



cutting through complexity

IFRS AND U.S. GAAP

Issues In-Depth

Revenue from Contracts with Customers

September 2014

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A new global framework for revenue

In May 2014, the IASB and the FASB published their new joint standard on revenue recognition. This replaces most of the guidance on revenue recognition that currently exists under IFRS and U.S. GAAP.

The 2017 effective date might seem a long way off but already many companies are analyzing the implications – for both external financial reporting and the core systems used to produce the numbers. Most companies are finding that they are impacted in some way, although the impacts vary widely depending on the nature of their business and how they contract with their customers.

In this publication, we have pooled the insights and experience of our revenue recognition teams in the United States and globally to guide you through the requirements of the new standard. We have illustrated the main points with examples and explained our emerging thinking on key interpretative issues. We know that one of the first questions companies ask is “how does this compare with my current accounting?” and have included comparisons with current IFRS and U.S. GAAP requirements.

Proud as we are to present this publication, we realize that it is a work in progress. Every day brings new questions and new insights, which we will share in future publications.

Whether you are beginning your analysis of the new standard or deep into your implementation project, we hope this publication will help you move forward.

Brian K. Allen
Mark M. Bielstein
Prabhakar Kalavacherla (PK)
Paul H. Munter

**Department of Professional Practice,
KPMG LLP, United States**

Phil Dowad
Catherine Morley
Brian O'Donovan
Thomas Schmid

KPMG International Standards Group

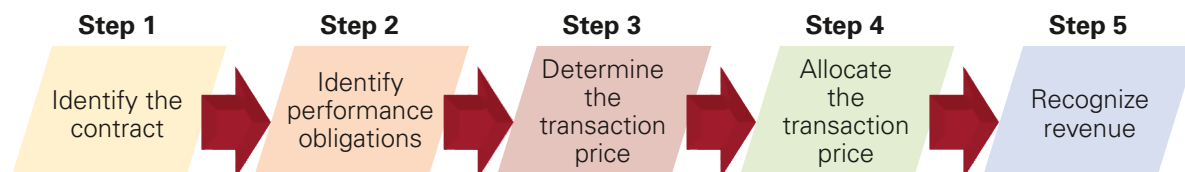
1 Key facts

The new standard provides a framework that replaces existing revenue guidance in U.S. GAAP and IFRS. It moves away from the industry- and transaction-specific requirements under U.S. GAAP, which are also used by some IFRS preparers in the absence of specific IFRS guidance.

New qualitative and quantitative disclosure requirements aim to enable financial statement users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

Entities will apply a five-step model to determine when to recognize revenue, and at what amount. The model specifies that revenue should be recognized when (or as) an entity transfers control of goods or services to a customer at the amount to which the entity expects to be entitled. Depending on whether certain criteria are met, revenue is recognized:

- over time, in a manner that best reflects the entity's performance; or
- at a point in time, when control of the goods or services is transferred to the customer.



The new standard provides application guidance on numerous related topics, including warranties and licenses. It also provides guidance on when to capitalize the costs of obtaining a contract and some costs of fulfilling a contract (specifically those that are not addressed in other relevant authoritative guidance – e.g., for inventory).

For some entities, there may be little change in the timing and amount of revenue recognized. However, arriving at this conclusion will require an understanding of the new model and an analysis of its application to particular transactions. In addition, all entities will be subject to extensive new disclosure requirements.

The new standard is effective for annual periods beginning on or after January 1, 2017 for entities applying IFRS, and for annual periods beginning after December 15, 2016 for public business entities and certain not-for-profit entities applying U.S. GAAP.¹ Early adoption is permitted only under IFRS.²

The impact of the new standard will vary by industry. Those steps of the model that are most likely to affect the current practice of certain industries are summarized below.

	Step				
	1	2	3	4	5
Aerospace and defense	✓	✓	✓		✓
Asset managers			✓		
Building and construction			✓		✓
Contract manufacturers					✓
Health care (U.S.)	✓		✓		
Licensors (media, life sciences, franchisors)	✓*	✓	✓		✓
Real estate	✓	✓			✓
Software		✓	✓	✓	✓
Telecommunications (mobile networks, cable)		✓		✓	

* In particular, life sciences.

¹ 'Public business entity' is defined in ASU 2013-12, *Definition of a Public Business Entity – An Addition to the Master Glossary*, available at www.fasb.org. 'Certain not-for-profit entities' are those that have issued or are a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market. All other entities applying U.S. GAAP have the option to defer application of the new guidance for one year for annual reporting purposes.

² All other entities applying U.S. GAAP may adopt at the same time as public business entities.

2 Key impacts

- **Revenue may be recognized at a point in time or over time.** Entities that currently use the stage-of-completion/percentage-of-completion or proportional performance method will need to reassess whether to recognize revenue over time or at a point in time. If they recognize it over time, the manner in which progress toward completion is measured may change. Other entities that currently recognize revenue at a point in time may now need to recognize it over time. To apply the new criteria, an entity will need to evaluate the nature of its performance obligations and review its contract terms, considering what is legally enforceable in its jurisdiction.
- **Revenue recognition may be accelerated or deferred.** Compared with current accounting, revenue recognition may be accelerated or deferred for transactions with multiple components, variable consideration, or licenses. Key financial measures and ratios may be impacted, affecting analyst expectations, earn-outs, compensation arrangements, and contractual covenants.
- **Revisions may be needed to tax planning, covenant compliance, and sales incentive plans.** The timing of tax payments, the ability to pay dividends in some jurisdictions, and covenant compliance may all be affected. Tax changes caused by adjustments to the timing and amounts of revenue, expenses, and capitalized costs may require revised tax planning. Entities may need to revisit staff bonuses and incentive plans to ensure that they remain aligned with corporate goals.
- **Sales and contracting processes may be reconsidered.** Some entities may wish to reconsider current contract terms and business practices – e.g., distribution channels – to achieve or maintain a particular revenue profile.
- **IT systems may need to be updated.** Entities may need to capture additional data required under the new standard – e.g., data used to make revenue transaction estimates and to support disclosures. Applying the new standard retrospectively could mean the early introduction of new systems and processes, and potentially a need to maintain parallel records during the transition period.
- **New estimates and judgments will be required.** The new standard introduces new estimates and judgmental thresholds that will affect the amount or timing of revenue recognized. Judgments and estimates will need updating, potentially leading to more financial statement adjustments for changes in estimates in subsequent periods.
- **Accounting processes and internal controls will need to be revised.** Entities will need processes to capture new information at its source – e.g., executive management, sales operations, marketing, and business development – and to document it appropriately, particularly as it relates to estimates and judgments. Entities will also need to consider the internal controls required to ensure the completeness and accuracy of this information – especially if it was not previously collected.
- **Extensive new disclosures will be required.** Preparing new disclosures may be time-consuming, and capturing the required information may require incremental effort or system changes. There are no exemptions for commercially sensitive information. In addition, IFRS and SEC guidance require entities to disclose the potential effects that recently issued accounting standards will have on the financial statements when adopted.
- **Entities will need to communicate with stakeholders.** Investors and other stakeholders will want to understand the impact of the new standard on the overall business – probably before it becomes effective. Areas of interest may include the effect on financial results, the costs of implementation, expected changes to business practices, the transition approach selected, and, for IFRS preparers and entities other than public business entities and certain not-for-profit entities reporting under U.S. GAAP, whether they intend to early adopt.



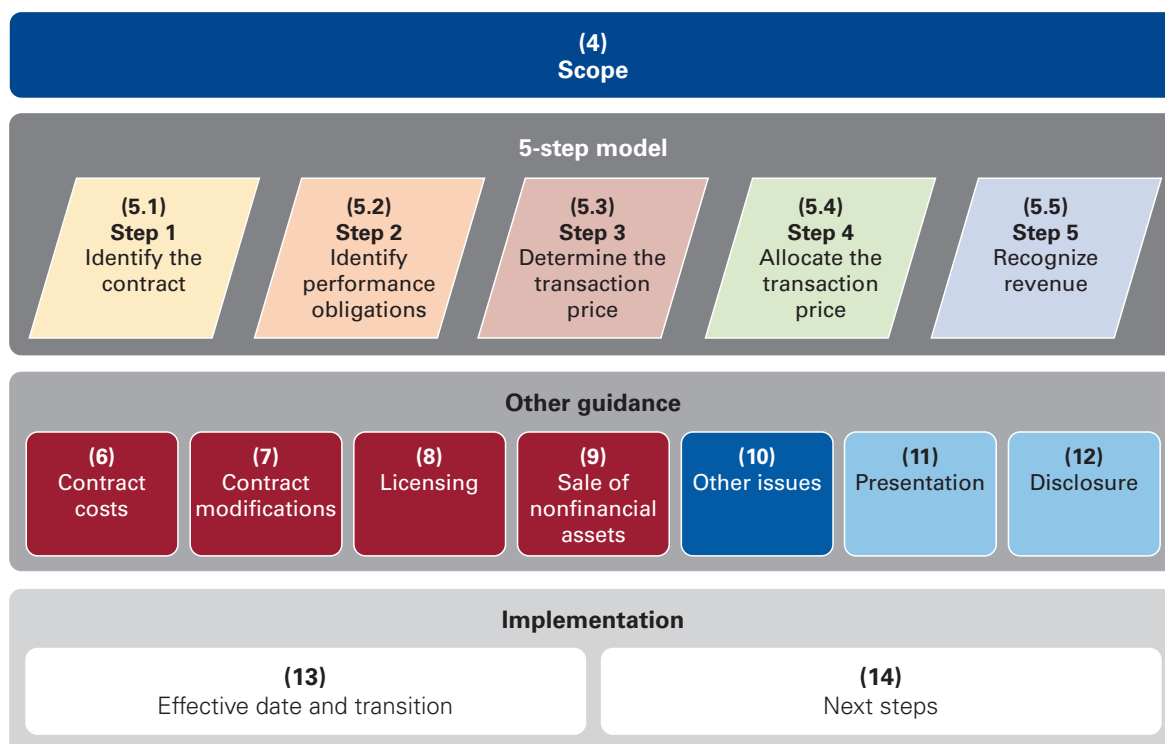
3 Putting the new standard into context

This publication provides a detailed analysis of the new standard, including a discussion of the elements of the new requirements and the areas that may result in a change in practice. Examples have also been provided to help assess the impact of implementation. In many cases, further analysis and interpretation may be needed for an entity to apply the requirements to its own facts, circumstances, and individual transactions. Furthermore, some of the information contained in this publication is based on our initial observations, which may change as issues from the implementation of the new guidance arise, and as practice develops.

This section provides important context to the rest of the publication, including whether particular guidance in the new standard is authoritative, and the interaction with existing guidance.

Organization of the text

The following diagram highlights the layout of the new standard and provides the corresponding sections in this publication. Within each section we generally provide an overview, the requirements of the new standard, examples, our observations, and comparisons with current IFRS and U.S. GAAP guidance.



Guidance referenced in this publication

This publication considers the requirements of IFRS 15 *Revenue from Contracts with Customers* and FASB ASU 2014-09, *Revenue from Contracts with Customers*, published jointly in May 2014.

For specific provisions of the revenue recognition guidance, KPMG *summarizes* the requirements, *identifies* differences between IFRS and U.S. GAAP, and *identifies* KPMG's observations. Neither this

publication nor any of KPMG's publications should be used as a substitute for reading the standards and interpretations themselves.

References in the left hand margin of this publication relate to guidance issued as at August 31, 2014. A list of the guidance referenced in this publication is available in the appendix 'Guidance referenced in this publication'.



Authoritative portions of the new standard

The new standard includes:

- core requirements, including scope, recognition, measurement, disclosure, and presentation;
- additional guidance that is labeled 'application guidance' in the IFRS version of the new standard and 'implementation guidance' in the U.S. GAAP version (referred to as application guidance in this publication);
- illustrative examples;
- consequential amendments to other guidance (other standards in IFRS and other Codification Topics in U.S. GAAP); and
- a basis for conclusions.

Both the IFRS and U.S. GAAP versions of the new standard include a mapping of the paragraphs in each version of the new standard to the other. The following table provides an overview of which portions of the new standard are authoritative in IFRS and U.S. GAAP.

Portion of the new standard	IFRS	U.S. GAAP
Core requirements (e.g. 606-10-05-1 to 606-10-50-23 IFRS 15.1 – 15.129)	✓	✓
Application/implementation guidance	✓	✓
Illustrative examples	✗	✓
Consequential amendments to other guidance	✓	✓
Basis for conclusions	✗	✗

 Authoritative
  Nonauthoritative

Guidance replaced by the new standard

The new standard contains a single model that is applied when accounting for contracts with customers across all industries. The new standard replaces substantially all of the current revenue recognition guidance in both IFRS and U.S. GAAP, excluding contracts that are out of scope – e.g., leases and insurance.

For entities applying IFRS, the new standard replaces IAS 11 *Construction Contracts*; IAS 18 *Revenue*; IFRIC 13 *Customer Loyalty Programmes*; IFRIC 15 *Agreements for the Construction of Real Estate*; IFRIC 18 *Transfer of Assets to Customers*; and SIC-31 *Revenue-Barter Transactions Involving Advertising Services*.

For entities applying U.S. GAAP, the new standard replaces substantially all revenue guidance, including the general revenue guidance in FASB ASC Topic 605 (e.g., FASB ASC Subtopics 605-15, *Revenue Recognition—Products*; and 605-20, *Revenue Recognition—Services*) and specialized industry guidance (e.g., FASB ASC Subtopics 360-20, *Property, Plant, and Equipment—Real Estate Sales*; 928-605, *Entertainment—Music—Revenue Recognition*; 954-605, *Health Care Entities—Revenue Recognition*; and 985-605, *Software—Revenue Recognition*).

Summary of key differences between IFRS and U.S. GAAP

While the new revenue recognition standards are substantially converged, the following key differences exist between the two standards.

606-10-25-1(e)
[IFRS 15.9(e)]

340-40-35-6
[IFRS 15.104]

270-10-50-1A
[IAS 34.16A]

606-10-50-7, 50-11,
50-16, 50-21;
340-40-50-4

606-10-65-1
[IFRS 15.C1]

	IFRS	U.S. GAAP
Collectibility threshold (see 5.1.1)	'Probable' means 'more likely than not'	'Probable' means 'likely'
Reversal of previously impaired contract acquisition and contract fulfillment costs for a change in facts and circumstances (see 6.4)	Required (limited to the carrying amount, net of amortization, that would have been determined if no impairment loss had been recognized)	Prohibited
Interim disclosures (see 12.2)	Only disclosure on disaggregated revenue added to required interim disclosures	Disclosures on disaggregated revenue, contract balances, and remaining performance obligations added to required interim disclosures
Reduction of disclosure requirements for 'all other entities' (see 12.3)	Not applicable	Some relief on disclosures for entities other than public business entities and certain not-for-profit entities
Effective date (see 13.1)	Annual periods beginning on or after January 1, 2017	Fiscal years beginning after December 15, 2016 for public business entities and certain not-for-profit entities; one-year deferral available for all other entities
	Early adoption permitted	Early adoption prohibited, except that all other entities can adopt at the same time as public business entities

SEC guidance

This publication contains comparisons to current U.S. GAAP, including the SEC's guidance on revenue recognition.³ Although the new standard supersedes substantially all of the existing revenue recognition guidance issued by the FASB and included in the Codification, it does not supersede the SEC's guidance for registrants. At the time of this publication, it is unknown whether, and if so when, the SEC will revise or rescind its revenue guidance.

Transition Resource Group for revenue recognition

The IASB and the FASB have formed a Joint Transition Resource Group for Revenue Recognition (TRG) for the purpose of:

- soliciting, analyzing, and discussing stakeholder issues arising from the implementation of the new standard;
- informing the IASB and the FASB about implementation issues that will help the Boards determine what action, if any, will be needed to address them; and
- providing a forum for stakeholders to learn about the new guidance from others involved with implementation.

The TRG advises the Boards, but does not have standard-setting authority. The 19 members of the TRG include auditors, financial statement preparers, and users from various industries and geographies (both United States and international), and both public and private companies and organizations. Others who attend and participate in the meeting as observers include the IASB and FASB Board members and staff, the PCAOB, the SEC, AICPA, and IOSCO. The TRG had its first meeting in July 2014 and is expected to meet approximately four times annually until the new standard becomes effective.

Any stakeholder can submit an issue to the Boards for potential consideration by the TRG. The issues should relate to the new standard, be pervasive, and involve guidance that can be interpreted in different ways that would potentially result in diversity in practice. The IASB and FASB staff will decide which issues the TRG will discuss. For discussion purposes, the staff will analyze the various interpretations in issue papers and post those papers to the IASB and FASB websites before the TRG meeting. The TRG members will discuss the issues in a public setting but will not issue authoritative guidance. After each meeting, the Boards will determine what the next step should be for each issue, including whether standard setting is necessary.

In addition to the TRG, there are various other industry groups – including the Revenue Recognition Task Forces formed by the AICPA – that are discussing how to apply the new standard. An entity should actively monitor these activities and consider adjusting its implementation plan if new guidance is developed.

Criteria versus indicators

Throughout the new standard, there are several assessments that include either explicit criteria or indicators for an entity to evaluate. Indicators are provided as a non-exhaustive list of factors for an entity to consider when applying the guidance to the specific facts and circumstances of a contract, whereas an entity is required to evaluate some or all of the specified criteria.

3 SEC Staff Accounting Bulletin Topic 13, *Revenue Recognition*, available at www.sec.gov.

4 Scope

Overview

The new standard applies to contracts to deliver goods or services to a customer. The guidance is applied to contracts with customers in all industries. A contract with a customer is outside the scope of the new standard if it comes under the scope of other specific requirements.

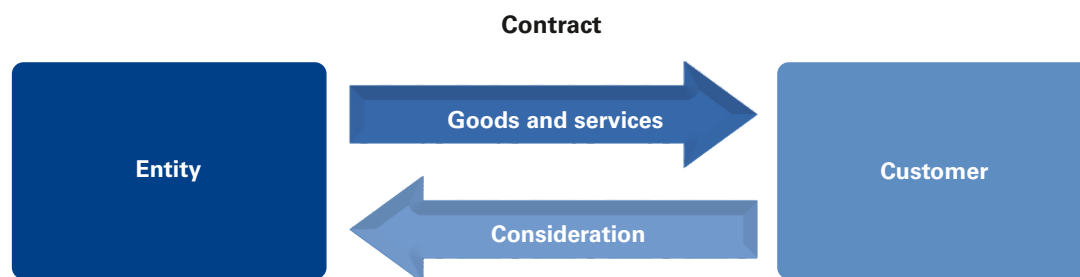
In some cases, the new standard will be applied to part of a contract or, in certain circumstances, to a portfolio of contracts. The new standard provides guidance on when it should or may be applied to these circumstances and how it is applied.

4.1 In scope

606-10-15-3
[IFRS 15.6]

Requirements of the new standard

A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.



Example 1

Identifying in-scope contracts

Company X is in the business of buying and selling commercial property. It sells a property to Purchaser Y. This transaction is in the scope of the new standard, because Purchaser Y has entered into a contract to purchase an output of Company X's ordinary activities and is therefore considered a customer of Company X.

Conversely, if Company X was instead a manufacturing entity selling its corporate headquarters to Purchaser Y, the transaction would not be a contract with a customer because selling real estate is not an ordinary activity of Company X. For further discussion on which parts of the model apply to contracts with a non-customer see Section 9.

Observations

Customer defined but no definition of ordinary activities given

ASU 2014-09 BC52 to
BC53
[IFRS 15.BC52 to BC53]

The definition of a customer focuses on an entity's ordinary activities. The Boards did not define 'ordinary activities' but referred to the definitions of revenue in the Boards' respective conceptual frameworks. The IASB's *Conceptual Framework for Financial Reporting* specifically includes 'ordinary activities of an entity', while the FASB's *Statements of Financial Accounting Concepts* refer to the notion of an entity's 'ongoing major or central operations'.

4.2 Out of scope

Requirements of the new standard

606-10-15-2
[IFRS 15.5]

The new standard does not apply to:

- lease contracts;
- insurance contracts (for U.S. GAAP, insurance contracts in the scope of ASC Topic 944);
- contractual rights or obligations in the scope of certain financial instruments guidance – e.g., receivables, debt and equity securities, liabilities, debt, derivative contracts, and transfers of financial assets;
- guarantees (other than product or service warranties); and
- non-monetary exchanges between entities in the same line of business that facilitate sales to customers other than the parties to the exchange.

Differences between IFRS and U.S. GAAP

Insurance contracts

Topic 944
[IFRS 4]

There is a difference between what is scoped out for U.S. GAAP (contracts issued by insurance entities) compared with IFRS (insurance contracts).

The new standard only excludes insurance contracts for entities that apply current insurance industry guidance under U.S. GAAP. Contracts that meet the definition of insurance contracts but are issued by entities that do not apply insurance entity-specific guidance – e.g., an entity that issues a warranty contract to a third party – are in the scope of the new standard under U.S. GAAP. Therefore, the new standard is applied more broadly under U.S. GAAP.

Under IFRS, insurance contracts are scoped out regardless of the type of entity that issues them. In addition, some warranty contracts are considered to be insurance contracts under IFRS, and are scoped out of the new standard.

Guarantees

Topic 460
[IFRS 9; IAS 39]

The new standard scopes out guarantees. The U.S. GAAP version of the new standard specifically references guarantees as being scoped out because they are covered in a stand-alone ASC Topic; however, the IFRS version of the new standard scopes out rights and obligations that are in the scope of the financial instruments guidance in IFRS, which includes guidance on guarantees.

Observations

606-10-55-30 to 55-35
[IFRS 15.B28 to B33]

Guidance included for product and service warranties

Entities with product or service warranties apply the guidance in the new standard (see 10.2) to determine whether to account for them under the new standard or under other accounting guidance.

Comparison with current IFRS

[IAS 18.6]

Similar scope despite some differences in explicit exemptions

IAS 18 includes specific scope exceptions relating to changes in the fair value of biological assets, the initial recognition of agricultural produce, the extraction of mineral ores, and changes in the value of other current assets. The new standard does not explicitly include these scope exemptions, but because these items do not arise from contracts with customers they are also out of scope of the new standard.

[IAS 18.30(c); IFRS 9;
IAS 39.55A]

Guidance on dividends moved to financial instruments standard

The new standard does not include guidance on the accounting for dividend income. Instead, guidance that is consistent with existing requirements has been incorporated into the financial instruments standards.

Comparison with current U.S. GAAP

Transaction- and industry-specific guidance is eliminated

The new standard eliminates substantially all transaction- and industry-specific guidance and applies to all contracts with customers other than those scoped out as described above. Therefore, some entities currently applying transaction- or industry-specific guidance may find that their revenue recognition policies will change under the new standard.

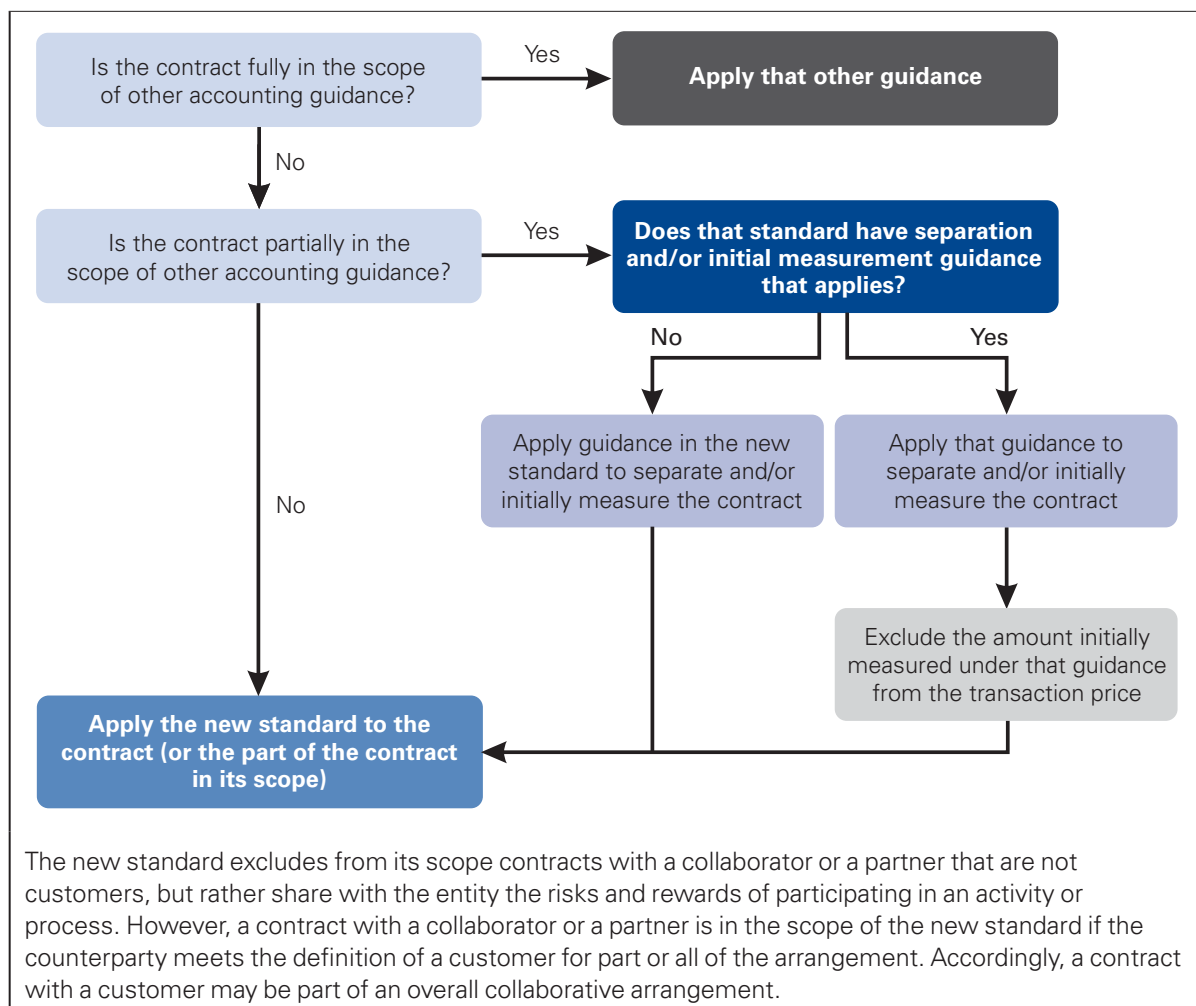
4.3 Partially in scope

606-10-15-4
[IFRS 15.7]

Requirements of the new standard

A contract with a customer may be partially in the scope of the new standard and partially in the scope of other accounting guidance. If the other accounting guidance specifies how to separate and/or initially measure one or more parts of a contract, then an entity first applies those requirements. Otherwise, the entity applies the new standard to separate and/or initially measure the separately identified parts of the contract.

