Grant Thornton

Insights into MFRS 15

Step 1: Identifying a contract with a customer

Revenue recognition is a critical aspect of financial reporting for all reporting entities. Ensuring it is applied consistently and comparably across industries and capital markets is essential. MFRS 15 'Revenues from Contracts with Customers' provides comprehensive guidance on accounting for revenue recognition. Nonetheless, there are some aspects of MFRS 15 that are complex and can pose practical challenges for reporting entities to apply and implement effectively.

Our 'Insights into MFRS 15' series summarises the key areas of the Standard, highlighting some areas that are challenging to apply in practice, to assist reporting entities in understanding how to apply MFRS 15's requirements.

MFRS 15 introduces the five-step model for revenue recognition which applies specifically to contracts with customers. Given this limitation in scope, the first step of the model is to identify contracts with customers. This article focuses on this step, and explains how to identify a contract with a customer as well as what constitutes a contract within the scope of the Standard.

An overview of the five-step model is below; however for a detailed discussion of the five steps, refer to our article '**Insights into MFRS 15 – Overview and scope**'.

The five-step model

An entity recognises revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Step 1	Step 2	Step 3	Step 4	Step 5
Identify the contract with the customer	Identify the performance obligations	Determine the transaction price	Allocate the transaction price to the performance obligation	Recognise revenue

Definitions from MFRS 15

A **contract** is an agreement between two or more parties that creates enforceable rights and obligations.

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.

The guidance in MFRS 15 makes it clear that the rights and obligations in a contract must be 'enforceable' before an entity applies the five-step revenue model. Enforceability is a matter of law, so an entity needs to consider the local relevant legal environment to determine whether rights and obligations are enforceable. That said, while the contract must be legally enforceable, oral or implied promises may give rise to performance obligations in the contract under Step 2 'Identify the performance obligations in the contract'.

An agreement does not need to be in writing to be a contract. Whether the agreed-upon terms are written, oral or evidenced otherwise (eg by electronic assent), a contract exists if the agreement creates rights and obligations that are enforceable against the parties. Although there must be enforceable rights and obligations between parties for a contract to exist, the performance obligations within the contract could include promises that result in the customer having a valid expectation that the entity will transfer goods or services to the customer, even though those promises are not enforceable.

To assist entities in determining if an arrangement is within the scope of MFRS 15, the guidance specifies five criteria that the arrangement must meet. This article discusses the five criteria in detail and explores some examples to help illustrate.

Five criteria for recognising a contract

Step 1 serves as a 'gate' through which a contract must pass before an entity applies the later steps of the model. In other words, if at the inception of an arrangement, an entity concludes that the criteria below are not met, it should not apply the remaining steps of the model until it determines that the Step 1 criteria are subsequently met. Significant judgement may be required to conclude whether an accounting contract exists. When a contract meets the five criteria and 'passes' Step 1, the entity will not reassess the Step 1 criteria unless there is an indication of a significant change in facts and circumstances.

An accounting contract for the purposes of MFRS 15 exists only when an arrangement with a customer meets the following five criteria:

- the parties have approved the contract and are committed to perform their contractual obligations
- the entity can identify each party's rights
- the entity can identify the payment terms
- the contract has commercial substance, and
- it is probable that the entity will collect substantially all of the consideration to which it expects to be entitled.

If the arrangement does not meet the five criteria for recognising a contract, an accounting contract does not exist, even though a legal contract may exist. Therefore, the entity follows the guidance in MFRS 15 described on page 6 of this article. These criteria are assessed at the inception of the arrangement. If the criteria are met at that time, an entity does not reassess the criteria unless there is an indication of a significant change in facts and circumstances.

Five criteria for recognising a contract

The parties have approved the contract and are committed to perform

The previous revenue recognition Standard, MFRS 108 'Revenue', did not have any specific guidance related to contracts and focused primarily on the transfer of risk and rewards as the basis for revenue recognition. In contrast, MFRS 15 provides a control-based approach for revenue recognition, and an approved contract is the foundation for the five-step model.

