Special Edition on Revenue

MFRS Hot Topics

July 2014

"After more than five years in development the IASB and FASB have at last published their new, converged Standard on revenue recognition – IFRS 15 'Revenue from Contracts with Customers'. IFRS 15 replaces IAS 18 and IAS 11 and will affect almost every revenue-generating entity that applies IFRSs. We applaud the two Boards for delivering a converged Standard in this critical area. Convergence has been challenging and sometimes controversial. Against that background, we see this Standard as a landmark achievement that will provide a major boost for investors looking to compare company performance across borders.

IFRS 15 will apply to most revenue contracts, including construction contracts. Among other things, it changes the criteria for determining whether revenue is recognised at a point in time or over time. IFRS 15 also has more guidance in areas where current IFRSs are lacking – such as multiple element arrangements, variable pricing, rights of return, warranties and licensing.

The actual impact on each company's top line will depend on their specific customer contracts and how they have applied existing Standards. For some it will be a significant shift, and systems changes will be required, while others may see only minor changes. Although IFRS 15 only takes effect in 2017, management should begin their impact assessment much sooner."

Andrew Watchman
Global Head – IFRS

A shift in the top line – the new global revenue standard is here at last

The IASB has published IFRS 15 'Revenue from Contracts with Customers'. IFRS 15:

- replaces IAS 18 'Revenue', IAS 11 'Construction Contracts' and some revenue-related Interpretations
- establishes a new control-based revenue recognition model
- changes the basis for deciding whether revenue is recognised at a point in time or over time
- provides new and more detailed guidance on specific topics
- expands and improves disclosures about revenue.

This special edition of IFRS News explains the key features of the new Standard and provides practical insights into its application and impact.

A single model for revenue recognition

IFRS 15 is based on a core principle that requires an entity to recognise revenue:

- in a manner that depicts the transfer of goods or services to customers
- at an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services.

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." Applying this core principle involves the following five steps:

Five steps for revenue recognition

1. Identify the contract(s) with a customer
2. Identify the performance obligations
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognise revenue when or as an entity satisfies performance obligations

IFRS 15 at a glance

Situation	Details
Who's affected?	• all entities that enter into contracts with customers with few exceptions.
What is the impact?	• entities affected will need to reassess their revenue recognition policies and may need to revise them • the timing and amount of revenue recognised may not change for simple contracts for a single deliverable but most complex arrangements will be affected to some extent • IFRS 15 requires more and different disclosures.
When are the changes effective?	• annual periods beginning on or after 1 January 2017 • early application is permitted.

Practical insight – some industries will be affected more than others

Some of the industries that will be most affected by revenue recognition changes include:

- **telecoms and IT** – where multiple deliverables are commonplace and current practice is mixed. Cell-phone businesses that account for a "free" handset as a marketing cost will need to change this policy and instead allocate revenue based on relative standalone selling prices
- **real estate** – when to take revenue for "off plan" apartment sales has been a difficult issue and the new model will shift the boundary between percentage-of-completion and on-completion revenue recognition
- **asset management, legal and professional services and other sectors where performance-based or contingent fees are commonplace** – under the new model variable payments are accounted for on a best estimate basis subject to a constraint
- **retail** – accounting for rights of return, customer loyalty schemes and warranties could all be affected.

Other areas that could be affected include deferred and advanced payments, licensing arrangements, breakage and non-refundable upfront fees.

Scope

IFRS 15 applies to contracts with customers to provide goods or services. It does not apply to certain contracts within the scope of other IFRSs such as lease contracts, insurance contracts, financing arrangements, financial instruments, guarantees other than product warranties, and non-monetary exchanges between entities in the same line of business to facilitate sales to third-party customers.

Practical insight – scope

Although the scope of IFRS 15 is described differently, for practical purposes we expect it will be very similar to the scope of IAS 18 and IAS 11 taken together.

IFRS 15 also covers arrangements currently in the scope of IFRIC 13 'Customer Loyalty Programmes', IFRIC 15 'Agreements for the Construction of Real Estate' and IFRIC 18 'Transfers of Assets from Customers'.

Scope of IFRS 15

In scope

- revenue from contracts with customers (subject to specific exceptions), including contracts for
  – sales of goods
  – rendering of services, including construction services
  – licensing of intellectual property
- exchanges of non-monetary assets other than scoped-out exchanges (see below).

Not in scope

- non-contractual income eg fair value of agricultural produce recognised under IAS 41 'Agriculture'
- contracts within the scope of:
  – IAS 17 'Leases'
  – IFRS 4 'Insurance Contracts'
  – IAS 39 'Financial Instruments: Recognition and Measurement' (or IFRS 9 'Financial Instruments')
- contracts that are not with customers (eg some risk-sharing contracts)
- non-monetary exchanges between entities in the same line of business to facilitate sales to customers.

The five steps

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

The first step in IFRS 15 is to identify the "contract," which IFRS 15 defines as "an agreement between two or more parties that creates enforceable rights and obligations." A contract can be written, oral, or implied by an entity's customary business practices.

In addition the general IFRS 15 model applies only when or if:

- the contract has commercial substance
- the parties have approved the contract
- the entity can identify
  - each party's rights
  - the payment terms for the goods and services to be transferred
- it is probable the entity will collect the consideration.

If a customer contract does not meet these criteria, revenue is recognised only when either:

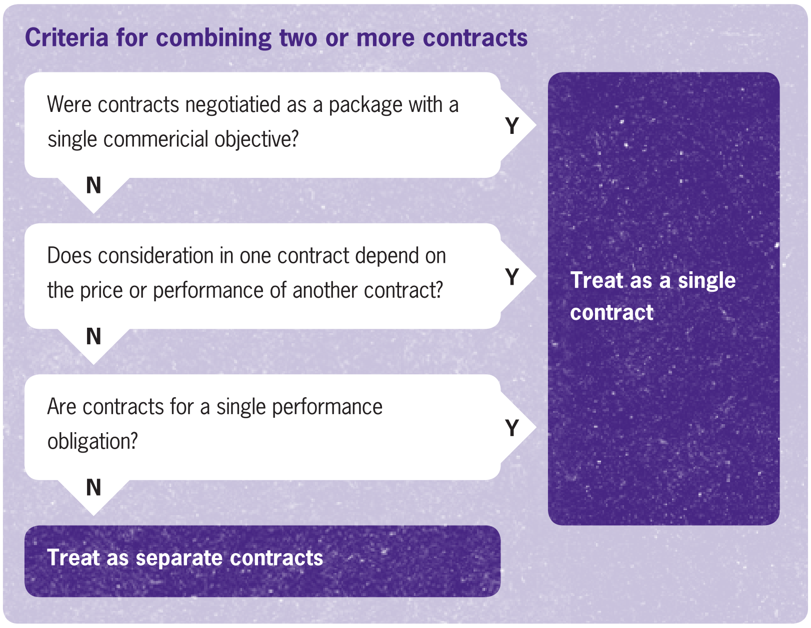
- the entity's performance is complete and substantially all of the consideration in the arrangement has been collected and is non-refundable
- the contract has been terminated and the consideration received is non-refundable.