The following flow chart highlights the key considerations when determining the accounting for a contract that is partially in the scope of the new standard.



Example 2

Zero residual amount after applying other accounting requirements

Bank A enters into a contract with a customer in which it receives a cash deposit and provides treasury services for no additional charge. The cash deposit is a liability in the scope of financial instruments guidance. Bank A first applies the initial recognition and measurement requirements in the financial instruments guidance to measure the cash deposit. The residual amount is then allocated to the treasury services and accounted for under the new standard. Because the amount received for the cash deposit is recognized as a deposit liability, there are no remaining amounts to allocate to the treasury services. This conclusion may change if Bank A also charged a monthly fee.

Example 3

Collaborative agreement

Biotech X has an arrangement with PharmaY to research, develop, and commercialize a drug candidate. Biotech X is responsible for the research and development (R&D) activities, while PharmaY is responsible for the commercialization of the drug candidate. Both Biotech X and PharmaY agree to participate equally in the results of the R&D and commercialization activities. Because the parties are active participants and share in the risks and rewards of the end product – i.e., the drug – this is a collaborative arrangement. However, there may be a revenue contract within the overall collaborative arrangement (see ‘Observations’ and ‘Comparison with current U.S. GAAP’, below).

Observations

In some cases, there will be little or no residual amount remaining to allocate

For some arrangements, as illustrated in Example 2 of this publication, after applying the other accounting guidance on separation and/or initial measurement, there may be little or no amount left to allocate to components of the contract that are in the scope of the new standard.

An entity may be both a collaborator and customer

The counterparty may be a collaborator for certain parts of the arrangement and a customer for other parts of the arrangement. It will be important for an entity that engages in collaborative arrangements to analyze whether the other parties to such arrangements are customers for some activities, and therefore lead to revenue-generating activities. Making this assessment will require judgment and consideration of all applicable facts and circumstances of the arrangement.

Rate-regulated entities continue to apply existing standards applicable to alternative revenue programs

The new standard applies to the normal operations of rate-regulated entities (e.g., the sale of electricity, gas, or water to customers in the course of an entity’s ordinary activities that are not subject to rate regulation). However, some regulators have alternative revenue programs that allow for an adjustment (increase or decrease) to rates charged to customers in the future based on changes in demand (e.g., weather abnormalities or other external factors) and/or if certain objectives are met (e.g., reducing costs, reaching milestones, or improving customer service).

In cases where other guidance permits or requires an entity to recognize assets, liabilities, or other balances arising as a result of such programs, changes in these items are generally recognized in applying those other standards. For further discussion, see ‘Comparison with current IFRS’ and ‘Comparison with current U.S. GAAP’, below.

Parts of the new standard apply to sales of nonfinancial assets

Parts of the new standard also apply to sales of intangible assets and property, plant and equipment, including real estate in transactions outside the ordinary course of business. For further discussion on sales of nonfinancial assets outside the ordinary course of business, see Section 9.

*ASU 2014-09 BC55
[IFRS 15.BC55]*

980-605-25-1 to 25-4

*ASU 2014-09 BC57
[IFRS 15.BC57]*

Comparison with current IFRS

Guidance on financial services fees that are retained

[IAS 18.5; IFRS 9;
IAS 39.AG8A to AG8C]

IAS 18 includes illustrative examples that address a variety of financial services fees. This guidance is not included in the new standard, but has been transferred to the financial instruments standards as part of the consequential amendments. Therefore, it will still be used when determining the financial services fees that are included in the measurement of the financial instrument, and those fees that will be accounted for under the new standard.

Movements in regulatory deferral account balances remain out of scope

[IFRS 14]

Currently, the only specific guidance on the accounting for the effects of rate regulation under IFRS is IFRS 14, an interim standard, which permits – but does not require – first-time adopters of IFRS to continue using previous GAAP to account for regulatory deferral account balances. An entity that applies IFRS 14 will therefore measure movements in regulatory deferral account balances using its previous GAAP. The interim standard requires such movements, as well as the regulatory deferral account balances, to be presented as separate line items in the financial statements, distinguished from assets, liabilities, income, and expenses that are recognized under other IFRSs. This is consistent with the new standard's requirement to disclose revenue arising from contracts with customers separately from the entity's other sources of revenue. Consistent with current IFRS, regardless of whether an entity is eligible to apply IFRS 14, revenue arising from contracts with customers is recognized and measured under the new standard.

Comparison with current U.S. GAAP

Separation and initial measurement

605-25-15-3 to 15-3A;
Topic 825; Topic 460

The guidance on separation and measurement for contracts that are partially in the scope of the new standard is consistent with the current guidance on multiple-element arrangements. Examples of guidance in current U.S. GAAP in which an entity first applies that specific separation and measurement guidance before applying the new standard include financial instruments and guarantees.

Gas-balancing agreements

932-10-S99-5

Under current SEC staff guidance for a natural gas arrangement, an entity may present the participants' share of net revenue as revenue regardless of which partner has actually made the sale and invoiced the production (commonly known as the entitlement method). The new standard does not seem to be consistent with current SEC staff guidance relating to the entitlement method of accounting for gas-balancing arrangements.

Under the new standard, the gas-balancing arrangement may be considered to comprise:

- the actual sale of product to a third party, which is accounted for as revenue from a contract with a customer; and
- the accounting for imbalances between the partners, which is accounted for outside of the new standard's scope.

808-10

Collaborative arrangements

Current U.S. GAAP provides some limited income statement presentation guidance for a collaborative arrangement, which is defined as an arrangement that meets the following two criteria:

- the parties are active participants in the arrangement; and
- the participants are exposed to significant risks and rewards that depend on the endeavor's ultimate commercial success.

This guidance is not superseded or amended by the new standard. However, the guidance on presentation refers entities to other authoritative literature, or if there is no appropriate analogy, suggests that they apply a reasonable, rational, and consistently applied accounting policy election. The guidance does not address the recognition and measurement of collaborative arrangements. Collaborative arrangements with parties that are not customers are excluded from the scope of the new standard. Therefore, an entity may continue to evaluate whether the counterparty is a customer consistent with current practice and, if so, apply the new standard to the aspect of the arrangement for which the other party is a customer.

Alternative revenue programs

980-605-25-1 to 25-4

Current U.S. GAAP requirements on the recognition of regulatory assets and liabilities from alternative revenue programs are not in the scope of the new standard. However, the new standard requires revenue arising from regulatory assets and liabilities to be presented separately from revenue arising from contracts with customers in the statement of comprehensive income.

Entities will continue to follow current U.S. GAAP requirements to account for such programs, because these contracts are considered to be contracts with a regulator and not with a customer. This may result in a difference for rate-regulated entities with similar alternative revenue programs if they apply IFRS but are not eligible to apply the interim standard on regulatory deferral accounts.

4.4 Portfolio approach

606-10-10-4
[IFRS 15.4]

Requirements of the new standard

The new standard is generally applied to an individual contract with a customer. However, as a practical expedient, an entity may apply the revenue model to a portfolio of contracts with similar characteristics if the entity reasonably expects that the financial statement effects of applying the new standard to the portfolio or to individual contracts within that portfolio would not differ materially.

Observations

Entities need to consider costs versus benefits of portfolio approach

While the portfolio approach may be more cost effective than applying the new standard on an individual contract basis, it is not clear how much effort may be needed to:

- evaluate what similar characteristics constitute a portfolio – e.g., the impact of different offerings, periods of time, or geographic locations;
- assess when the portfolio approach may be appropriate; and
- develop the process and controls needed in accounting for the portfolio.

No specific guidance on assessing whether portfolio approach can be used

The new standard includes illustrative examples where the portfolio approach is applied, including for rights of return and breakage. However, the new standard provides no specific guidance on how an entity should assess whether the results of a portfolio approach would differ materially from applying the new standard on a contract-by-contract basis.

*606-10-55-202 to 55-207,
55-353 to 55-356
[IFRS 15.IE110 to IE115,
IE267 to IE270]*

5 The model

5.1 Step 1: Identify the contract with a customer

Overview

A contract with a customer is in the scope of the new standard when the contract is legally enforceable and certain criteria are met. If the criteria are not met, the contract is not in the scope of the new standard and any consideration received from the customer is generally recognized as a liability. Contracts entered into at or near the same time with the same customer (or a related party of the customer) are combined and treated as a single contract when certain criteria are met.

5.1.1 Criteria to determine whether a contract exists

Requirements of the new standard

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

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

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



* The threshold differs under IFRS and U.S. GAAP due to different meanings of the term 'probable'.

In making the collectibility assessment, an entity considers the customer's ability and intention (which includes assessing its creditworthiness) to pay the amount of consideration when it is due. This assessment is made after taking into account any price concessions the entity may offer to the customer (see 5.3.1).

606-10-25-2
[IFRS 15.10]

606-10-25-4
[IFRS 15.12]

606-10-25-1
[IFRS 15.9]

606-10-25-1(e)
[IFRS 15.9(e)]

606-10-25-6
[IFRS 15.14]

If the criteria are not initially met, an entity continually reassesses the contract against the criteria and applies the requirements of the new standard to the contract from the date on which the criteria are met. Any consideration received for a contract that does not meet the criteria is accounted for under the requirements set out in 5.1.2.

606-10-25-5
[IFRS 15.13]

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

Example 4

Existence of a contract

In an agreement to sell real estate, Seller X assesses the existence of a contract, considering factors such as:

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

If Seller X concludes that it is not probable that it will collect the amount to which it expects to be entitled, then a contract does not exist. Instead, Seller X applies the guidance on consideration received before concluding that a contract exists (see 5.1.2) and will initially account for any cash collected as a deposit.

Observations

Assessment focuses on enforceability not form of the contract

The assessment of whether a contract exists for the purposes of applying the new standard focuses on the enforceability of rights and obligations rather than the form of the contract (oral, implied, or written). The assessment focuses on whether enforceable rights and obligations have been established, based on the relevant laws and regulations. This may require significant judgment in some jurisdictions or for some arrangements. In cases of significant uncertainty about enforceability, a written contract and legal interpretation by qualified counsel may be required to support a conclusion that the parties to the contract have approved and are committed to perform under the contract.

However, although the contract has to create enforceable rights and obligations, not all of the promises in the contract to deliver a good or service to the customer need to be legally enforceable to be considered performance obligations (see 5.2).

ASU 2014-09 BC32
[IFRS 15.BC32]

Collectibility is only a gating question

Under current requirements, an entity assesses collectibility when determining whether to recognize revenue. Under the new standard, the collectibility criterion is included as a gating question designed to prevent entities from applying the revenue model to problematic contracts and recognizing revenue and a large impairment loss at the same time. This change is unlikely to have a significant effect for most industries. However, the criterion will replace specific U.S. GAAP guidance for health care entities and real estate transactions (see 'Comparison with current U.S. GAAP', below).

Judgment required to differentiate between collectibility issue and price concession

Judgment will be required in evaluating whether the likelihood that an entity will not receive the full amount of stated consideration in a contract gives rise to a collectibility issue or a price concession. The new standard includes two examples of implicit price concessions: a life science prescription drug sale (Example 2 in the new standard) and a transaction to provide health care services to an uninsured (self-pay) patient (Example 3 in the new standard). In both examples, the entity concludes that the transaction price is not the stated price or standard rate and that the promised consideration is therefore variable. Consequently, an entity may need to determine the transaction price in Step 3 of the model, including any price concessions, before concluding on the collectibility criterion in Step 1 of the model.

Fiscal funding clauses may affect assessment of whether a contract exists

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

606-10-55-99 to 55-105;
ASU 2014-09 BC45
[IFRS 15.IE7 to IE13,
BC45]

Comparison with current IFRS

Two definitions of a contract exist in IFRS

The definition of a contract in the new standard focuses on legal enforceability. Although the term 'contract' is also defined in IAS 32, the IAS 32 definition is different and stops short of requiring that a contract be enforceable by law. The IASB did not amend the definition of a contract in IAS 32, on the grounds that this may have unintended consequences on the accounting for financial instruments. As a result, there are two definitions of a contract in IFRS – one in IFRS 15 and another in IAS 32.

[IAS 32.13]

Comparison with current U.S. GAAP

Collectibility criterion replaces specific guidance for health care entities and real estate transactions

Under the new standard, if a health care provider expects to accept a lower amount of consideration than the amount billed for a patient class – e.g., those with uninsured, self-pay obligations – in exchange for services provided, then the provider estimates the transaction price based on historical collections for that patient class. This may be a change for health care providers currently recognizing significant amounts of patient service revenue and related bad debt when services are rendered even though they do not expect the patient to pay the full amount.

954-605-45-4

360-20

To recognize full profit on a real estate sale under current U.S. GAAP, the buyer has to provide a specified amount of initial and continuing investment and the seller cannot have significant continuing involvement in the property. Under the new standard, the bright lines that currently exist, as well as the specific criteria about significant continuing involvement, are eliminated, and collectibility is only considered in determining whether a contract exists and a sale has occurred. This may result in some transactions being treated as a sale under the new standard that would not qualify for full profit recognition under current U.S. GAAP.

Customary business practices versus legally enforceable

SEC SAB Topic 13

Under current SEC guidance, if an entity's customary business practice is to have, in addition to meeting the other criteria, a contract signed by both parties before it concludes that persuasive evidence of an arrangement exists, the entity does not recognize revenue until a written sales agreement is finalized – including being signed by both the customer and the entity. Under the new standard, if the placement of the customer order and shipment of the goods constitute a legally enforceable contract, the guidance in the new revenue model is applied even if that differs from an entity's customary business practices. Similar arrangements in different jurisdictions may be treated differently if the determination of a legally enforceable contract varies.

Consideration not required to be fixed or determinable

SEC SAB Topic 13;
985-605-25-3

Under current SEC guidance and U.S. GAAP for software entities, consideration in a contract has to be fixed or determinable in order for the entity to recognize revenue. Under the new standard, the payment terms need to be identified for a contract to exist under the model, but do not need to be fixed or determinable. Instead, an entity estimates variable consideration in Step 3 of the model (see 5.3.1).

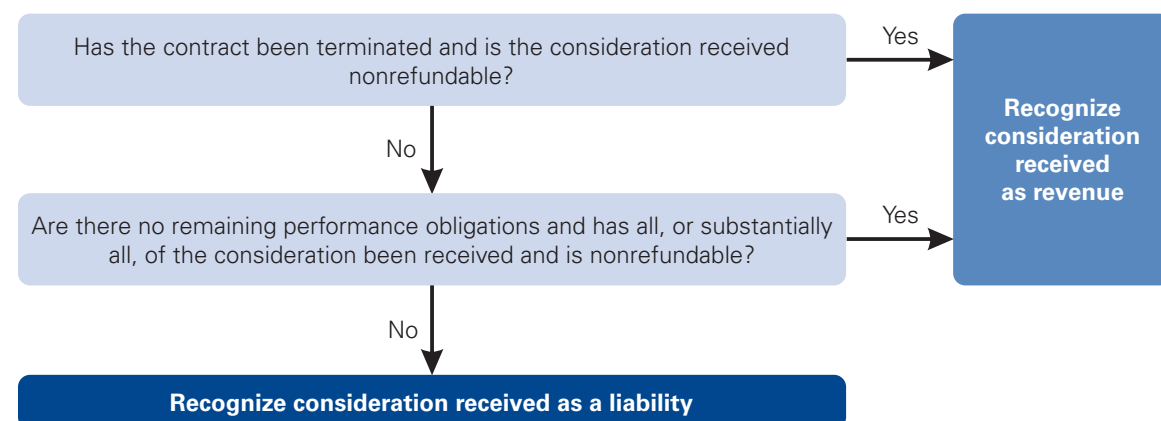
5.1.2

Consideration received before concluding that a contract exists

606-10-25-7 to 25-8
[IFRS 15.15 to 16]

Requirements of the new standard

The following flow chart outlines when consideration received from a contract that is not yet in the scope of the new standard can be recognized.



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

Observations

ASU 2014-09 BC495
[IFRS 15.BC495]

Guidance also applies to the sale of nonfinancial assets

Under U.S. GAAP, the new standard's guidance also applies to the sales of nonfinancial assets to parties other than a customer, because an entity is required to apply the requirements of Step 1 of the model to sales of nonfinancial assets. For further discussion on sales of nonfinancial assets, see Section 9.

Revenue recognition may be deferred for a significant period

If an entity cannot conclude that a legally enforceable contract exists, it may be difficult to evaluate when all or substantially all of the promised consideration has been received and is nonrefundable. In some cases, an entity may have a deposit recognized for a significant period of time until it can conclude that a contract exists in the model or that the criteria above for recognizing the consideration are met.

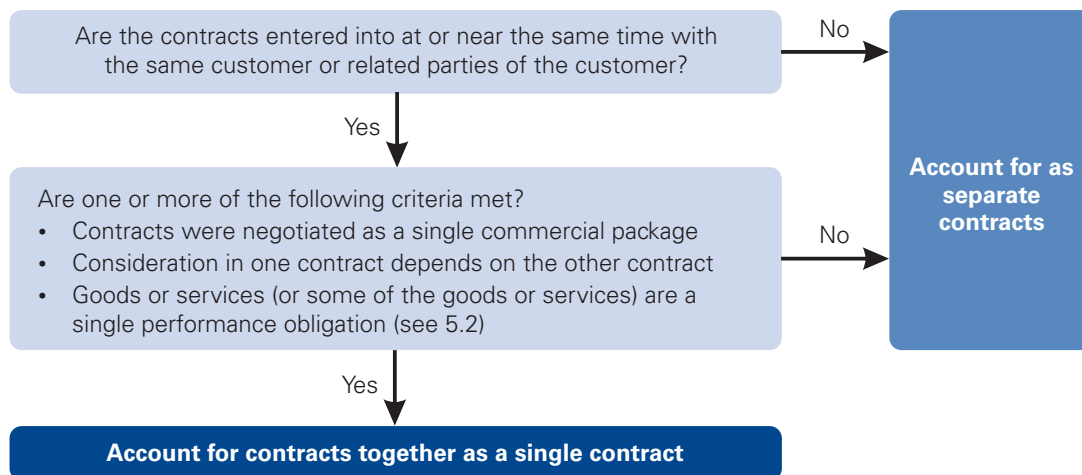
5.1.3

Combination of contracts

606-10-25-9
[IFRS 15.17]

Requirements of the new standard

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



Example 5

Combination of contracts for related services

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

Software Company A determines that the two contracts are combined because they were entered into at nearly the same time with the same customer, and the goods or services in the contracts are a single performance obligation. Software Company A is providing a significant service of integrating the license and consulting services into the combined item for which the customer has contracted. In addition, the software will be significantly customized by the consulting services. For further discussion on identifying the performance obligations in a contract (Step 2 of the model), see 5.2.

Observations

Definition of related parties acquires new significance

*ASU 2014-09 BC74;
850-10-20
[IFRS 15.BC74; IAS 24]*

The new standard specifies that for two or more contracts to be combined, they should be with the same customer or related parties of the customer. The Boards state that the term ‘related parties’ as used in the new standard has the same meaning as the definition in current related party guidance. This means that the definition originally developed in U.S. GAAP and IFRS for disclosure purposes acquires a new significance, as it can affect the recognition and measurement of revenue transactions.

Combining contracts criteria similar but not identical to current guidance

*605-35
[IAS 11.8 to 9]*

Both U.S. GAAP and IFRS contain explicit guidance on combining construction contracts, which is sometimes applied by analogy to other contracts to identify different components of a transaction. The new standard’s guidance on combining contracts applies to all contracts in its scope. The approach to combining contracts in the new standard is similar but not identical to that in current U.S. GAAP and IFRS, which may result in different outcomes under the new standard than under current practice.

Additional complexities for sales through distribution channels

*ASU 2014-09 BC92
[IFRS 15.BC92]*

When applying the guidance on combining contracts, an entity needs to determine who the customer is under the contract. Contracts entered into by an entity with various parties in the distribution channel that are not customers of the entity are not combined. For example, for automotive manufacturers, the customer for the sale of a vehicle is typically a dealer, while the customer for a lease of a vehicle is typically the end consumer. Because the dealer and the end consumer are not related parties, these contracts (the initial sales contract for the vehicle to the dealer and the subsequent lease contract with the end consumer) are not evaluated for the purpose of combining them, and are treated as separate contracts.

However, performance obligations that an entity implicitly or explicitly promises to an end consumer in a distribution channel – e.g., free services to the end customer when the entity’s sale is to an intermediary party – are evaluated as part of the contract. For further discussion on identifying the performance obligations in a contract (Step 2 of the model), see 5.2.

Comparison with current U.S. GAAP

Elimination of rebuttable presumption

605-25-25-3

Current U.S. GAAP on multiple-element arrangements contains a rebuttable presumption that contracts entered into at or near the same time with the same entity or related parties are a single contract. The new standard does not include a similar rebuttable presumption, although it is unclear whether that will affect the analysis in practice.

Software-specific indicators versus specified criteria

985-605-55-4

Existing software guidance provides six indicators that an entity considers to determine whether multiple contracts with the same customer are combined and accounted for as a single multiple-element arrangement. Although one of the indicators is that contracts are negotiated or executed within a short time frame of each other, it is only an indicator to be considered along with the other five indicators.

Under the new standard, entities are required to combine contracts if the contracts are entered into at or near the same time with the same customer (or related parties) and any one of the three specified criteria is met. Although this is similar in concept to the current guidance, it may result in some different conclusions about whether multiple contracts are combined because there are specified criteria instead of indicators to consider.

5.2 Step 2: Identify the performance obligations in the contract

Overview

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

Requirements of the new standard

606-10-25-14, 25-18
[IFRS 15.22, 26]

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

- a good or service (or a bundle of goods or services) that is distinct (see 5.2.1); or
- a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see 5.2.3).

This will include an assessment of implied promises and administrative tasks (see 5.2.2).

5.2.1 Distinct goods or services

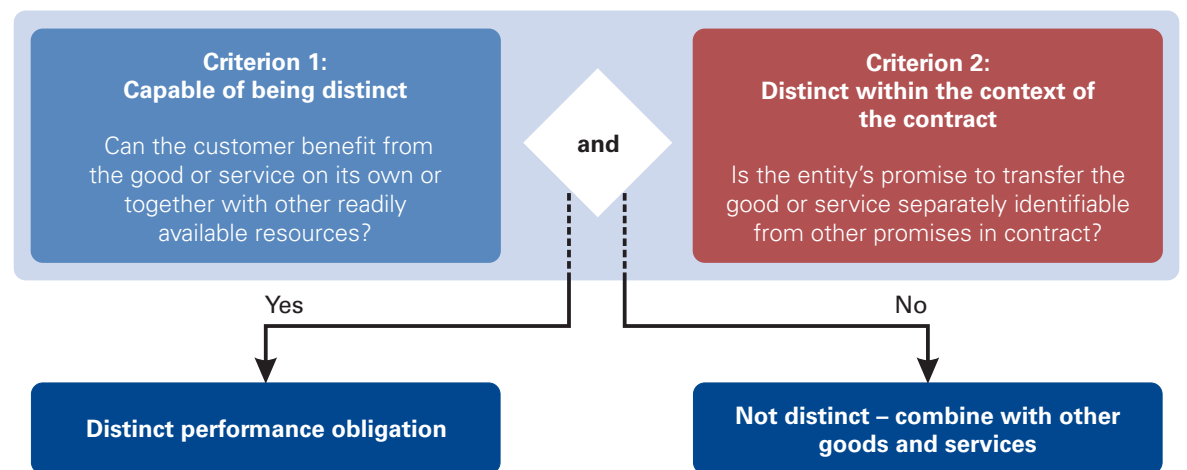
606-10-25-14
[IFRS 15.22]

606-10-25-19
[IFRS 15.27]

Requirements of the new standard

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

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



606-10-25-20
[IFRS 15.28]

Criterion 1 Good or service is capable of being distinct

A customer can benefit from a good or service if it can be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits.

A customer can benefit from a good or service on its own or in conjunction with:

- other readily available resources that are sold separately by the entity, or by another entity; or
- resources that the customer has already obtained from the entity – e.g., a good or service delivered up-front – or from other transactions or events.

The fact that a good or service is regularly sold separately by the entity is an indicator that the customer can benefit from a good or service on its own or with other readily available resources.

606-10-25-21
[IFRS 15.29]

Criterion 2 Distinct within the context of the contract

The new standard provides indicators to evaluate whether a promised good or service is distinct within the context of the contract, which include, but are not limited to, the following.

- The entity does not provide a significant service of integrating the good or service (or bundle of goods or services) with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted – i.e., the entity is not using the good or service as an input to produce or deliver the output specified in the contract.
- The good or service does not significantly modify or customize another good or service promised in the contract.
- The good or service is not highly dependent on or highly interrelated with other goods or services promised in the contract – e.g., if a customer could decide not to purchase the good or service without significantly affecting the other promised goods or services in the contract.

606-10-25-22
[IFRS 15.30]

If a promised good or service is determined not to be distinct, an entity continues to combine that good or service with other goods or services until the combined bundle is a distinct performance obligation, or until all of the goods or services in the contract have been combined into a single performance obligation.

Example 6

Single performance obligation in a contract

606-10-55-137 to 55-140
[IFRS 15.IE45 to IE48]

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

Construction Company C identifies various goods and services that will be provided during the hospital construction that might otherwise benefit Customer D. Customer D could benefit from various goods or services on their own – e.g., if each construction material is sold separately by numerous entities, could be resold for more than scrap value by Customer D, or is sold together with other readily available resources such as additional materials or the services of another contractor.

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

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

Example 7

Multiple performance obligations in a contract

Telco T has a contract with Customer R that includes the delivery of a handset and 24 months of voice and data services.

The handset is locked to Telco T's network and cannot be used on a third-party network without modification – i.e., through an unlock code – but can be used by a customer to perform certain functions – e.g., calendar, contacts list, email, internet access, and accessing apps via Wi-Fi and to play music or games.

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

In this example, Telco T concludes that the handset and the wireless services are two separate performance obligations based on the following evaluation.

