits derived from use of the tool – that may indicate the right to control how and for what purpose a customised tool is used include the following. • A right to change *when* the output is produced. • A right to change *whether* the output is produced and the quantity of that output. • A right to change *where* the output is produced. This may only be relevant when an entity has more than one production facility and substantive decisions can be taken about the location of the parts' production – e.g. the location of the production is not contractually predetermined.
Predetermined decisions	Tooling arrangements that run on 'auto pilot' are likely to be rare, because most contracts to supply parts involve some degree of decision-making – e.g. over the production process itself and over production levels.

If a tooling arrangement contains a lease, then that lease is accounted for only on commencement of the lease – i.e. when the tool is made available for use. Under the leases standard, if an entity incurs costs relating to the construction or design of the tool before commencement of the lease, then it accounts for those costs under the applicable standard – e.g. as inventory or property, plant and equipment. Once the tool is available for use, any lease identified in the arrangement is accounted for according to its classification (see below).

Tooling – Lease classification

IFRS 16.65

If an entity concludes that it leases the tool to a customer, then it needs to consider the classification of that lease applying the criteria in the leases standard. When a substantial portion of the tool's fair value is expected to be recovered only through optional purchases by a customer – i.e. recovery is not contractually guaranteed either directly or through sufficient contractual minimum quantities of parts to be ordered – this suggests that the lease may be classified as an operating lease. This is because the entity continues to bear risks and rewards associated with ownership of the tool through the contingent payment mechanism.

Under an operating lease, an entity accounts for tools produced as its own property, plant and equipment (see below). An entity recognises payments from a customer allocated to the lease as operating lease income. Lease income is disclosed separately from revenue from contracts with customers.

Under a finance lease, an entity derecognises the tools on lease commencement.

Tools produced by an entity – Own asset

Unless control over a tool is transferred over time as it is constructed (see Section 5.2), an entity considers whether any costs incurred during the construction of the tool can be capitalised under the applicable standard – e.g. the inventory standard, the property, plant and equipment standard or the revenue standard. If control over a tool is not transferred to a customer and it is not leased to a customer in a finance lease, then costs capitalised are depreciated (amortised) and tested for impairment in accordance with the relevant standard.

Tooling – Comparing the approaches

Although the detailed analysis – and the presentation and disclosure requirements – differ under the leases and the revenue standards, the broad accounting may be similar in some cases.

For example, consider a tooling arrangement in which there is a finance lease of the tool to the customer, and a tooling arrangement in which there is a point-in-time sale of the tool to the customer. In these cases, the point in time at which control over a tool is transferred to the customer (under the revenue standard) may be similar to the time when a finance lease of the tool to the customer (under the leases standard) commences (see below). In addition, in both cases, the entity would derecognise the tool and recognise a profit or loss on transfer of the tool.

In another example, the entity would apply a broadly similar accounting model to a tooling arrangement in which there is an operating lease of the tool to the customer, and a tooling arrangement in which the tool is its property, plant and equipment. That is, the entity would continue to recognise the tool as its property, plant and equipment and depreciate the tool over its useful life.

Tools produced by a customer

In some arrangements, tools required by an entity for the production of customised parts are developed and manufactured by a customer, and subsequently transferred to the entity. Similar to the discussion above, judgement is required to determine whether control over the tool is transferred to the entity or whether the entity has a right to use the tool, which is then accounted for as a lease. If an entity obtains control over a customised tool or leases it, then the entity also needs to consider whether the tool itself or the right to use it is non-cash consideration received from a customer (see Section 3.4) for a contract in the scope of the revenue standard.

Example 1 – Tools produced by an entity: Sale

Manufacturer M enters into a six-year MSA with Customer C to manufacture a bottle to C's specification.

- The shape of the bottle is covered by customer-specific intellectual property owned by C.
- M arranges for and funds manufacture of a customer-specific tool.
- The customer-specific tool can only be used to manufacture bottles for C.
- At the end of the manufacturing arrangement, the customer-specific tool is to be transferred to C.
- The MSA does not include contractually committed volumes but specifies a volume target. If the volume target is achieved, then M will recover the cost of the tool.
- If the MSA is terminated by C before the volume target is achieved, then M is entitled to compensation based on the actual quantities purchased such that it will recover the cost of the tool. In this case, M is required to transfer the customer-specific tool to C.
- The tool is operated and maintained by M.

M evaluates the nature of the arrangement and notes the following.

- M can use the tool only to manufacture the bottle for C.
- Although the MSA does not contain a minimum purchase quantity, M's right to receive compensation if the target volume is not met means that M will recover the cost of the tool.
- Practically, another manufacturer cannot use the tool.
- The tool is operated and maintained by M.

M determines that the nature of the arrangement is a sale of the tool to C – i.e. control over the tool transfers to C.

Example 2 – Tools produced by an entity: Property, plant and equipment

Supplier S enters into a two-year MSA with Customer C to manufacture a specific part for C.

The following facts are relevant to this example.

- S needs a specific tool to manufacture the part and enters into an arrangement with a subcontractor to produce the tool for 25,000.
- The MSA includes a fixed price per unit of 7.6 and a guaranteed minimum purchase quantity of 10,000 units over the contract term. The quantity and timing of delivery of parts are determined by each separate purchase order raised under the MSA.
- In addition, S and C enter into a separate tooling contract under which S charges C 1,000 every month for 24 months (i.e. 24,000 over the contract term) to recover the cost of the tool.
- The tool is purchased to manufacture the part for C, but it can also be used during the contract term to manufacture parts for other customers without C's permission.
- The contract does not give rise to a material right.
- S expects to recover the difference between the purchase price of the tool (i.e. 25,000) and the amount invoiced to C (i.e. 24,000) from transactions with other customers.

S evaluates the nature of the arrangement and notes that it retains the title over the tool and has the ability to use the tool to manufacture parts for other customers (and expects to do so). Therefore, S concludes that it does not transfer control over the tool to C – i.e. the tool is its own property, plant and equipment to be accounted for under the respective standard. In addition, S determines that the arrangement does not contain a lease because it has the ability to use the tool for customers other than C, and expects to do so.

S analyses the MSA and the tooling contract for the purposes of the revenue accounting and determines the following.

- The MSA and the tooling contract should be combined and accounted for as a single contract, because the two agreements were entered into near the same time, with the same customer (C) and were negotiated as a package with a single commercial objective.
- S's promise in the contract is to produce and supply 10,000 parts. Therefore, revenue is recognised on a per-unit basis on fulfilment of each purchase order at a per-unit price of 10 (7.6 + 24,000 / 10,000).
- The contract does not include a material right and purchases above 10,000 units are treated as optional purchases.

11 Presentation

Overview

This section addresses the various presentation requirements in the standard.

11.1 Statement of financial position

IFRS 15.105

An entity presents a contract liability or a contract asset in its statement of financial position when either party to the contract has performed. The entity 'performs' by transferring goods or services to the customer, and the customer performs by paying consideration to the entity.

IFRS 15.105–107

Any unconditional rights to consideration are presented separately as a receivable.

'Contract liabilities' are obligations to transfer goods or services to a customer for which the entity has received consideration, or for which an amount of consideration is due from the customer.

'Contract assets' are rights to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time. Contract assets are assessed for impairment under the requirements in the financial instruments standard.

IFRS 15.109

An entity may use alternative captions for the contract assets and contract liabilities in its statement of financial position. However, it needs to provide sufficient information to distinguish a contract asset from a receivable.