To pass the first criterion for recognising a contract, the parties must approve the contract. This approval may be written, oral, or implied, as long as the parties intend to be bound by the terms and conditions of the contract.

Whether evidence of an arrangement exists is based on the normal business practice of an entity. Some entities document the terms of all customer arrangements in written contracts. For these entities, evidence of an arrangement does not exist until a written contract is finalised and signed by both the vendor and the customer. If a vendor's customary practice is to use approved third-party purchase orders or online authorisations to document customer arrangements, the purchase order or online authorisation is appropriate evidence of the arrangement. The documentation used by the vendor to demonstrate persuasive evidence of an arrangement must be final and should include (or reference) all pertinent terms and conditions of the arrangement. Legal assistance may be required to determine whether persuasive evidence of an arrangement exists if the vendor does not have a customary practice of using written documentation.

The parties should also be committed to performing their respective obligations under the contract. This does not mean that the parties need to be committed to fulfill all their respective rights and obligations in order for this criterion to be met. For example, an entity may include a requirement in a contract for the customer to purchase a minimum quantity of goods each month, but the entity may have a history of not enforcing the requirement. In this example, the contract approval criterion can still be satisfied if evidence supports that the customer and the entity are both substantially committed to the contract. The standard setters noted that requiring all rights and obligations to be fulfilled would have inappropriately resulted in no recognition of revenue for some contracts in which the parties are substantially committed to the contract.

For example, there are cases where after a contract between two parties expires and before they execute a new contract, both parties will continue to perform under the terms of the expired contract. This indicates that even in the absence of a formally executed contract, a contract may exist since both parties remain committed to perform.

Additionally, typically when an entity enters into a master service arrangement or master supply arrangement (MSA), purchases are subsequently made by the customer by issuing a purchase order that explicitly references the MSA and specifies the products, services and quantities to be delivered. Entities need to evaluate both the MSA and the subsequent purchase order(s) together to determine whether and when the criteria in MFRS 15 are met.

Some entities offer free trial periods to prospective customers to entice business. These trial periods must be carefully evaluated to determine if evidence exists to support that the customer has approved the contract and the entity is committed to perform.

Example 1 – Evaluating trial periods

Members of a wine club receive a bottle of wine each month for 12 months for CU200 per month. The wine vendor is offering a promotional trial period to prospective customers starting 1 January 20X5. Under the terms of the promotion, the vendor offers new participants up to a free two-month trial period. If participants wish to join the club, they must notify the vendor any time before the trial period lapses (28 February 20X5). Participants that join the club receive an invoice for the 12-month membership period, which will end 28 February 20X6.

Analysis

Until the customer gives notice to the wine vendor of its acceptance of the offer (either oral or written), the entity might not conclude that the customer has approved the contract and is committed to perform.

Determining whether a contractual right or obligation is enforceable is a question to be considered within the context of the relevant legal framework. It is essential to note that the factors that determine enforceability may differ between jurisdictions. Significant judgement may be involved in certain jurisdictions or for some arrangements, and it is important to keep in mind that a different conclusion may result for similar contracts in different jurisdictions or different industries. In cases of significant uncertainty about enforceability, a legal interpretation may be sought from qualified counsel to support the conclusion.

In some cases, a service provider is entitled to consideration for its services only if a specific outcome is achieved and the customer has a right to cancel the contract at any point in time without compensating the entity. These kinds of arrangements are very common in service industries such as law firms, real estate agents and travel agents. Since the outcome of the service would determine the amount of consideration, such arrangements would not be a contract with a customer within the scope of MFRS 15 until the outcome has been achieved. The service provider in these type of arrangements does not have right to payment for services performed and the recipient of the services does not have an obligation to pay.

The entity can identify each party's rights

An entity must be able to identify its rights, as well as the rights of all other parties to the contract. An entity cannot assess the transfer of goods or services if it cannot identify each party's rights regarding those goods or services.