For purposes of IFRS 15, a contract does not exist if each party has an enforceable right to terminate a wholly unperformed contract without compensating the other party.

Combining contracts

An entity is required to combine two or more contracts and account for them as a single contract if they are entered into at or near the same time and meet one of the following criteria:

- the contracts were negotiated as a package with one commercial objective
- the amount paid under one contract is dependent on the price or performance under another contract
- the goods or services to be transferred under the contracts constitute a single performance obligation.

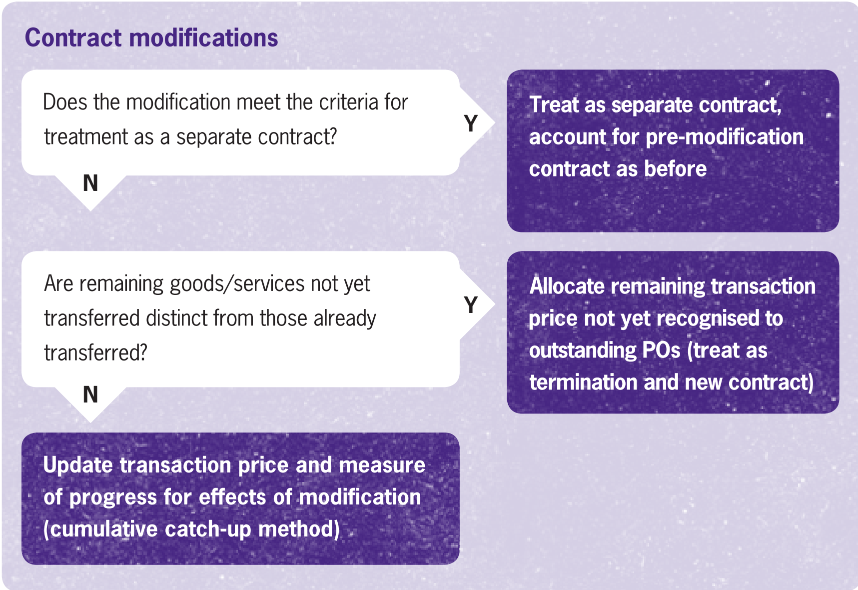


Contract modifications

A contract modification arises when the parties approve a change in the scope and/or the price of a contract (eg a change order). The accounting for a contract modification depends on whether the modification is deemed to be a separate contract or not.

An entity accounts for a modification as a separate contract, if both:

- the scope changes due to the addition of 'distinct' goods or services (see below)
- the price change reflects the goods' or services' stand-alone selling prices under the circumstances of the modified contract.



In this case, only future revenue is impacted as the entity will continue to account for the pre-modification contract as before.

The accounting for a contract modification that is not a separate contract depends on whether the remaining goods and services to be delivered under the modified contract are 'distinct' from those already transferred to the customer at the modification date:

- if the remaining goods or services are distinct, then the modification is treated as a termination of the original contract and the creation of a new contract. The transaction price to be allocated to the remaining separate performance obligations is the (modified) total consideration promised by the customer less the amount already recognised as revenue.

  No adjustments are made to the amount of revenue recognised for separate performance obligations satisfied on or before the modification date. If a change to an amount of variable consideration arises subsequently and relates to performance prior to the modification the entity applies the guidance on variable consideration
- if the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied as of the modification date, the entity adjusts both the transaction price and the measure of progress toward completion of the performance obligation. Revenue recognised to date is adjusted for the contract modification on a 'cumulative catch-up' basis
- if the remaining goods or services are a combination of these scenarios the entity accounts for the effects of the modification on unsatisfied or partially satisfied obligations consistently with the guidance above. No adjustments are made to the amount of revenue recognised for separate performance obligations satisfied on or before the modification date.

If the parties approve a change in scope but the price change has not yet been determined, the entity applies the relevant guidance to the modified contract using an estimate of the change in transaction price arising from the modification. The guidance on variable consideration applies in such cases – see Step 3.

Step 2: Identify the performance obligations

Having identified a contract, the entity next identifies the performance obligations within that contract. A performance obligation is a promise in a contract with a customer to transfer either (1) a good or service, or a bundle of goods or services, that is 'distinct' (see below); or (2) a series of distinct goods or services that are substantially the same and meet certain criteria.

Performance obligations are normally specified in the contract but could also include promises implied by an entity's customary business practices, published policies or specific statements that create a valid customer expectation that goods or services will be transferred under the contract.

Performance obligations do not include administrative-type tasks that do not result in a transfer of a good or service to a customer (eg some set-up activities).

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

- the customer can benefit from the good or service either on its own or with other resources readily available to them. A readily available resource is a good or service that is sold separately (by the entity or by another entity) or that the customer has already obtained
- it is separately identifiable from other promises in the contract. Indicators of separate identifiability include:
  - significant integration services are not provided (ie the entity is not using the good or service merely as an input to produce the specific output called for in the contract)
  - the good or service does not significantly modify or customise other promised goods or services in the contract
  - the good or service is not highly dependent on, or interrelated with, other promised goods or services in the contract.

Meaning of 'distinct'

Customer can benefit from goods/services + Separately identifiable from other contract promises = Distinct

Practical insight – performance obligations

The concept of performance obligations is a cornerstone of the IFRS 15 model. The timing of revenue recognition is based on satisfaction of performance obligations rather than the contract as a whole. This area is sometimes referred to as 'multiple element arrangements' – a topic on which IAS 18 and IAS 11 are lacking in guidance. Practice has therefore been somewhat mixed under current IFRSs and in some industries, such as software, many entities have turned to much more detailed US GAAP for guidance.