Criterion 1	Handset is capable of being distinct <ul style="list-style-type: none"> • Customer R can benefit from the handset either on its own – i.e., because the handset can be resold for more than scrap value and has substantive, although diminished, functionality that is separate from Telco T's network – or together with its wireless services that are readily available to Customer R, because Telco T sells those services separately. • Customer R can benefit from the wireless services in conjunction with readily available resources – i.e., either the handset is already delivered at the time of contract set-up or is purchased from alternative retail vendors.
Criterion 2	Distinct within the context of the contract <ul style="list-style-type: none"> • The handset and the wireless services are separable in this contract because they are not inputs to a single asset – i.e., a combined output – which indicates that Telco T is not providing a significant integration service. • Neither the handset nor the wireless services significantly modifies or customizes the other. • Customer R could purchase the handset and the voice/data services from different parties – i.e., Customer R could purchase the handset from a retailer – therefore providing evidence that the handset and voice/data services are not highly dependent on, or highly interrelated with, each other.

Telco T concludes that it does not need to evaluate whether the voice and data services are distinct from each other because the services will be provided over the same concurrent period and have the same pattern of transfer to Customer R.

Observations

Applying the indicators will require judgment

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

Certain indicators may provide more compelling evidence to the separability analysis than others in different scenarios or types of contracts. In addition, there are some instances where the relative strength of an indicator, in light of the specific facts and circumstances of that contract, may lead an entity to conclude that two or more promised goods or services are not separable from each other within the context of the contract. This may occur even if the other two indicators might suggest separation.

For example, a software entity may conclude that in some cases its off-the-shelf software is separable from its non-complex implementation services because the core software code itself will not be significantly modified or customized by implementation-type services, and because the process itself may not be complex or significant. In other cases, the entity may conclude that its implementation services are not separable from the software license due to their complex interfacing or other specialized requirements, because they are significant to the customer's ability to obtain its intended benefit from the license. In the latter case, the fact that certain services are available from another provider, or that the core software code will not be significantly modified or customized by these implementation services, may have less relevance.

A potential change in practice for the software industry

606-10-55-141 to 55-150
[IFRS 15.IE49 to IE58]

In Example 11 of the new standard, post-contract customer support (PCS) that includes both technical support and unspecified software upgrades provided on a when-and-if available basis comprises two separate performance obligations. Additionally, in that example the two performance obligations are distinct from the software license itself, which is also a separate performance obligation. Current IFRS does not provide any specific guidance on revenue recognition for software-related transactions and the substance of each transaction needs to be considered to determine whether the various components are linked.

985-605-25-67

Under current U.S. GAAP, PCS is treated as a single element when it is separable from the license – i.e., when the entity has vendor-specific objective evidence (VSOE) of the fair value of the PCS. Because that example separates the PCS into two performance obligations, their treatment may differ as the model is applied to each of these two performance obligations.

Contractual restrictions may not be determinative

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

ASU 2014-09 BC100
[IFRS 15.BC100]

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

ASU 2014-09 BC111 to
BC112
[IFRS 15.BC111 to
BC112]

Multiple units of a new product may be a single performance obligation

The Boards believe that promised goods or services may not be separately identifiable from the other promised goods or services when they are highly dependent on, or highly interrelated with each other – even when there is not a significant integration service or the goods or services do not significantly modify or customize other goods or services in the contract. In these cases, the Boards believe that it will be difficult for a customer to purchase one good or service without having a significant effect on the other promised goods or services in the contract.

For example, if an entity agrees to design a new product for a customer and then manufactures a limited number of prototype units, the entity should consider whether each promise is highly dependent on, and highly interrelated with, the other promises in the contract. If some or all of the initial units produced require rework because of design changes in the production process, it might be difficult to determine whether the customer could choose to purchase only the design service or manufacturing service without having a significant effect on the other. Although the entity may be able to benefit from each unit on its own, the units may not be separately identifiable, because each promise may be highly dependent on, or highly interrelated with, the other promised goods or services in the contract.

Systems and processes may be needed to allocate revenue to individual products or services

Under the new standard, a single performance obligation may be a combination of two or more goods and services. Although an entity may have one performance obligation, it may need systems and processes in place to allocate revenue between the individual products and services to meet voluntary or regulatory disclosures – e.g., the SEC requirement to present tangible product sales and sales from services separately.

SEC Regulation S-X,
Rule 5-03(b)

Comparison with current IFRS

Separately identifiable components

Current IFRS includes limited guidance on identifying whether a transaction contains separately identifiable components. However, our view is that based on analogy to the test in IFRIC 18, an entity should consider whether a component has stand-alone value to the customer and whether the fair value of the component can be reliably measured (see 4.2.50.60 in *Insights into IFRS*, 11th Edition).

The new standard introduces comprehensive guidance on identifying separate components that applies to all revenue-generating transactions, which could result in goods or services being unbundled or bundled more frequently than under current practice.

[IAS 18.13; IFRIC 13;
IFRIC 15; IFRIC 18]

Comparison with current U.S. GAAP

Benefit to the customer versus stand-alone value

For a promised good or service to be distinct under the new standard, it has to be:

- capable of being distinct (Criterion 1); and
- distinct within the context of the contract (Criterion 2).

605-25-25-5

Criterion 1 (capable of being distinct) is similar, but not identical, to the stand-alone value criterion required under current U.S. GAAP. Specifically, under current U.S. GAAP a delivered item has value on a stand-alone basis if it is sold separately by any entity or if the customer could resell the delivered item on a stand-alone basis (even in a hypothetical market).

Under the new standard, an entity evaluates whether the customer can benefit from the good or service on its own or together with other readily available resources. This evaluation no longer depends entirely on whether the entity or another entity sells an identical or largely interchangeable good or service separately, or whether the delivered item can be resold by the customer, to support a conclusion that a good or service is distinct. Rather, in evaluating whether the customer can benefit from the good or service on its own, an entity determines whether the good or service is sold separately (by the entity or another entity) or could be resold for more than scrap value. An entity also considers factors such as a product's stand-alone functional utility. Therefore, potentially more goods can qualify as distinct under Criterion 1 than under current U.S. GAAP. However, an entity also has to evaluate Criterion 2.

Promised goods or services versus deliverables

There may not be an exact correlation in all cases between what is considered a 'deliverable' under current U.S. GAAP and what is considered a 'promised good or service' under the new standard. The term 'deliverable' is not defined in current U.S. GAAP. However, in a 2007 speech,⁴ the SEC staff noted that the following criteria are a helpful starting point in determining whether an item is a deliverable in the arrangement:

- the item is explicitly referred to as an obligation of the entity in a contractual arrangement;
- the item requires a distinct action by the entity;
- if the item is not completed, the entity will incur a significant contractual penalty; or
- inclusion or exclusion of the item from the arrangement will cause the arrangement fee to vary by more than an insignificant amount.

Under the new standard, a promised good or service is embedded within the guidance on identifying a contract. Specifically, promised goods or services are the promised obligations within the contract.

Essential to functionality versus separately identifiable

When determining whether software and services in a contract should be accounted for separately under current U.S. GAAP, an entity considers whether the service element is essential to the functionality of the other elements in the arrangement, including the software license.

However, under the new standard an entity considers whether the software and the related services are separately identifiable, which includes evaluating whether there is a significant integration service, whether one good or service significantly modifies or customizes the other, or whether the goods or services are highly dependent on, or highly interrelated with, each other. Although significant judgment may be required, some entities may conclude that services and software will be combined under the new standard, even though the services do not meet the currently required level of being essential to the software's functionality.

985-605-25-76 to 25-85

⁴ SEC Speech, "Remarks Before the 2007 AICPA National Conference on Current SEC and PCAOB Developments," by Mark Barrysmith, Professional Accounting Fellow at the SEC, available at www.sec.gov.

SEC SAB Topic 13;
ASU 2014-09 BC89 to
BC90

No perfunctory or inconsequential concept

Current SEC guidance permits revenue from sales arrangements to be recognized in its entirety if the seller's remaining obligation(s) was perfunctory or inconsequential. The new standard does not exempt an entity from accounting for promised goods or services that the entity might regard as being perfunctory or inconsequential. The Boards believe that it would be difficult and subjective for an entity to determine what goods or services promised in a contract were perfunctory or inconsequential to other goods or services in the contract and that different entities would likely apply the minor or inconsequential concept inconsistently. Therefore, an entity needs to consider all promised goods or services in a contract, subject to general materiality considerations.

Potential change for life sciences

In the pharmaceutical industry, entities do not typically sell technology licenses because the technology is proprietary. Therefore, entities that license unique technology together with proprietary R&D services are currently often required to combine the license with the R&D services in the contract.⁵ However, under the new standard a customer may be able to benefit from the license with other readily available resources. An entity also considers whether the good or service is distinct within the context of the contract in order to separate the goods or services in the contract. This could result in a change in practice for some pharmaceutical companies.

5.2.2

Implied promises and administrative tasks

606-10-25-16 to 25-17
[IFRS 15.24 to 25]

Requirements of the new standard

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

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

Example 8

Implied promise to reseller's customers

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

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

- Reseller D and the end customers are not related parties – and as such, these contracts will not be combined; and

5 SEC Speech, "Remarks Before the 2009 AICPA National Conference on Current SEC and PCAOB Developments," by Arie Wilgenburg, Professional Accounting Fellow at the SEC, available at www.sec.gov.

- the promise to provide telephone support free of charge to end users is considered a service that meets the definition of a performance obligation when control of the software product transfers to Reseller D.

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

Example 9

Implied performance obligation – Pre- and post-sale incentives

Car Manufacturer N has an historical practice of offering free maintenance services – e.g., oil changes and tire rotation – for two years to the end customers of dealers who purchase its vehicles. Although not explicitly stated in the contract with its dealers, Car Manufacturer N has a customary business practice of offering the two-year maintenance incentive; therefore, the maintenance is treated as a separate performance obligation in the sale of the vehicle to the dealer. Revenue from the sale of the vehicle is recognized when control of the vehicle is transferred to the dealer. Revenue from the maintenance services is recognized as the maintenance services are provided to the retail customer.

However, if Car Manufacturer N does not have a customary business practice of offering free maintenance, and instead announces the maintenance program as a limited-period sales incentive after control of the vehicle has transferred to the dealer, then the free maintenance is not a separate performance obligation in the sale of the vehicle to the dealer. In this case, Car Manufacturer N recognizes the full amount of revenue when control of the vehicle is transferred to the dealer. If Car Manufacturer N subsequently creates an obligation by announcing that it will provide incentives, Car Manufacturer N will accrue as an expense its expected cost of providing maintenance services on the vehicles in the distribution channel – i.e., controlled by dealers – when the program is announced.

Determining whether a sales incentive to end customers was offered pre- or post-sale to the dealer will be challenging for some entities, especially for implied sales incentives where the entity has a customary business practice of offering incentives. The entity will need to assess whether the dealer and customer have an expectation that the entity will provide a free service.

606-10-55-156 to 55-157
[IFRS 15.IE64 to IE65]

Example 10

Administrative task – Registration of software keys

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

In this example, delivery of the key is contingent only on Customer L's actions, and the delivery of the key is an administrative task. Therefore, that activity is not considered to be a promised service in the contract. Assuming that all other revenue recognition criteria have been met – including Customer L obtaining control of the operating system software – Software Company B recognizes revenue on delivery of the operating system software because delivery of the key is an administrative activity that does not transfer a promised good or service.

Observations

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

ASU 2014-09 BC93,
BC411(b)
[IFRS 15.BC93, BC411(b)]

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

Comparison with current U.S. GAAP

Administrative tasks

SEC SAB Topic 13

The notion of an administrative task exists in current SEC guidance and refers to activities that do not represent discrete earnings events – i.e., selling a membership, signing a contract, enrolling a customer, activating telecommunications services, or providing initial set-up services. Current SEC guidance distinguishes between deliverables and these activities. It states that activities that do not represent discrete earnings events are typically negotiated in conjunction with the pricing of the deliverables to the contract, and that the customer generally views these types of non-deliverable activities as having significantly lower or no value separate from the entity's overall performance under the contract.

In general, entities are unlikely to reach a substantially different conclusion under the new standard in attempting to identify administrative tasks than they have reached under current SEC guidance in identifying activities that do not represent discrete earnings events.

5.2.3

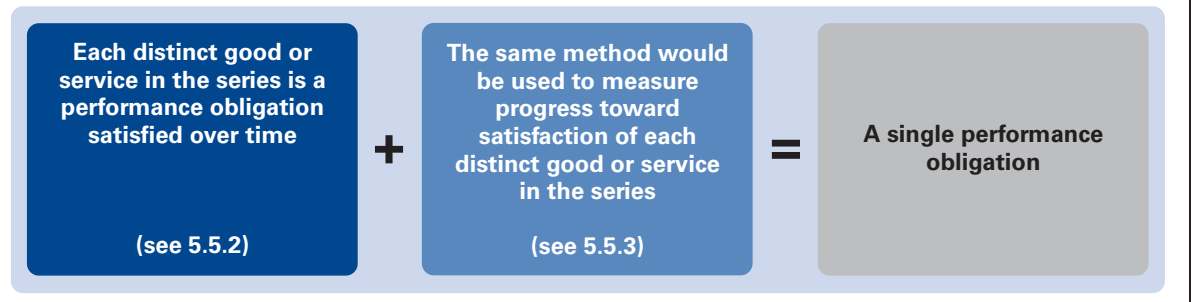
Series of distinct goods or services

Requirements of the new standard

606-10-25-14(b)
[IFRS 15.22(b)]

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

606-10-25-15
[IFRS 15.23]



Example 11**Series of distinct goods or services treated as a single performance obligation**

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

- they have no alternative use to Contract Manufacturer X; and
- Customer A is contractually obligated to pay Contract Manufacturer X for any finished or in-process widgets, including a reasonable margin, if Customer A terminates the contract for convenience.

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

Based on this fact pattern, Contract Manufacturer X concludes that each of the 1,000 widgets is distinct, because:

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

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

- each widget will transfer to Customer A over time; and
- Contract Manufacturer X uses the same method to measure progress toward complete satisfaction of the obligation to transfer each widget to Customer A.

Example 12**Distinct service periods within a long-term service contract**

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

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

Observations

Accounting for a series provides a simplification of the model

ASU 2014-09 BC113 to
BC114
[IFRS 15.BC113 to
BC114]

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

ASU 2014-09 BC115
[IFRS 15.BC115]

However, if the contract is modified then the entity considers the distinct goods or services rather than the performance obligation. This in turn simplifies the accounting for the contract modification (see Section 7).

Comparison with current U.S. GAAP

Separate performance obligations

605-25-25-5

The current U.S. GAAP separation model focuses on whether *delivered* goods or services are separable from other goods or services – i.e., *undelivered* goods or services do not need to meet explicit separability criteria. Under the new standard, entities consider at contract inception whether each good or service in the contract is a separate performance obligation or whether they have promised a series of distinct goods or services that is a single performance obligation.

5.3 Step 3: Determine the transaction price

Overview

606-10-32-2
[IFRS 15.47]

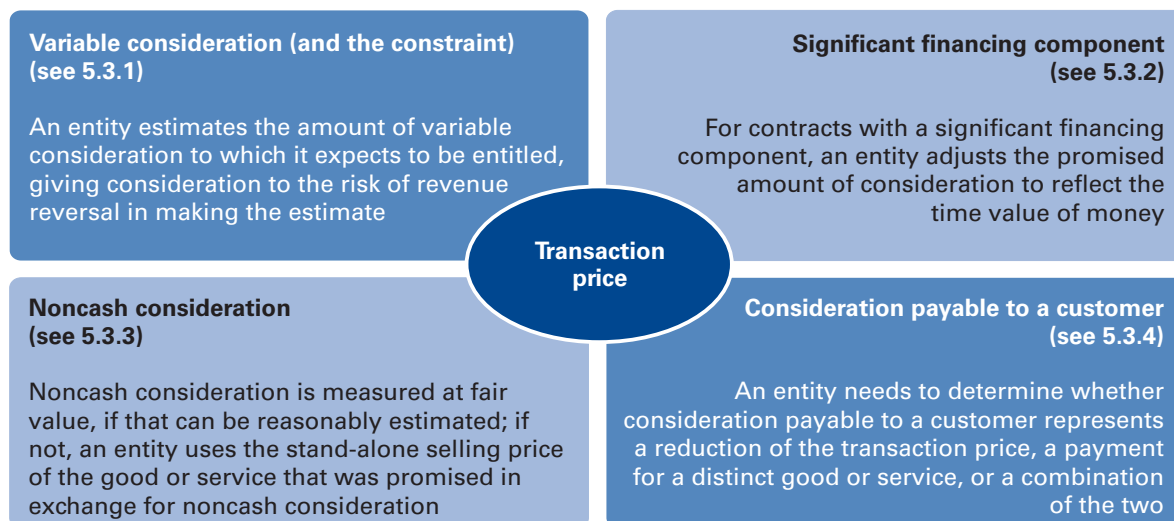
The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g., some sales taxes. To determine this amount, an entity considers multiple factors.

606-10-32-4
[IFRS 15.49]

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

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

606-10-32-3
[IFRS 15.48]



Customer credit risk is not considered when determining the amount to which an entity expects to be entitled – instead, credit risk is considered when assessing the existence of a contract (see 5.1). However, if the contract includes a significant financing component provided to the customer, the entity considers credit risk in determining the appropriate discount rate to use (see 5.3.2).

606-10-32-13, 55-65
[IFRS 15.58, B63]

An exception exists for sales- or usage-based royalties arising from licenses of intellectual property (see 8.4).

5.3.1

Variable consideration (and the constraint)

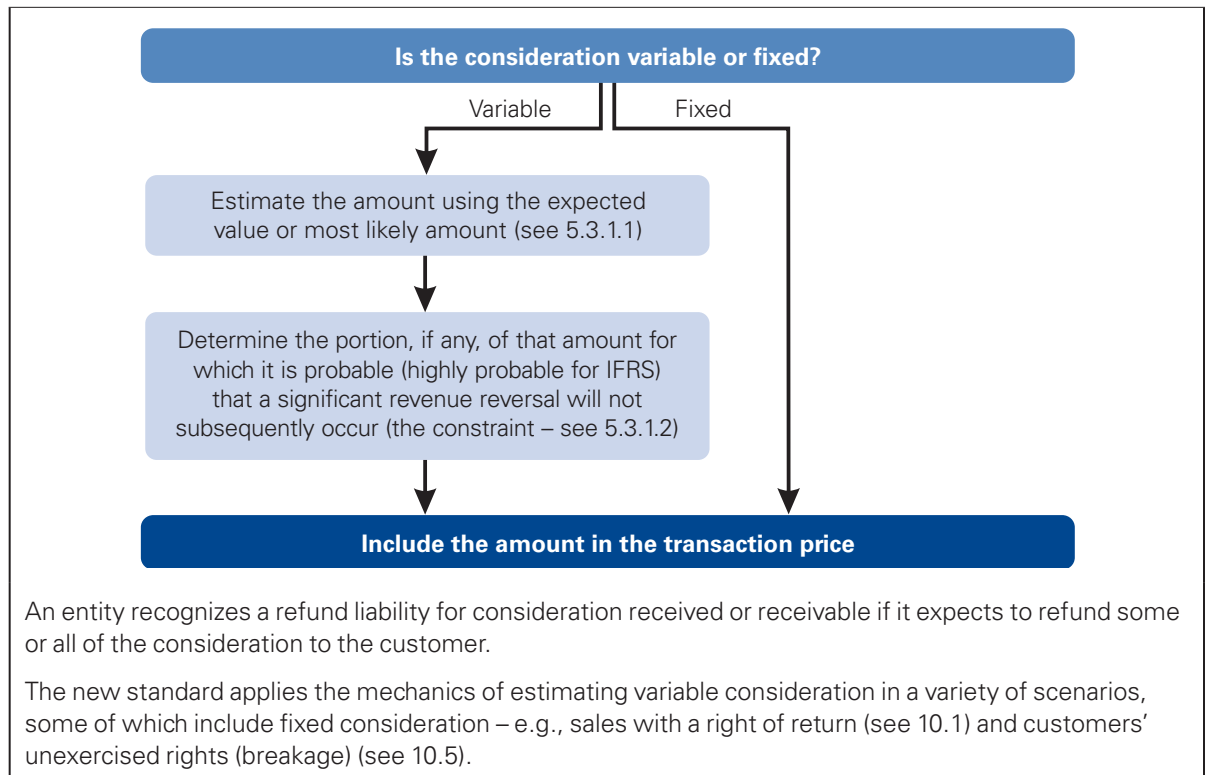
606-10-32-6 to 32-7
[IFRS 15.51 to 52]

Requirements of the new standard

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

606-10-32-8, 32-11, 32-13
[IFRS 15.53, 56, 58]

An entity assesses whether, and to what extent, it can include an amount of variable consideration in the transaction price at contract inception. The following flow chart sets out how an entity determines the amount of variable consideration in the transaction price, except for sales- or usage-based royalties from licenses of intellectual property.



606-10-32-10
[IFRS 15.55]

Observations

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

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

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

ASU 2014-09 BC190 to
BC194
[IFRS 15.BC190 to
BC194]

5.3.1.1

Estimate the amount of variable consideration

Requirements of the new standard

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

606-10-32-8
[IFRS 15.53]

606-10-32-9
[IFRS 15.54]

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

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

Example 13

Estimate of variable consideration – Expected value

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

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

Manufacturer M determines that the expected value method provides the better prediction of the amount of consideration to which it will be entitled. As a result, it estimates the transaction price to be 480 per television – i.e., $(500 \times 70\%) + (450 \times 20\%) + (400 \times 10\%)$ – before considering the constraint (see 5.3.1.2).

Example 14

Estimate of variable consideration – Most likely amount

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

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

Because there are only two possible outcomes under the contract, Company C determines that using the most likely amount provides the better prediction of the amount of consideration to which it will be entitled. Company C estimates the transaction price – before it considers the constraint (see 5.3.1.2) – to be 130,000, which is the single most likely amount.

Observations

All facts and circumstances considered when selecting estimation method

ASU 2014-09 BC200
[IFRS 15.BC200]

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

Expected value method – No need to quantify less probable outcomes

ASU 2014-09 BC201
[IFRS 15.BC201]

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

A combination of methods may be appropriate

ASU 2014-09 BC202
[IFRS 15.BC202]

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

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

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

In this case, the entity may conclude that it is appropriate to use an expected value method for the first uncertainty, and a most likely amount method for the second uncertainty.

5.3.1.2

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

Requirements of the new standard

606-10-32-11
[IFRS 15.56]

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

606-10-32-12
[IFRS 15.57]

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

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

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

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

This assessment needs to be updated at each reporting date.

An exception exists for sales- or usage-based royalties arising from licenses of intellectual property (see 8.4).

606-10-32-14
[IFRS 15.59]

606-10-32-13
[IFRS 15.58]

Difference between IFRS and U.S. GAAP

Level of confidence – A difference in wording only

The term 'highly probable' in the IFRS version of the new standard has been used with the intention of converging with the term 'probable' as used in the U.S. GAAP version of the new standard. The IASB took a similar approach in IFRS 5.

ASU 2014-09 BC208 to
BC212
[IFRS 15.BC208 to
BC212]

Example 15

Applying the constraint to an investment management contract

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

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

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

606-10-55-221 to 55-225
[IFRS 15.IE129 to IE133]

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

Quarterly management fee	Investment Manager M determines that the cumulative amount of consideration from the management fee to which it is entitled is not constrained, because it is calculated based on asset values at the end of each quarter; therefore, once the quarter finishes the consideration for the quarter is known. Investment Manager M determines that it can allocate the entire amount of the fee to the completed quarters, because the fee relates specifically to the service provided for those quarters.
Performance-based incentive fee	Investment Manager M determines that the full amount of the performance fee is constrained, and therefore excluded from the transaction price. This is because: <ul style="list-style-type: none"> • the performance fee has a high variability of possible consideration amounts, and the magnitude of any downward adjustment could be significant; • although Investment Manager M has experience with similar contracts, that experience is not predictive of the outcome of the current contract because the amount of consideration is highly susceptible to volatility in the market based on the nature of the assets under management; and • there are a large number of possible outcomes.

As a result, Investment Manager M determines that before the end of the contract period, the revenue recognized during the reporting period is limited to the quarterly management fees.

Observations

Constraint assessment made against cumulative revenue

When constraining its estimate of variable consideration, an entity assesses the potential magnitude of a significant revenue reversal relative to the cumulative revenue recognized – i.e., for both variable and fixed consideration, rather than on a reversal of only the variable consideration. Although the constraint is included in Step 3 of the model, there are diverse views on whether the constraint applies at the contract level or at the individual performance obligation level.

Specified level of confidence included in constraint requirements

The inclusion of a specified level of confidence – ‘probable’ (‘highly probable’ under IFRS) – clarifies the notion of whether an entity *expects* a significant revenue reversal. The use of existing defined terms should improve consistency in application between preparers, and reduce concerns about how regulators and users will interpret the requirement. This is an area of significant judgment, and entities will need to align their judgmental thresholds, processes, and internal controls with these new requirements. Documentation of these judgments will also be critical.

ASU 2014-09 BC209
[IFRS 15.BC209]

ASU 2014-09 BC207
[IFRS 15.BC207]

Constraint introduces an element of prudence

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

Comparison with current IFRS

[IAS 18.14(c)]

Estimation uncertainty limits rather than precludes revenue recognition

The constraint represents a significant change in accounting for revenue under IFRS. Under current IFRS, an entity recognizes revenue only if it can estimate the amount reliably – so uncertainty over the outcome may preclude revenue recognition. By contrast, the constraint sets a ceiling – it limits rather than precludes revenue recognition.

Comparison with current U.S. GAAP

SEC SAB Topic 13

Applying the constraint

Unlike current U.S. GAAP, the new standard requires an entity to estimate variable consideration and apply the constraint in determining the transaction price, rather than assessing whether the amount is fixed or determinable. This may result in earlier revenue recognition in a number of circumstances.

Sell-in versus sell-through

985-605-25-36

Many entities sell products through distributors or resellers. When a reseller is unable to sell the products, the entity is often compelled to grant a price concession through price protection, or accept product returns.

Under current U.S. GAAP, some entities conclude that fees are not fixed or determinable, or that the significant risks and rewards of ownership have not been transferred to the customer if the entity has a history of offering price concessions. These entities recognize revenue when they have evidence that the reseller has sold the product to an end customer (sell-through), rather than when they sell products to a distributor or reseller (sell-in). However, other entities conclude that the fees are fixed or determinable because they can reasonably predict the amount of price concessions or returns that will be given to customers based on the entity's historical experience. These entities recognize revenue on sell-in.