An entity may utilise an MSA with its customers. Each MSA must be evaluated to determine if the MSA alone establishes enforceable rights and obligations.

The MSA may establish only basic terms and conditions with customers and the entity may require its customers to also submit purchase orders specifying quantify and/or type of goods or services. In such cases, the MSA alone may not establish enforceable rights and obligations of the parties. Assuming all of the other criteria in MFRS 15 are met, the MSA might not pass Step 1, and a contract might not exist, until a purchase order is submitted and approved. Often this will lead to each purchase order being a contract, depending on facts and circumstances.

An MSA that specifies minimum purchase quantities may create enforceable rights and obligations. However, if the entity has a past practice of waiving the minimum purchase requirement and such practice would render the term legally unenforceable, then the term is not considered when determining if the MSA alone creates legally enforceable rights and obligations.

The entity can identify the payment terms for the goods or services

An entity must also be able to identify the payment terms for the promised goods or services within the contract. The entity cannot determine how much it will receive in exchange for the promised goods or services (the 'transaction price' in Step 3 of the model for revenue recognition) if it cannot identify the contractual payment terms. The payment terms do not need to be fixed, but the contract must contain enough information to allow an entity to reasonably estimate the consideration that it expects to be entitled to.

Practical insight – Unpriced change orders

It is common practice in the construction industry for entities to utilise unpriced change orders. This occurs when an entity identifies the payment terms for change orders for which the scope of work has been defined even though the specific amount of consideration for that work has not yet been determined and may not be finally determined for a period of time. The Standard does not preclude revenue recognition for this type of order if the scope of the work has been approved and the entity expects that the price will be approved. Therefore, in those cases, the entity would consider the requirements for contract modifications.

The contract has commercial substance

A contract has commercial substance if the risk, timing, or amount of the entity's cash flows is expected to change as a result of the contract. In other words, the contract must have economic consequences. This criterion was added to prevent entities from transferring goods or services back and forth to each other for little or no consideration to artificially inflate their revenue. This criterion is applicable for both monetary and non-monetary transactions, because without commercial substance, it is questionable whether an entity has entered into a transaction that has economic consequences.

It is probable the entity will collect substantially all of the consideration

To pass Step 1, an entity must determine that it is probable that it will collect substantially all of the consideration to which it will be entitled under the contract in exchange for goods or services that it will transfer to the customer. This criterion is also referred to as the 'collectability assessment'. In determining whether collection is probable, the entity considers the customer's ability and intention to pay when amounts are due. Probable is defined by MFRS 15 as:

Probable – The future event or events are 'more likely than not' to occur.

The objective of the collectability assessment is to evaluate whether there is a substantive transaction between the entity and the customer. When evaluating collectability, an entity bases its assessment on whether the customer has the ability and intention to pay the promised consideration in exchange for the goods or services that will be transferred under the contract, rather than assessing the collectability of the consideration agreed for all of the promised goods or services.

An entity should determine whether the contractual terms and its customary business practices indicate that it has the ability to mitigate credit risk. For example, some contracts may require upfront payments before any goods or services are transferred to the customer. Any consideration received before the entity transfers the goods or services would not be subject to credit risk. In other cases, such as a telecom providing wireless network access to a building, the entity may be able to stop transferring goods or services under the contract upon a customer's failure to pay. In that situation, the entity would consider the likelihood of payment for only the promised goods or services that would be transferred to the customer.

The provisions related to collectability are similar to the previous revenue standard – MFRS 108. Under the guidance in MFRS 108, revenue was recognised only when it is probable that the economic benefits associated with the transaction would flow to the entity. This principle has been retained in MFRS 15. However, when an uncertainty arises about the collectability of an amount already included in revenue, the uncollectible amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

Example 2 – Collectability assessment: liquidity issues and issue of letter of credit

Entity A has a customer, Entity P, which is undergoing restructuring due to issues related to liquidity. Entity A has decided not to do any further business with Entity P. In response, Entity P informed Entity A that it would get a letter of credit from a nationalised bank against which Entity A can despatch goods.