Entities applying IFRSs will need to analyse all but the simplest customer contracts to identify whether they include more than one performance obligation, based on the 'distinct' principle described above. That said, we expect that many long-term construction and service contracts will be identified as single performance obligations because they often include a significant integration service. By contrast, the calculation of revenue attributable to free or discounted mobile phones delivered by telecommunications companies as part of an airtime or data package will change if those companies previously applied a 'cash limit' by analogy to US GAAP when assessing the probability of receipt.

IFRS 15 also includes specific guidance on some contract elements such as warranties and customer loyalty schemes.

Step 3: Determine the transaction price

Under IFRS 15, the "transaction price" is defined as the amount of consideration an entity expects to be entitled to in exchange for the goods or services promised under a contract, excluding any amounts collected on behalf of third parties (for example, sales taxes). The transaction price is not adjusted for effects of the customer's credit risk, but is adjusted if the entity (eg based on its customary business practices) has created a valid expectation that it will enforce its rights for only a portion of the contract price.

An entity must consider the effects of all the following factors when determining the transaction price:

- variable consideration
- the constraint on variable consideration
- time value of money
- non-cash consideration
- consideration payable to the customer.

Practical insight – customer credit risk

Under IAS 18 and IAS 11 collectability is a recognition principle because an entity cannot recognise revenue until it is probable that the economic benefits will flow to it. IFRS 15 is somewhat similar in that the model applies only if collection is probable.

Once the entity has determined that the IFRS 15 model applies, the transaction price is based on the contractual entitlement such that expected losses are not treated as variable consideration for revenue recognition purposes (although an expectation of granting a price concession may arise in circumstances of high customer credit risk). Instead IFRS 15 requires that an entity would measure credit losses under the financial instruments standards. The IASB plans to shortly issue a new section of IFRS 9 'Financial Instruments' that will generally require the immediate recognition of lifetime expected losses on both contract assets and short-term trade receivables.

Under IFRS 15 credit losses (initial and subsequent) on both contract assets and receivables must either be presented on the face of the statement of comprehensive income or disclosed in the footnotes – but need not be presented adjacent to revenue as proposed in the 2011 Exposure Draft.

Variable consideration

The amount of consideration received under a contract might vary due to discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties and similar items. IFRS 15's guidance on variable consideration also applies if:

- the amount of consideration received under a contract is contingent on the occurrence or non-occurrence of a future event (eg a fixed-price contract would be variable if the contract included a return right)
- the facts and circumstances at contract inception indicate that the entity intends to offer a price concession.

To estimate the transaction price in a contract that includes variable consideration, an entity determines either:

- the expected value (the sum of probability-weighted amounts) or
- the most likely amount of consideration to be received,

whichever better predicts the amount of consideration to which the entity will be entitled.

The expected value might be the appropriate amount in situations where an entity has a large number of similar contracts. The most likely amount might be appropriate in situations where a contract has only two possible outcomes (for example, a bonus for early delivery that either would be fully received or not at all).

An entity should use the same method to estimate the transaction price throughout the life of a contract.

An entity that expects to refund a portion of the consideration to the customer would recognise a liability for the amount of consideration it reasonably expects to refund. The entity would update the refund liability each reporting period based on current facts and circumstances.

Constraint on variable consideration

If the amount of consideration from a customer contract is variable, an entity is required to evaluate whether the cumulative amount of revenue recognised should be constrained. The objective of the constraint is for an entity to recognise revenue only to the extent that it is highly probable that there will not be a significant reversal (ie significant downward adjustment) when the uncertainty about the variable consideration resolves.

Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, the following:

- the amount of consideration is highly susceptible to factors outside the entity's influence
- the uncertainty is not expected to be resolved for a long time
- the entity's experience with similar contracts is limited
- the entity has a practice of offering a broad range of price concessions
- there are a large number and wide range of possible consideration amounts in the contract.

Sales-based or usage-based royalties

An exception to the general principles on variable consideration applies to revenue for a sales-based or usage-based royalty promised in exchange for a licence of intellectual property. Revenue is recognised only on the later of:

- when the customer makes the subsequent sales or use that triggers the royalty
- the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

Time value of money

Under IFRS 15, an entity must reflect the time value of money in its estimate of the transaction price if the contract includes a significant financing component. The objective in adjusting the transaction price for the time value of money is to reflect an amount for the selling price as though the customer had paid cash for the goods or services when they were transferred.

To determine whether a financing component is significant, an entity considers several factors, including, but not limited to, the following:

- the difference, if any, between the promised consideration and the cash price
- the combined effect of:
  - the expected length of time between delivery of the goods or services and receipt of payment
  - the prevailing interest rates in the relevant market.

A contract may not have a significant financing component if:

- advance payments have been made but the transfer of the good or service is at the customer's discretion
- the consideration is variable based on factors outside the vendor's and customer's control (eg a sales-based royalty)
- a difference between the promised consideration and the cash price relates to something other than financing such as protecting one of the parties from non-performance by the other.

Variable consideration and the revenue constraint

1. Estimate variable consideration and include in transaction price

2. Apply constraint

Expected value

Or

Most likely amount

≤

Limited to the extent that it is 'highly probable' that there will not be a significant revenue reversal

Practical insight – uncertainty in the transaction price

Under IASs 18 and 11, uncertainty in the transaction price is partly a recognition issue. If the revenue amount cannot be measured reliably then no revenue can be recognised (or revenue is limited to the costs incurred when their recovery is probable). If a reliable estimate is available then the uncertain consideration would typically be measured at fair value. Assessing reliability may involve considerable judgement.

IFRS 15 has more specific and detailed guidance and will change some current practices. That said, in highly uncertain situations (eg some success fee-type arrangements when the outcome of the relevant contingency is unpredictable) the practical effect is likely to be the same – ie revenue is recognised only when the uncertainty is resolved. In situations involving multiple similar transactions, such that the entity has relevant, predictive experience, we believe that IFRS 15 could lead to earlier recognition in some cases.

As a practical expedient, an entity can ignore the impact of the time value of money on a contract if it expects, at contract inception, that the period between the delivery of goods or services and customer payment will be one year or less.

To adjust the amount of consideration for the time value of money, an entity applies the discount rate that would be used in a separate financing transaction between the entity and the customer at contract inception. That rate reflects the credit risk of whichever party is receiving credit (ie the customer if payment is deferred and the vendor if payment is in advance) and any collateral or security provided by the customer or the entity, including assets transferred under the contract.