Example 1 – Contract liability and receivable: Cancellable contract

IFRS 15.IE198

On 1 January 2022, Manufacturer D enters into a cancellable contract to transfer a product to Customer E on 31 March 2022. The contract requires E to pay consideration of 1,000 in advance on 31 January 2022. E pays the consideration on 1 March 2022 – i.e. after the due date. D transfers the product on 31 March 2022. D records the following entries to account for:

- cash received on 1 March 2022 and the related contract liability; and
- revenue on transfer of the product on 31 March 2022.

In this example, D does not have an unconditional right to consideration on 31 January 2022 and therefore it does not have a receivable.

	Debit	*Credit*
1 March 2022		
Cash	1,000	
Contract liability		1,000
To record cash of 1,000 received (cash is received in advance of performance)		
31 March 2022		
Contract liability	1,000	
Revenue		1,000
To record D's satisfaction of performance obligation		

IFRS 15.IE199–IE200

Contract asset and contract liability – Based on past performance

The standard requires an entity to present a contract asset or contract liability after at least one party to the contract has performed. However, Example 38 in the standard suggests that an entity recognises a receivable when it is due if the contract is non-cancellable, because the entity has an unconditional right to consideration (for further discussion, see 11.1.1).

IFRS 15.BC317

Single contract asset or contract liability for contracts with multiple performance obligations

An entity presents a contract asset or a contract liability in its statement of financial position when at least one party to the contract has performed. When a contract contains multiple performance obligations, it is possible that at a given point in time some performance obligations could be in a contract asset position and others in a contract liability position. In this case, an entity presents a single contract asset or liability representing the net position of the contract as a whole. The entity does not present both a contract asset and a contract liability for the same contract. It may be challenging to determine a single net position in some circumstances if, for example, different systems are used for different performance obligations.

In addition, if under the contract combination guidance (see Section 1.4) an entity combines two or more contracts and accounts for them as a single contract, then it presents a single contract asset or contract liability for that combined contract. This is consistent with the guidance on the combination of contracts that determines the unit of account based on the substance of the transaction, rather than its legal form.

IFRS 15.BC317–BC318

Contract assets and contract liabilities for multiple contracts are not netted

A single contract is presented either as a net contract asset or as a net contract liability. However, if an entity has multiple contracts, then it cannot present on a net basis contract assets and contract liabilities of unrelated contracts (i.e. contracts that cannot be combined under Step 1). Therefore, it presents total net contract assets separately from total net contract liabilities, rather than a net position on all contracts with customers.

IFRS 15.BC301

An asset arising from the costs of obtaining a contract is presented separately from the contract asset or liability.

IFRS 15.BC320–BC321

The standard does not specify whether an entity is required to present its contract assets and contract liabilities as separate line items in the statement of financial position or whether it can aggregate them with other items in the statement of financial position – e.g. include contract assets in an 'other assets' balance. Therefore, an entity applies the general principles for the presentation of financial statements and the offsetting requirements.

Impairment assessment of contract assets for contracts with multiple performance obligations

IFRS 15.107, 113(b), BC317

To assess a contract asset for impairment, an entity applies the requirements in the financial instruments standard and uses the expected credit loss method. There is limited guidance on how to perform the impairment assessment of contract assets. For contracts with multiple performance obligations, a question arises over whether the impairment assessment should be performed at the contract level or the performance obligation level.

In our view, in these cases contracts with multiple performance obligations an entity should perform the impairment assessment of contract assets at the contract level. This is because the net contract asset/liability position best represents the entity's real exposure to the credit risk of its customer.

Impairment assessment of contract assets when the consideration is variable

IFRS 15.56–58, 107, 113(b)

When a contract includes variable consideration, an entity recognises revenue at the constrained amount (see 3.1.2). As a result, any related contract asset is measured based on the constrained amount. In these cases, a question arises over whether the impairment assessment of the contract asset should be performed based on the constrained or the unconstrained amount of the related consideration.

In our view, an impairment assessment of the contract asset should be performed based on the constrained consideration because under this approach the expected cash flows are estimated on a basis consistent with the measurement of the contract asset.

We believe that an alternative approach would be to compare the theoretical unconstrained contract asset with the unconstrained consideration, and recognise any resulting impairment loss in proportion to the recognised contract asset. This would result in the same impairment loss amount as the approach based on the constrained amounts.

For a detailed illustration, see Example 2 in this chapter.

Classification as current vs non-current

IAS 1.60–61, 65–71

An entity applies the general principles for presenting assets and liabilities as current or non-current in the statement of financial position to contract assets, contract liabilities and costs to obtain and costs to fulfil a contract arising under the standard. In applying these principles, an entity considers the expected timing of performance, payment or utilisation under the contract.

As a first step, an entity considers whether an asset or a liability arising under the standard is expected to be realised or settled within the entity's operating cycle. If it is, then it is classified as current. To determine its operating cycle, the entity considers the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. It is the ultimate realisation in cash that matters for the analysis, rather than a change in the nature of the item – e.g. a contract asset becoming a trade receivable.

If an entity has different operating cycles for different parts of the business – e.g. retail and construction – then the classification of an asset as current is based on the normal operating cycle that is relevant to that particular asset. In our view, the entity need not identify a single operating cycle.

If an asset is realised or a liability is settled beyond an entity's operating cycle, then to determine the appropriate classification in the statement of financial position the entity considers the nature of that asset or liability and applies the existing guidance for similar assets or liabilities. In determining the appropriate classification, the entity considers whether:

- the entire item should be presented as current or non-current; or
- it should be split into current and non-current components.

The nature of contract assets, contract liabilities and costs to obtain or costs to fulfil a contract may differ under different contracts. An entity needs to consider all facts and circumstances in determining the nature of the item.

An example of the analysis is included in the table below.

Item	**Similar in nature to…**	**Classification**
Asset arising from costs to obtain a contract	Intangible assets	Non-current in its entirety
Asset arising from costs to fulfil a contract	Inventory	Current in its entirety
Contract asset	Trade receivables	Current and non-current – split
Contract liabilities	Other operating liabilities	Current in its entirety
Contract liabilities	Long-term borrowings	Current and non-current – split

If an entity classifies an asset or a liability as current, but does not expect to realise or settle it within the 12 months after the reporting period, then it discloses the amount expected to be realised or settled after more than 12 months, as required by the presentation standard.

For detailed illustrations, see Examples 4–7B in this chapter.

Presentation of costs to obtain and costs to fulfil a contract in the statement of financial position

IAS 1.29–30A, 55, 58–59, 77, IFRS 15.110

Neither the revenue nor the presentation standard provides specific guidance on the presentation of assets arising from the costs to obtain and costs to fulfil a contract. An entity applies judgement, based on considerations of materiality, in determining whether these items should be presented separately in the statement of financial position or can be aggregated with other items and disclosed in the notes. In doing so, an entity assesses:

- the nature and liquidity of assets;
- the function of assets within the entity; and
- the measurement basis of the item.

An entity cannot aggregate material items that have a different nature or function.

If an entity determines on the basis of materiality considerations that contract costs do not warrant separate presentation in the statement of financial position, then it considers whether there is another line item(s) with which it would be appropriate to aggregate them. The key factor in this analysis is the nature of items being considered for aggregation. For example, in some cases costs to obtain a contract may be similar in nature to an intangible asset – e.g. customer relationship. This is because those costs are amortised over a period beyond the existing contract term taking into account future anticipated contracts. Conversely, costs to fulfil a contract may be similar in nature to prepaid operating costs or work in progress – i.e. inventory.

The nature of costs to obtain or costs to fulfil a contract may differ under different contracts and an entity needs to consider all facts and circumstances in determining the nature of the item.

Additional application examples

Example 2 – Impairment assessment of contract assets: Variable consideration

Company X enters into a contract with Customer C to deliver 100 tonnes of copper concentrate for 100. C determines the actual quantity of copper delivered after processing the concentrate. X delivers copper concentrate on 20 December and C is expected to confirm the actual quantity on 15 January.