Entity A has already manufactured the goods exclusively for Entity P, but the letter of credit has not yet been finalised. When should Entity A recognise the revenue?

Analysis

MFRS 15 requires that for revenue to be recognised, it should be probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In this case, as the customer has liquidity issues, collection is not considered to be probable. Accordingly, until the time the letter of credit is finalised, the collectability criterion is not met. However, if Entity A is able to demonstrate through any other means that the collectability criterion would be met, then it may recognise the revenue in accordance with the principles of IFRS 15, assuming all other conditions are met.

Furthermore, if a contract with a customer does not meet the initial criteria in MFRS 15 for identifying contracts with customers that are with the scope of the Standard, an entity must continue to assess the contract to determine whether the criteria are subsequently met. Additionally, if the initial criteria are not met but an entity receives consideration from the customer, there are additional criteria to assess to determine whether to recognise revenue. In this case, Entity A will need to continue to reassess whether the criteria for a contract with a cusomer are subsequently met.

Price concessions

In determining the consideration to which an entity will be entitled for purposes of the collectability assessment, an entity needs to evaluate at contract inception whether it expects to provide a price concession that will result in receiving less than the full contract price from the customer. Although price concessions are a form of variable consideration and are more fully evaluated when determining the transaction price under Step 3, when evaluating collectability under Step 1, an entity should also assess at the onset of an arrangement whether it expects to provide a price concession.

When an entity expects to accept less than the contractual amount for goods and services that will be transferred to the customer, it should evaluate all relevant facts and circumstances, which may require significant judgement, to determine whether it has accepted a customer's credit risk or has provided an implicit price concession. Price concessions may take the form of a discount, refund or credit, among others, and are a form of variable consideration.

It can sometimes be difficult to distinguish between a price concession and a collectability issue. The ramifications could impact the accounting because one path (a collectability concern) might lead an entity to conclude that it does not pass Step 1 for a particular arrangement, while another path (a price concession) may result in variable consideration and allow the entity to proceed to Step 2 with a lower transaction price. Judgement will be required to determine which path is appropriate.

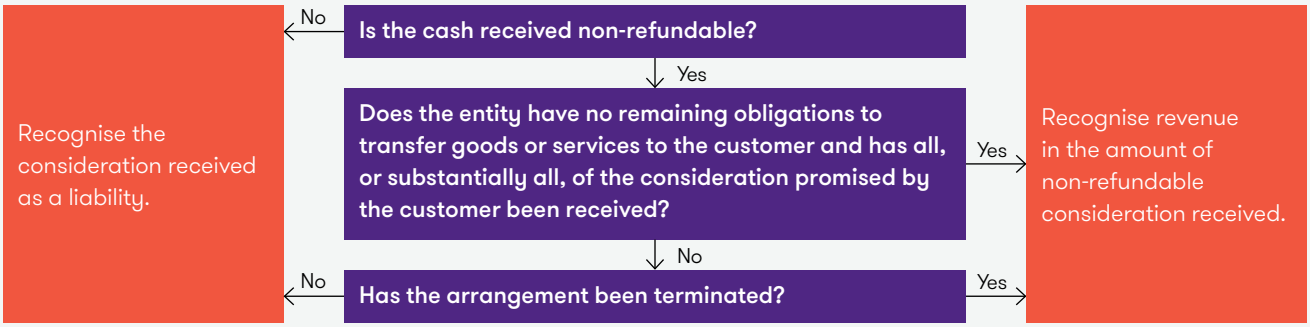
Contracts that do not 'pass' Step 1 (Identifying the contract with a customer)

If an entity determines at an arrangement's inception that one or more of the criteria in MFRS 15 for identifying a contract with a customer have not been met, an accounting contract, for purposes of applying MFRS 15, does not exist, and the entity should continue to reassess whether the five criteria are subsequently met.