An entity presents the effects of financing separately from revenue as interest expense or interest income in the statement of comprehensive income.

Non-cash consideration

If a customer promises consideration in a form other than cash, an entity measures the non-cash consideration at fair value in determining the transaction price. This includes arrangements in which the customer transfers control of goods or services (eg materials, equipment, labour) to facilitate the entity's fulfilment of the contract.

If an entity is unable to reasonably measure the fair value of non-cash consideration, it indirectly measures the consideration by referring to the stand-alone selling price of the goods or services promised under the contract.

Consideration payable to a customer

Consideration payable to a customer includes amounts that an entity pays or expects to pay to a customer in the form of cash or non-cash items. This includes credit or other items that the customer can apply against amounts owed to the entity. An entity reduces the transaction price by the amount it owes to the customer, unless the consideration owed is in exchange for distinct goods or services transferred from the customer to the entity.

If the customer transfers distinct goods or services to an entity in exchange for payment, the entity accounts for the purchase of these goods or services similarly to other purchases from suppliers. If the amount of consideration owed to the customer exceeds the fair value of those goods or services, the entity reduces the transaction price by the amount of the excess. If the entity cannot estimate the fair value of the goods or services it receives from the customer, it reduces the transaction price by the total consideration owed to the customer.

An entity recognises any reduction in revenue associated with adjusting the transaction price for consideration payable to a customer at the later of the following dates:

- the date the entity recognises revenue for the transfer of goods or services to the customer
- the date the entity pays or promises to pay the consideration to the customer. That promise may be implied by the entity's customary business practices.

Consideration payable to a customer

Is consideration payable to the customer for a distinct good or service?

Y

Account for the purchase of distinct good or service similarly to purchases from suppliers
- if consideration owed to the customer > fair value of goods/services: reduce transaction price by that excess
- if entity cannot estimate fair value of goods/services received from customer: reduce transaction price by total consideration owed to the customer

N

Reduce the transaction price by the amount owed to the customer at later of:
- related revenue is recognised
- consideration is paid or promised to customer

Step 4: Allocate the transaction price to the performance obligations

Under IFRS 15, an entity allocates a contract's transaction price to each separate performance obligation within that contract on a relative stand-alone selling price basis at contract inception. IFRS 15 defines a stand-alone selling price as "the price at which an entity would sell a promised good or service separately to a customer." The best evidence of the stand-alone selling price is the observable selling price charged by the entity to similar customers and in similar circumstances, if available. If not, the stand-alone selling price is estimated using all reasonably available information (including market conditions, entity-specific factors, and information about the customer or class of customer), maximising the use of observable inputs.

IFRS 15 suggests, but does not require, the following three methods as suitable for estimating the stand-alone selling price:

Possible methods to estimate the stand-alone selling price

Method	Description
Adjusted market assessment approach	Involves evaluating the market in which the entity sells goods or services and estimating the price that customers in that market would pay for those goods or services. An entity might also consider price information from its competitors and adjust that information for the entity's particular costs and margins.
Expected cost plus margin approach	An entity would forecast its expected costs to provide goods or services and add an appropriate margin to the estimated selling price.
Residual approach	Involves subtracting the sum of observable stand-alone selling prices for other goods and services promised under the contract from the total transaction price to arrive at an estimated selling price for a performance obligation. This method is permitted only if the entity: • sells the same good/service to different customers (at or near the same time) for a broad range of amounts; or • has not yet established price for the good/service and the good/service has not previously been sold on a stand-alone basis.

Allocating discounts and variable consideration

If the sum of the stand-alone selling prices for the promised goods or services exceeds the contract's total consideration, an entity treats the excess as a discount to be allocated to the separate performance obligations on a relative stand-alone selling price basis. However, an entity would allocate a discount to only some of the performance obligations only if it has observable evidence of the obligations to which the entire discount belongs. IFRS 15 sets out criteria that must be met to satisfy this requirement.

If a discount is allocated entirely to one or more, but not all, performance obligations in a contract, then IFRS 15 requires an entity to allocate that discount before using a residual approach to estimate a stand-alone selling price for a good or service.

Variable consideration may be attributable to the entire contract or only to a specific part. IFRS 15 requires that variable consideration is allocated entirely to a single performance obligation (or to a distinct good or service that forms part of a performance obligation) if and only if both of the following conditions have been met:

- the terms of the variable payment relate specifically to the entity's efforts towards, or outcome from, satisfying that performance obligation (or distinct good or service)
- the result of the allocation is consistent with the amount of consideration to which the entity expects to be entitled in exchange for the promised goods or services.

Changes in estimated transaction price

If the estimated transaction price changes, an entity allocates the change to the performance obligations on the same basis as at contract inception (subject to the specific guidance on contract modifications). Amounts allocated to a satisfied performance obligation are recognised either as revenue or as a reduction in revenue in the period the change occurs.

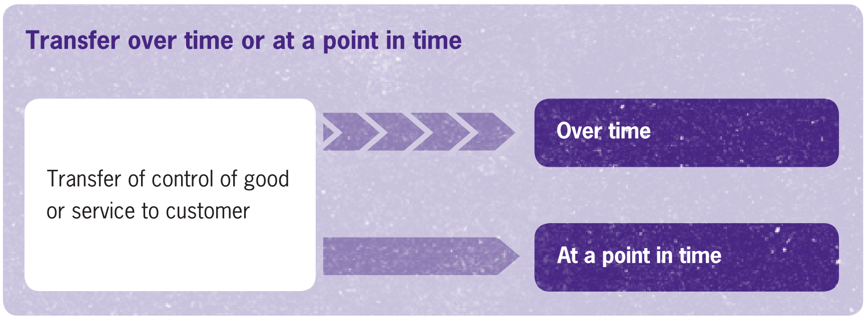
Changes in the transaction price are allocated entirely to one performance obligation (or only some of the total performance obligations) using the same criteria applied to allocation of variable consideration to a single performance obligation.

Step 5: Recognise revenue when or as an entity satisfies performance obligations

Under IFRS 15, an entity recognises revenue when or as it transfers promised goods or services to a customer. A "transfer" occurs when the customer obtains control of the good or service.