X determines that the consideration under the contract is variable and therefore it applies the constraint. On 20 December, X recognises revenue and a contract asset of 80. At 31 December, X assesses the contract asset for impairment. X expects to recover 95% of the transaction price.

We believe that X should perform the impairment assessment of the contract asset based on the constrained consideration of 80 and recognise an impairment loss of 4 (80 - 80 × 95%).

Alternatively, X can perform the impairment assessment based on the unconstrained amounts and recognise the impairment loss in proportion to the contract assets recognised. This would lead to the same outcome as the impairment assessment based on the constrained amounts – i.e. an impairment loss of 4 ((100 - 100 × 95%) × 80 / 100).

Example 3 – Impairment assessment of contract assets: Contracts with multiple performance obligations

Company M enters into a contract with Customer L to provide tax advice, accounting training to L's employees and advice on implementing a new accounting standard for total consideration of 300. M determines that the contract contains three separate performance obligations. Under the contract, M has an unconditional right to receive consideration on issuing an invoice for work performed. At 31 December, M has a trade receivable of 120 and a contract asset of 14.

M allocates revenue, invoiced amounts and contract assets to each performance obligation as follows.

	PO1	PO2	PO3	Total
Revenue allocated	80	100	120	300
Percentage of completion	60%	50%	30%	
Revenue recognised	48	50	36	134
Invoiced amounts allocated[1]	32	40	48	120
Contract asset (liability)	16	10	(12)	14

Note

1. In this example, the invoiced amounts are allocated based on the stand-alone selling price of each separate performance obligation, consistently with the allocation of revenue.

M expects to recover 95% of its trade receivables and contract asset.

We believe that M should assess its contract asset for impairment at the contract level and recognise an impairment loss of 0.7 (14 - 14 × 95%) because the net contract asset of 14 best represents M's real exposure to L.

Example 4 – Current vs non-current classification: Contract assets: Telco

IAS 1.61

Telco T enters into a contract with Customer C to provide a handset and 24 months of service. The contract term is 24 months because of significant penalties that are due on cancellation. Under the contract, C pays 200 up-front on receiving the handset and 70 at the end of each month. The stand-alone selling prices of the handset and monthly services are 600 and 65 respectively. T allocates 522 to the handset and 56.58 per month to the services.

On delivering the handset, T recognises a contract asset of 322 (522 - 200). Of that amount, 161 (322 / 24 × 12) will be collected within 12 months and the remaining 161 (322 - 161) will be collected after 12 months.

T notes that its contracts with customers are generally of 24 months. Therefore, it concludes that its operating cycle is 24 months. As such, T classifies the entire amount of the contract asset of 322 as a current item. T also discloses amounts that are expected to be recovered after 12 months in accordance with the requirements in the presentation standard.

Modifying the fact pattern, if T's contracts within the same business were of different duration and it defaults to the 12-month operating cycle, then it would look at the nature of the contract asset. It may determine that it is similar to a trade receivable and therefore the amount would be split into a current and non-current portion. The non-current portion would subsequently be reclassified into current when it is due within 12 months.

Example 5 – Current vs non-current classification: Contract assets: Real estate developer

IAS 1.61

Developer D enters into a contract with Customer P to construct a building for fixed consideration of 100 million. The construction takes 30 months to complete. The milestone payments and actual construction progress are as follows (in millions).

Month	Milestone payments	Actual construction progress	Contract assets/ (liability)
0 (at inception)	5	0%	(5)
12	10	30%	15
24	10	80%	55
30	65	100%	10
42	10	100%	-

Of the contract assets of 15 million recognised at the end of the first 12 months, 10 million will be collected within 12 months and the remaining 5 million will be collected after 12 months.

D considers the duration of its projects in determining its operating cycle. If all projects are performed within a similar timeframe, then this may indicate that D's operating cycle is identifiable and approximates the average duration of its projects – e.g. 30 months. In this case, the entire amount of the contract asset of 15 is presented as a current item. The amounts that are expected to be recovered after 12 months are separately disclosed in accordance with the requirements in the presentation standard.

The analysis is similar to Example 4 in this chapter if D's projects are of different duration and it defaults to the 12-month operating cycle.

IFRIC 12.15, 17

Example 6 – Current vs non-current classification: Contract assets: Service concession

Company S enters into a contract with the government to build a toll bridge. Construction takes 30 months. On completion, S receives a right to charge tolls at the bridge for 10 years (i.e. it recognises an intangible asset as the consideration for its construction service).

S recognises a contract asset as the construction progresses and an intangible asset when the construction is completed and it has a right to charge the toll.

Similar to Examples 4 and 5 in this chapter, S needs to consider its operating cycle. If S defaults to a 12-month operating cycle, then it considers the nature of the asset. In this example, the nature may be similar to an intangible asset and therefore it may be appropriate to classify the contract asset as a non-current item in its entirety.

Example 7A – Current vs non-current classification: Contract liabilities: Full prepayment for a good that transfers at a point in time

Developer D enters into a contract with Customer S for a sale of a residential unit. The development takes three years and control over the unit transfers at a point in time on completion of construction. D requires S to pay the full contract price of 300 on entering into the contract. D recognises a contract liability of 300.

Similar to Examples 4–6 in this chapter, D considers its operating cycle. If it approximates three years, then the contract liability is classified as current.

If D defaults to a 12-month operating cycle, then there are two approaches.

Approach 1 – Operating nature

Under this approach, D determines that the nature of the contract liability is similar to other operating items. Therefore, it is classified as current.

Approach 2 – Long-term borrowing nature

Under this approach, D determines that the nature of the advance received is similar to a long-term borrowing. D classifies 300 as non-current on initial recognition and reclassifies the balance as current 12 months before the expected completion of the project and recognition of revenue.

Example 7B – Current vs non-current classification: Contract liabilities: Full prepayment for a good that transfers over time

Modifying Example 7A, control over the residential unit transfers over time. Developer D uses the cost-to-cost method to measure its progress and performs evenly throughout the project.

The analysis is the same as in Example 7A except that under Approach 2 when D defaults to the 12-month operating cycle D classifies 200 as non-current and 100 related to the amount of revenue expected to be recognised during the next 12 months as current. D reclassifies the balance of 200 proportionally as current as it progresses with the construction based on the measure of progress.

11.1.1 Contract assets vs receivables

IFRS 15.105, 108, IFRS 9

If the entity has an unconditional right to consideration, then this is presented as a receivable. A right to consideration is 'unconditional' if only the passage of time is required before payment becomes due. Receivables are presented separately from contract assets and cannot be netted against contract liabilities.

An entity accounts for receivables, including their measurement and disclosure, using the financial instruments guidance. On initial recognition of a receivable, any difference between the measurement of that receivable using the financial instruments guidance (e.g. impairment as a result of credit risk) and the corresponding amount of revenue recognised is presented as an expense. Any subsequent impairment of the receivable is also accounted for as an expense.

Example 8 – Contract liability and receivable: Non-cancellable contract

IFRS 15.IE199–IE200

Modifying Example 1 in this chapter, assume that Manufacturer D's contract is non-cancellable. D has an unconditional right to consideration on 31 January 2022 and therefore it recognises a receivable. D records the following entries to account for:

- the receivable on 31 January 2022 and the related contract liability;
- cash received on 1 March 2022; and
- revenue on transfer of the product on 31 March 2022.