A contract may not pass Step 1 but the entity may still transfer goods or services to the customer and receive non-refundable consideration in exchange for those goods or services. In that circumstance, the entity cannot recognise revenue for the non-refundable consideration received until either the Step 1 criteria are subsequently met, or one of the events discussed in the flowchart below has occurred.

Until the contract passes Step 1 or one of the above criteria is met, an entity should recognise the consideration received from a customer as a liability that is measured at the amount of consideration received from the customer.

When cash is received for a contract that does not pass Step 1



Example 3 – Non-refundable receipt – payment term not identified

On 1 March 20X5, Entity P agrees to sell 1,000 bath fittings to Entity X, which are manufactured by using customised screws supplied by a specific vendor. The payment terms between Entity P and Entity X have not been decided as they are dependent on the price of the customised screws which is yet to be finalised. Entity P received a non-refundable amount of CU1,000. How should Entity P Account for this transaction under MFRS 15 if Entity P is the principal in this transaction?

Analysis

Since the payment terms are not identified, the contract does not meet all of the criteria in MFRS 15 for identifying a contract with a customer that is within the scope of the Standard.

Entity P must account for the non-refundable amount of CU1,000 as a liability, as none of the events described in MFRS 15 for when a contract does not meet the criteria for a contract with a customer within the scope of the Standard but consideration has been received have occurred – that is, the entity has neither received substantially all of the consideration nor has it has terminated the contract.

Consequently, Entity P will continue to account for the non-refundable amount, as well as any future payments, as a liability until the criteria for identifying a contract with a customer that is within the scope of the Standard are met (ie the payment terms are identified) or one of the events described above has occurred. Further, Entity P will continue to assess the contract to determine whether the criteria to be considered a contract with a customer in the scope of the Standard are subsequently met or whether the specific events that allow for recognition of revenue after consideration has been received have occurred.

Practical insight – At the crossroads

The goal of the requirements in MFRS 15 is to filter out contracts that may not be valid and that do not represent genuine transactions. In such cases, recognising revenue would not provide a faithful representation of the transaction. The requirements therefore preclude an entity from recognising any revenue until the contract is either complete or cancelled or until a subsequent reassessment indicates that the contract meets all of the criteria in MFRS 15 for identifying a contract.

Reassessing the Step 1 criteria

When an entity determines that a contract passes Step 1, it should not reassess contract existence unless there is an indication of a significant change in facts and circumstances. It is important to reassess the criteria in these cases because that change might clearly indicate that the remaining contractual rights and obligations are no longer enforceable.

Example 4 – Reassessing the criteria for identifying a contract

An entity licences a trademark to a customer in exchange for a usage-based royalty. At contract inception, the contract meets all the criteria for a contract with a customer within the scope of the Standard and the entity accounts for the contract with the customer in accordance with the requirements in IFRS 15. The entity recognises revenue when the customer's subsequent usage occurs in accordance with the guidance in IFRS 15 on usage-based royalties.

Throughout the first year of the contract, the customer provides quarterly reports of usage and pays within the agreed-upon period.

During the second year of the contract, the customer continues to use the entity's trademark, but the customer's financial condition declines. The customer's current access to credit and available cash on hand are limited. The entity continues to recognise revenue on the basis of the customer's usage throughout the second year. The customer pays the first quarter's royalties but makes nominal payments for the usage of the patent in quarters two to four. The entity accounts for any impairment of the existing receivable in accordance with IFRS 9 'Financial instruments'.

During the third year of the contract, the customer continues to use the entity's trademark. However, the entity learns that the customer has lost access to credit and its major customers, and thus the customer's ability to pay significantly deteriorates. The entity therefore concludes that it is unlikely that the customer will be able to make any further royalty payments for ongoing usage of the entity's trademark.

Analysis

As a result of this significant change in facts and circumstances, in accordance with the reassessment requirements outlined in MFRS 15, the entity reassesses whether the contract now meets the criteria to be considered a contract with a customer within the scope of the Standard, and determines that they are not met because it is no longer probable that the entity will collect the consideration to which it will be entitled. Accordingly, the entity does not recognise any further revenue associated with the customer's future usage of its trademark. The entity must account for any impairment of the existing receivable by measuring the loss allowance at an amount equal to lifetime expected losses in accordance with MFRS 9.