A customer obtains control of an asset (good or service) when it can direct the use of and obtain substantially all the remaining benefits from it. Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset. The benefits of an asset are the potential cash flows that can be obtained directly or indirectly from the asset in many ways.

A key part of the model is the concept that for some performance obligations control is transferred over time while for others control transfers at a point in time.



Control transferred over time

An entity determines at contract inception whether each performance obligation will be satisfied (that is, control will be transferred) over time or at a specific point in time.

Control is considered to be transferred over time if one of the following conditions exists:

- the customer controls the asset as it is created or enhanced by the entity's performance under the contract
- the customer receives and consumes the benefits of the entity's performance as the entity performs. A customer receives a benefit from the entity's performance as the entity performs if another entity does not have to substantially reperform the work completed to date if it stepped in to complete the remaining obligation(s) under the contract

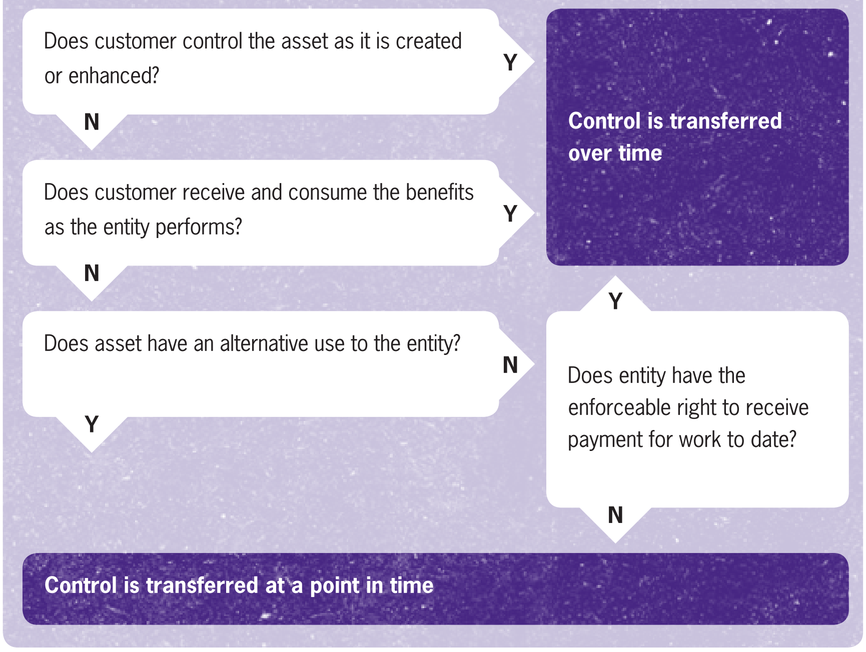
- the entity's performance creates or enhances an asset that has no alternative use to the entity, and the entity has the right to receive payment for work performed to date. An entity evaluates whether a promised asset has an alternative use to it at contract inception by considering whether it can readily redirect the partially completed asset to another customer throughout the production process. In addition, the right to payment should be enforceable, and a vendor considers the contractual terms, as well as any legislation or legal precedent that could override those terms, in assessing the enforceability of that right.

An entity recognises over time revenue that is associated with a performance obligation that is satisfied over time by measuring its progress toward completion of that performance obligation. The objective of this measurement is to depict the pattern by which the entity transfers control of the goods or services to the customer. The entity must update this measurement over time as circumstances change and accounts for these changes as a change in accounting estimate under IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.

IFRS 15 discusses two classes of methods that are appropriate for measuring an entity's progress toward completion of a performance obligation:

- output methods and
- input methods.

Determining the timing of transfer



Methods for measuring an entity's progress toward completion:

Method	Description	Examples
Output methods (revenue recognised by directly measuring the value of the goods and services transferred to date to the customer)	• revenue could be recognised at amount invoiced only if this corresponds directly with the value of the goods or services transferred to date • the units produced or units delivered method could provide a reasonable proxy for the entity's performance provided any work-in-process or finished goods controlled by the customer are appropriately included in the measure of progress.	• surveys of performance to date, milestones reached or units produced
Input methods (revenue recognised based on the extent of efforts or inputs toward satisfying a performance obligation compared to the expected total efforts or inputs needed)	• it may be appropriate to recognise revenue on a straight-line basis if efforts/inputs are expended evenly over the performance period • IFRS 15 requires that if an entity selects an input method such as costs incurred it must adjust the measure of progress for any inputs that do not depict performance, for example costs incurred that: – do not contribute to progress (eg wasted materials) – are not proportionate to progress (eg some non-distinct goods procured from another supplier with limited involvement by the entity).	• resources consumed, labour hours expended, costs incurred, machine hours used or time lapsed

Ability to reasonably measure progress

An entity recognises revenue for a performance obligation satisfied over time only if it can reasonably measure its progress toward completion of that performance obligation. An entity is not able to reasonably measure its progress toward completion if it lacks reliable information that is required to apply an appropriate method of measurement.

In some cases, such as during the early stages of a contract, an entity might not be able to reasonably measure its progress toward completion, but may still expect to recover its costs incurred in satisfying the performance obligation. An entity is then permitted to recognise revenue to the extent of costs incurred until it can reasonably measure its progress.

Control indicators

Control transferred at a point in time

In situations where control over an asset (goods or services) is transferred at a single point in time, an entity recognises revenue by evaluating when the customer obtains control of the asset.

In performing the evaluation, an entity should consider indicators of control, including, but not limited to, the following:

- the entity has a present right to receive payment for the asset
- the customer has legal title to the asset
- the customer has physical possession of the asset
- the customer has assumed the significant risks and rewards of owning the asset
- the customer has accepted the asset.

Other topics

Contract costs

Costs to fulfil a contract

If costs incurred in fulfilling a contract with a customer are covered under another Standard (such as IAS 2 'Inventory' and IAS 16 'Property, Plant, and Equipment'), an entity accounts for those costs in accordance with those Standards. If not, an entity recognises an asset for such costs, provided all of the criteria in the adjacent table are met.

Incremental costs of obtaining a contract

Under IFRS 15, an entity capitalises the incremental costs of obtaining a contract if it expects to recover those costs. Incremental costs of obtaining a contract are costs that an entity would not have incurred if it had not obtained the contract. Costs that an entity incurs regardless of whether it obtains a contract are expensed as incurred, unless the costs are explicitly chargeable to the customer regardless of whether the entity obtains the contract.