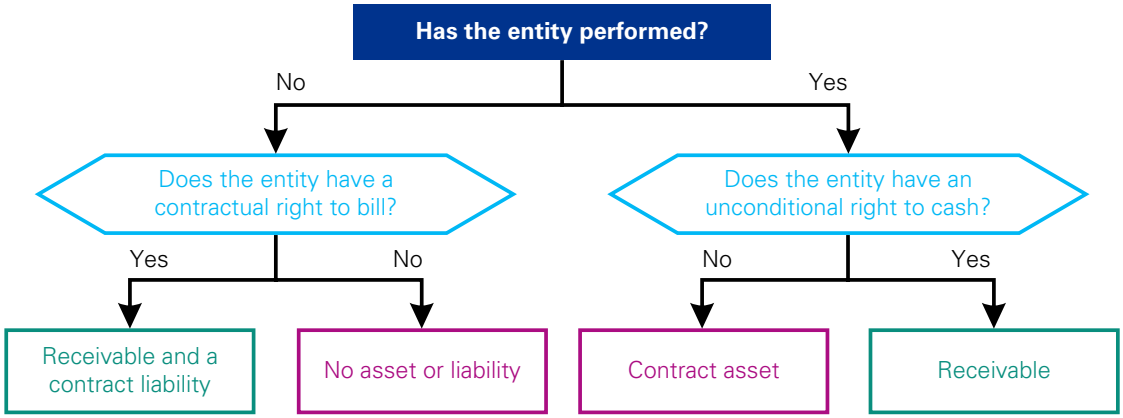
	Debit	*Credit*
31 January 2022		
Receivable	1,000	
Contract liability		1,000
To record consideration due		
1 March 2022		
Cash	1,000	
Receivable		1,000
To record D's receipt of cash		
31 March 2022		
Contract liability	1,000	
Revenue		1,000
To record D's satisfaction of performance obligation		

If D issued the invoice before 31 January 2022 – i.e. the payment due date – then it would not record a receivable before 31 January 2022 because it would not yet have an unconditional right to consideration.

Receivable vs contract asset – Distinction based on unconditional right to consideration

IFRS 15.IE201–IE204

Under the standard, an entity recognises a receivable when it has a right to consideration that is unconditional. The timing of recognition of receivables is critical because it may impact their classification and measurement. For example, there may be an impact on the classification assessment under the financial instruments standard, or the fair value of a receivable may be different from the carrying amount of the related contract asset. Determining when to recognise a receivable may be straightforward in some cases but challenging in others. The following flowchart may help with the analysis.



The first step in the analysis is to determine whether the entity has performed under the contract. If it has, then the entity considers whether it has an unconditional right to receive cash. The right to receive cash may be conditional on continuing performance under the contract. Example 39 in the standard illustrates a scenario in which the right to consideration for a delivered product is conditional on the delivery of a second product – i.e. an entity has an unconditional right to consideration only after both products are transferred. Because the right to consideration under the contract is not unconditional, the entity recognises a contract asset instead of a receivable.

IFRS 15.108, IE199–IE200

Under some contracts, an entity has a right to bill the customer in advance of delivering a good or service. In our view, in these cases, an entity should generally recognise a receivable and a contract liability when both of the following conditions are met:

- the contract is non-cancellable; and
- the entity has an unconditional right to bill the customer under the payment terms of the contract.

Under other contracts, an entity may have a right to demand payment for performance completed to date if the contract is terminated by the customer or another party. If the contract is not terminated in this way, then the entity has a right to bill the customer only once the contract is complete. In our view, in these cases, the entity should not generally recognise a receivable as it performs. This is because, before completion of the contract, the right to compensation is conditional on termination of the contract. For an illustration, see Example 9A in this chapter.

Receivables – Unconditional right to consideration may differ from transaction price

In some cases, an entity may have an unconditional right to an amount of consideration that differs from the transaction price – e.g. contracts involving retrospective rebate arrangements. In our view, in these cases the receivable should be recognised at the amount to which the entity has an unconditional right rather than the transaction price. The difference between the two amounts is recognised as a refund liability.

Derecognition of contract assets – Apply derecognition requirements in the financial instruments standard

An entity generally recognises a receivable rather than a contract asset when its right to consideration becomes unconditional. However, in some cases an entity may transfer its right to consideration related to a contract asset to another party – e.g. in a factoring arrangement. The revenue standard does not provide guidance on how to evaluate whether the contract asset should be derecognised in this scenario. In the absence of specific requirements, in our view it is appropriate to apply the derecognition requirements in the financial instruments standard by analogy.

In our experience, the transfer of a contract asset is unlikely to meet the derecognition criteria in the financial instruments standard when the right to receive cash is conditional on the entity's future performance – e.g. when a contract asset relates to a partially satisfied over-time performance obligation. This is because it would be unlikely that another party would agree to take on the risk that the entity does not complete its performance.

Receivable vs contract asset – Refund obligations do not impact the analysis

IFRS 15.BC326

An entity's possible obligation to refund consideration to a customer in the future does not affect the entity's present right to the gross amount of consideration. When a right of return exists, an entity recognises a receivable and a separate refund liability for the amount of the estimated refund (see Section 10.1).

Milestone payments under over-time contracts

Under some contracts for which revenue is recognised over time, an entity may have a right to bill the customer when it achieves a specific stage of the project. These payments are often referred to as 'milestone payments'. In our view, in these cases an entity should recognise a receivable when the milestone payment is due if it is not conditional on the completion of the entire performance obligation. For an illustration, see Example 9B in this chapter.

IFRS 15.108, IE205–IE208, IASBU 12–15

Recognising a receivable when the consideration is variable

An entity may have a right to receive partially or wholly variable consideration for a previously transferred good or service. In our view, in these cases an entity should recognise a receivable to the extent that it has an unconditional right to a fixed amount of consideration. For variable amounts, the timing of recognition of a receivable depends on the nature of variability. We believe that the following is one acceptable approach to accounting for variable amounts.

- *Variable amounts subject to a refund:* Recognise a receivable when the entity has a present right to payment, even if the payment may be subject to a refund in the future.
- *Other variable consideration in the scope of the revenue standard:* Recognise a receivable only after the amounts become fixed. This is because the payment for these amounts depends on conditions other than the passage of time (e.g. possible actions by the entity, customers or third parties – see Section 3.1).
- *Variable consideration not in the scope of the revenue standard:* This variability does not prevent recognition of receivables. Instead, it is considered to be a part of the contractual terms of the receivable recognised and may impact the classification and measurement of the receivable under the financial instruments standard (e.g. changes in the market price of a commodity that has been delivered – see Section 3.1).

For an illustration, see Example 10 in this chapter.

Additional application examples

Example 9A – Recognising receivables: Compensation on termination

On 1 January Year 1, Manufacturing Company X enters into a contract to construct a specialised asset for Customer S for 1,000. Under the payment terms in the contract, all consideration is payable on completion of construction. However, if the contract is terminated by S then X has an enforceable right to payment for its performance completed to date. X determines that Criterion 3 for over-time revenue recognition is met (see Section 5.2).

On 31 March Year 1, construction is 25% complete and X recognises revenue of 250. We believe that X should recognise a contract asset, and not a receivable, of 250. This is because X's right to payment for performance completed to date is conditional on early termination of the contract.

Example 9B – Recognising receivables: Milestone payments

Modifying Example 9A, Manufacturing Company X is entitled to a milestone payment of 100 when construction is 25% complete. We believe that on 31 March Year 1, X should recognise a receivable of 100 and a contract asset of 150. This is because on that date X has an unconditional right to the milestone payment of 100.

Example 10 – Recognising receivables: Variable consideration

On 1 January Year 1, Real Estate Company Y sells a plot of land, which it classified as inventory, to Customer C. Under the payment terms in the contract, C will pay Y 1,000 on 1 April Year 1. In addition, if C obtains a planning permit to redevelop the land, then it will pay an additional 300 to Y. On 1 January Year 1, Y determines that it is not highly probable that C will obtain the permit and therefore it recognises revenue of 1,000 (see 3.1.2).