Under the new standard, the transfer of risks and rewards of ownership is only one of several indicators of control transfer. An entity also needs to:

- determine the total amount of consideration to which it expects to be entitled, and for which it is probable that a significant revenue reversal will not occur (the constraint); and
- recognize that amount at the time of the sale to the distributor or reseller. Its determination of the consideration will also need to be updated each reporting period until the uncertainty is resolved.

Sell-through may not be appropriate unless:

- control of the goods has not transferred – e.g., inventory is consigned (see 5.5.6); or
- by applying the constraint, the amount recognized on selling to the distributor or reseller will be zero (which will not usually be the case) – i.e., the entire amount of consideration is at risk of a significant revenue reversal. Even then, however, if the entity has transferred control of the products to the distributor or reseller, it will derecognize the inventory and recognize the cost of goods sold.

Extended payment terms

985-605-25-33 to 25-35

Under current U.S. GAAP on software revenue recognition, for transactions in which the risk of technological obsolescence is high, an arrangement fee is presumed not to be fixed or determinable if payment of a significant portion of the licensing fee is not due until after expiration of the license, or more than 12 months after delivery. Other entities with extended payment terms and technological obsolescence risk sometimes follow this guidance by analogy.

In these circumstances, revenue is currently not recognized (unless the presumption can be overcome) until the payments become due and payable, assuming that all other revenue recognition criteria are met.

Under the new standard, extended payment terms do not necessarily preclude revenue recognition; rather, an entity applies the constraint – i.e., the amount included in the transaction price is limited to amounts for which it is probable that a significant revenue reversal will not occur. When determining the transaction price, an entity also considers the existence of a significant financing component. Therefore, the new standard is likely to result in earlier revenue recognition for many software arrangements with extended payment terms.

Performance-based incentive fees

605-20-S99

An asset manager's performance-based incentive fees are subject to the revenue constraint. The inclusion of these fees in the transaction price is limited to amounts for which it is probable that a significant revenue reversal will not occur, considering that the consideration is highly susceptible to external factors – e.g., market volatility (see Example 15 in this publication).

Although Method 2 under current SEC guidance – i.e., to recognize revenue each period at the amount that the asset manager would earn if the reporting date were the end of the contract period – is seen by some as providing a good depiction of an asset manager's performance each period, it is not consistent with the constraint's objective, because a risk of significant revenue reversal due to market volatility is likely to exist.

The new standard's guidance on performance-based incentive fees is also different from Method 1 under current SEC guidance – i.e., to recognize revenue at the end of the contract period. This is because an asset manager is not precluded from recognizing a portion of the performance-based incentive fee before the contingency is resolved if it is probable that there will not be a significant revenue reversal when the uncertainty is resolved. For example, if the asset manager locks in the performance fee before the end of the contract period by investing the managed funds in money market investments, and intends to hold the managed funds in money market investments until the end of the contract period, then the asset manager may be able to recognize a portion of the performance fees before the end of the contract period.

5.3.2 Significant financing component

606-10-32-15
[IFRS 15.60]

606-10-32-16
[IFRS 15.61]

606-10-32-17
[IFRS 15.62]

606-10-32-19
[IFRS 15.64]

606-10-32-18
[IFRS 15.63]

Requirements of the new standard

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

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

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

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

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

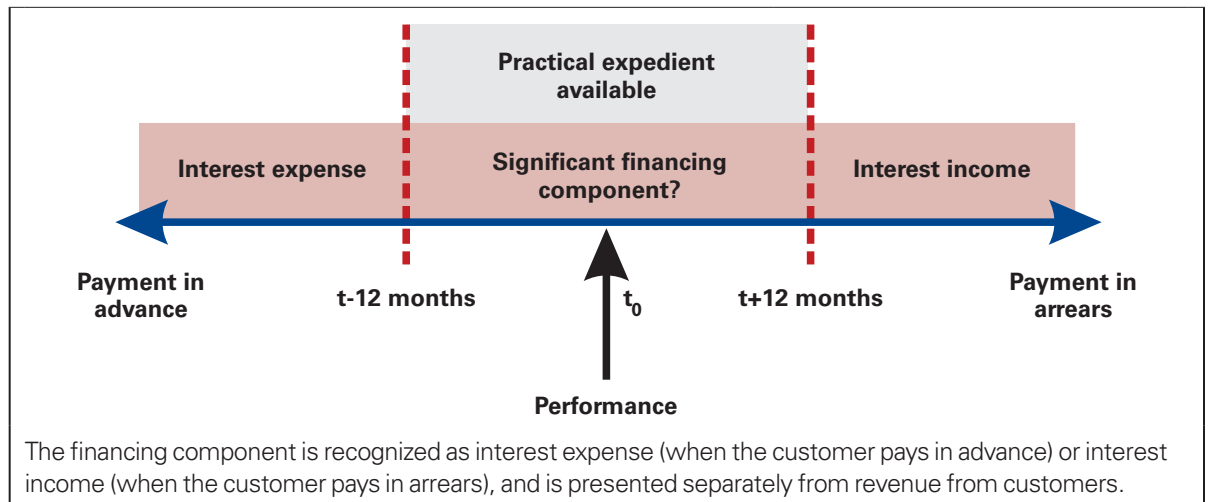
Factor	Example
An entity receives an advance payment where the timing of the transfer of goods or services to a customer is at the discretion of the customer	A prepaid phone card or customer loyalty points
A substantial portion of the consideration is variable, and the amount and/or timing of the consideration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

The new standard indicates that:

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

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

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



606-10-32-20
[IFRS 15.65]

Example 16

Time value of money in a multiple-element arrangement

Construction Company B enters into a contract with Customer C to construct and deliver Product X and Product Y for an up-front cash payment of 150,000. Product X will be delivered in two years and Product Y will be delivered in five years.

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

Contract inception	Recognize a contract liability for the payment of 150,000
Years 1 and 2	During the 2 years from contract inception until the transfer of Product X, recognize interest expense of 18,540 ^(a) on 150,000 at 6% for 2 years
	Recognize revenue of 42,135 ^(b) for the transfer of Product X
Years 3, 4 and 5	Recognize interest expense of 24,145 ^(c) for 3 years on the remaining contract liability of 126,405 ^(d)
	Recognize revenue of 150,550 ^(e) for the transfer of Product Y

Notes

- (a) Calculated as $150,000 \times (1.06^2 - 1)$.
- (b) Calculated as $37,500 + 4,635$, being the initial allocation to Product X plus Product X's portion of the interest for the first 2 years of the contract ($25\% \times 18,540$).
- (c) Calculated as $126,405 \times (1.06^3 - 1)$, being the contract liability balance after 2 years.
- (d) Calculated as $150,000 + 18,540 - 42,135$, being the initial contract liability plus interest for 2 years less the amount derecognized from the transfer of Product X.
- (e) Calculated as $126,405 + 24,145$, being the contract liability balance after 2 years plus interest for 3 years.

Observations

Assessment undertaken at the individual contract level

ASU 2014-09 BC234
[IFRS 15.BC234]

An entity determines the significance of the financing component at an individual contract level, rather than at a portfolio level. The Boards believe that it would be unduly burdensome to require an entity to account for a financing component if the effects of the financing component are not material to the individual contract, but the combined effects for a portfolio of similar contracts would be material to the entity as a whole. An entity should apply judgment in evaluating whether a financing component is significant to the contract.

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

ASU 2014-09 BC233(a)
[IFRS 15.BC233(a)]

Customers pay for some types of goods or services in advance – e.g., prepaid phone cards, gift cards, and customer loyalty points – and the transfer of the related goods or services to the customer is at the customer's discretion. In these cases, the contracts do not include a significant financing component, because the payment term does not relate to a financing arrangement. Also, the Boards believe that the costs of requiring an entity to account for the financing component in these situations would outweigh any perceived benefits, because the entity would not know – and would therefore have to continually estimate – when the goods or services will transfer to the customer.

Limited examples provided of when payments have a primary purpose other than financing

ASU 2014-09 BC233(c)
[IFRS 15.BC233(c)]

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

While it seems that the Boards are attempting to address retention payments in the construction industry with these observations, it is unclear whether this concept might apply to other situations. The Boards explicitly considered advance payments received by an entity during their redeliberations – e.g., compensating the entity for incurring up-front costs – but decided not to exempt entities from accounting for the time value of money effect of advance payments.

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

Determining the effect of the time value of money for a contract with a significant financing component can be complex for long-term or multiple-element arrangements. In these contracts, goods or services are transferred at various points in time, cash payments are made throughout the contract, and there may be a change in the estimated timing of the transfer of goods or services to the customer. If additional variable elements are present in the contract – e.g., contingent consideration – then these calculations can be even more sophisticated, making the cost and complexity for preparers significant. In addition, an entity will need to have appropriate processes and internal controls in place to handle these potential complexities in assessing whether a significant financing component exists and, if so, developing the appropriate calculations and estimates.

ASU 2014-09 BC239 to
BC241
[IFRS 15.BC239 to
BC241]

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

It may not always be appropriate to use an interest rate that is explicitly specified in the contract, because the entity might offer 'cheap' financing as a marketing incentive. Consequently, an entity applies the rate that would be used in a separate financing transaction between the entity and its customer that does not involve the provision of goods or services. This can lead to practical difficulties for entities with large volumes of customer contracts, as they will have to determine a specific discount rate for each customer or class of customer.

Presentation of interest income as revenue is not precluded

The new standard does not preclude an entity presenting interest income (when it has provided financing to the customer) as a type of revenue if the interest represents income arising from ordinary activities – e.g., for banks, and entities with similar operations.

Advance payments will affect EBITDA

When an entity receives an advance payment that represents a significant financing component, the entity increases the amount of revenue recognized, with a corresponding increase to interest expense. This change will result in an increase to EBITDA, which may affect compensation arrangements and debt covenant compliance.

ASU 2014-09 BC247
[IFRS 15.BC247]

Comparison with current IFRS

No specific guidance for advance payments

Under current IFRS, an entity discounts consideration to a present value if payment is deferred and the arrangement effectively constitutes a finance transaction. However, current IFRS is silent on whether an entity adjusts consideration if payment is received in advance.

[IAS 18.11]

Comparison with current U.S. GAAP

Advance payments

Amounts that do not require repayment in the future, but that will instead be applied to the purchase price of the property, goods, or services involved, are currently excluded from the requirement to impute interest. This is because the liability – i.e., deferred revenue – is not a financial liability. Examples include deposits or progress payments on construction contracts, advance payments for the acquisition of resources and raw materials, and advances to encourage exploration in the extractive industries.

The requirements under the new standard represent a change from current practice, and may particularly impact contracts in which payment is received significantly earlier than the transfer of control of goods or services. For example, they may affect construction contractors with long-term contracts and software entities that bundle several years of PCS in arrangements with payments received at the outset or in the early stages of a contract.

When the financing component is significant to a contract, an entity increases the contract liability and recognizes a corresponding interest expense for customer payments received before the delivery of the good or service. When it satisfies its performance obligation, the entity recognizes more revenue than the cash received from the customer, because the contract liability has been increased by the interest expense that has accreted.

835-30-15-3(b);
932-835-25-2

5.3.3

Noncash consideration

606-10-32-21 to 32-22
[IFRS 15.66 to 67]

606-10-32-23
[IFRS 15.68]

606-10-32-24
[IFRS 15.69]

Requirements of the new standard

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

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

Noncash consideration received from the customer to facilitate an entity's fulfillment of the contract – e.g., materials or equipment – is accounted for when the entity obtains control of those contributed goods or services.

Observations

ASU 2014-09 BC251 to BC252
[IFRS 15.BC251 to BC252]

Constraint does not apply when variation is due to the form of noncash consideration

The Boards believe that the requirement for constraining estimates of variable consideration apply regardless of whether the amount received will be in the form of cash or noncash consideration. They therefore decided to constrain variability in the estimate of the fair value of noncash consideration if that variability relates to changes in the fair value for reasons other than the form of the consideration – i.e., changes other than the price of the noncash consideration. If the variability is because of the entity's performance – e.g., a noncash performance bonus – then the constraint applies. If the variability is because of the form of the noncash consideration – e.g., changes in the stock price – then the constraint does not apply.

Measurement date of share-based payments received by an entity is not specified

The general principles covering noncash consideration include accounting for share-based payments received by an entity in exchange for goods or services. However, the new standard does not specify when to measure noncash consideration. Therefore, there may be diversity in views about whether to measure the consideration:

- when the contract is entered into; or
- when or as the performance obligation is satisfied.

It is also unclear how to account for equity-based consideration when the terms change after the measurement date – i.e., whether revenue could increase or decrease by the entire change in fair value, by some incremental portion of the change in fair value, or not at all.

606-10-55-248 to 55-250
[IFRS 15.IE156 to IE158]

No measurement date for noncash consideration specified

The new standard does not provide explicit guidance on the measurement date for noncash consideration. Example 31 in the new standard illustrates how an entity measures equity instruments for a single performance obligation that is satisfied over time. On completion of each weekly service, the entity measures the fair value of the shares received as consideration for that week. Subsequent changes in the fair value of the shares received are not presented as revenue.

Entities will need to apply judgment to determine the measurement date for:

- performance obligations that are satisfied over time;
- multiple performance obligations that are satisfied at different points in time in one contract; and
- performance obligations that are satisfied at a point in time but for which the terms of the noncash consideration – e.g., equity instruments – change after that point in time.

Comparison with current IFRS

Changes in the measurement threshold

[IAS 18.12; IFRS 2]

The requirement to measure noncash consideration at fair value is broadly similar to the current IFRS requirements. However, under current IFRS, when the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by any cash transferred. By contrast, under the new standard, in these circumstances the entity measures the transaction price at the stand-alone selling price of the goods or services transferred.

Furthermore, the threshold for using the fair value of the noncash consideration as the measurement basis is that the entity can 'reliably measure' the fair value, not 'reasonably estimate' it.

Barter transactions involving advertising services

[SIC-31]

Currently, revenue from advertising barter transactions is measured at the fair value of the advertisement services given, provided that the fair value of these services can be measured reliably. Furthermore, an exchange of similar advertisement services is not a transaction that generates revenue under IAS 18.

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

Transfer of assets from customers

[IFRIC 18]

Unlike current IFRS, the new standard does not contain any specific guidance on transfers of items of property, plant, and equipment that entities receive from their customers. However, if an entity recognizes revenue on the transfer, there is no change in the measurement attribute, and the entity continues to measure revenue at the fair value of the item transferred.

Comparison with current U.S. GAAP

Exchanges of non-monetary assets

845-10-30-3 to 30-4

The accounting for non-monetary transactions based on fair value under the new standard is broadly consistent with the current U.S. GAAP on non-monetary transactions, except for those in which the consideration received from the customer is a share-based payment.

One of the requirements for a contract to exist under the new standard is that it has commercial substance, which would result in non-monetary exchanges being accounted for at fair value. Under the new standard, if an entity cannot reasonably estimate the fair value of the noncash consideration received, then it looks to the estimated selling price of the promised goods or services.

However, under current U.S. GAAP, rather than looking to the estimated selling price of the promised goods or services, the entity uses the fair value of either the assets received or the assets relinquished in the exchange – unless the fair value of the assets cannot be determined within reasonable limits, or the transaction lacks commercial substance.

Goods or services in exchange for share-based payments

505-50

Current U.S. GAAP provides guidance on the measurement date for equity-based consideration received by an entity in exchange for goods or services transferred to a customer. In addition, it provides guidance on recognition and measurement when the equity-based consideration includes terms that change after the measurement date as a result of achieving a performance or market condition – e.g., a change in the exercise price or term of a stock option.

The new standard eliminates current U.S. GAAP on the accounting for share-based payments received by an entity in exchange for goods or services; therefore, equity instruments received in a contract with a customer are accounted for consistently with other noncash consideration.

Use of the estimated selling price

Topic 845; 605-20-25-14 to 25-18

The alternative of using the estimated selling price of the promised goods or services if the fair value of the noncash consideration cannot be reasonably estimated may result in differences from current practice if an entity uses the stand-alone selling price rather than following the guidance for other fair value measurements.

In addition, the new standard eliminates the specific requirements on determining whether sufficient evidence exists – including prescriptive guidance requiring sufficient recent cash transactions to support the selling price – when recognizing revenue on exchanges of advertising space and exchanges involving barter credit transactions. Rather, under the new standard an entity recognizes revenue based on the fair value of the services received if that fair value can be reasonably estimated in a barter transaction involving advertising services. If not, the entity recognizes revenue based on the estimated stand-alone selling price of the services provided. However, an entity will need to conclude that the contract has commercial substance – i.e., it will change the amount, timing, or uncertainty of the contract's future cash flows – in order to conclude that a contract exists; otherwise, no revenue is recognized because the requirements for a contract under the new standard are not met.

5.3.4 Consideration payable to a customer

606-10-32-25
[IFRS 15.70]

606-10-32-26
[IFRS 15.71]

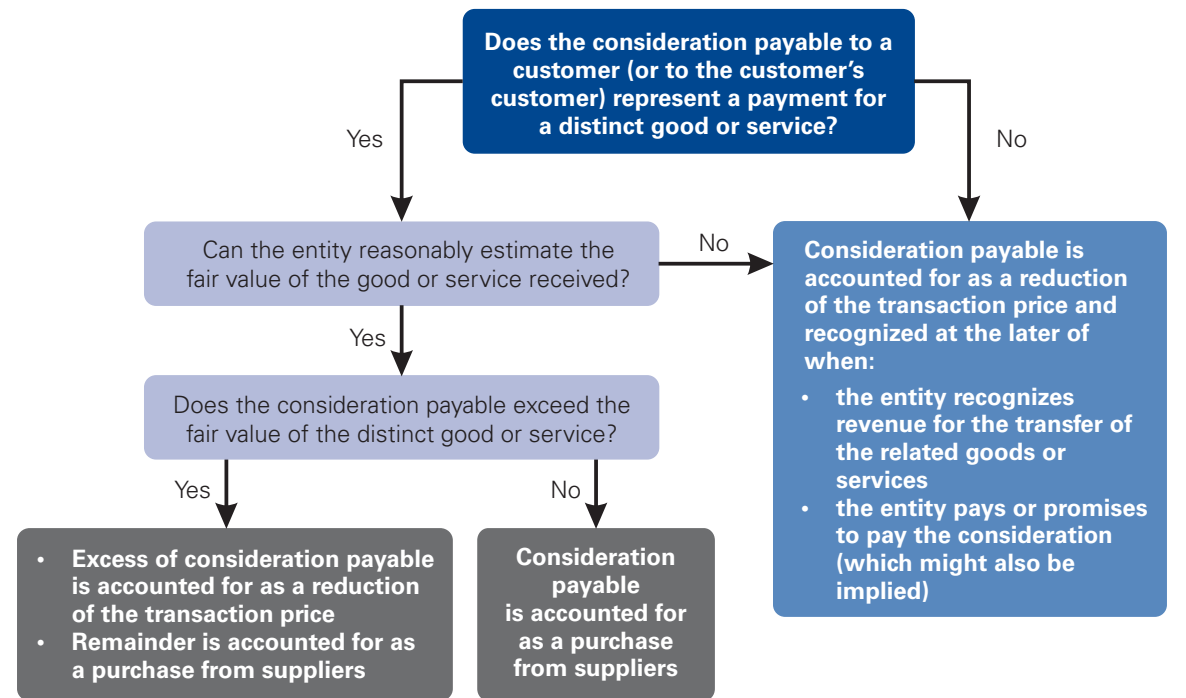
606-10-32-25 to 32-27
[IFRS 15.70 to 72]

Requirements of the new standard

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

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

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



Example 17

Payments to customers

606-10-55-252 to 55-254
[IFRS 15.IE160 to IE162]

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

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

Observations

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

Consumer goods companies often make payments to their distributors and retailers. In some cases, the payments are for identifiable goods or services – e.g., display cases for their products or co-branded advertising. In these cases, the goods or services provided by the customer may be distinct from the customer's purchase of the seller's products. If the entity cannot estimate the fair value of the good or service received from the customer, it recognizes the payments as a reduction of the transaction price. If the payments to customers exceed the fair value of the good or service provided, any excess is a reduction in the transaction price.

No specific guidance on slotting fees

Slotting fees are payments made to a retailer in exchange for product placement in the retailer's store. IFRS is silent on how to account for slotting fees. Under U.S. GAAP, these payments are presumed to be a reduction in revenue.

Under the new standard, an entity determines whether slotting fees are:

- paid in exchange for a distinct good or service that the customer transfers to the entity, and therefore recognized as an expense by the entity; or
- sales incentives granted by the entity, and therefore recognized as a reduction from the transaction price by the entity.

The new standard does not contain an example, and is silent on its application specifically to slotting fees. As a consequence, an entity will need to carefully consider the guidance above in respect of its particular circumstances to conclude whether such payments are for a distinct good or service or should be treated as a reduction of the transaction price. For many of these arrangements, this will require significant judgment and an entity will need appropriate internal controls and documentation to support that judgment.

Comparison with current IFRS

Customer incentives

Accounting for customer incentives and similar items is a complex area for which there is limited guidance under current IFRS, other than specific guidance on customer loyalty programs (see 10.4). Customer incentives take many forms, including cash incentives, discounts and volume rebates, free or discounted goods or services, customer loyalty programs, loyalty cards, and vouchers. Currently, there is some diversity in practice as to whether incentives are accounted for as a reduction in revenue, as an expense, or as a separate deliverable (as in the case of customer loyalty programs) depending on the type of incentive. The requirements of the new standard may change the accounting for some entities.

605-50-45-4

[IFRIC 13]

Comparison with current U.S. GAAP

No rebuttable presumption

605-50-45-2

Under current U.S. GAAP, cash payments made from an entity to a customer are presumed to be a reduction of revenue. This presumption can be overcome if the entity receives an identifiable benefit in exchange for the cash payment and the fair value of the benefit can be reasonably estimated.

Unlike current U.S. GAAP, the new standard requires an entity to evaluate whether it receives distinct goods or services in exchange for its payment to a customer, instead of whether the entity has received an identifiable benefit. Although these concepts appear to be similar, the new standard does not contain the rebuttable presumption that the payment is a reduction of revenue, which exists under current U.S. GAAP.

Other parties in the distribution chain

605-50-15-2

Similar to current U.S. GAAP, the new standard requires an entity to consider other parties in the distribution chain that purchase the entity's goods or services from the entity's customer when applying the guidance on consideration payable to the customer.

Reduction of revenue may be recognized earlier in some cases

605-50-25-3

The new standard indicates that consideration payable to a customer might be implied by the entity's customary business practices. Under current U.S. GAAP, consideration payable to a customer is recognized at the later of when revenue is recognized and when an offer is made to a customer – which some have interpreted to be when an explicit offer is made to the customer. When an entity's promise to pay the consideration is implied by its customary business practices, the consideration payable to a customer that is accounted for as a reduction of revenue could be recognized earlier under the new standard than under current U.S. GAAP.

5.4 Step 4: Allocate the transaction price to the performance obligations in the contract

Overview

606-10-32-28, 32-30
[IFRS 15.73, 75]

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

606-10-32-29
[IFRS 15.74]

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

606-10-32-31
[IFRS 15.76]

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

**Determine stand-alone
selling prices
(see 5.4.1)**

**Allocate the
transaction price
(see 5.4.2)**

5.4.1 Determine stand-alone selling prices

606-10-32-32
[IFRS 15.77]

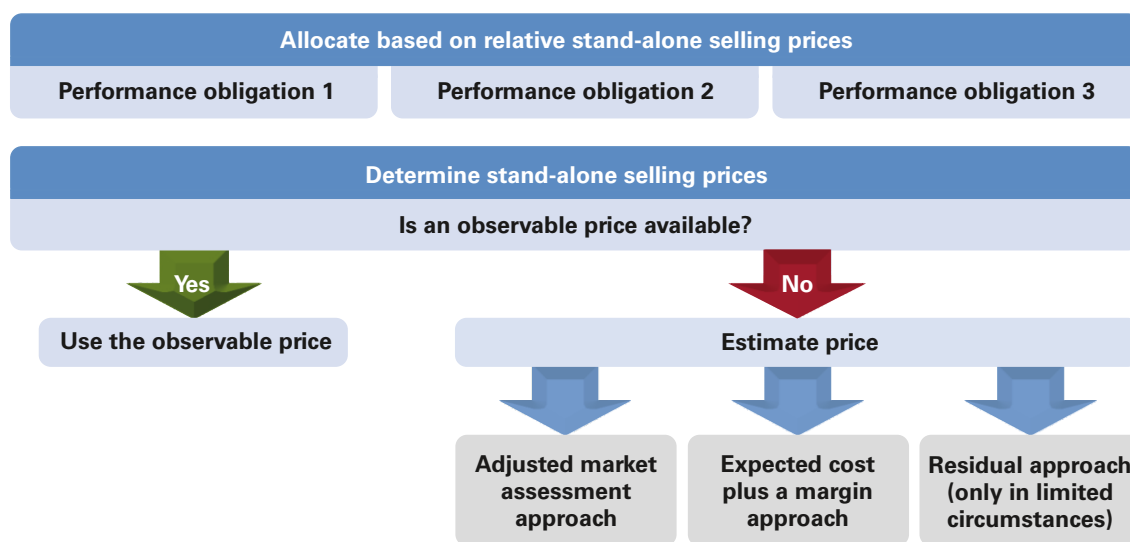
606-10-32-33
[IFRS 15.78]

606-10-32-34
[IFRS 15.79]

Requirements of the new standard

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of this is an observable price from stand-alone sales of that good or service to similarly situated customers. A contractually stated price or list price may be the stand-alone selling price of that good or service, although this is not presumed to be the case.

If the stand-alone selling price is not directly observable, then the entity estimates the amount using a suitable method (see 5.4.1.1), as illustrated below. In limited circumstances, an entity may estimate the amount using the residual approach (see 5.4.1.2).



Observations

New standard does not contain a reliability threshold

Under the new standard, the stand-alone selling price is determined at contract inception for each performance obligation in a contract. There are no circumstances in which revenue recognition is postponed for lack of a stand-alone selling price. If an observable price is available, it is used to determine the stand-alone selling price, and if not, the entity is required to estimate the amount. The new standard does not require that the amount can be 'reliably' estimated, nor does it prescribe another threshold. An entity is required to maximize the use of observable inputs, but in all circumstances will need to arrive at a stand-alone selling price and allocate the transaction price to each performance obligation in the contract. An entity will need to apply judgment when there are observable prices but those prices are highly variable.