As a practical expedient, IFRS 15 allows an entity to expense the incremental costs of obtaining a contract as incurred if the amortisation period of the asset that the entity would have otherwise recognised is one year or less.

Costs to fulfil a contract

Costs are capitalised if the following conditions are met:

- the costs relate directly to a contract, including:
  - direct labour
  - direct materials
  - allocations that relate directly to the contract or contract activities (for example, contract management and supervision costs and depreciation of tools and equipment used in fulfilling the contract)
  - costs that are explicitly chargeable to the customer
  - other costs that the entity incurs only because it entered into the contract (eg payments to subcontractors)
- the costs generate or enhance resources of the entity that will be used to satisfy performance obligations in the future
- the entity expects to recover the costs.

Costs to be expensed as incurred:

- general and administrative costs that are not explicitly chargeable to the customer
- costs of wasted materials, labour, or other resources that were not reflected in the contract price
- costs that relate to satisfied performance obligations
- costs related to remaining performance obligations that cannot be distinguished from costs related to satisfied performance obligations.

Amortisation and impairment

Under IFRS 15, an entity amortises capitalised contract costs on a systematic basis consistent with the pattern of transferring the goods or services related to those costs. If an entity identifies a significant change to the expected pattern of transfer, it updates its amortisation to reflect that change in estimate in accordance with IAS 8.

An entity recognises an impairment loss in earnings if the carrying amount of an asset exceeds the remaining amount of consideration that the entity expects to receive in connection with the related goods or services less any directly related contract costs yet to be recognised. When determining the amount of consideration it expects to receive, an entity ignores the constraint on variable consideration previously discussed, and adjusts for the effects of the customer's credit risk.

Before recognising an impairment loss under the revenue recognition guidance, an entity recognises impairment losses associated with assets related to the contract that are accounted for under other guidance, such as IAS 2. An entity would reverse a previously recognised impairment loss when the impairment conditions no longer exist or have improved.

Practical insight – contract costs

IFRS 15's guidance on contract fulfilment costs is similar to IAS 11's. However, IFRS 15 applies to all customer contracts not only to construction contracts. The treatment of contract costs for services is somewhat mixed under IAS 18, and depends in part on the extent to which service providers apply IAS 11's guidance (IAS 18 states that the requirements of IAS 11 are "generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services").

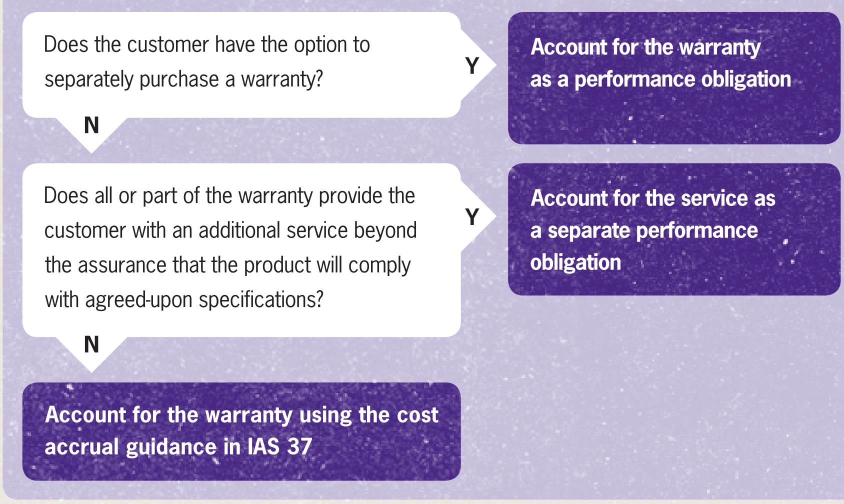
IFRS 15's guidance on the costs of obtaining or securing a contract appear more restrictive than IAS 11's but apply to a broader range of contracts. IFRS 15 requires immediate expensing of those costs that will be incurred regardless of whether a contract is won or lost (eg most bid costs). By contrast, under IAS 11 the costs of securing a contract are included in contract costs if they relate directly to a contract, can be separately identified and measured reliably and it is probable that the contract will be obtained.

Warranties

If a customer has the option to separately purchase a warranty, then an entity accounts for that warranty as a performance obligation. If a customer does not have the option to separately purchase a warranty, then the entity accounts for the warranty using the cost accrual guidance in IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' unless all or part of the warranty provides the customer with an additional service beyond the assurance that the product will comply with agreed-upon specifications.

IFRS 15 provides the following examples of factors that an entity must consider in determining whether a warranty provides a customer with an additional service:

Accounting for warranties



Warranty obligations

Factor	Description
Whether the warranty is required by law	A legal requirement to provide a warranty indicates that it is not a performance obligation because such laws are typically intended to protect the customer from the risk of purchasing a defective product
Term of the warranty coverage period	The longer the coverage period, the more likely a warranty is a performance obligation
Nature of the tasks the entity promises to perform under the warranty	If an entity must perform certain tasks to provide assurance to the customer that the product complies with agreed-upon specifications, those services do not likely constitute a separate performance obligation.

If an entity determines that a warranty provides a service that is separate from assurance on the product's compliance with agreed-upon specifications, that service is considered to be a separate performance obligation. The entity allocates a portion of the transaction price to that service unless it cannot reasonably account for the assurance and service portions of the warranty separately. If an entity determines that it cannot reasonably separate the assurance and service components of a warranty, it accounts for both together as a single performance obligation.

Practical insight – warranty obligations

IAS 18 and IAS 11 have no specific guidance on whether warranty obligations are separate deliverables. However, although IFRS 15 has more detailed guidance we believe it is largely consistent with accepted practices for standard and extended-type warranties under existing IFRSs.

In our experience standard-type warranties are not typically regarded as separate deliverables and are instead accounted for by accruing estimated costs under IAS 37. For extended-type warranties the application of IAS 11 and 18 requires judgement but in our experience these are commonly identified as separate deliverables, with allocated revenue recognised over the coverage period.

Licensing

Under IFRS 15 revenue from licensing rights to the entity's intellectual property (eg software, technology, motion pictures, music, franchises, patents, trademarks and copyrights) is recognised either over time or at a point in time, depending on:

- the separability or non-separability of any other promises in the contract
- the nature of the entity's performance under the license.