On 30 June Year 1, C reaches the final stage of the process for receiving the planning permit. Therefore, Y determines that it is highly probable that the additional consideration will be received and recognises additional revenue of 300. On 31 December Year 1, C obtains the permit and the additional consideration becomes billable under the payment terms in the contract.

We believe that on 1 January Year 1, Y should recognise a receivable of 1,000 for the land sold. On 30 June Year 1, Y should recognise revenue of 300 and a contract asset. This is because at this date receipt of this amount remains conditional on C receiving the planning permit for the land. On 31 December Year 1, Y should recognise a receivable of 300 because on that date the additional amount becomes fixed.

Example 11 – Recognising receivables: Unconditional amount differs from transaction price

On 1 February 2022, Company S enters into a contract with Customer C to sell widgets at 10 per unit. C is required to pay for the widgets 30 days after delivery. If C purchases more than 1,000 units, then it is entitled to a retrospective rebate of 1 per unit. To settle the rebate, S can issue a credit note to reduce the amount outstanding from C rather than making a cash payment.

On 1 March 2022, C purchases 500 units. S estimates that C will meet the volume threshold for the rebate later in the year, and therefore the transaction price should reflect the unit price of 9 (10 - 1). However, before C has met that volume threshold, S has an unconditional right to consideration reflecting the unit price of 10. S issues an invoice to C at the amount of 5,000 (500 x 10) and records:

- a receivable of 5,000;
- revenue of 4,500 (500 x 9); and
- a refund liability of 500.

11.2 Statements of profit or loss and cash flows

Neither the revenue standard nor the standards dealing with presentation matters include specific requirements for presentation of items related to contracts with customers in the statement of profit or loss and in the statement of cash flows.

This section provides our insights on some common issues.

IFRS 15.113, IAS 1.29–30, 85

Presenting 'revenue from contracts with customers' separately on the face of the statement of profit or loss is not required

In our view, an entity is not required to present revenue from contracts with customers as a separate line item in the statement of profit or loss and may aggregate it with other types of revenue considering the requirements in the presentation standard. However, in providing a separate disclosure of revenue from contracts with customers – either in the notes or in the statement of profit or loss – we believe that an entity should not include amounts that do not fall in the scope of the revenue standard (see Section 12.1).

IFRS 15.A, 65

Interest income recognised from a significant financing component may be presented as 'revenue' but not 'revenue from contracts with customers'

An entity that regularly provides customers with implicit financing may earn interest income in the course of its ordinary activities. If so, then it may present interest income arising from a significant financing component as a type of revenue in the statement of profit or loss. However, this interest income has to be presented separately from revenue from contracts with customers.

Sale-and-leaseback as part of ordinary activities results in revenue and cost of sales

An entity may enter into sale-and-leaseback transactions regularly. There is no specific guidance in the Accounting Standards on presenting such transactions in the statement of profit or loss of the seller-lessee.

If sale-and-leaseback transactions are part of the ordinary activities of a seller-lessee, then it appears that the seller-lessee should recognise revenue and cost of sales, similar to the presentation requirements for manufacturer or dealer lessors. Conversely, if a sale-and-leaseback transaction is not part of the ordinary activities of the seller-lessee, then it should recognise a net gain or loss from the transaction.

IU 09-2019

Revenue from a contract with a customer can be negative

Unless a payment to a customer is for a distinct good or service, an entity accounts for it as reduction in the transaction price and therefore revenue. In some cases, the amount that an entity pays to a customer under a contract may exceed the amount of consideration the entity receives from that customer, resulting in net negative revenue. The revenue standard does not specify whether such amounts should be presented as part of revenue or as an expense.

In addition, the IFRS Interpretations Committee discussed the accounting for compensation paid to passengers in the airline industry, but specifically declined to address the question of whether negative revenue can be presented as an expense.

The revenue standard envisages that revenue from a contract with a customer can be negative; for example, the guidance on consideration payable to a customer means that the transaction price and therefore revenue can be negative. In our experience, net negative revenue is generally presented in the revenue line item in the statement of profit or loss. However, there may be limited cases in which presenting net negative revenue as an expense may result in more relevant information to the users – e.g. when a customer relationship is terminated such that there are unlikely to be any further anticipated contracts and the payment exceeds cumulative revenue earned to date under the contract. Determining whether to present a net negative revenue contract as an expense requires significant judgement based on the specific facts and circumstances. If an entity presents negative revenue as an expense, then it needs to disclose in the financial statements the presentation approach applied and any significant judgements made in applying that approach.

Presentation of amortisation costs in the statement of profit or loss

IAS 1.97, 99

If an entity presents its expenses by nature, then judgement is required to determine the nature of the expenses arising from the amortisation of capitalised contract costs. The appropriate classification may often depend on the nature of the entity and the industry in which it operates.

Similarly, if an entity presents its expenses by function, then it applies judgement to allocate the amortisation costs to the appropriate function. There is no guidance in IFRS Accounting Standards on how specific expenses are allocated to functions. An entity establishes its own definitions of functions – e.g. cost of sales, distribution and administrative activities – and applies these definitions consistently. It may be appropriate to disclose the definitions used.

In all cases, an entity is subject to the general requirements in the presentation standard to ensure that its presentation is not misleading and is relevant to an understanding of its financial statements.

For an illustration, see Examples 13A and 13B in this chapter.

Classification of cash flows related to contract costs depends on the nature of the activity

IAS 7.6, 11, 14(c), 16(a), IU 03-12, 07-12, 03-13

If an entity capitalises costs to obtain or fulfil a contract, then it needs to determine how to present the related cash outflows in the statement of cash flows. Cash flows are generally classified as operating, investing or financing based on the nature of the activity to which they relate, rather than on the classification of the related item in the statement of financial position.

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of an entity. Some entities may, therefore, present *all* cash flows related to their revenue-generating activity, including costs to obtain and costs to fulfil a contract with a customer, as part of operating activities.

Other entities may analyse costs to obtain a contract and costs to fulfil a contract differently. Although they link costs to fulfil a contract to the revenue-generating activity, and therefore present the related cash flows as part of operating activities, they argue that costs to obtain a contract are more closely linked to their long-term business objective of obtaining and building a customer relationship, which may extend beyond the boundaries of an individual contract. This activity is of an investing nature and therefore the cash flows related to costs to obtain a contract are presented as part of investing activities.

National securities regulators may have specific requirements on this matter.

Additional application examples

Example 12 – Presentation of sale-and-leaseback transaction: Ordinary activity of the entity

The business activities of Property Developer F include property development and management of holiday resorts. As part of its property development business, F designs and develops new holiday resorts and sells units in the new resorts to investors. To run its business of managing holiday resorts, F simultaneously enters into lease arrangements with the buyers of the units to lease the units back under non-cancellable agreements for a period of 15 years. F has determined that these arrangements meet the definition of a sale-and-leaseback transaction because it has concluded that the initial transfer of the units to investors is a sale under the revenue standard. F applies the leases standard to account for the lease transaction.

The Accounting Standards do not provide specific guidance on the presentation of sale-and-leaseback transactions in the statement of profit or loss of a seller-lessee. To determine whether to present revenue and cost of sales for these arrangements or a net gain, F considers whether they are part of its ordinary activities. Because the sale of units to customers is part of its ordinary activities, F concludes that it should present it gross – i.e. showing separately revenue and the related cost of sales. Conversely, if the arrangements were not considered part of F's ordinary activities, then it would present a net gain in the statement of profit or loss.