Comparison with current IFRS

Introduction of specific guidance

[IFRIC 12.13; IFRIC 13.5 to 7; IFRIC 15.8]

Current IFRS is largely silent on the allocation of consideration to components of a transaction. However, recent interpretations include guidance on allocation for service concession arrangements, customer loyalty programs, and agreements for the sale of real estate, under which consideration can be allocated:

- to components with reference to the relative fair values of the different components; or
- to the undelivered components measured at their fair value, with the remainder of the balance allocated to components that were delivered up-front (residual method).

The new standard introduces guidance applicable to all in-scope contracts with customers. It therefore enhances comparability and brings more rigor and discipline to the process of allocating the transaction price.

Comparison with current U.S. GAAP

More flexibility in establishing stand-alone selling prices

605-25

Currently, arrangement consideration is allocated to all deliverables meeting the separation criteria on the basis of their relative selling price, unless some other specific guidance is applicable – e.g., software arrangements and separately priced warranty contracts. Multiple-element arrangement guidance requires an entity to determine the selling price for each deliverable by using:

- VSOE of the selling price, if it exists;
- third-party evidence of the selling price, if VSOE does not exist; or
- the best estimate of the selling price for that deliverable, if neither VSOE nor third-party evidence exists.

The effect of allocating the transaction price to performance obligations based on stand-alone selling prices will vary among contracts and industries. However, the approach and methods available for establishing stand-alone selling prices provide more flexibility than is currently available – e.g., using ‘observable selling prices’ under the new standard versus the current practice of establishing VSOE (for example, 80 percent of sales within +/- 15 percent of the median selling price for the good or service).

5.4.1.1

Estimating stand-alone selling prices

Requirements of the new standard

606-10-32-33
[IFRS 15.78]

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

606-10-32-34
[IFRS 15.79]

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

Adjusted market
assessment approach

Evaluate the market in which goods or services are sold and estimate the price that customers in the market would be willing to pay

Expected cost plus a
margin approach

Forecast the expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service

Residual approach
(limited circumstances)

Subtract the sum of the observable stand-alone selling prices of other goods or services promised in the contract from the total transaction price

After contract inception, an entity does not reallocate the transaction price to reflect subsequent changes in stand-alone selling prices.

606-10-32-43
[IFRS 15.88]

Observations

Judgment will often be required

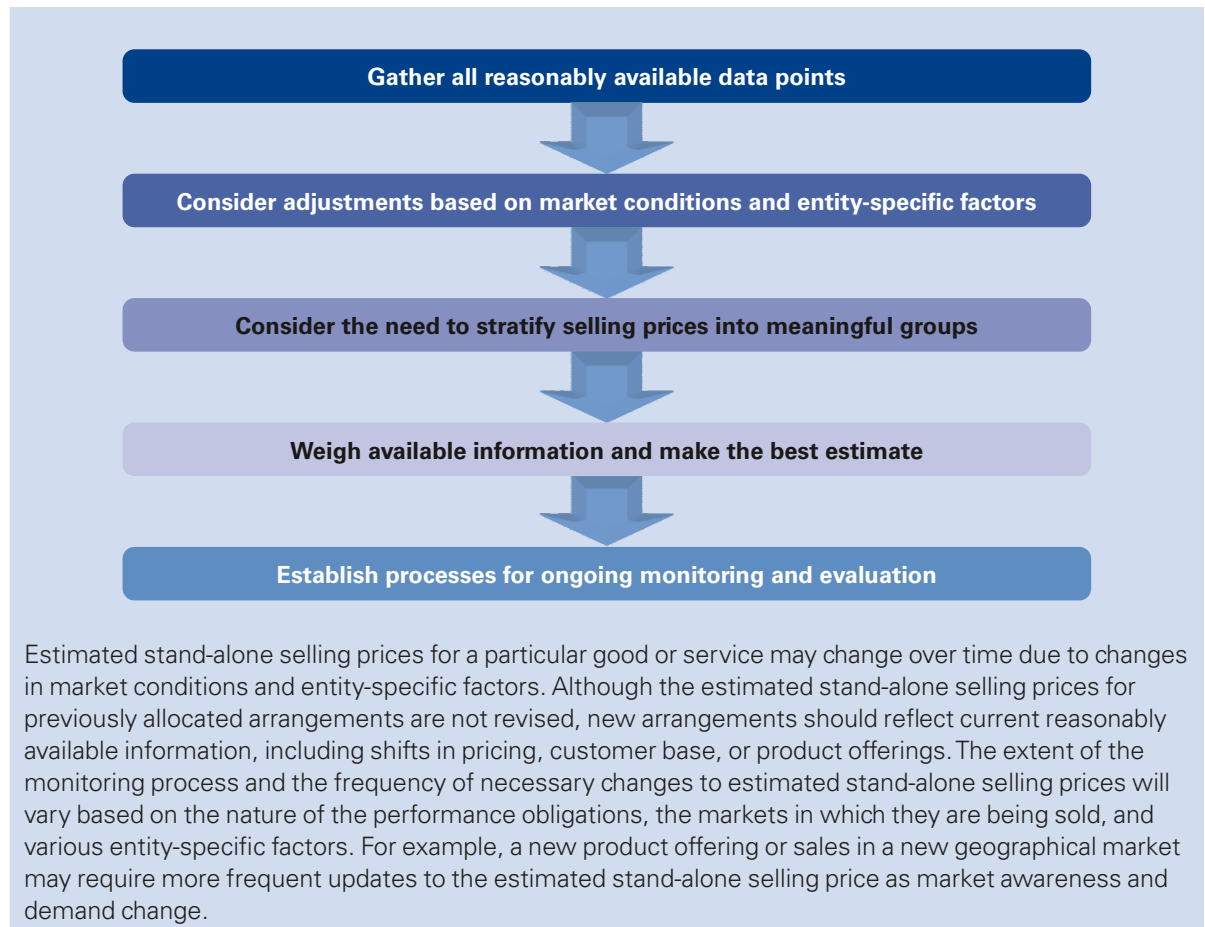
Observable selling prices will often not exist for all of the goods or services in a contract with a customer. As a result, significant judgment will often be involved in estimating the stand-alone selling price of a good or service. Whereas some entities may already have robust processes in place, others will need to develop new processes with appropriate internal controls over those processes for estimating stand-alone selling prices of goods or services that are not typically sold separately.

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

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

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

ASU 2014-09 BC269
[IFRS 15.BC269]



Comparison with current IFRS

Similar emphasis on use of observable inputs

Under current IFRS, our view is that a cost plus a margin approach should generally be applied only when it is difficult to measure the fair value of a component based on market inputs because of a lack of such inputs (see 4.2.60.110 of *Insights into IFRS*, 11th Edition). This emphasis on the use of available market inputs – e.g., sales prices for homogeneous or similar products – is consistent with the new standard’s requirement to maximize the use of observable inputs.

[IAS 18.IE11;
IFRIC 13.AG3]

Comparison with current U.S. GAAP

No specified hierarchy for non-observable inputs

605-25; ASU 2014-09
BC274 to BC276

Multiple-element arrangement guidance currently contains a specified hierarchy for determining the selling price. Similar to the requirement to use VSOE first, the new standard requires an entity to use 'observable prices' (which is a lower threshold than VSOE) when it sells a good or service separately. However, the new standard does not prescribe a hierarchical order or a particular method for estimating the stand-alone selling price when observable prices are not available. Additionally, even when observable prices are not consistent enough to constitute VSOE, an entity will still consider those observable transactions in estimating the stand-alone selling price of the good or service. Furthermore, an entity may be able to use an alternative estimation method, even if third party evidence of the selling price is available, as long as the approach taken maximizes the use of observable inputs.

985-605-25-10;
605-20-25-2

The new standard applies the same approach regardless of the type of transaction or industry, and therefore differs from certain transaction- and industry-specific guidance in U.S. GAAP – e.g., the use of the residual method if VSOE exists for undelivered items in a software arrangement or the requirement to assign the stated price in an extended-price warranty arrangement to the warranty component of the arrangement.

5.4.1.2

Using the residual approach

606-10-32-34(c)
[IFRS 15.79(c)]

Requirements of the new standard

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

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

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

606-10-32-35
[IFRS 15.80]

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

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

Example 18

Residual approach

Software Vendor M enters into a contract to provide rights to use Licenses S and T for three years, as well as PCS services for both licenses, for a contract price of 100,000.

The PCS services comprise telephone technical support for each license. Vendor M has identified four performance obligations in the contract: License S; technical support for License S; License T; and technical support for License T. The stand-alone observable price of 12,500 is available for the technical support for each of the licenses based on renewals that are sold separately. However, the prices at which Vendor M has sold licenses similar to Licenses S and T are not directly observable and the level of discounting in bundled arrangements varies based on negotiations with individual customers.

Vendor M estimates the stand-alone selling prices of the performance obligations in the contract as follows.

Product	Stand-alone selling price	Approach
Licenses S and T	75,000	Residual approach (100,000 - 12,500 - 12,500)
Technical support for License S	12,500	Directly observable price
Technical support for License T	12,500	Directly observable price
Total	100,000	

The residual approach is used to estimate the stand-alone selling price for the bundle of products (Licenses S and T) with highly variable selling prices. Because the licenses will transfer to the customer at different points in time, Vendor M then estimates the stand-alone selling price of each license. Vendor M estimates the stand-alone selling price by allocating the 75,000 to Licenses S and T based on its average residual selling price over the past year, as follows.

Product	Average residual selling price	Ratio	Allocation	
License S	40,000	40%	30,000	(75,000 x 40%)
License T	60,000	60%	45,000	(75,000 x 60%)
Total	100,000		75,000	

Observations

In contracts for intellectual property or other intangible products, a residual approach may be the appropriate technique

Determining stand-alone selling prices may be particularly challenging for contracts for intellectual property or intangible assets as they are infrequently sold separately but are often sold in a wide range of differently priced bundles. They often have little or no incremental cost to the entity providing those goods or services to a customer (resulting in a cost plus a margin approach being inappropriate) and may not have substantially similar market equivalents from which to derive a market assessment. In such circumstances, the residual approach may be the most appropriate approach for estimating the stand-alone selling price of these types of performance obligations in a contract.

ASU 2014-09 BC271
[IFRS 15.BC271]

ASU 2014-09 BC273
[IFRS 15.BC273]

Consideration allocated is unlikely to be zero or close to zero

If applying the residual approach results in no or very little consideration being allocated to a good or service, or to a bundle of goods or services, then this outcome may not be reasonable unless other GAAP applies (see 4.3). In applying Step 2 of the model, if an entity has determined that a good or service is distinct, then by definition it has value to the customer on a stand-alone basis. In this case, an entity considers all reasonably available data and whether the stand-alone selling price of that good or service should be estimated using another method.

Comparison with current IFRS

Conditions need to be met to use the residual approach, but its application is not restricted to delivered items

Unlike current guidance, the new standard requires specific conditions to be met for an entity to use the residual approach. Entities in certain industries that use the residual method may conclude that these conditions are not met, and therefore that the transaction price will be allocated based on stand-alone selling prices – generally resulting in accelerated revenue recognition for the delivered good or service (e.g., the handset).

However, when it is appropriate to apply the residual approach, the new standard permits its application to any promised goods or services in the contract, including undelivered items. This is a change from our current view that the reverse residual method is not an appropriate basis for allocating revenue (see 4.2.60.50 of *Insights into IFRS*, 11th Edition).

Comparison with current U.S. GAAP

Broader application of the residual method and potential acceleration of software license revenue recognition

Using the residual approach to estimate stand-alone selling prices under the new standard may yield similar results to current guidance on multiple-element arrangements in some circumstances. Although under current guidance it is not an allowed method for estimating the selling price, the amount that would be allocated under the residual approach may be one of several data points identified when developing an estimated selling price for the delivered element. In addition, the use of the residual method is currently permitted for:

- software arrangements in which the entire discount is allocated to the delivered item(s) in the contract and for which there is VSOE for all of the remaining undelivered elements in the contract; and
- deliverables bundled together with a separately priced extended warranty or maintenance obligation, in which the stated price is allocated to that obligation and the residual is allocated to the remaining deliverables in the contract.

The residual approach under the new standard differs from the residual method under current software guidance, in that:

- it can be used to develop an estimate of the selling price of a good or service, rather than to determine the allocation of consideration to a specific performance obligation – although in some circumstances it will result in the same outcome;

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- its application is not limited to delivered items – i.e., a reverse residual approach is allowed; and
- it requires only observable stand-alone selling prices of other goods or services that are promised in the contract, which allows greater application of the residual method than the requirement to establish VSOE.

Given that an entity is no longer required to have VSOE for the undelivered items in a software arrangement, and the entity is required to estimate the stand-alone selling price for each distinct good or service, the new standard may accelerate revenue recognition for many multiple-element software arrangements.

5.4.2 Allocate the transaction price

606-10-32-31
[IFRS 15.76]

606-10-32-43 to 32-44
[IFRS 15.88 to 89]

Requirements of the new standard

At contract inception, the transaction price is generally allocated to each performance obligation on the basis of relative stand-alone selling prices. However, when specified criteria are met, a discount (see 5.4.2.1) or variable consideration (see 5.4.2.2) is allocated to one or more, but not all, of the performance obligations in the contract.

After initial allocation, changes in the transaction price are allocated to satisfied and unsatisfied performance obligations on the same basis as at contract inception, subject to certain limited exceptions (see 5.4.3).

Example 19

Allocation of the transaction price

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

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

The transaction price of 420 (35 x 12 months)^(a) is allocated to the performance obligations based on their relative stand-alone selling prices as follows.

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

Note

(a) In this example, the entity does not adjust the consideration to reflect the time value of money. This could happen if the entity concludes that the transaction price does not include a significant financing component, or if the entity elects to use the practical expedient (see 5.3.2).

5.4.2.1

Allocating a discount

606-10-32-36
[IFRS 15.81]

606-10-32-37
[IFRS 15.82]

606-10-32-38
[IFRS 15.83]

Requirements of the new standard

If the sum of the stand-alone selling prices of a bundle of goods or services exceeds the promised consideration in a contract, then the discount is allocated proportionately to all of the performance obligations in the contract unless there is observable evidence that the entire discount relates to only one or more of the performance obligations.

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

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

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

Example 20**Discount allocated entirely to one or more, but not all, performance obligations in a contract**

606-10-55-259 to 55-264
[IFRS 15.IE167 to IE172]

Company B enters into a contract to sell Products X, Y, and Z for a total amount of 100. Company B regularly sells the products individually for the following prices.

Product	Price
X	40
Y	55
Z	45
Total	140

Company B also regularly sells Products Y and Z together for 60.

The contract includes a discount of 40 on the overall transaction (140 - 100), which would be allocated proportionately to all three products in the contract when applying the relative stand-alone selling price method. However, because Company B regularly sells Products Y and Z as a bundle for 60 and Product X for 40, it has evidence that the entire discount should be allocated to the promises to transfer Products Y and Z.

Control of Products Y and Z is transferred at different points in time, and therefore the allocated amount of 60 is individually allocated to the promises to transfer Products Y and Z by reference to their relative stand-alone selling prices as follows.

Product	Stand-alone selling price	Selling price ratio	Allocation	
X	55	55%	33	(60 x 55%)
Y	45	45%	27	(60 x 45%)
Total	100	100%	60	

Observations

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

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

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

Determination of ‘regularly sells’ will be a key judgment

The guidance on allocating a discount entirely to one or more performance obligations requires that a bundle of goods or services is regularly sold on a stand-alone basis. An entity may need to establish a policy to define ‘regularly sells’ for implementing this aspect of the new standard. The entity will need to have processes and related controls to monitor sales transactions and determine which bundles are regularly sold.

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

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

ASU 2014-09 BC283
[IFRS 15.BC283]

Comparison with current IFRS

New prescriptive guidance

There is no specific guidance on allocating a discount in current IFRS. If an entity allocates consideration according to the relative fair value of components, then it effectively allocates a discount to all components in the arrangement. If an entity uses the residual method to allocate consideration, then it effectively allocates the discount to the delivered component. The new standard introduces specific guidance on allocating discounts.

Comparison with current U.S. GAAP**Discount may be allocated to undelivered items**

Generally, an entity cannot attribute a discount in a contract to one or more separate deliverables, other than when the residual method is used – e.g., in software arrangements – and the entire discount is attributed to the delivered items. However, the allocation of a discount under the new standard is not restricted to particular industries or circumstances – so if the criteria are met, a discount is allocated entirely to one or more performance obligations in a contract, regardless of whether they are delivered or undelivered items.

5.4.2.2**Allocating variable consideration**

606-10-32-39
[IFRS 15.84]

Requirements of the new standard

Variable consideration (see 5.3.1) may be attributable to:

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

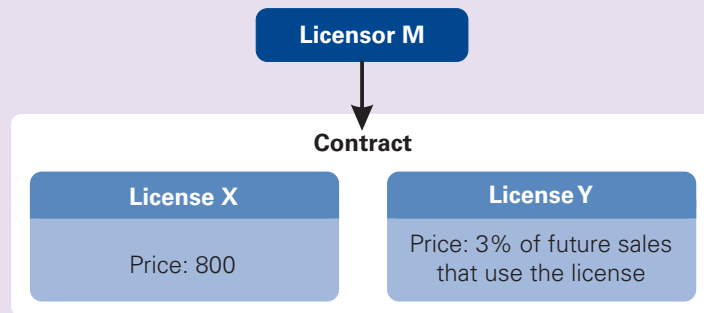
606-10-32-40
[IFRS 15.85]

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

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

Example 21

Variable consideration allocated entirely to one performance obligation in the contract



Licensors M enters into a contract with Customer N for two intellectual property licenses (Licenses X and Y), which Licensors M determines to represent two performance obligations, each satisfied at a point in time. The stand-alone selling prices of Licenses X and Y are 800 and 1,000 respectively.

The price stated in the contract for License X is a fixed amount of 800 and for License Y is 3% of the customer's future sales that use License Y. Licensors M estimates that it will be entitled to variable consideration of 1,000.

Licensors M allocates the estimated 1,000 in sales-based royalties entirely to License Y because:

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

Licensors M transfers License Y at contract inception and License X one month later. Based on the new standard's guidance on sales- or usage-based royalties for licenses of intellectual property (see Section 8), Licensors M does not recognize revenue on the transfer of License Y because the subsequent sales have not yet occurred. When License X is transferred, Licensors M recognizes revenue of 800.

Comparison with current IFRS

A new area of practice

There is no specific guidance in current IFRS on allocating variable consideration. Arguably, the general requirement in current IFRS to measure revenue at the fair value of the consideration received or receivable means that such guidance is less relevant than it is under the new standard. However, the new standard's guidance on variable consideration and the constraint, including the exception for some sales- or usage-based royalties (see 8.4), could produce counter-intuitive results if variable consideration were always allocated to all performance obligations in a contract. The new standard therefore requires alternative approaches in specific circumstances.

606-10-55-271 to 55-274
[IFRS 15.IE179 to IE182]

[IAS 18.9]

Comparison with current U.S. GAAP

Similarities to the milestone method

The notion of allocating variable consideration to distinct goods or services within a single performance obligation when the consideration relates specifically to transferring a distinct good or service is similar to the milestone method. Although under current U.S. GAAP, the milestone method is a recognition method – not an allocation method – the outcomes may be similar in many circumstances.

Provided that a milestone is substantive, an entity currently recognizes a milestone payment as revenue when that milestone is achieved – effectively allocating the payment entirely to the efforts to satisfy that milestone. A milestone is ‘substantive’ only if:

- the payment is commensurate with either:
 - the entity’s performance to achieve the milestone; or
 - the enhancement of the value of the delivered item(s) as a result of a specific outcome resulting from the entity’s performance to achieve the milestone;
- the payment relates solely to past performance by the entity; and
- the payment is reasonable relative to all of the deliverables and payment terms – including other potential milestone considerations – in the arrangement.

Under the new standard, similar results are likely when variable consideration in the contract remains constrained until an entity achieves a milestone. However, revenue may be recognized:

- before a milestone is achieved if it is probable that a subsequent change in the estimate of the amount of variable consideration will not result in a significant revenue reversal; or
- if the variable consideration is a sales- or usage-based royalty for a license of intellectual property, then at the later of when the customer’s sales or usage occur and when the performance obligation is satisfied or partially satisfied.

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5.4.3

Changes in the transaction price

Requirements of the new standard

After contract inception, the transaction price may change for various reasons – including the resolution of uncertain events or other changes in circumstances that affect the amount of consideration to which an entity expects to be entitled. In most cases, such changes are allocated to performance obligations on the same basis as at contract inception; however, changes in the transaction price resulting from a contract modification are accounted for under the new standard’s contract modifications guidance (see Section 7). If a change in the transaction price occurs after a contract modification, then it is allocated to the performance obligations in the modified contract – i.e., those that were unsatisfied or partially unsatisfied immediately after the modification – unless:

- the change is attributable to an amount of variable consideration that was promised before the modification; and
- the modification was accounted for as a termination of the existing contract and creation of a new contract.

606-10-32-42 to 32-45
[IFRS 15.87 to 90]

606-10-32-44
[IFRS 15.89]

A change in the transaction price is allocated to one or more distinct goods or services only if specified criteria are met (see 5.4.2.2).

606-10-32-43
[IFRS 15.88]

Any portion of a change in transaction price that is allocated to a satisfied performance obligation is recognized as revenue – or as a reduction in revenue – in the period of the transaction price change.

Comparison with current IFRS

Introduction of guidance on reallocation

Current IFRS is largely silent on the allocation of revenue to components, and is therefore silent on the reallocation of revenue. Under the new standard, if some of the performance obligations to which the transaction price was initially allocated have already been satisfied when the change in transaction price takes place, then this results in an adjustment to the amount of revenue recognized to date – including revenue on completed performance obligations.

Comparison with current U.S. GAAP

Removal of the contingent cap

The allocation of arrangement consideration to delivered items is currently limited to amounts of revenue that are not contingent on an entity's future performance. The new standard does not have such a limitation: the full estimated transaction price – which includes all amounts, including contingent amounts, to which the entity expects to be entitled – is allocated on a relative stand-alone selling price basis to each separate performance obligation. However, the recognition of variable consideration may be constrained (see 5.3.1.2). Nevertheless, the new standard's removal of the contingent cap may accelerate the recognition of contingent or variable consideration.

ASU 2014-09 BC287 to
BC293; 605-25-30

5.5

Step 5: Recognize revenue when or as the entity satisfies a performance obligation

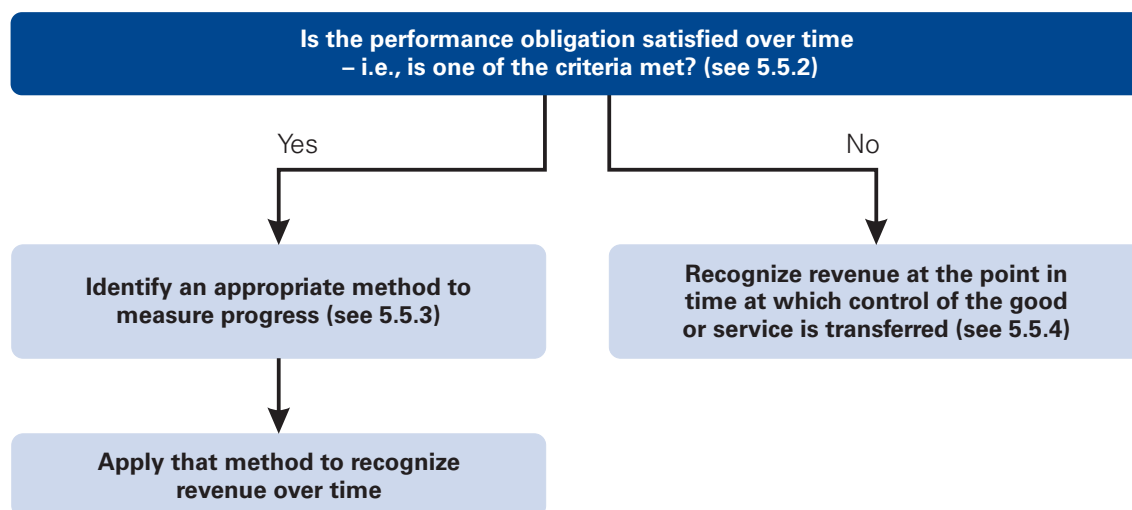
Overview

An entity recognizes revenue when or as it satisfies a performance obligation by transferring a good or service to a customer, either at a point in time (when) or over time (as). A good or service is transferred when or as the customer obtains control of it.

606-10-25-24
[IFRS 15.32]

Requirements of the new standard

At contract inception, an entity first evaluates whether it transfers control of the good or service over time – if not, then it transfers control at a point in time.



606-10-55-54 to 55-64
[IFRS 15.B52 to B62]

For a distinct license of intellectual property, the new standard provides specific application guidance on assessing whether revenue is recognized at a point in time or over time (see Section 8).

Comparison with current IFRS

Over-time recognition retained, but with new criteria

[IAS 11; IAS 18.21]

Construction contracts, and contracts for the rendering of services, are currently accounted for under the stage-of-completion method. The new standard is consistent with stage-of-completion accounting, but introduces new criteria to determine when revenue should be recognized over time. Accordingly, some contracts that are currently accounted for under the stage-of-completion method may now require revenue to be recognized on contract completion; however, for other contracts, over-time recognition may be required for the first time under the new model.

Comparison with current U.S. GAAP

Over-time recognition retained, but with criteria rather than guidance based on type of activity

Currently, construction- and production-type contracts in the scope of ASC Subtopic 605-35 are generally accounted for under the percentage-of-completion method, and although service contracts do not fall in the scope of ASC Subtopic 605-35, revenue from services is generally recognized under the proportional performance or straight-line method.

Under the new standard, an entity currently applying these methods can continue to recognize revenue over time only if one or more of three criteria are met (see 5.5.2). Unlike current industry- and transaction-specific guidance, the requirements in Step 5 of the model are not a matter of scope, but rather are applied consistently to each performance obligation in a contract. Accordingly, on applying the new criteria some entities may determine that revenue that is currently recognized at a point in time should be recognized over time, or vice versa.

605-35-25-57

5.5.1

Transfer of control

Requirements of the new standard

A good or service is transferred to a customer when the customer obtains control of it. 'Control' refers to the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. It also includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. Potential cash flows that are obtained either directly or indirectly – e.g., from the use, consumption, sale, or exchange of an asset – represent benefits of an asset.

Control is ...

the ability

– i.e., the customer has a present right

to direct the use of

– i.e., the right enables it:

- to deploy the asset in its activities
- to allow another entity to deploy the asset in its activities
- to restrict another entity from deploying the asset

and obtain the remaining benefits from

– i.e., the right also enables it to obtain potential cash flows directly or indirectly, for example through:

- use of the asset
- consumption of the asset
- sale or exchange of the asset
- pledging the asset
- holding the asset

... an asset.