If the contract includes other promises that are non-separable from the right of access or use, the license is not distinct. The entity then accounts for the bundle of promises as a single performance obligation. It applies the control guidance to determine if transfer takes place (and revenue is then recognised) over time or at a point in time.

Revenue from licensing

Does contract include promises that are non-separable from license?

Y

License is not distinct and is accounted for together with other promises as a single performance obligation.

Entity assesses whether control transfers over time or at a point in time

N

License is distinct and is accounted for separately from other promises

Assess nature of entity's promise related to the license

Right to use the entity's intellectual property as it exists when licence is granted.

Y

Control is transferred at a point in time

Right to access the entity's intellectual property as it exists throughout the licence period.

Y

Control is transferred over time

If the license is distinct, the nature of the promise (as either a right to access or a right to use the entity's intellectual property) determines whether the license results in a performance obligation that is satisfied over time or at a point in time. If the license is a promise to provide a right to access the intellectual property, the performance obligation is satisfied over time. A license is a promise to provide *access* to the entity's intellectual property if all of the following conditions are met:

- there is a requirement or implicit understanding that the entity will undertake activities that will significantly change the underlying intellectual property
- the customer is exposed to positive or negative effects as those activities take place
- the activities do not transfer a good or service to the customer as they occur.

If these conditions are not present, then the promise is a right to *use* the intellectual property as it exists when the licence is granted. In this case, the performance obligation is satisfied at a point in time, similar to the sale of a good. IFRS 15 explains that other promises in the contract, restrictions on time, geography or use and guarantees that the entity has a valid patent over the intellectual property are not considered in making this determination.

Practical insight – licensing arrangements

IAS 18 provides limited guidance on licensing arrangements. IAS 18's guidance is consistent with IFRS 15 in as far as revenue is sometimes recognised over time (eg on a straight-line basis over the life of the agreement) and sometimes at a point in time. Under IAS 18 this depends on the "substance of the agreement", although there is little explanation as to how substance should be assessed.

IAS 18 also notes that an assignment of rights for a fixed fee under a non-cancellable contract which permits the licensee to exploit those rights freely and where the licensor has no remaining obligations to perform is, in substance, a sale (eg a licensing agreement for the use of software when the licensor has no obligations subsequent to delivery, or granting of rights to exhibit a motion picture film in markets where the licensor has no control over the distributor and expects to receive no further revenues from the box office receipts).

Accordingly, under both IFRS 15 and IAS 18 the existence of continuing obligations is a critical factor.

Rights of return and repurchase obligations

An entity may sell goods and also:

- grant the customer a right to return the asset
- promise, or obtain an option to repurchase the asset (a repurchase agreement).

Practical insight – product exchanges

Exchanges by customers of one product for another of the same type, quality, condition, and price (for example, one colour or size for another) are not considered returns for the purposes of IFRS 15.

Sale with a right of return

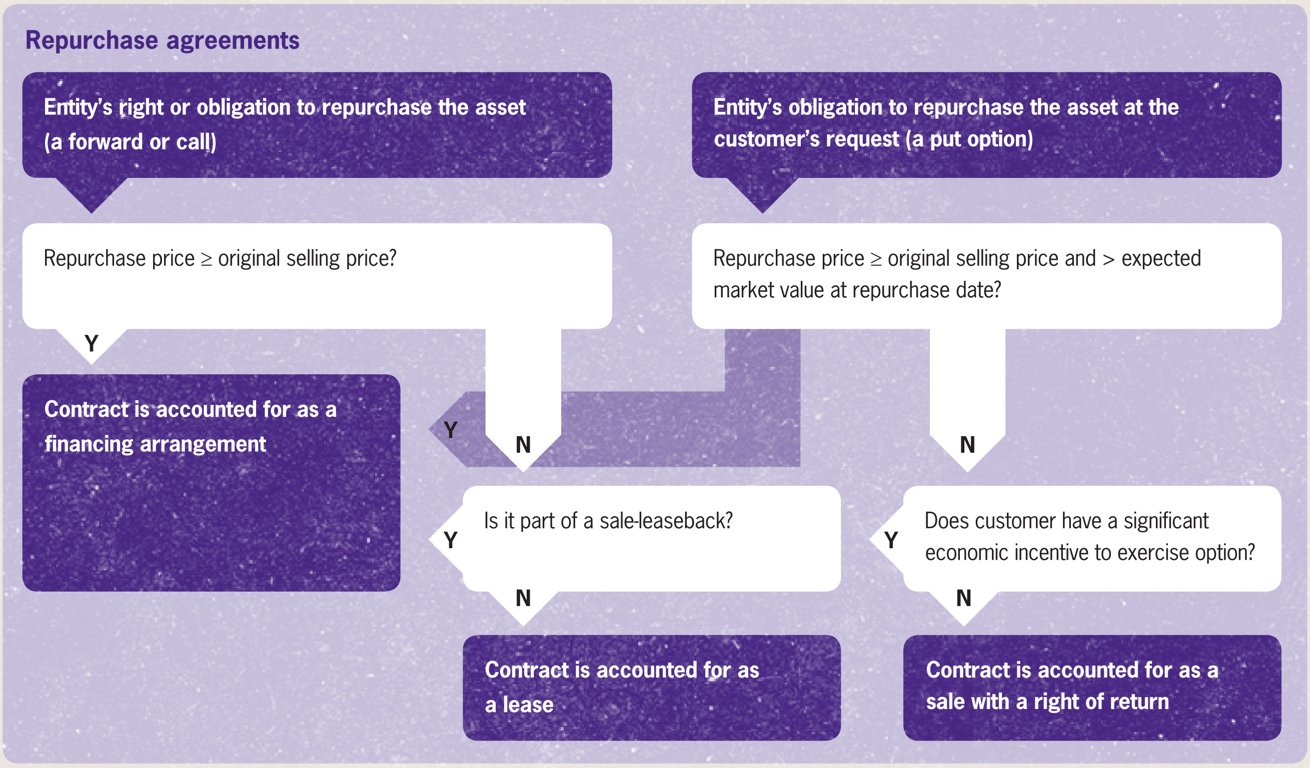
In some contracts, an entity transfers control of a product to a customer and also grants the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:

- 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
- another product in exchange.

Broadly, the entity recognises revenue for these arrangements net of estimated returns. To do this it recognises:

- revenue for the sold products, reduced for estimated returns (the guidance on variable consideration applies)
- a refund liability
- an asset, initially measured at the carrying amount of the inventory less costs of recovery, and corresponding adjustment to cost of sales.