Example 13A – Presentation of amortisation of contract costs: Expenses by function

Company X presents its expenses by function. During the year, X has recognised amortisation of:

- a commission to sales staff of 20: i.e. costs to obtain a contract; and
- initial third party testing fees of 50: i.e. costs to fulfil a contract.

X includes the commission to sales staff in selling and distribution expenses, and the initial third party testing fees in cost of sales.

Example 13B – Presentation of amortisation of contract costs: Expenses by nature

Modifying Example 13A, Company X presents its expenses by nature. Based on its analysis, X determines that the commission to sales staff is similar in nature to other staff costs and therefore presents the amortisation of the commission as part of employee expenses. Conversely, if X determined that the commission were similar in nature to an investment in a customer relationship, then it may present amortisation of the commission together with amortisation of other non-current assets.

X determines that the initial third party testing fees are similar in nature to other contract fulfilment costs and presents them in the same line as those other contract fulfilment costs.

12 Disclosure

Overview

The standard contains both qualitative and quantitative disclosure requirements for annual and interim periods.

12.1 Annual disclosures

IFRS 15.110

The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of the financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

IFRS 15.113, 129

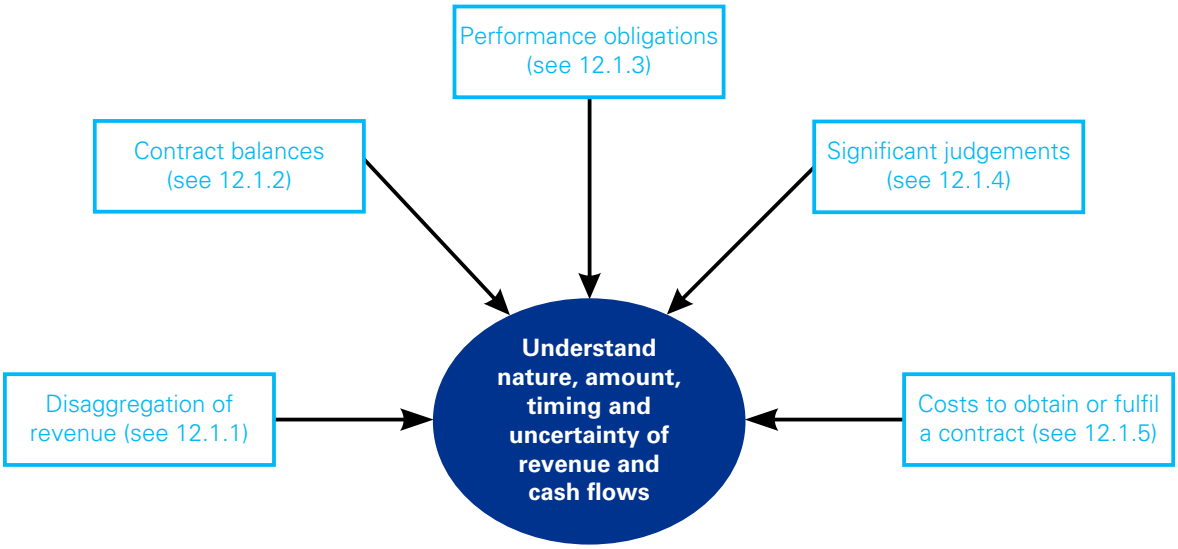
An entity is required to disclose, separately from other sources of revenue, revenue recognised from contracts with customers – i.e. revenue in the scope of the standard – and any impairment losses recognised on receivables or contract assets arising from contracts with customers. If an entity elects either the practical expedient not to adjust the transaction price for a significant financing component (see Section 3.2) or the practical expedient not to capitalise costs incurred to obtain a contract (see Section 7.1), then it discloses this fact.

IFRS 15.113, IAS 1.29–30, 85

In our view, an entity is not required to present revenue from contracts with customers as a separate line item in the statement of profit or loss and may aggregate it with other types of revenue considering the requirements in the presentation standard. However, in providing a separate disclosure of revenue from contracts with customers – either in the notes or in the statement of profit or loss – we believe that an entity should not include amounts that do not fall in the scope of the revenue standard.

IFRS 15.114–115, B87–B89

The standard includes disclosure requirements on the disaggregation of revenue, contract balances, performance obligations, significant judgements and assets recognised to obtain or fulfil a contract.



See our Guide to annual financial statements – Illustrative disclosures (September 2022) and Guide to annual financial statements – IFRS 15 Revenue supplement for example disclosures.

Revenue is a gross number

IFRS 15.A

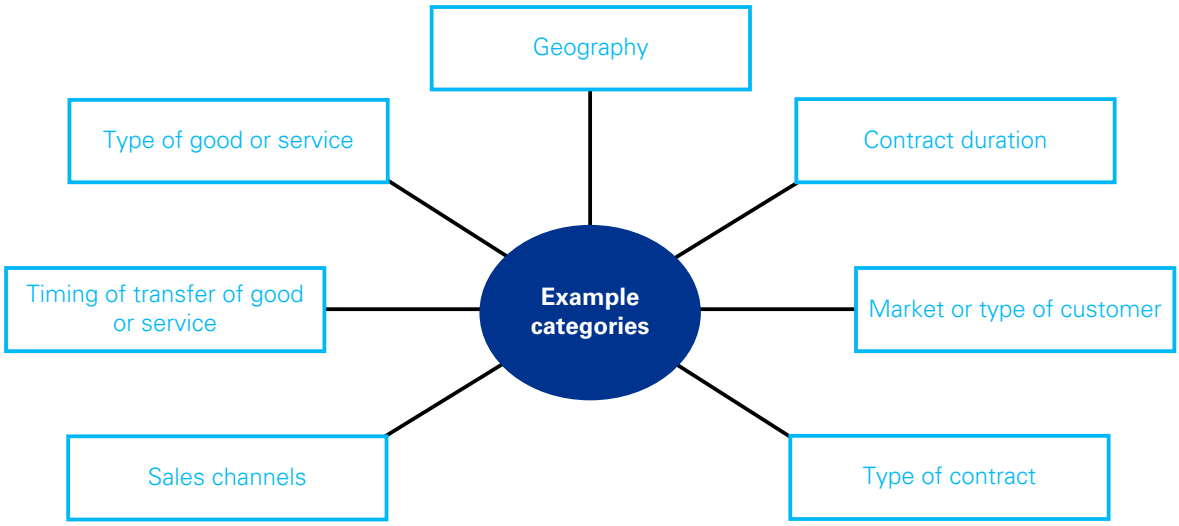
Some entities may present detailed information about their performance in the financial statements and other parts of their annual report on a net basis – e.g. banks often present detailed information about commission and fee income for the purposes of their segment reporting on a net basis, although they act as a principal in those transactions.

Revenue from contracts with customers is a gross inflow. Therefore, an entity cannot use net figures to meet the disclosure requirements in the revenue standard.

12.1.1 Disaggregation of revenue

IFRS 15.114, B89

The standard requires the disaggregation of revenue from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors, and includes examples of these categories.



IFRS 15.115, B87–B88

An entity also discloses the relationship between the disaggregated revenue and the entity's segment disclosures.

In determining these categories, an entity considers how revenue is disaggregated in:

a. disclosures presented outside the financial statements: e.g. earnings releases, annual reports or investor presentations;

b. information reviewed by the chief operating decision maker for evaluating the financial performance of operating segments; and

c. other information similar to (a) and (b) that is used by the entity or users of the entity's financial statements to evaluate performance or make resource allocation decisions.

Example 1 – Disaggregation of revenue

IFRS 8, IFRS 15.IE210–IE211

Company X reports the following segments in its financial statements: consumer products, transport and energy. When X prepares its investor presentations, it disaggregates revenue by primary geographic markets, major product lines and the timing of revenue recognition – i.e. separating goods transferred at a point in time and services transferred over time.