Practical insight – Significant change in facts and circumstances

When a contract 'passes' Step 1, what constitutes a 'significant change in facts and circumstances' necessitating a reassessment in the Step 1 criteria?

The determination of what constitutes a 'significant change in facts and circumstances' will often require judgement. If the entity determines that it is no longer probable that it will collect the consideration, the entity should not recognise revenue for the remaining goods and services as they are transferred to the customer, and would instead apply the guidance for contracts that do not meet the criteria of a customer contracts.

When the entity concludes that collectability is no longer probable, only the revenue related to the remaining goods or services yet to be transferred is impacted. Other than impairment considerations, the reassessment has no impact on revenue recognised to date, receivables recorded, or assets recognised as a result of satisfied performance obligations.

Contract term

An entity applies MFRS 15 to the contractual period over which the parties to the contract have present enforceable rights and obligations. Enforceability of the rights and obligations is a matter of law. Because practices and processes for establishing contracts with customers may vary across jurisdictions and entities, each entity should consider its established practices and processes when determining whether its agreements create enforceable rights and obligations.

Termination provisions

Some contracts can be terminated by either party at any time while others may only be terminated by one party. An accounting contract does not exist if each party to a contract has the unilateral enforceable right to terminate a wholly unperformed contract without paying a termination penalty. A 'wholly unperformed' contract is one that the entity hasn't yet performed and is not entitled to any consideration.

In some situations, only the customer has the ability to terminate the contract without penalty. In those situations, the contract term for accounting purposes may be shorter than the stated contract term. Management should apply judgement in determining whether a termination penalty is substantive. For example, a substantive penalty might exist if a customer must repay a portion of an upfront discount if the customer terminates the contract.

Example 5 – Ability to terminate without penalty

A tennis club enters into a contract with a new member to provide access to its tennis courts for a 12 month period at CU10,000 per month. The member can cancel their membership without penalty after six months.

Analysis

As the member can cancel without penalty after six months, the enforceable rights and obligations of this contract are for six months. Therefore, the contract term is six months.

Practical insight – How should termination clauses be evaluated in determining the duration of a contract?

The International Accounting Standards Board (IASB)/Financial Accounting Standards Board (FASB) joint Transition Resource Group (TRG) discussed the accounting for termination clauses at its October 2014 meeting. According to that discussion, when each party to the contract has the unilateral right to terminate the contract by paying a termination penalty, the contract exists throughout the period covered by the termination penalties because the penalties are evidence of enforceable rights and obligations throughout the term of the contract. That said, the mere existence of a penalty by itself would not mean that the contract term includes the periods covered by the penalties. The penalties must be substantive.

A common business model for some entities is to sell goods at a loss and to make money through sales of consumables that the customer has to purchase again and again (for example, a razor and razor blades, or a printer and printer cartridges). Sometimes these contracts are structured in such a way that if the customer does not purchase a minimum amount of consumables, it must pay a termination penalty. These contracts may effectively include a substantive termination penalty, which creates enforceable rights and obligations that may impact the contract term.

Practical insight – Customer has the right to cancel without cause

At its November 2015 meeting, the TRG discussed a scenario where only one party has the termination right. The TRG considered a contract for equipment and consumable parts in which the standalone selling price of the equipment and parts is CU10,000 and CU100, respectively. The entity sells the equipment for CU6,000 and provides the customer with an option to purchase each part for CU100. If the customer does not purchase at least 200 parts, it must pay a penalty that repays some or all of the CU4,000 discount, and that penalty decreases as each part is purchased at a rate of CU20 per part. The example assumes that the equipment and consumables are distinct goods, revenue is recognised at a point in time, and a discount of CU10 would be a material right to the customer.