The refund liability and asset are updated at the end of each reporting period for changes in expectations, with corresponding adjustments as revenue (or reductions of revenue).



Repurchase agreements

Sometimes an entity will enter into a contract to sell an asset and also promises or has the option to repurchase the asset (or an asset that is substantially the same or another asset of which the asset that was originally sold is a component).

An entity will need to evaluate the form of the promise to repurchase the asset in determining the accounting (for example, a forward, call or put option).

If a contract includes a forward (entity obligation to repurchase) or a call option (entity right to repurchase), an entity accounts for the contract (1) as a lease if it can or must repurchase the asset for an amount that is less than the original selling price; or (2) as a financing arrangement if it can or must repurchase the asset for an amount that is equal to or more than the original selling price.

If a customer is granted a right to require an entity to repurchase the asset (put option) at a price that is less than the original selling price, the entity assesses whether the customer has a significant economic incentive to exercise its right. This assessment considers various factors including the relationship between the repurchase price and the expected market value at the date of repurchase. If the repurchase price is expected to significantly exceed market value then a significant economic incentive exists. The agreement is then accounted for as a lease (because the customer is effectively paying the entity for the right to use the asset for a period of time), unless the contract is a part of a sale-leaseback (see below).

If the customer does not have a significant economic incentive to exercise the put option, the entity accounts for the agreement as a sale with a right of return (see guidance above).

If a contract grants the customer a put option and 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, the contract is considered to be a financing arrangement. The entity continues to recognise the asset and recognises a liability initially measured at the original selling price of the asset.

Sale-leaseback transactions

A sale-leaseback transaction with a put option that has an exercise price less than the original sales price is accounted for as a financing transaction rather than as a lease if the holder of the put option has a significant economic incentive to exercise the option.

Customer options for additional goods or services

An entity may sell goods or services and also provide customers with options to acquire additional goods or services free or at a discount – for example sales incentives, award credits or points, renewal options or other discounts. Such options are a performance obligation for the purpose of IFRS 15 if, and only if, they represent a 'material right'. The following are not considered to be material rights:

- a discount or other right that the customer could receive without entering into the contract
- a discount that is no more than the range of discounts typically given for those goods or services to that class of customer in that geographical area or market
- an option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service.

Practical insight – comparison with IFRIC 13 'Customer Loyalty Programmes'

IFRS 15's guidance in this area covers the same issues as IFRIC 13 (which it supersedes). The new guidance is generally similar and is expected to have little or no practical effect on the accounting for many loyalty schemes. However, IFRS 15:

- addresses a broader range of arrangements (such as individual discount awards that might not be viewed as 'programmes' for IFRIC 13 purposes)
- has more guidance on when such arrangements are a 'material right'
- has more detailed requirements on allocating the transaction price.

If a customer option is a material right then the entity should allocate part of the transaction price to that performance obligation on a relative standalone selling price basis. If the standalone selling price is not directly observable, as is often the case, it must be estimated. The estimate should reflect the discount the customer would obtain when exercising the option, adjusted for:

- any discount that the customer could receive without exercising the option
- the likelihood that the option will be exercised.

Revenue allocated to customer options is recognised when the options are exercised or expire.

IFRS 15 also provides a practical expedient that applies to some customer rights to renew a contract on pre-agreed terms. In such cases the entity is permitted to allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration.

Presentation and disclosure

Presentation

Under IFRS 15, an entity presents a contract in its statement of financial position as a contract liability, a contract asset, or a receivable, depending on the relationship between the entity's performance and the customer's payment at the reporting date.

An entity presents a contract as a contract liability if the customer has paid consideration, or if payment is due as of the reporting date but the entity has not yet satisfied a performance obligation by transferring a good or service. Conversely, if the entity has transferred goods or services as of the reporting date but the customer has not yet paid, the entity recognises either a contract asset or a receivable. An entity recognises a contract asset if its right to consideration is conditioned on something other than the passage of time; otherwise, an entity recognises a receivable.

Disclosure

IFRS 15 requires many new disclosures about contracts with customers. The following table provides a summary:

Disclosures

Disclosure area	Summary of requirements
General	• revenue recognised from contracts with customers, separately from its other sources of revenue • impairment losses on receivables or contract assets.
Disaggregation of revenue	• categories that depict the nature, amount, timing, and uncertainty of revenue and cash flows • sufficient information to enable users of financial statements to understand the relationship with revenue information disclosed for reportable segments under IFRS 8 'Operating Segments'.
Information about contract balances	• including opening and closing balances of contract assets, contract liabilities, and receivables (if not separately presented) • revenue recognised in the period that was included in contract liabilities at the beginning of the period and revenue from performance obligations (wholly or partly) satisfied in prior periods • explanation of relationship between timing of satisfying performance obligations and payment • explanation of significant changes in the balances of contract assets and liabilities.
Information about performance obligations	• when the entity typically satisfies performance obligations • significant payment terms • nature of goods and services • obligations for returns, refunds and similar obligations • types of warranties and related obligations • aggregate amount of transaction price allocated to remaining performance obligations at end of period*.
Information about significant judgements	• judgements impacting the expected timing of satisfying performance obligations • methods used to recognise revenue for performance satisfied over time, and explanation • the transaction price and amounts allocated to performance obligations (eg estimating variable consideration and assessing if constrained and allocating to performance obligations).
Assets recognised from the costs to obtain or fulfil a contract	• judgements made in determining costs capitalised • amortisation method used • closing balances by main category and amortisation expense.

* not required if (i) performance obligation is part of a contract which has an original expected duration of less than one year; or (ii) entity applies expedient to recognise revenue at amount it is entitled to invoice when this corresponds directly with value to the customer from entity's performance

Effective date and transition

IFRS 15 is effective for annual reporting periods beginning on or after 1 January 2017. Early adoption is permitted.

Entities are required to apply the new revenue standard either:

- retrospectively to each prior period presented, subject to some practical expedients or
- retrospectively, with the cumulative effect of initial application recognised in the current period.

An entity that chooses to restate only the current period is required to provide the following additional disclosures in the initial year of adoption:

- by financial statement line item, the current year impact of applying the new revenue standard
- an explanation of the reasons behind the significant impacts.

Grant Thornton
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