X determines, based on its analysis, that the categories used in the investor presentations can be used for the disaggregation disclosure requirement. The following table illustrates the disaggregation disclosure by primary geographical market, major product line and timing of revenue recognition. It includes a reconciliation showing how the disaggregated revenue ties in with the consumer products, transport and energy segments.

Segments	Consumer products	Transport	Energy	Total
Primary geographic markets				
North America	990	2,250	5,250	8,490
Europe	300	750	1,000	2,050
Asia	700	260	-	960
	1,990	**3,260**	**6,250**	**11,500**

Segments	Consumer products	Transport	Energy	Total
Major goods/service lines				
Office supplies	600	-	-	600
Appliances	990	-	-	990
Clothing	400	-	-	400
Motorcycles	-	500	-	500
Cars	-	2,760	-	2,760
Solar panels	-	-	1,000	1,000
Power plant	-	-	5,250	5,250
	1,990	**3,260**	**6,250**	**11,500**
Timing of revenue recognition				
Goods transferred at a point in time	1,990	3,260	1,000	6,250
Services transferred over time	-	-	5,250	5,250
	1,990	**3,260**	**6,250**	**11,500**

No minimum number of categories required

Although the standard provides some examples of disaggregation categories, it does not prescribe a minimum number of categories. The number of categories required to meet the disclosure objective will depend on the nature of the entity's business and its contracts.

Disaggregation of revenue may be at a different level from segment disclosures

IFRS 15.114

The level of disclosure under the standard is not restricted to the information that the chief operating decision maker uses to assess the entity's performance and allocate its resources. Although an entity considers that information when preparing its disaggregation of revenue disclosures, it also considers other similar information that is used to evaluate performance or make resource allocation decisions.

As a result, some entities may not be able to meet the objective in the standard for disaggregating revenue by providing segment revenue information and may need to use more than one type of category. Other entities may meet the objective by using only one type of category. Even if an entity uses consistent categories in the segment note and in the revenue disaggregation note, further disaggregation of revenue may be required because the objective of providing segment information under the segment reporting standard is different from the objective of the disaggregation disclosure under the revenue standard and, unlike in the segment reporting standard, there are no aggregation criteria in the revenue standard.

For example, an entity's chief operating decision maker regularly reviews a single report that combines the financial information about economically dissimilar businesses – i.e. these businesses form part of one operating segment. However, if segment management makes performance or resource allocation decisions within the segment based on that disaggregated information, then those economically dissimilar businesses could include revenue that would meet the requirements for disaggregation disclosure under the standard.

Nonetheless, an entity does not need to provide disaggregated revenue disclosures if the information about revenue provided for the purposes of the segment reporting meets the revenue disaggregation requirements and those revenue disclosures are based on the recognition and measurement requirements in the standard.

12.1.2 Contract balances

IFRS 15.116–118

An entity is required to disclose all of the following:

- the opening and closing balances of contract assets, contract liabilities and receivables from contracts with customers (if they are not otherwise separately presented or disclosed);
- the amount of revenue recognised in the current period that was included in the opening contract liability balance;
- the amount of revenue recognised in the current period from performance obligations satisfied (or partially satisfied) in previous periods: e.g. changes in transaction price;
- an explanation of how the entity's contracts and typical payment terms will affect its contract asset and contract liability balances; and
- an explanation of the significant changes in the balances of contract assets and contract liabilities, which should include both qualitative and quantitative information, such as:
  - changes arising from business combinations;
  - cumulative catch-up adjustments to revenue (and to the corresponding contract balance) arising from a change in the measure of progress, a change in the estimate of the transaction price or a contract modification;
  - impairment of a contract asset; or
  - a change in the timeframe for a right to consideration becoming unconditional (reclassified to a receivable) or for a performance obligation to be satisfied (the recognition of revenue arising from a contract liability).

Changes in the transaction price may need to be disclosed

IFRS 15.116, 118(b)

To disclose the amount of revenue recognised in the current period that relates to performance obligations that were satisfied (or partially satisfied) in a prior period, as well as cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, an entity may need to track separately the effects of changes in the transaction price.

For example, Manufacturer M enters into a contract containing a single performance obligation that is satisfied over time. The contract price includes 5,000 fixed consideration plus up to 1,000 variable consideration based on manufacturing targets.

At the end of Year 1, the contract is 35% complete and M estimates that total variable consideration will be 200. At the end of Year 2, the contract is 90% complete and M estimates that total variable consideration will be 1,000.

M therefore recognises revenue as follows.

	Fixed consideration	Variable consideration	Total
At end of Year 1 (contract 35% complete)			
Estimated transaction price	5,000	200	5,200
Revenue recognised in Year 1 (35%)	1,750	70	1,820
At end of Year 2 (contract 90% complete)			
Estimated transaction price	5,000	1,000	6,000
Cumulative revenue to end of Year 2 as contract is 90% complete	4,500	900	5,400
Less revenue recognised in Year 1	(1,750)	(70)	(1,820)
Revenue recognised in Year 2	2,750	830	3,580

In the financial statements for Year 2, M discloses the amount of revenue recognised in Year 2 as a result of the change in the transaction price. Because the transaction price increased by 800 (1,000 – 200) and the contract was 35% complete at the end of Year 1, the amount to be disclosed as revenue recognised in the reporting period from a performance obligation partially satisfied in a previous period is 280 (800 × 35%).

12.1.3 Performance obligations

IFRS 15.119–120

An entity provides the following information about its performance obligations:

- *when the entity typically satisfies its performance obligations:* e.g. on shipment, on delivery, as services are rendered or on completion of service;
- *significant payment terms:* e.g. whether the contract has a significant financing component, the consideration is variable and the variable consideration is constrained;
- *the nature of the goods or services* that it has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (if the entity is acting as an agent);
- *obligations for returns, refunds* and other similar obligations;
- *types of warranties* and related obligations; and
- *the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied* (or partially unsatisfied) at the reporting date. The entity also provides either a quantitative (using time bands) or a qualitative explanation of when it expects that amount to be recognised as revenue.

IFRS 15.121

As a practical expedient, an entity is not required to disclose the transaction price allocated to unsatisfied (or partially unsatisfied) performance obligations if:

- the contract has an original expected duration of one year or less;
- the entity applies the practical expedient to recognise revenue at the amount to which it has a right to invoice, which corresponds directly to the value to the customer of the entity's performance completed to date – e.g. a service contract in which the entity bills a fixed hourly amount (see 5.3.4).

IFRS 15.122

The entity also discloses whether it is applying the practical expedient and whether any consideration from contracts with customers is not included in the transaction price – e.g. whether the amount is constrained and therefore not included in the disclosure.

Remaining performance obligation disclosures may differ from backlog disclosures

IFRS 15.BC349

Some entities, including those with long-term contracts, publicly disclose bookings or backlogs (i.e. contracts received but incomplete or not yet started). Bookings are typically a metric defined by management to facilitate discussions with investors and, under some local regulations, 'backlog' may be subject to legal interpretation.

The disclosure about remaining performance obligations is based on the determination of the transaction price for unsatisfied (or partially unsatisfied) performance obligations and therefore it may differ from the disclosure of bookings or backlog – e.g. because it does not include orders for which neither party has performed and each party has the unilateral right to terminate a wholly unperformed contract without compensating the other party.

Contract renewals are included only if they provide a material right

The standard requires passive and active renewals to be accounted for in the same way, because the customer is making the same economic decision. For example, a one-year service contract with an option to renew for an additional year at the end of the initial term is economically the same as a two-year service contract that allows the customer to cancel the contract at the end of the first year without penalty and avoid payment for the second year.