How should an entity evaluate the contract term when only the customer has the right to cancel without cause, and how do termination penalties affect that analysis? The TRG generally agreed that substantive termination penalties create enforceable rights and obligations, effectively creating a minimum purchase obligation for 200 parts in the example above. The TRG debated what constitutes a 'substantive' penalty and acknowledged that significant judgement would be required to make that determination. One consideration in assessing whether a penalty is substantive would be to evaluate how many customers opt to pay the penalty. A significant number of customers opting to pay the penalty might indicate that the penalty is not substantive. If the penalty is not substantive, the entity must still evaluate whether the termination right (which is similar to an option for additional goods or services) gives rise to a material right. Said differently, if the existence of a contractual penalty does not create a longer contract term, it still could impact whether a material right is present for the optional goods or services.

At a separate meeting, the TRG discussed whether an entity's past practice of waiving termination penalties would impact the assessment of the contract term and generally agreed that the answer depends on whether the past practice changes the legally enforceable rights and obligations, as explained below.

Practical insight – Contract term: past practice of waiving termination penalty

At its October 2014 meeting, the TRG discussed a fact pattern whereby an entity enters into a contract to provide services for 24 months. Either party can terminate the contract by compensating the other party. The entity has a past practice of not enforcing collection of the termination penalty when customers cancel after at least 12 months.

When an entity has a past practice of not enforcing the collection of termination penalties, does the past practice affect the assessment of the contract term?

The TRG agreed that the determination of whether the contractual period is 24 months or 12 months depends on whether the past practice legally restricts the enforceable rights and obligations of the parties, which may vary by jurisdiction. The entity's past practice would affect the contract term only if that past practice changes the parties' legally enforceable rights and obligations. If that past practice does not change the parties' legally enforceable rights and obligations, then the contract term is 24 months.

Practical insight – Determining contract term – evergreen contract

When assessing the contract term of an arrangement that automatically renews and is cancellable by either party each month without penalty, it can be useful to compare to contracts where each party renews the contract at the end of each month via written contract. In both cases the entity would determine the contract term to be one month and would not assume a longer contract term.

Portfolio practical expedient

The guidance in MFRS 15 applies to an individual contract with a customer but allows entities to apply the guidance to a portfolio of contracts or performance obligations with similar characteristics as a practical expedient. However, an entity may apply the practical expedient only if it expects that the effects of applying the guidance on a portfolio basis would not differ materially from applying the guidance on an individual contract-by-contract basis.

An entity will need to exercise judgement to determine how to group particular contracts or performance obligations for purposes of applying the portfolio practical expedient.

Practical insight – Use of evidence from other similar contracts to develop an estimate using the expected value method

Is an entity applying the portfolio practical expedient when it considers evidence from other, similar contracts to develop an estimate using the expected value method?

At its July 2015 meeting, the TRG generally agreed that an entity can consider evidence from other, similar contracts to develop an estimate of variable consideration using the expected value method without applying the portfolio practical expedient. Said differently, considering historical experience does not necessarily mean that the entity is applying the portfolio practical expedient. This view is further supported by the guidance on estimating the standalone selling price of a good or service. MFRS 15 states that a suitable method for estimating the standalone selling price of a good or service would include referring to prices of similar goods or services.

The portfolio approach may be particularly useful in some industries in which an entity has a large number of similar contracts and applying the model separately for each contract may be impractical. For example, entities in the telecommunications industry implementing accounting systems to determine the standalone selling price for the promised goods or services in each contract and, in turn, allocating the transaction price to the performance obligations identified in that contract would be complex and costly.

Practical insight – How should an entity evaluate whether contracts have similar characteristics?

MFRS 15 does not include prescriptive guidance on how to determine if contracts may be grouped within the same portfolio.