If an entity concludes that it is appropriate to recognize revenue for a bill-and-hold arrangement, then it is also providing a custodial service to the customer. The entity will need to determine whether the custodial service constitutes a separate performance obligation to which a portion of the transaction price is allocated.

606-10-25-23 to 25-24
[IFRS 15.31 to 32]

606-10-55-84
[IFRS 15.B82]

Observations

ASU 2014-09 BC118
[IFRS 15.BC118]

Use of control concept to recognize revenue aligns with the accounting for assets

The new standard is a control-based model. First, an entity determines whether control of the good or service transfers to the customer over time based on the criteria in the new standard and, if so, the pattern of that transfer. If not, control of the good or service transfers to the customer at a point in time, with the notion of risks and rewards being retained only as an indicator of the transfer of control (see 5.5.4). Assessing the transfer of goods or services by considering when the customer obtains control may result in different outcomes – and therefore significant differences in the timing of revenue recognition. The Boards believe that it can be difficult to judge whether the risks and rewards of ownership have been transferred to a customer, such that applying a control-based model may result in more consistent decisions about the timing of revenue recognition.

The new standard extends a control-based approach to all arrangements, including service contracts. The Boards believe that goods and services are assets – even if only momentarily – when they are received and used by the customer. The new standard's use of control to determine when a good or service is transferred to a customer is consistent with the current definitions of an asset under both U.S. GAAP and IFRS, which principally use control to determine when an asset is recognized or derecognized.

New conceptual basis for revenue recognition

The new standard takes a conceptually different approach to revenue recognition than current U.S. GAAP and IFRS. Although the basic accounting outcomes – recognition of revenue at a point in time or over time – are similar, they may apply in different circumstances for many entities.

Comparison with current IFRS

[IAS 11.23; IAS 18.14, 20; IFRS 15.BC118]

Move away from a risk-and-reward approach

Currently, revenue from the sale of goods that are in the scope of IAS 18 is recognized based on when, among other criteria, the entity has transferred to the buyer the significant risks and rewards of ownership. Under this approach, which is unlike the new standard, revenue is typically recognized at the point in time at which risks and rewards pass.

However, IFRIC 15 introduced the notion that the criteria for recognizing a sale of goods could also be met progressively over time, resulting in the recognition of revenue over time. However, this approach is not generally applied, except in the specific circumstances envisaged in IFRIC 15.

For construction contracts that are in the scope of IAS 11, and for contracts for the rendering of services, revenue is recognized by reference to the stage of completion of the transaction at the reporting date. This is essentially an activity-based model, rather than a transfer of control model. The new standard applies a control-based approach (whereby control can be transferred either over time or at a point in time) to all arrangements, regardless of transaction or industry type.

Comparison with current U.S. GAAP

Move away from a risk-and-reward approach

Unlike the new standard, revenue from the sale of goods is currently recognized when the entity has transferred the significant risks and rewards of ownership to the buyer. This is evidenced by:

- persuasive evidence of an arrangement;
- delivery or performance having occurred;
- the sales price being fixed or determinable; and
- collectibility being reasonably assured.

Revenue from contracts in the scope of current guidance on construction- or production-type contracts is generally accounted for under the percentage-of-completion method and revenue from service contracts is generally recognized under the proportional performance or straight-line method. Additionally, there are other revenue recognition models and requirements in the industry- and transaction-specific guidance in current U.S. GAAP that can result in other patterns of revenue recognition. The new standard applies a control-based approach to all arrangements, regardless of transaction or industry type.

SEC SAB Topic 13;
ASU 2014-09 BC118;
605-35-25

5.5.2

Performance obligations satisfied over time

Requirements of the new standard

For each performance obligation in a contract, an entity first determines whether the performance obligation is satisfied over time – i.e., control of the good or service transfers to the customer over time – using the following criteria.

	Criterion	Example
1	The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs	Routine or recurring services – e.g., cleaning services
2	The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced	Building an asset on a customer's site
3	The entity's performance does not create an asset with an alternative use to the entity (see 5.5.2.1) and the entity has an enforceable right to payment for performance completed to date (see 5.5.2.2)	Building a specialized asset that only the customer can use, or building an asset to a customer order

If one or more of these criteria are met, then the entity recognizes revenue over time, using a method that depicts its performance – i.e., the pattern of transfer of control of the good or service to the customer. If none of the criteria is met, control transfers to the customer at a point in time and the entity recognizes revenue at that point in time (see 5.5.4).

606-10-25-24, 25-27
[IFRS 15.32, 35]

606-10-25-27,
25-30 to 25-31
[IFRS 15.35, 38 to 39]

606-10-55-5 to 55-6
[IFRS 15.B3 to B4]

Criterion 1

A customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs if another entity would not need to substantially reperform the work that the entity has completed to date.

When determining whether another party would not need to substantially reperform, an entity also presumes that another party would not have the benefit of any asset that the entity presently controls and would continue to control – e.g., work in progress – if the performance obligation were to transfer.

Criterion 2

In evaluating whether a customer controls an asset as it is created or enhanced, an entity considers the guidance on control in the new standard, including the indicators of the transfer of control (see 5.5.4).

Criterion 3

In assessing whether an asset has an alternative use, at contract inception an entity considers its ability to readily direct that asset in its completed state for another use, such as selling it to a different customer.

The new standard provides the following guidance on the assumptions that an entity should make when applying Criteria 1 and 3.

Determining whether ...	Consider contractual restrictions?	Consider practical limitations?	Consider possible termination?
... another entity would not need to substantially re-perform (Criterion 1)	No	No	Yes
... the entity's performance does not create an asset with an alternative use (Criterion 3)	Yes	Yes	No

606-10-55-7
[IFRS 15.B5]

606-10-25-28
[IFRS 15.36]

606-10-55-6, 55-8 to 55-10; ASU 2014-09 BC127
[IFRS 15.B4, B6 to B8, BC127]

Example 22

Assessing whether another entity would need to substantially reperform the work completed by the entity to date

Company M enters into a contract to transport equipment from Los Angeles to New York City. If Company M delivers the equipment to Denver – i.e., only part of the way – then another entity could transport the equipment the remainder of the way to New York City without re-performing Company M's performance to date. In other words, the other entity would not need to take the goods back to Los Angeles in order to deliver them to New York City. Accordingly, Criterion 1 is met and transportation of the equipment is a performance obligation that is satisfied over time.

ASU 2014-09 BC126
[IFRS 15.BC126]

Observations

Differences in assumptions used when applying Criteria 1 and 3

ASU 2014-09 BC139
[IFRS 15.BC139]

The consideration of contractual restrictions and practical limitations differs for the assessment of Criteria 1 and 3, because they are designed to apply to different scenarios.

Criterion 1 involves a hypothetical assessment of what another entity would need to do if it took over the remaining performance obligation. Accordingly, contractual restrictions or practical limitations are not relevant when assessing whether the entity has transferred control of the goods or services provided to date.

By contrast, Criterion 3 focuses on the entity's ability to direct the completed asset for an alternative use. That ability is directly affected by the existence of contractual restrictions and practical limitations.

Comparison with current IFRS

Applying the new criteria may alter the timing of revenue recognition

[IAS 11; IAS 18;
IFRIC 15]

Under current IFRS, there are three circumstances in which revenue is recognized over time:

- the contract is a construction contract in the scope of IAS 11 – this is the case when, and only when, the contract has been specifically negotiated for the construction of an asset or assets;
- the contract is for the sale of goods under IAS 18 and the conditions for the recognition of a sale of goods are met progressively over time; and
- the contract is for the rendering of services.

By contrast, the new standard introduces new concepts and uses new wording that entities need to apply to the specific facts and circumstances of individual performance obligations. Subtle differences in contract terms could result in different assessment outcomes – and therefore significant differences in the timing of revenue recognition compared with current practice.

In practice, many contracts for the rendering of services will meet Criterion 1, and many construction contracts will meet Criterion 2 and/or Criterion 3. However, detailed analysis may be required to assess these and other arrangements, notably pre-sale contracts for real estate, which are the main focus of IFRIC 15.

Comparison with current U.S. GAAP

Some similarities but new concepts to be applied

605-35-05-8;
ASU 2014-09 BC130

The basis for using the percentage-of-completion method for construction- and production-type contracts in the scope of ASC Subtopic 605-35 is that in many cases the contractor has, in effect, agreed to sell its rights to work in progress as the work progresses. Accordingly, the parties have agreed, in effect, to a continuous sale that occurs as the contractor performs. This rationale is similar to Criterion 2 under the new standard – that control of a good or service is transferred over time if the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.

However, Criteria 1 and 3 under the new standard will require entities to think differently about the satisfaction of performance obligations. In general, the impact of applying the new criteria will vary depending on relevant facts and circumstances, but subtle differences in contract terms could result in different assessment outcomes – and therefore significant differences in the timing of revenue recognition.

For example, manufacturing arrangements to produce goods to a customer's specifications are currently generally treated as product sales, and revenue is recognized at the point in time at which the manufactured goods are shipped or delivered to the customer. Under the new standard, these types of performance obligations may meet Criterion 3 and, if so, revenue will be recognized over time.

5.5.2.1

Performance does not create an asset with an alternative use

Requirements of the new standard

606-10-55-9
[IFRS 15.B7]

For an asset to have no alternative use to an entity, a contractual restriction on the ability to direct its use has to be substantive – i.e., an enforceable right. If an asset is largely interchangeable with other assets and could be transferred to another customer without breaching the contract or incurring significant incremental costs, then the restriction is not substantive.

606-10-55-10
[IFRS 15.B8]

A practical limitation on an entity's ability to direct an asset for another use – e.g., design specifications that are unique to a customer – exists if the entity would:

- incur significant costs to rework the asset; or
- be able to sell the asset only at a significant loss.

606-10-25-28
[IFRS 15.36]

The assessment of whether an asset has an alternative use is made at contract inception and is not subsequently updated, unless a contract modification substantially changes the performance obligation (see Section 7).

Example 23

Applying the guidance on alternative use

606-10-55-165 to 55-168
[IFRS 15.IE73 to IE76]

ManufacturerY enters into a contract with a customer to build a specialized satellite. ManufacturerY builds satellites for various customers; however, the design and construction of each satellite differs substantially, on the basis of each customer's needs and the type of technology that is incorporated into the satellite.

At contract inception, Manufacturer Y assesses whether the satellite, in its completed state, will have an alternative use. Although the contract does not preclude Manufacturer Y from directing the completed satellite to another customer, Manufacturer Y would incur significant costs to rework the design and function of the satellite to do so. The customer-specific design of the satellite therefore restricts Manufacturer Y's practical ability to readily direct the satellite to another customer, and the satellite does not have an alternative use to Manufacturer Y.

Observations

Many factors to consider when evaluating alternative use

Under the new standard, an asset may not have an alternative use due to contractual restrictions. For example, units constructed for a multi-unit residential complex may be standardized; however, an entity's contract with a customer may preclude it from transferring a specific unit to another customer.

Protective rights – e.g., a customer having legal title to the goods in a contract – may not limit the entity's practical ability to physically substitute or redirect an asset, and therefore on their own are not sufficient to establish that an asset has no alternative use to the entity.

In the absence of a contractual restriction, an entity considers:

- the characteristics of the asset that will ultimately be transferred to the customer; and
- whether that asset, in its completed form, could be redirected without a significant cost of rework.

The focus is not on whether the asset can be redirected to another customer or for another purpose during a portion of the production process – e.g., up until the point where significant customization begins to occur. For example, in some manufacturing contracts the basic design of an asset may be the same across many contracts, but the customization of the finished good is substantial. Consequently, redirecting the asset in its completed state to another customer would require significant rework.

ASU 2014-09 BC136 to
BC139
[IFRS 15.BC136 to
BC139]

5.5.2.2

The entity has an enforceable right to payment for performance completed to date

Requirements of the new standard

An entity that is constructing an asset with no alternative use is effectively constructing the asset at the direction of the customer, and the contract will often contain provisions providing some economic protection from the risk of the customer terminating the contract and leaving the entity with an asset with little or no value. Therefore, to demonstrate that a customer controls an asset that has no alternative use as it is being created, an entity evaluates whether it has an enforceable right to payment for the performance completed to date. In performing this evaluation, the entity considers whether, throughout the contract, it is entitled to compensation for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised.

606-10-25-29
[IFRS 15.37]

606-10-55-11 to 55-15
[IFRS 15.B9 to B13]

In assessing whether this part of Criterion 3 is met, the entity's right to payment should be for an amount that approximates the selling price of the goods or services transferred – e.g., a right to recover costs incurred plus a reasonable profit margin. The amount to which it is entitled does not need to equal the contract margin, but should be based on either a reasonable proportion of the entity's expected profit margin or a reasonable return on the entity's cost of capital.

Other factors to consider include the following.

Payment terms	<ul style="list-style-type: none"> An unconditional right to payment is not required, but rather an enforceable right to demand or retain payment if the contract is terminated
Payment schedule	<ul style="list-style-type: none"> A payment schedule does not necessarily indicate whether an entity has an enforceable right to payment for performance to date
Contractual terms	<ul style="list-style-type: none"> If a customer acts to terminate a contract without having a contractual right at that time, then the contract terms may entitle the entity to continue to transfer the promised goods or services and require the customer to pay the corresponding consideration promised
Legislation or legal precedent	<ul style="list-style-type: none"> Even if a right is not specified in the contract, jurisdictional matters such as legislation, administrative practice, or legal precedent may confer a right to payment on the entity By contrast, legal precedent may indicate that rights to payment in similar contracts have no binding legal effect, or an entity's customary business practice not to enforce a right to payment may result in that right being unenforceable in that jurisdiction

Example 24

Applying the over-time criteria to a consulting contract

606-10-55-161 to 55-164
[IFRS 15.IE69 to IE72]

Consulting Firm B enters into a contract to provide a professional opinion to Customer C based on Customer C's specific facts and circumstances. If Customer C terminates the consulting contract for reasons other than Consulting Firm B's failure to perform as promised, then the contract requires Customer C to compensate Consulting Firm B for its costs incurred plus a 15% margin. The 15% margin approximates to the profit margin that Consulting Firm B earns from similar contracts.

Consulting Firm B assesses the contract against the over-time criteria, and reaches the following conclusions.

Criterion	Conclusion	Rationale
1	Not met	If Consulting Firm B did not issue the professional opinion and Customer C hired another consulting firm, then the other firm would need to substantially re-perform the work completed to date, because it would not have the benefit of any work in progress performed by Consulting Firm B. Accordingly, Customer C does not simultaneously receive and consume the benefits of its performance.
2	Not met	Consulting Firm B is not creating or enhancing an asset of which Customer C obtains control as it performs because the professional opinion is delivered to Customer C only on completion.
3	Met	The development of the professional opinion does not create an asset with an alternative use to Consulting Firm B, because it relates to facts and circumstances that are specific to Customer C. Therefore, there is a practical limitation on Consulting Firm B's ability to readily direct the asset to another customer. The contract's terms provide Consulting Firm B with an enforceable right to payment, for its performance completed to date, of its costs incurred plus a reasonable margin.

Because one of the three criteria is met, Consulting Firm B recognizes revenue relating to the consulting services over time.

Conversely, if Consulting Firm B determined that it did not have a legally enforceable right to payment if Customer C terminated the consulting contract for reasons other than Consulting Firm B's failure to perform as promised, then none of the three criteria would be met and the revenue from the consulting service would be recognized at a point in time – probably on completion of the engagement and delivery of the professional opinion.

Example 25

Applying the over-time criteria to sales of real estate

Developer D is developing a multi-unit residential complex. Customer Y enters into a binding sales contract with Developer D for Unit X, which is under construction. Each unit has a similar floor plan and is of a similar size. The following facts are relevant.

- Customer Y pays a nonrefundable deposit on entering into the contract and will make progress payments intended to cover costs to date plus the margin percentage in the contract during construction of Unit X.
- The contract has substantive terms that preclude Developer D from being able to direct Unit X to another customer.
- If Customer Y defaults on its obligations by failing to make the promised progress payments as and when they are due, then Developer D has a right to all of the consideration promised in the contract if it completes the construction of the unit.

606-10-55-173 to 55-182
[IFRS 15.IE81 to IE90]

- The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

At contract inception, Developer D determines that because it is contractually restricted from transferring Unit X to another customer, Unit X does not have an alternative use. In addition, if Customer Y were to default on its obligations, then Developer D would have an enforceable right to all of the consideration promised under the contract. Consequently, Criterion 3 is met and Developer D recognizes revenue from the construction of Unit X over time.

Observations

Agreements for the construction of real estate may have different patterns of transfer of control

Applying the criteria to real estate contracts may result in different conclusions on the pattern of transfer of control, depending on the relevant facts and circumstances of each contract. For example, the terms of some real estate contracts may prohibit an entity from transferring an asset to another customer and require the customer to pay for performance completed to date (therefore meeting Criterion 3). However, other real estate contracts that create an asset with no alternative use may only require a customer to make an up-front deposit, and therefore would not provide the entity with an enforceable right to payment for its performance completed to date (therefore failing to meet Criterion 3).

In practice, a detailed understanding of the terms of the contract and local laws may be required to assess whether an entity has a right to payment for performance to date. For example, in some jurisdictions customer default may be infrequent and contracts may not include extensive detail on the rights and obligations that arise in the event of termination. In such cases, expert opinion may be required to establish the legal position.

In other jurisdictions, real estate developers may have a practice of not enforcing their contractual rights if a customer defaults, preferring instead to take possession of the property with a view to selling it to a new customer. Again, evaluation of the specific facts and circumstances, including appropriate legal consultation, may be required to establish whether the contractual rights remain enforceable given an established pattern of non-enforcement in practice.

Comparison with current IFRS

Analysis of specific facts and circumstances is still a key consideration for real estate arrangements

Difficulty in determining when control of real estate transfers to the customer has resulted in diversity in current practice, particularly for certain multi-unit residential developments. The new standard replaces IFRIC 15 with specific requirements for determining when goods or services transfer over time. Applying this guidance – especially when assessing whether Criterion 3 is met – will require consideration of the specific facts and circumstances of each case. Given the judgment that may be required in this assessment, the recognition of revenue for real estate arrangements may continue to be a challenging area in practice.

*ASU 2014-09 BC150
[IFRS 15.BC150]*

*[IFRS 15.BC149 to
BC150; IFRIC 15]*

Comparison with current U.S. GAAP

Revenue from real estate sales may be recognized earlier or later

Current U.S. GAAP includes transaction-specific guidance on profit recognition for sales of real estate. For real estate sales that transfer at a point in time, the new standard may result in earlier recognition of profit because, for example, the guidance on the amount of downpayment and the seller's continuing involvement is less prescriptive. Conversely, for other transactions – e.g., certain condominium developments – profit is recognized using the percentage-of-completion method when certain criteria are met; in many of these arrangements, none of the three criteria for recognition of revenue over time will be met, which will delay profit recognition for some entities.

360-20-40

5.5.3

Measuring progress toward complete satisfaction of a performance obligation

5.5.3.1

Selecting a method to measure progress

Requirements of the new standard

For each performance obligation that is satisfied over time, an entity applies a single method of measuring progress toward the complete satisfaction of that performance obligation. The objective is to depict the transfer of control of the goods or services to the customer. To meet this objective, an entity selects an appropriate output or input method. It then applies that method consistently to similar performance obligations and in similar circumstances.

Method	Description	Examples
Output	Based on direct measurements of the value to the customer of goods or services transferred to date, relative to the remaining goods or services promised under the contract	<ul style="list-style-type: none"> • Surveys of performance to date • Appraisals of results achieved • Milestones reached • Time elapsed
Input	Based on an entity's efforts or inputs toward satisfying a performance obligation, relative to the total expected inputs to the satisfaction of that performance obligation	<ul style="list-style-type: none"> • Resources consumed • Costs incurred • Time elapsed • Labor hours expended • Machine hours used

As a practical expedient, if an entity has a right to invoice a customer at an amount that corresponds directly with its performance to date, then it can recognize revenue at that amount. For example, in a services contract an entity may have the right to bill a fixed amount for each unit of service provided.

If an entity's performance has produced a material amount of work in progress or finished goods that are controlled by the customer, then output methods such as units-of-delivery or units-of-production as they have been historically applied may not faithfully depict progress. This is because not all of the work performed is included in measuring the output.

606-10-25-31 to 25-35,
55-17 to 55-21
[IFRS 15.39 to 43, B15
to B19]

606-10-55-18
[IFRS 15.B16]

606-10-55-17
[IFRS 15.B15]

606-10-55-20

[IFRS 15.B18]

606-10-55-21

[IFRS 15.B19]

606-10-25-36 to 25-37

[IFRS 15.44 to 45]

If an input method provides an appropriate basis to measure progress and an entity's inputs are incurred evenly over time, then it may be appropriate to recognize revenue on a straight-line basis.

However, there may not be a direct relationship between an entity's inputs and the transfer of control. As such, an entity that uses an input method considers the need to adjust the measure of progress for uninstalled goods and significant inefficiencies in the entity's performance that were not reflected in the price of the contract – e.g., wasted materials, labor, or other resources (see 5.5.3.3). For example, if the entity transfers to the customer control of a good that is significant to the contract but will be installed later, and if certain criteria are met, then the entity recognizes the revenue on that good at zero margin.

An entity recognizes revenue over time only if it can reasonably measure its progress toward complete satisfaction of the performance obligation. However, if the entity cannot reasonably measure the outcome but expects to recover the costs incurred in satisfying the performance obligation, then it recognizes revenue to the extent of the costs incurred.

Observations

ASU 2014-09 BC159

[IFRS 15.BC159]

Determining which measure of progress to apply is not a free choice

The new standard requires an entity to select a method that is consistent with the objective of depicting its performance. An entity therefore does not have a free choice of which method to apply to a given performance obligation – it needs to consider the nature of the good or service that it promised to transfer to the customer.

The new standard also provides examples of circumstances in which a particular method does not faithfully depict performance – e.g., it states that units-of-production may not be an appropriate method when there is a material amount of work in progress. Accordingly, judgment is required when identifying an appropriate method of measuring progress.

When evaluating which method depicts the transfer of control of a good or service, the entity's ability to apply that method reliably may also be relevant. For example, the information required to use an output method may not be directly observable or may require undue cost to obtain – in such circumstances, an input method may be appropriate.

Comparison with current IFRS

[IAS 11.30;

IFRS 15.BC164]

Similar measures of progress

Under IAS 11, no specific method is mandated for assessing the stage of completion, but an entity is required to use a method that reliably measures the work performed. The methods described as being appropriate under IAS 11 are consistent with the more detailed descriptions and examples provided in the new standard.

The new standard does not prescribe when certain methods should be used, but the Boards believe that, conceptually, an output measure is the most faithful depiction of an entity's performance because it directly measures the value of the goods or services transferred to the customer. The Boards also believe that an input method would be appropriate if it would be less costly and would provide a reasonable basis for measuring progress. Our view under current IFRS is that output measures are the more appropriate measure of the stage of completion as long as they can be established reliably (see 4.2.290.30 of *Insights into IFRS*, 11th Edition).

Comparison with current U.S. GAAP

Similar measures of progress

605-35-25-70 to 25-81,
25-83 to 25-84;
ASU 2014-09 BC164

When applying the percentage-of-completion method under current construction- and production-type-specific guidance, either input or output methods of measuring progress toward completion may be appropriate. The new standard provides descriptions and examples of methods that may be applied.

Current guidance indicates that if a reliable measure of output can be established, it is generally the best measure of progress toward completion; however, it acknowledges that output measures often cannot be established, in which case input measures are used. Similarly, the Boards believe that, conceptually, an output measure is the most faithful depiction of an entity's performance because it directly measures the value of the goods or services transferred to the customer. The Boards also believe that an input method would be appropriate if it would be less costly and would provide a reasonable basis for measuring progress.

Currently, the percentage-of-completion method is used to determine the amount of income to recognize – i.e., revenue and costs – but there are two methods for this determination. Alternative A provides a basis for recognizing costs in the financial statements earlier or later than when they are incurred. Alternative B allows an entity to apply a margin to the costs incurred. The new standard supersedes both of these methods. However, if an entity uses cost-to-cost as its measure of progress, the amount of revenue and costs recognized will be similar to the amounts under Alternative B in current construction- and production-type-specific guidance.

5.5.3.2

Limitations on applying the units-of-delivery or units-of-production methods

606-10-55-17
[IFRS 15.B15]

Requirements of the new standard

An output method may not provide a faithful depiction of performance if the output selected fails to measure some of the goods or services for which control has transferred to the customer. For example, if at the reporting date an entity's performance has produced work in progress or finished goods that are controlled by the customer, then using an output method based on units produced or units delivered as it has been historically applied would distort the entity's performance. This is because it would not recognize revenue for the assets that are created before delivery or before production is complete but that are controlled by the customer.

Observations

A units-of-delivery method or a units-of-production method may not be appropriate if both design and production services are provided under the contract

ASU 2014-09 BC165 to
BC166
[IFRS 15.BC165 to
BC166]

A units-of-delivery method or a units-of-production method may not be appropriate if the contract provides both design and production services, because in this case each item produced or delivered may not transfer an equal amount of value to the customer. These contracts are common, for example, in the aerospace and defense, contract manufacturing, engineering, and construction industries.

The clarifications provided in the new standard as to when certain methods for measuring progress may not be appropriate emphasize the need for an entity to consider its facts and circumstances and select the method that depicts its performance and the transfer of control of the goods or services to the customer.

605-35-25-55
[IAS 11.30]

Current IFRS and U.S. GAAP do not restrict the use of a measure of progress based on units of delivery or units of production. Therefore, for some entities that currently use these methods to measure progress, the guidance in the new standard may result in a change in practice.

5.5.3.3

Adjusting the measure of progress

606-10-55-21
[IFRS 15.B19]

Requirements of the new standard

An entity applying an input method excludes the effects of any inputs that do not depict its performance in transferring control of goods or services to the customer. In particular, when using a cost-based input method – i.e., cost-to-cost – an adjustment to the measure of progress may be required when an incurred cost:

- does not contribute to an entity's progress in satisfying the performance obligation – e.g., unexpected amounts of wasted materials, labor, or other resources (such costs are expensed as incurred); or
- is not proportionate to the entity's progress in satisfying the performance obligation – e.g., uninstalled materials.