Contracts with passive or active renewals that do not give the customer a material right are not included in the disclosure of remaining performance obligations, but a one-year contract with a renewal period that is a material right is included to the extent of the material right. Similarly, a two-year contract that provides the customer with a cancellation provision after the first year is included in the disclosure of remaining performance obligations if the second year of the contract provides the customer with a material right.

Certain contracts can be excluded from remaining performance obligation disclosures

The practical expedient allows an entity to exclude from the remaining performance obligations disclosure contracts that have an original expected duration of one year or less. However, an entity is not precluded from including all contracts in the disclosure.

Constrained transaction price is used in the remaining performance obligation disclosures

The transaction price used in the remaining performance obligations disclosure is the constrained amount. An entity also explains qualitatively whether any consideration is not included in the transaction price – e.g. constrained variable consideration – and, therefore, is not included in the remaining performance obligations disclosure.

12.1.4 Significant judgements when applying the standard

IFRS 15.123 An entity discloses the judgements and changes in judgements made in applying the standard that affect the determination of the amount and timing of revenue recognition – specifically, those judgements used to determine whether an entity acts as a principal or an agent, the timing of the satisfaction of performance obligations, the transaction price and amounts allocated to performance obligations.

IFRS 15.124 For performance obligations that are satisfied over time, an entity describes the method used to recognise revenue – e.g. a description of the output or input method and how those methods are applied – and why the methods are a faithful depiction of the transfer of goods or services.

IFRS 15.125 For performance obligations that are satisfied at a point in time, the standard requires a disclosure about the significant judgements made to evaluate when the customer obtains control of the promised goods or services.

IFRS 15.126 An entity also discloses information about the methods, inputs and assumptions used to:

- determine the transaction price, which includes estimating variable consideration, assessing whether the variable consideration is constrained, adjusting the consideration for a significant financing component and measuring non-cash consideration;
- allocate the transaction price, including estimating the stand-alone selling prices of promised goods or services and allocating discounts and variable consideration; and
- measure obligations for returns and refunds and other similar obligations.

Greater specificity in the revenue standard

IFRS 15.BC355 IFRS Accounting Standards have general requirements on disclosing an entity's significant accounting estimates and judgements, but the revenue standard provides specific areas for which disclosures are required about the estimates used and judgements made in determining the amount and timing of revenue recognition.

12.1.5 Assets recognised for costs to obtain or fulfil a contract with a customer

IFRS 15.127–128 An entity discloses the closing balance of assets that are recognised from the costs incurred to obtain or fulfil a contract with a customer, separating them by their main category – e.g. acquisition costs, pre-contract costs, set-up costs and other fulfilment costs – and the amount of amortisation and any impairment losses recognised in the reporting period. An entity describes the judgements made in determining the amount of the costs incurred to obtain or fulfil a contract with a customer and the method used to determine the amortisation for each reporting period.

12.2 Interim disclosures

IAS 34.16A(g)

IFRS Accounting Standards require entities to include information about disaggregated revenue in their interim financial reporting.

Extent of interim revenue disclosures requires judgement

IAS 1.17(c), 34.15–15C, 16A(l)

The interim reporting standard includes only one explicit requirement related to revenue from contracts with customers – i.e. to provide information about disaggregated revenue. However, to meet other requirements in the interim reporting standard – e.g. to provide an explanation of events and transactions that are significant to an understanding of the changes in the entity's financial position and performance since the most recent annual reporting period – other revenue disclosures in addition to disaggregated information may be relevant. An entity considers its specific facts and circumstances, including guidance provided by a local regulator, and exercises judgement in determining the extent of additional revenue disclosures in the interim period.

Guidance referenced

Standards are referred to in this handbook by their topic – e.g. references to 'the financial instruments standard' are to IFRS 9.

Guidance referenced in this handbook	
	The Conceptual Framework for Financial Reporting
IFRS 1	First-time Adoption of International Financial Reporting Standards
IFRS 2	Share-based Payment
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
IFRS 8	Operating Segments
IFRS 9	Financial Instruments
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint Arrangements
IFRS 14	Regulatory Deferral Accounts
IFRS 15	Revenue from Contracts with Customers
IFRS 16	Leases
IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Statement of Cash Flows
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 16	Property, Plant and Equipment
IAS 24	Related Party Disclosures
IAS 28	Investments in Associates and Joint Ventures
IAS 32	Financial Instruments: Presentation
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IAS 40	Investment Property
IFRIC 12	Service Concession Arrangements
IU MM-YY	IFRIC Update month year

Detailed contents

Index of examples

3 Determine the transaction price (Step 3)

3.1 Variable consideration (and the constraint)

3.2 Significant financing component

3.3 Non-cash consideration

3.4 Consideration payable to a customer

10 Other application issues

10.1 Sale with a right of return

10.2 Warranties

10.3 Principal vs agent considerations

10.4 Customer options for additional goods or services

10.5 Customers' unexercised rights (breakage)

10.6 Non-refundable up-front fees

Index of KPMG insights

2.2 Implied promises and administrative tasks

2.3 Series of distinct goods or services

3 Determine the transaction price (Step 3)

3.1 Variable consideration (and the constraint)

3.2 Significant financing component

3.3 Non-cash consideration

About this publication

Content

Our *IFRS handbooks* are prepared to address practical application issues that a company may encounter when applying a specific standard or interpretation. They include discussion of the key requirements, guidance and examples to elaborate or clarify the practical issues in applying the requirements.

This edition of our *IFRS handbook* provides a comprehensive analysis of IFRS 15 and addresses practical application issues that KPMG member firms have encountered. It includes extensive interpretative guidance and illustrative examples.

This handbook reflects standards in issue at 1 November 2022 that are effective for annual periods beginning on or after 1 January 2022. This handbook focuses on the requirements of IFRS 15 and its interaction with other standards, though it does not provide a comprehensive analysis of the requirements of the other standards and interpretations to which it refers. Further discussion and analysis of these standards and interpretations is included in our publication Insights into IFRS.

In many cases, further analysis and interpretation may be needed for an entity to apply the requirements to its own facts, circumstances and individual transactions. Furthermore, some of our observations may change and new observations will be made as issues arise from the implementation of the new guidance and as practice develops.

IFRS Accounting Standards and their interpretation change over time. Accordingly, neither this handbook nor any of our other publications should be used as a substitute for referring to the standards and interpretations themselves.

Acknowledgements

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited). We are grateful for the input of current and former members of the group and the Department of Professional Practice of KPMG LLP in the US.

We would like to acknowledge the efforts of the following members of the KPMG International Standards Group, who were the principal authors of and main contributors to this publication: Suzanne Arnold, Kim Heng, Kaori Ikeda, Irina Ipatova, Daisuke Masuda, Brian O'Donovan, Phong Phan, Anthony Voigt and Stacy Wingrove.

We would also like to thank the following, who contributed their time for exhaustive and challenging reviews of this edition.

KPMG Global IFRS Revenue Recognition and Provisions Topic Team

Tiago Bernert	Brazil
Meredith Canady	US
Eric Damotte	Spain
Matthias Fuchs	Germany
Yoshi Hasegawa	Japan
Yusuf Hassan	United Arab Emirates
Kim Heng	Australia
Reinhard Klemmer	Singapore
Michael Kraehnke	US
David Littleford	UK
Allison McManus	Canada
Brian O'Donovan	UK
Emmanuel Paret	France
Tara Smith	South Africa
Ko Sin	China
Patouche Van Staaij	Belgium

home.kpmg/ifrs

Publication name: *Revenue – IFRS 15 handbook*

Publication number: 137827

Publication date: November 2022