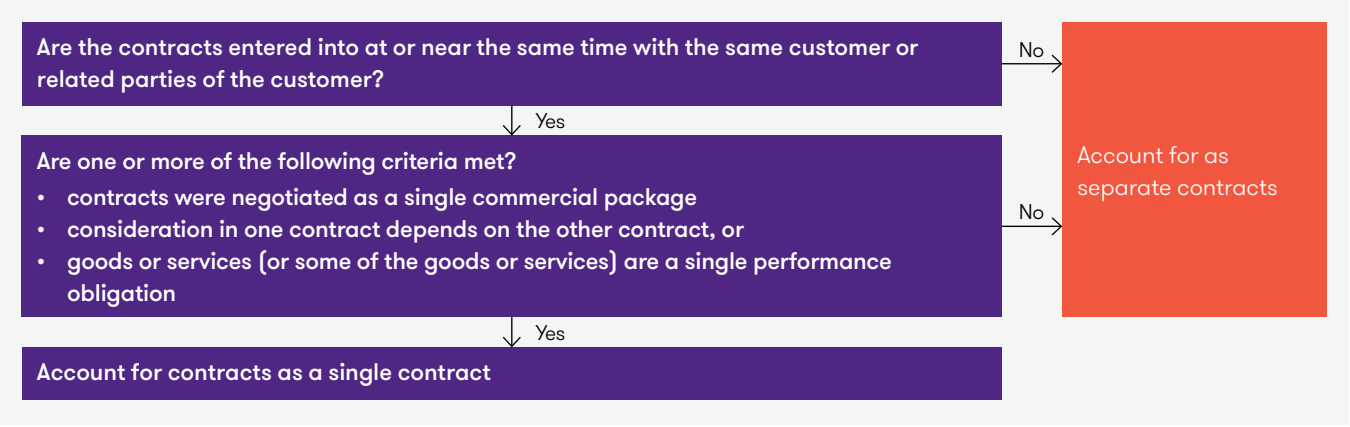
An entity will need to exercise judgement to determine which contracts have similar characteristics when evaluating whether the contracts may be grouped within the same portfolio. One way to categorise contracts by portfolio may be by contract type. If an entity typically uses standard contract language, this may indicate that grouping the contracts into a single portfolio may be appropriate.

Another possible way to categorise contracts by portfolio would be by class of customer and the customer's behaviour pattern. For example, a healthcare entity may have evidence that suggests that uninsured patients (customers) act similarly while insured patients (customers) act similarly and result in similar revenue recognition patterns. Additionally, insured patients might fall into different portfolios based on the terms of their insurance coverage.

Combining contracts

An entity should combine two or more contracts and account for them as a single contract in certain circumstances because the substance of the individual contracts cannot be understood without considering the entire arrangement. For example, a group of separate contracts may need to be combined for accounting purposes if they are so closely related that they are, in effect, a single project with an overall profit margin. That includes recognising profits and determining the need for a provision for losses. This evaluation takes place at contract inception.

The following flow chart illustrates the process to assess whether two or more contracts need to be accounted for as a single contract:



The guidance does not specify what constitutes 'at or near the same time', so an entity will need to exercise judgement to determine what constitutes this time frame as well as develop processes to evaluate whether the criteria are met.

Practical insight – combining two or more contracts

In the basis for conclusions to MFRS 15, the MASB clarifies that for two or more contracts to be combined, they should be with the same customer. However, the MASB acknowledged that in some situations, contracts with related parties (as defined in MFRS 124 'Related Party Disclosures') should be combined if there are interdependencies between the separate contracts with those related parties. As a result, in those situations, combining the contracts with related parties results in a more appropriate depiction of the amount and timing of revenue recognition.

The MASB also considered whether to specify that all contracts should be combined if they were negotiated as a package to achieve a single commercial objective, regardless of whether those contracts were entered into at or near the same time with the same customer. However, the MASB decided not to do this, primarily because they were concerned that doing so could have the unintended consequence of an entity combining too many contracts and not faithfully depicting performance. Furthermore, the MASB decided that an entity should apply judgement to determine whether a contract is entered into 'at or near the same time'. However, the longer the period between the commitments of the parties to the contracts, the more likely it is that the economic circumstances affecting the negotiations have changed.

How we can help

We hope you find the information in this article helpful in giving you insight into aspects of MFRS 15. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact.

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