For uninstalled materials, a faithful depiction of performance may be for the entity to recognize revenue only to the extent of the cost incurred – i.e., at a zero percent profit margin – if, at contract inception, the entity expects that all of the following conditions will be met:

- the good is not distinct;
- the customer is expected to obtain control of the good significantly earlier than it receives services related to the good;
- the cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation; and
- the entity is acting as principal, but procures the good from a third party and is not significantly involved in designing and manufacturing the good.

Example 26

Treatment of uninstalled materials

In November 2015, Contractor P enters into a lump-sum contract with Customer Q to refurbish a three-story building and install new elevators for total consideration of 5,000. The following facts are relevant.

- The refurbishment service, including the installation of elevators, is a single performance obligation that is satisfied over time.
- Contractor P is not involved in designing or manufacturing the elevators, but is acting as principal and obtains control of the elevators when they are delivered to the site in December 2015.
- The elevators are not expected to be installed until June 2016.
- Contractor P uses an input method based on costs incurred to measure its progress toward complete satisfaction of the performance obligation.

606-10-55-187 to 55-192
[IFRS 15.IE95 to IE100]

The transaction price and expected costs are as follows.

Transaction price	5,000
Costs	
Elevators	1,500
Other costs	2,500
Total expected costs	4,000

Contractor P concludes that including the costs of procuring the elevators in the measure of progress would overstate the extent of its performance. Consequently, it adjusts its measure of progress to exclude these costs from the costs incurred and from the transaction price, and recognizes revenue for the transfer of the elevators at a zero margin.

As at December 31, 2015, other costs of 500 have been incurred (excluding the elevators) and Contractor P therefore determines that its performance is 20% complete ($500 / 2,500$). Consequently, it recognizes revenue of 2,200 ($20\% \times 3,500^{(a)} + 1,500$) and costs of goods sold of 2,000 ($500 + 1,500$).

Note

(a) Calculated as the transaction price of 5,000 less the cost of the elevators of 1,500.

Observations

No guidance on the timing and pattern of the recognition of margin on uninstalled materials

An entity may be entitled to a margin on the uninstalled goods that is clearly identified in the contract terms or forms part of the overall transaction price. The new standard does not provide guidance on the timing of recognition for this margin – i.e., whether it is recognized when the materials are installed, or incorporated into the revenue recognition calculation for the remainder of the contract.

The Boards believe that recognizing a contract-wide profit margin before the goods are installed could overstate the measure of the entity's performance and, therefore, revenue. However, requiring an entity to estimate a profit margin that is different from the contract-wide profit margin could be complex and could effectively create a performance obligation for goods that are not distinct (therefore bypassing the requirements for identifying performance obligations). The adjustment to the cost-to-cost measure of progress for uninstalled materials is generally intended to apply to a subset of goods in a construction-type contract – i.e., only to those goods that have a significant cost relative to the contract and only if the entity is essentially providing a simple procurement service to the customer.

Judgment will be required in determining whether a customer is obtaining control of a good 'significantly' before receiving services related to the good. In Example 26 in this publication, it is unclear whether the same guidance would apply if the elevators were expected to be installed in January 2016 instead of June 2016.

No detailed guidance on identification of inefficiencies and wasted materials

Generally, some level of inefficiency, reworks or overruns is assumed in a service or construction contract and an entity contemplates these in the arrangement fee. Although the new standard specifies that unexpected amounts of wasted materials, labor, or other resources should be excluded from a cost-to-cost measure of progress, it does not provide additional guidance on how to identify unexpected costs. Judgment is therefore required to distinguish normal wasted materials or inefficiencies from those that do not depict progress toward completion.

ASU 2014-09 BC171
[IFRS 15.BC171]

ASU 2014-09 BC176 to
BC178
[IFRS 15.BC176 to
BC178]

Comparison with current IFRS

Revenue recognized to the extent of costs

[IAS 11.31(a)]

Under IAS 11, materials that have not yet been installed are excluded from contract costs when determining the stage of completion of a contract. Therefore, recognizing revenue on uninstalled materials at a zero percent profit margin under the new standard may result in changes to an entity's profit recognition profile.

Comparison with current U.S. GAAP

Revenue recognized to the extent of costs

605-35-25-75

Current guidance indicates that some costs incurred – particularly in the early stages of a contract – are disregarded in applying the percentage-of-completion method because they do not relate to contract performance. These include the costs of items such as uninstalled materials that are not specifically produced or fabricated for the project or subcontracts that have not been performed. This guidance is largely consistent with the new standard, except that the costs of these items are currently excluded from costs incurred for the purpose of measuring progress toward completion, whereas under the new standard they are measured at a zero percent profit margin.

5.5.3.4

Reasonable measures of progress

Requirements of the new standard

606-10-25-36

[IFRS 15.44]

In order to recognize revenue, an entity needs to have a reasonable basis to measure its progress. An entity may not be able to measure its progress if reliable information required to apply an appropriate method is not available.

606-10-25-37

[IFRS 15.45]

If an entity cannot reasonably measure its progress, but nevertheless expects to recover the costs incurred in satisfying the performance obligation, then it recognizes revenue only to the extent of the costs incurred until it can reasonably measure the outcome.

Comparison with current IFRS

Similar to current practice

[IAS 11.33]

IAS 11 indicates that, during its early stages, the outcome of a contract often cannot be estimated reliably, but it may be probable that the entity will recover the contract costs incurred. The recognition of revenue is restricted to those costs incurred that are expected to be recoverable, and no profit is recognized. However, if it is probable that the total contract costs will exceed the total contract revenue, then any expected excess is recognized as an expense immediately.

This requirement is consistent with the new standard's guidance that revenue is recognized only to the extent of the costs incurred – i.e., at a zero percent profit margin – until the entity can reasonably measure its progress.

[IAS 37]

However, the new standard does not include guidance on the accounting for losses. Instead, an entity applies IAS 37 to assess whether the contract is onerous and, if it is onerous, to measure the provision (see 10.7).

Comparison with current U.S. GAAP

Similar to current practice

605-35-25-60, 25-66 to 25-67

If estimating the final outcome is impracticable, except to assure that no loss will be incurred, then current U.S. GAAP recommends the percentage-of-completion method based on a zero percent profit margin (rather than the completed-contract method) until more precise estimates can be made. Such a scenario may arise if the scope of the contract is ill-defined but the contractor is protected by a cost-plus contract or other contractual terms.

This requirement is consistent with the new standard's guidance that revenue is recognized only to the extent of costs incurred – i.e., at a zero percent profit margin – until the entity can reasonably measure its progress, although this situation does not arise frequently in our experience. However, the new standard does not include guidance on the accounting for losses, and therefore this method is not directly linked to loss considerations (see 10.7).

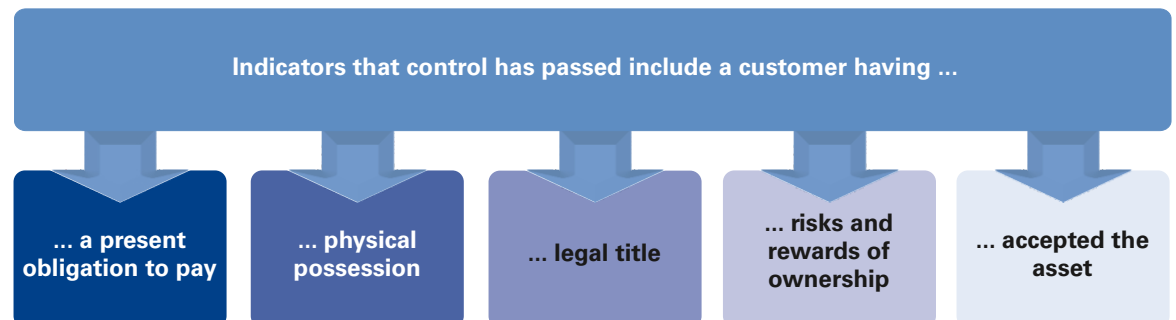
5.5.4

Performance obligations satisfied at a point in time

606-10-25-30
[IFRS 15.38]

Requirements of the new standard

If a performance obligation is not satisfied over time, then an entity recognizes revenue at the point in time at which it transfers control of the good or service to the customer. The new standard includes indicators as to when transfer of control occurs.



Relevant considerations for some of these indicators include the following.

- In some cases, possession of legal title is a protective right and may not coincide with the transfer of control of the goods or services to a customer – e.g., when a seller retains title solely as protection against the customer's failure to pay.
- In consignment arrangements (see 5.5.6) and some repurchase arrangements (see 5.5.5), an entity may have transferred physical possession but still retain control. Conversely, in bill-and-hold arrangements (see 5.5.7) an entity may have physical possession of an asset that the customer controls.
- When evaluating the risks and rewards of ownership, an entity excludes any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset.
- An entity needs to assess whether it can objectively determine that a good or service provided to a customer is in accordance with the specifications agreed in a contract (see 5.5.8).

Observations

ASU 2014-09 BC155
[IFRS 15.BC155]

Judgment may be required to determine the point in time at which control transfers

The indicators of transfer of control represent a list of factors that are often present if a customer has control of an asset; however, they are not individually determinative, nor do they represent a list of conditions that have to be met. The new standard does not suggest that certain indicators should be weighted more heavily than others, nor does it establish a hierarchy that applies if only some of the indicators are present.

Accordingly, judgment may be required to determine the point in time at which control transfers. This determination may be particularly challenging when there are indicators that control has transferred alongside 'negative' indicators suggesting that the entity has not satisfied its performance obligation.

SEC SAB Topic 13
[IAS 18.14]

Potential challenges may exist in determining the accounting for some delivery arrangements

Revenue is not currently recognized if an entity has not transferred to the buyer the significant risks and rewards of ownership. For product sales, the risks and rewards are generally considered to be transferred when a product is delivered to the customer's site – i.e., if the terms of the sale are 'free on board' (FOB) destination, then legal title to the product passes to the customer when the product is handed over to the customer. When a product is shipped to the customer FOB shipping point, legal title passes and the risks and rewards are generally considered to have transferred to the customer when the product is handed over to the carrier.

Under the new standard, an entity considers whether any risks may give rise to a separate performance obligation in addition to the performance obligation to transfer the asset itself. A common example is when an entity ships a product FOB shipping point, but the seller has a historical business practice of providing free replacements of that product to the customer or waiving its invoice amount if the products are damaged in transit (commonly referred to as a 'synthetic FOB destination arrangement'). It is unclear whether this will result in a separate performance obligation – i.e., a stand-ready obligation to cover the risk of loss if goods are damaged in transit – or whether control of the product has not transferred. Under current guidance, depending on the relevant facts and circumstances, revenue recognition is generally precluded until the product is delivered to the customer's destination, because the risks and rewards of ownership have not transferred to the customer, despite having satisfied the FOB shipping point delivery terms.

It may be difficult in practice to distinguish between situations in which the lack of transfer of the significant risks and rewards of ownership of an asset:

- leads to a conclusion that control of the asset has not transferred to a customer; or
- creates a separate performance obligation.

5.5.5

Repurchase agreements

Overview

An entity has executed a repurchase agreement if it sells an asset to a customer and promises, or has the option, to repurchase it. If the repurchase agreement meets the definition of a financial instrument, it is outside the scope of the new standard. If not, the repurchase agreement is in the scope of the new standard and the accounting for it depends on its type – e.g., a forward, call option, or put option – and on the repurchase price.

Requirements of the new standard

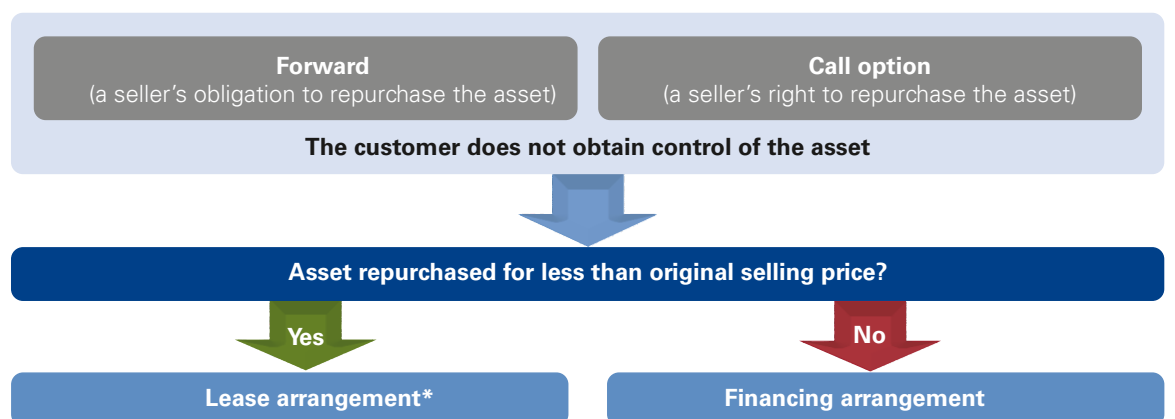
A forward or a call option

606-10-55-68 to 55-69
[IFRS 15.B66 to B67]

If an entity has an obligation (a forward) or a right (a call option) to repurchase an asset, then a customer does not have control of the asset. This is because the customer is limited in its ability to direct the use of and obtain the benefits from the asset, despite its physical possession. If the entity expects to repurchase the asset for less than its original sales price, the entity accounts for the entire agreement as a lease. Conversely, if the entity expects to repurchase the asset for an amount that is greater than or equal to the original sales price, it accounts for the transaction as a financing arrangement. When comparing the repurchase price with the selling price, the entity considers the time value of money.

606-10-55-70 to 55-71
[IFRS 15.B68 to B69]

In a financing arrangement, the entity continues to recognize the asset and recognizes a financial liability for any consideration received. The difference between the consideration received from the customer and the amount of consideration to be paid to the customer is recognized as interest, and processing or holding costs if applicable. If the option expires unexercised, the entity derecognizes the liability and the related asset, and recognizes revenue.



* Under U.S. GAAP, if the contract is part of a sale-leaseback transaction it is accounted for as a financing arrangement.

606-10-55-72 to 55-73
[IFRS 15.B70 to B71]

606-10-55-72, 55-74
[IFRS 15.B70, B72]

606-10-55-75, 55-78
[IFRS 15.B73, B76]

606-10-55-77
[IFRS 15.B75]

A put option

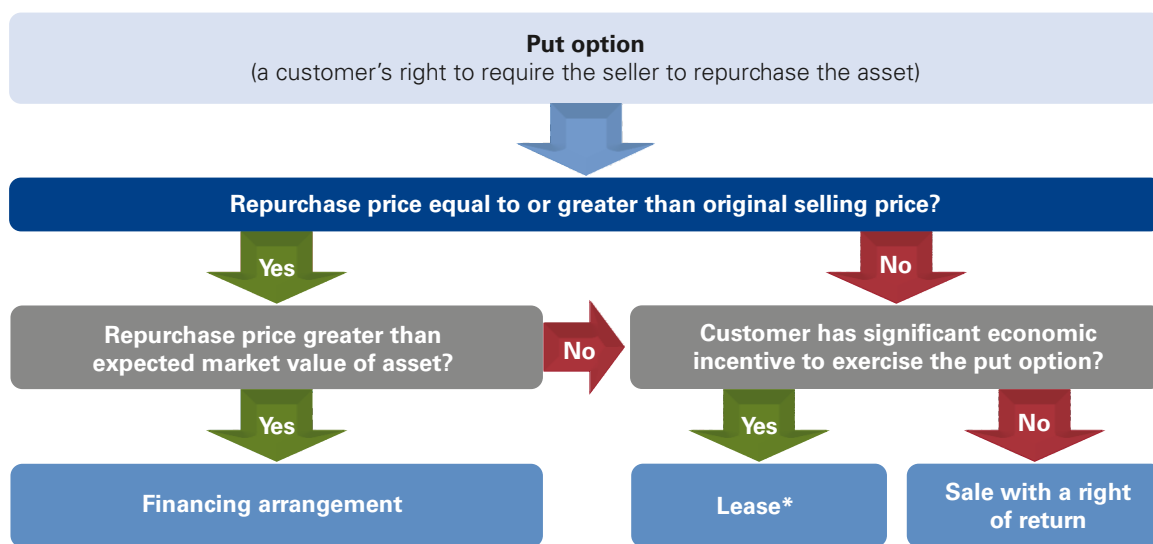
If a customer has a right to require the entity to repurchase the asset (a put option) at a price that is lower than the original selling price, then at contract inception the entity assesses whether the customer has a significant economic incentive to exercise that right. To make this assessment, an entity considers factors including:

- the relationship of the repurchase price to the expected market value of the asset at the date of repurchase; and
- the amount of time until the right expires.

If the customer has a significant economic incentive to exercise the put option, the entity accounts for the agreement as a lease. Conversely, if the customer does not have a significant economic incentive, the entity accounts for the agreement as the sale of a product with a right of return (see 10.1).

If the repurchase price of the asset is equal to or greater than the original selling price and is more than the expected market value of the asset, the contract is accounted for as a financing arrangement. In this case, if the option expires unexercised, the entity derecognizes the liability and the related asset and recognizes revenue at the date on which the option expires.

When comparing the repurchase price with the selling price, the entity considers the time value of money.



* Under U.S. GAAP, if the contract is part of a sale-leaseback transaction it is accounted for as a financing arrangement.

Observations

A revised approach that focuses on the repurchase price

The new standard includes guidance on the nature of the repurchase right or obligation and the repurchase price relative to the original selling price, whereas the current accounting focuses on whether the risks and rewards of ownership have been transferred. As a result, determining the accounting treatment for repurchase agreements may, in some cases, be more straight forward under the new standard, but different from current practice. However, judgment will be required to determine whether a customer with a put option has a significant economic incentive to exercise its right.

Requirements for repurchase agreements not applicable to arrangements with a guaranteed resale amount

ASU 2014-09 BC431;
460-10
[IFRS 15.BC431]

The Boards observed that although the cash flows of an agreement with a guaranteed minimum resale value may be similar to those of an agreement with a put option, the customer's ability to control the asset is different, and therefore the recognition of revenue may differ. This is because if a customer has a significant economic incentive to exercise a put option, it is restricted in its ability to consume, modify, or sell the asset – which would not be the case if instead the entity had guaranteed a minimum amount of resale proceeds. This could result in different accounting for arrangements with similar expected cash flows.

Accounting for vehicles sold and subsequently repurchased subject to a lease depends on facts and circumstances

840-10-55-10 to 55-25

A car manufacturer's customer is typically a dealer; however, in some cases, the car manufacturer agrees to subsequently repurchase the vehicle if the dealer's customer chooses to lease it through the car manufacturer's finance affiliate. The dealer and the end customer are not related parties, and therefore under the new standard the contracts – i.e., the initial sale of the vehicle to the dealer, and the lease contract with the end customer – are not evaluated for combination purposes and are treated as separate contracts.

Generally, when a car manufacturer sells a vehicle to a dealership, it recognizes revenue on the sale using the point-in-time transfer of control indicators in the new standard. On repurchase of the vehicle from the dealer, the car manufacturer typically records the vehicle at an amount in excess of the price the dealer initially paid, and then applies leases guidance to classify the lease. In our experience, the lease is usually an operating lease and is accounted for independently of the original transaction between the car manufacturer and the dealer.

840-10-25-1, 25-40 to
25-43

In a transaction where the end customer orders a customized vehicle from the car manufacturer and concurrently enters into a finance agreement with the car manufacturer's finance affiliate, the car manufacturer considers the principal versus agent guidance in the new standard to evaluate whether the dealer is acting as an agent for the car manufacturer (see 10.3). If the dealer is deemed to be an agent, the car manufacturer's revenue considers the sales price of the vehicle to the end customer and the amount due to the dealer. However, if the dealer is deemed to be a principal, the car manufacturer's revenue is based on the selling price to the dealer and not the price to the ultimate customer.

Differences between IFRS and U.S. GAAP

Sale-leaseback transactions

840-40
[IAS 17]

The accounting for sale-leaseback transactions currently differs between U.S. GAAP and IFRS. As a result, the specific guidance on the accounting for repurchase agreements that are part of sale-leaseback transactions included in the U.S. GAAP version of the new standard is not included in the IFRS version. Under IFRS, the existing authoritative guidance on sale-leaseback transactions continues to apply.

Comparison with current IFRS

Introduction of more prescriptive guidance

[IAS 18.IE5]

The limited guidance on repurchase agreements in current IFRS focuses on whether the seller has transferred the risks and rewards of ownership to the buyer. The new standard introduces explicit guidance that requires entities to apply a conceptually different approach when accounting for repurchase arrangements, and may therefore result in differences from current practice.

[IAS 17; IAS 18]

In addition, under current IFRS guaranteed residual amounts offered by an entity to the customer may preclude revenue recognition if significant risks are retained. By contrast, the specific guidance in the new standard on repurchase arrangements focuses on whether the entity retains control of the asset.

Comparison with current U.S. GAAP

New guidance for certain sale-leaseback transactions

840-40

Except in cases when the seller-lessee holds a forward or call option to repurchase an asset for an amount that is less than its original selling price, or the buyer-lessor has a significant economic incentive to exercise a put option, the guidance on the accounting for sale-leaseback transactions has not changed. However, if the seller-lessee holds a forward or call option to repurchase an asset for an amount that is less than its original selling price, or if the buyer-lessor has a significant economic incentive to exercise a put option, then the contract is accounted for as a financing arrangement under the new standard.

Consistent treatment of processing costs for product financing arrangements

470-40

A product financing arrangement may include processing performed by the buyer. For example, a car manufacturer may sell aluminum to a parts supplier, and in a related transaction agree to purchase component parts from the supplier containing a similar amount of aluminum. The price of the component parts includes processing, holding, and financing costs. The new standard is consistent with current guidance on the accounting for these types of arrangements. The entity will identify the processing costs from the financing and holding costs separately, and recognize the processing costs as part of the cost of the product.

Change in practice for guarantees of resale value

840-10-55-10 to 55-25;
460-10

Under current U.S. GAAP, if an entity guarantees the resale value of an asset, the arrangement is accounted for as a lease. Under the new standard, revenue is recognized at the point in time at which the customer obtains control of the asset, which may result in a significant change in practice for some entities.

5.5.6

Consignment arrangements

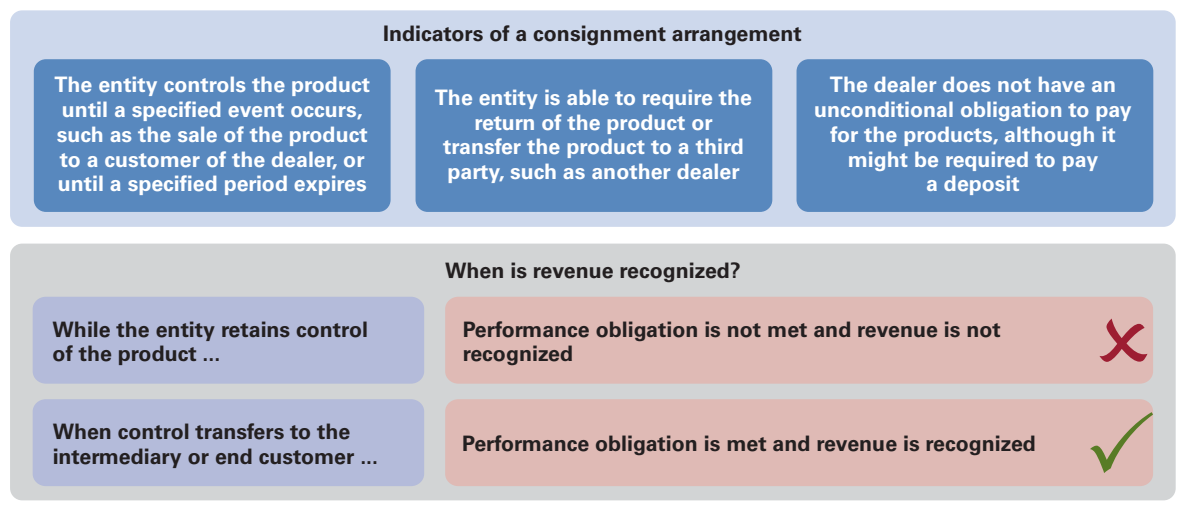
606-10-55-79
[IFRS 15.B77]

606-10-55-80
[IFRS 15.B78]

Requirements of the new standard

An entity may deliver goods to another party but retain control of those goods – e.g., it may deliver a product to a dealer or distributor for sale to an end customer. These types of arrangements are called consignment arrangements, which do not allow the entity to recognize revenue on delivery of the products to the intermediary.

The new standard provides indicators that an arrangement is a consignment arrangement, as follows.



Example 27

Consignment arrangement

Manufacturer M enters into a 60-day consignment contract to ship 1,000 dresses to Retailer A's stores. Retailer A is obligated to pay Manufacturer M 20 per dress when the dress is sold to an end customer. During the consignment period, Manufacturer M has the contractual right to require Retailer A to either return the dresses or transfer them to another retailer. Manufacturer M is also required to accept the return of the inventory.

Manufacturer M determines that control has not transferred to Retailer A on delivery, for the following reasons:

- Retailer A does not have an unconditional obligation to pay for the dresses until they have been sold to an end customer;
- Manufacturer M is able to require that the dresses be transferred to another retailer at any time before Retailer A sells them to an end customer; and
- Manufacturer M is able to require the return of the dresses or transfer them to another retailer.

Manufacturer M determines that control of the dresses transfers when they are sold to an end customer – i.e., when Retailer A has an unconditional obligation to pay Manufacturer M and can no longer return or otherwise transfer the dresses – and therefore recognizes revenue as the dresses are sold to the end customer.

Observations

Move away from a risk-and-reward approach

Under the new standard, an entity typically considers contract-specific factors to determine whether revenue should be recognized on sale into the distribution channel or whether the entity should wait until the product is sold by the intermediary to its customer.

This assessment may differ from current IFRS and U.S. GAAP as a result of the shift from a risk-and-reward approach to a transfer of control approach. However, consideration of whether the significant risks and rewards of ownership have been transferred is an indicator of the transfer of control under the new standard (see 5.5.4) and conclusions about when control has passed to the intermediate party or the end customer are generally expected to stay the same.

SEC SAB Topic 13
[IAS 18.16, IE2(c), IE6]

5.5.7

Bill-and-hold arrangements

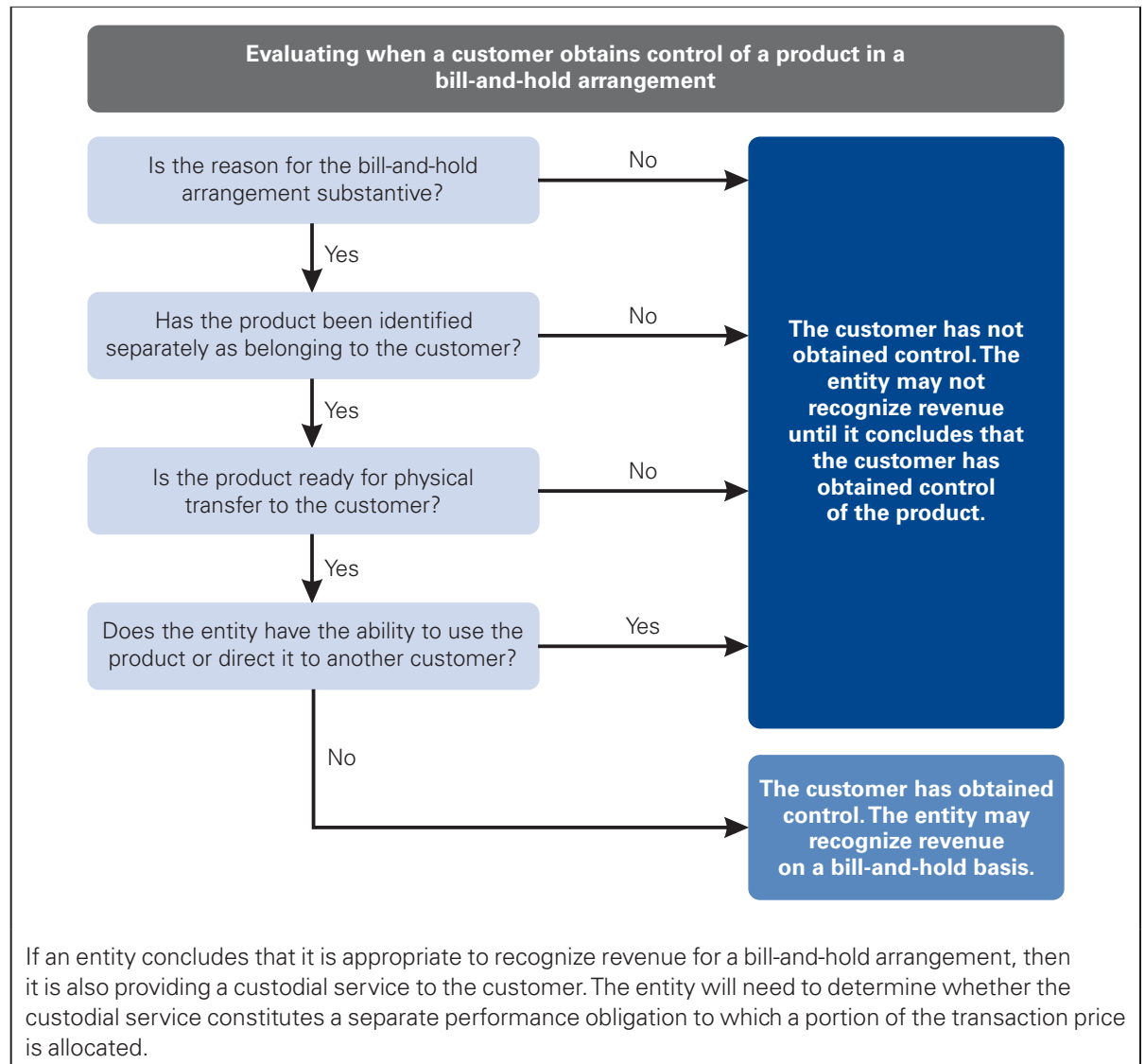
Requirements of the new standard

Bill-and-hold arrangements occur when an entity bills a customer for a product that it transfers at a point in time, but retains physical possession of the product until it is transferred to the customer at a future point in time – e.g., due to a customer's lack of available space for the product or delays in production schedules.

To determine when to recognize revenue, an entity needs to determine when the customer obtains control of the product. Generally, this occurs at shipment or delivery to the customer, depending on the contract terms (for discussion of the indicators for transfer of control at a point in time, see 5.5.4). The new standard provides criteria that have to be met for a customer to obtain control of a product in a bill-and-hold arrangement. These are illustrated below.

606-10-55-81
[IFRS 15.B79]

606-10-55-82 to 55-83
[IFRS 15.B80 to B81]



606-10-55-84
[IFRS 15.B82]

Example 28

Bill-and-hold arrangement

Company C enters into a contract to sell equipment to Customer A, who is awaiting completion of a manufacturing facility and requests that Company C holds the equipment until the manufacturing facility is completed.

Company C bills and collects the nonrefundable transaction price from Customer A and agrees to hold the equipment until Customer A requests delivery. The equipment is complete and segregated from Company C's inventory and is ready for shipment. Company C cannot use the equipment or sell it to another customer. Customer A has requested that the delivery be delayed, with no specified delivery date.

Company C concludes that Customer A's request for the bill-and-hold basis is substantive. Company C concludes that control of the equipment has transferred to Customer A and that it will recognize revenue on a bill-and-hold basis even though Customer A has not specified a delivery date. The obligation to warehouse the goods on behalf of Customer A represents a separate performance obligation. Company C needs to estimate the stand-alone selling price of the warehousing performance obligation based on its estimate of how long the warehousing service will be provided. The amount of the transaction price allocated to the warehousing obligation is deferred and then recognized over time as the warehousing services are provided.

Comparison with current IFRS

[IAS 18.IE1]

Broadly similar requirements, but with some differences

Although the criteria to recognize revenue on a bill-and-hold basis are broadly similar under current IFRS and under the new standard, there are some differences. For example, current IFRS requires that an entity's usual payment terms apply if it recognizes revenue on a bill-and-hold basis.

Another condition under current IFRS to recognize revenue on a bill-and-hold basis is that it is probable that delivery will be made. Under the new standard, this is not stated explicitly; however, if it is not probable that delivery will be made, then it is possible that the contract will not exist for the purpose of applying the requirements of the new standard or that the reason for the bill-and-hold arrangement will be deemed not to be substantive.

The fact that the entity pays for the cost of storage, shipment, and insurance on the goods is also taken into account under current requirements to assess whether the significant risks and rewards of ownership of the products have passed to the customer. This analysis is no longer directly relevant under the new requirements. However, it may be part of the assessment of whether the bill-and-hold terms are substantive.

Comparison with current U.S. GAAP

SEC SAB Topic 13

An explicit customer request and a specified delivery schedule are no longer required

The criteria for bill-and-hold arrangements under the new standard differ in two key respects from current SEC guidance.

First, the bill-and-hold arrangement is not required to be at the customer's explicit request. The new standard requires that the reason for the bill-and-hold arrangement has to be substantive. In some cases, this may require an explicit request from the customer as evidence to support a conclusion that it is substantive.

Second, the entity does not need a specified delivery schedule to meet the bill-and-hold criteria. However, an obligation to warehouse the goods is a separate performance obligation, and the entity will need a process and relevant controls to estimate the stand-alone selling price of the warehousing performance obligation based on its estimate of how long the warehousing service will be provided.

5.5.8 Customer acceptance

Requirements of the new standard

To determine the point in time at which a customer obtains control for point-in-time performance obligations (and therefore satisfies the performance obligation), an entity considers several indicators of the transfer of control, including whether the customer has accepted the goods or services.

Customer acceptance clauses included in some contracts are intended to ensure the customer's satisfaction with the goods or services promised in the contract. The table below illustrates examples of customer acceptance clauses.

If the entity:	Then:	For example:
Can objectively verify that the goods or services comply with the specifications underlying acceptance	Customer acceptance would be a formality, and revenue could be recognized before explicit acceptance	The customer acceptance clause is based on meeting objective size and weight specifications
Cannot objectively determine whether the specifications have been met	It is unlikely that the entity would be able to conclude that the customer has obtained control before formal customer acceptance	The customer acceptance clause is based on a modified product functioning in the customer's new production line
Delivers products for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses	Control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses	The customer acceptance clause specifies that the customer may use prototype equipment for a specified period of time

An entity's experience with similar contracts may provide evidence that goods or services transferred to the customer are based on the agreed specifications.

For further discussion on the accounting for consignment arrangements that may have attributes similar to customer acceptance clauses, see 5.5.6.

Comparison with current IFRS

Revenue may be recognized if certain formalities remain outstanding

Under current IFRS, revenue from goods that are shipped subject to customer acceptance is normally recognized when the customer accepts delivery. Current IFRS does not explicitly permit recognition of revenue before customer acceptance. However, if a transaction meets the general criteria for recognition of revenue, then revenue may be recognized under the new standard even if certain formalities remain outstanding.

606-10-25-30(e)
[IFRS 15.38(e)]

606-10-55-85
[IFRS 15.B83]

606-10-55-86
[IFRS 15.B84]

606-10-55-87
[IFRS 15.B85]

606-10-55-88
[IFRS 15.B86]

606-10-55-86
[IFRS 15.B84]

[IAS 18.IE2(a)]

Comparison with current U.S. GAAP

Unlikely to significantly change current practice

SEC SAB Topic 13

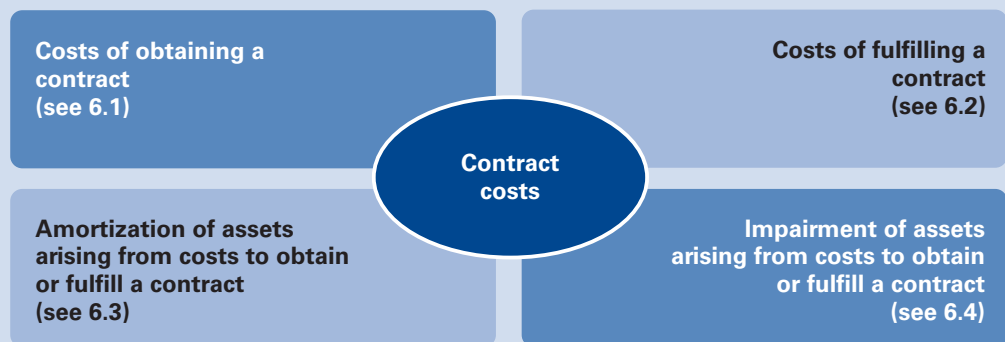
The SEC has provided guidance for specific types of acceptance clauses – e.g., vendor-specified objective criteria, customer-specified objective criteria, products shipped for trial or evaluation purposes, and subjective right of return or exchange.

While the new standard is unlikely to significantly change the current accounting for contracts that contain customer acceptance clauses, entities should consider whether certain customer-specified objective criteria give rise to a separate performance obligation. For further discussion on warranties, see 10.2.

6 Contract costs

Overview

The new standard does not seek to provide comprehensive guidance on the accounting for contract costs. In many cases, entities continue to apply existing cost guidance under U.S. GAAP and IFRS. However, the new standard does include specific guidance in the following areas.



6.1 Costs of obtaining a contract

Requirements of the new standard

An entity capitalizes incremental costs to obtain a contract with a customer – e.g., sales commissions – if the entity expects to recover those costs.

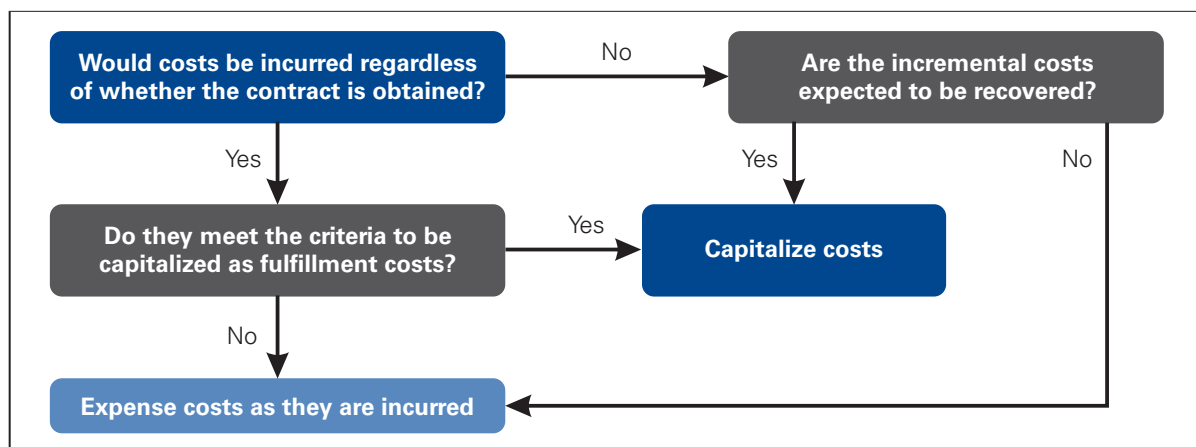
However, as a practical expedient, an entity is not required to capitalize the incremental costs to obtain a contract if the amortization period for the asset would be one year or less.

Costs that will be incurred regardless of whether the contract is obtained – including costs that are incremental to *trying* to obtain a contract, such as bid costs that are incurred even if the entity does not obtain the contract – are expensed as they are incurred, unless they meet the criteria to be capitalized as fulfillment costs (see 6.2).

340-40-25-1 to 25-2
[IFRS 15.91 to 92]

340-40-25-4
[IFRS 15.94]

340-40-25-3
[IFRS 15.93]



Example 29

Costs incurred to obtain a contract

340-40-55-2 to 55-4
[IFRS 15.IE189 to IE191]

Consulting Company E provides consulting services to customers. Following a competitive tender process, Consulting Company E wins a contract to provide consulting services to a new customer. Consulting Company E incurs the following costs to obtain the contract.

External legal fees for due diligence	15
Travel costs to deliver proposal	25
Commissions to sales employees	10
Total costs incurred	50

The commissions payable to sales employees are an incremental cost to obtain the contract, since they are payable only upon successfully obtaining the contract. Consulting Company E therefore recognizes an asset for the sales commissions of 10, subject to recoverability.

By contrast, although the external legal fees and travel costs are incremental costs, they are costs associated with *trying* to obtain the contract. Therefore, they were incurred even if the contract is not obtained. Consequently, Consulting Company E expenses the legal fees and travel costs as they are incurred, unless they are in the scope of other applicable guidance.

Observations

Amount of costs capitalized by an entity may change under the new standard

The requirement to capitalize the costs of obtaining a contract will be a change for entities that currently expense those costs. It may also be complex to apply, especially for entities with many contracts and a variety of contract terms and commission structures. Also, those entities that have not previously tracked the costs of acquiring a contract, and have expensed them as they were incurred, may find it difficult to determine which costs to capitalize, both for the transition amounts on adoption and in the ongoing application of the new standard.

An entity that currently capitalizes the costs to obtain a contract will need to assess whether its current capitalization policy is consistent with the new requirements. For example, an entity that currently capitalizes incremental bid costs will need to identify those costs that are incremental to obtaining the contract and exclude bid costs that are incurred irrespective of whether the contract is obtained. Likewise, an entity that capitalizes both incremental and allocable costs of obtaining a contract will need to revise its policy to only capitalize the incremental costs of obtaining a contract.

The practical expedient not to capitalize the incremental costs to obtain a contract offers potential relief for entities that enter into contracts of relatively short duration without a significant expectation of renewals. However, it will reduce comparability between entities that do and do not elect to use the practical expedient. The question over whether to use the practical expedient will be a key implementation decision for some entities.

Judgment required for multiple-tier commissions

Some entities pay sales commissions on a multiple-tier system, whereby the salesperson receives a commission on all contracts executed with customers, and their direct supervisor receives a commission based on the sales of the employees that report to them. Entities should use judgment when determining whether the supervisor's commission is incremental to obtaining a specific contract. The incremental cost should be the amount of acquisition cost that can be directly attributable to an identified contract.

Many sales commission models are based on multiple criteria, not just the acquisition of an individual contract – e.g., overall contract performance or the achievement of quotas for a period of time. It will require judgment to determine what portion of the supervisor's commission or quota 'kickers' are an acquisition cost that is directly related to a specific contract.

Comparison with current IFRS

Capitalizing costs to obtain a contract

[IAS 38]

There is no specific guidance on the accounting for the costs to obtain a contract with a customer in current IFRS. The IFRS Interpretations Committee discussed the treatment of selling costs and noted that only in limited circumstance will direct and incremental recoverable costs to obtain a specifically identifiable contract with a customer qualify for recognition as an intangible asset in the scope of IAS 38.

[IAS 11.21]

In addition, when a contract is in the scope of IAS 11, costs that relate directly to the contract and are incurred in securing it are included as part of the contract costs if they can be separately identified and reliably measured, and it is probable that the contract will be obtained.

[IAS 38]

The new standard therefore brings clarity to this topic. It also introduces a new cost category – an asset arising from the capitalization of the incremental costs to obtain a contract will be in the scope of the new standard, and not in the scope of IAS 38.

Comparison with current U.S. GAAP

Policy election

SEC SAB Topic 13

Under current SEC guidance, an entity can elect to capitalize direct and incremental contract acquisition costs – e.g., sales commissions – in certain circumstances. Under the new standard, an entity capitalizes costs that are incremental to obtaining a contract if it expects to recover them – unless it elects the practical expedient for costs with amortization periods of one year or less. This may affect those entities that currently elect to expense contract acquisition costs, because they will now be required to capitalize them if the anticipated amortization period for such costs is greater than one year.

310-20-25-6 to 25-7

Currently, some entities capitalize a portion of an employee's compensation relating to origination activities by analogy to current U.S. GAAP on loan origination fees. This is not permitted under the new standard, because these costs are not incremental to a specific contract – i.e., an employee's salary and benefits are paid whether or not they successfully solicit a sale.

Direct-response advertising costs

340-20-25-4;
720-35-25-5

The new standard amends existing cost-capitalization guidance to require the costs of direct-response advertising to be expensed as they are incurred, because they are not incremental costs to obtain a specific contract.

Costs for investment companies

946-605-25-8

The new standard will not affect current U.S. GAAP cost guidance for mutual fund distribution fees associated with contingent deferred sales charges.

6.2 Costs of fulfilling a contract

Requirements of the new standard

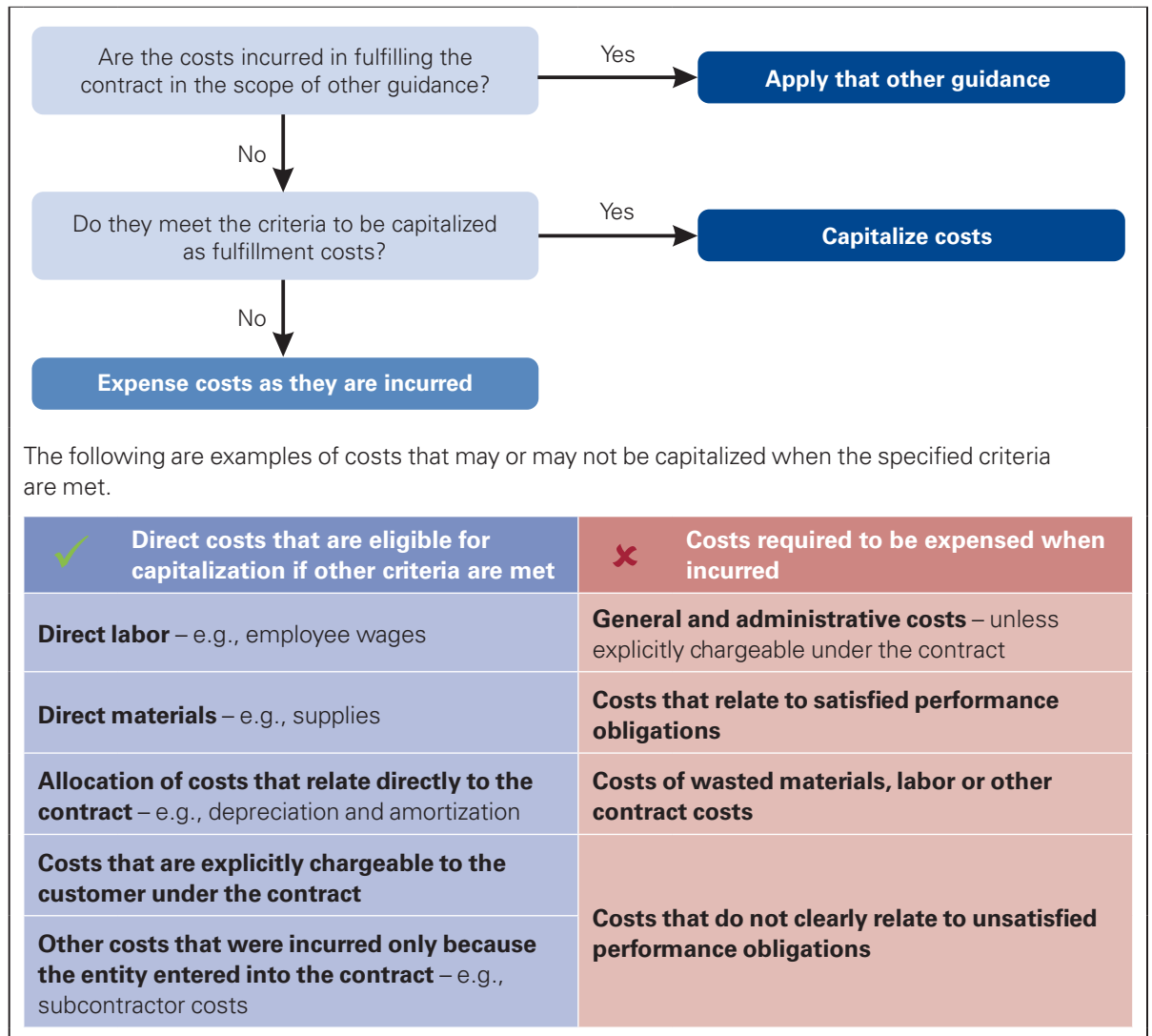
340-40-25-5
[IFRS 15.95]

If the costs incurred in fulfilling a contract with a customer are not in the scope of other guidance – e.g., inventory, intangibles, or property, plant, and equipment – then an entity recognizes an asset only if the fulfillment costs meet the following criteria:

- they relate directly to an existing contract or specific anticipated contract;
- they generate or enhance resources of the entity that will be used to satisfy performance obligations in the future; and
- they are expected to be recovered.

340-40-25-6
[IFRS 15.96]

If the costs incurred to fulfill a contract are in the scope of other guidance, then the entity accounts for them in accordance with that other guidance.



340-40-25-7 to 25-8
[IFRS 15.97 to 98]

Example 30

Set-up costs incurred to fulfill a contract

Managed Services Company M enters into a contract to manage CustomerY's IT data center for five years, for a monthly fixed fee. Before providing the services, Company M designs and builds a technology platform to migrate and test CustomerY's data. This platform is not transferred to CustomerY and is not considered a separate performance obligation. The initial costs incurred to set up the platform are as follows.

Design services	40
Hardware and software	210
Migration and testing	100
Total	350

340-40-55-5 to 55-9
[IFRS 15.IE192 to IE196]

These set-up costs relate primarily to activities to fulfill the contract, but do not transfer goods or services to the customer. M accounts for them as follows.

Type of cost	Accounting treatment
Hardware	Accounted for under guidance for property, plant, and equipment
Software	Accounted for under guidance for internal-use software development/intangible assets
Design, migration, and testing of the data center	Capitalized under the new standard because they: <ul style="list-style-type: none"> • relate directly to the contract • generate or enhance resources of the entity that will be used to satisfy performance obligations in the future • are expected to be recovered over the five-year contract period

The capitalized hardware and software costs are subsequently measured in accordance with other applicable guidance, including the potential capitalization of depreciation if certain criteria are met. The costs capitalized under the new standard are subject to its amortization and impairment requirements (see 6.3 and 6.4).

Observations

Judgment needed in determining whether to capitalize learning curve costs

The new standard may affect the accounting for contracts that have significant learning curve costs that decrease over time as process and knowledge efficiencies are gained. The Boards believe that if an entity has a single performance obligation that is satisfied over time, and also has significant learning curve costs, then the entity may recognize revenue over time (e.g., using a cost-to-cost method). This will result in the entity recognizing more revenue and expense in the earlier phases of the contract.

If a contract is for multiple performance obligations (e.g., selling multiple goods or products, such as multiple pieces of equipment or machinery) that are each satisfied at a point in time (e.g., on transfer of control of the good) then an entity will principally account for the costs of those performance obligations under existing inventory guidance.

ASU 2014-09 BC312 to BC316

[IFRS 15.BC312 to BC316]

330-10
[IAS 2]

Comparison with current IFRS

Capitalizing costs to fulfill a contract

The new guidance on the accounting for the costs to fulfill a contract is likely to be particularly relevant for contracts that are currently accounted for using the stage-of-completion method under IAS 11. The new standard withdraws IAS 11, including the cost guidance contained therein.

[IAS 11.21]

[IAS 11]

Notably, the new standard requires an entity to capitalize the costs of fulfilling an *anticipated* contract, if the other conditions are met. This is similar to the notion in IAS 11 that costs incurred before a contract is obtained are recognized as contract costs if it is 'probable' that the contract will be obtained. It is not clear whether the Boards intend 'anticipated' to imply the same degree of confidence that a contract will be obtained as 'probable'.

[IAS 2; IAS 18]

IAS 2 will remain relevant for many contracts for the sale of goods that are currently accounted for under IAS 18.

Comparison with current U.S. GAAP

Policy election

SEC SAB Topic 13

Although there is no specific authoritative guidance under current U.S. GAAP, fulfillment costs are generally expensed as they are incurred. For certain set-up costs, however, entities may make an accounting policy election under current SEC guidance to either expense or capitalize these costs. Entities that currently expense those costs may be required to capitalize them under the new standard.

Costs in excess of constrained transaction price

In limited circumstances under current U.S. GAAP, the SEC concluded that an entity should not necessarily recognize a loss on a delivered item in a multiple-element revenue arrangement – i.e., not recognize the full costs of a delivered good or service – where the loss that would result:

- is solely a result of applying the contingent revenue cap under current U.S. GAAP, which limits the allocation of revenue to a delivered item to only those amounts that are not contingent on the entity's future performance; and
- is expected to be recovered by the revenue under the contract – i.e., it is essentially an investment in the remainder of the contract.⁶

Under the new standard, an entity may similarly deliver a good or provide a service, and all or a portion of the transaction price relating to that good or service may be constrained from revenue recognition. There is no provision in the new standard that is similar to the current SEC guidance when the new standard's constraint on variable consideration applies and applying it results in an up-front loss on the delivered good or service. As a result, in certain circumstances an entity may be required to recognize expenses before recognizing expected revenue on satisfied performance obligations.

Pre-production costs relating to long-term arrangements

340-10-25

The new standard does not amend the current U.S. GAAP guidance for pre-production costs related to long-term supply arrangements. Design and development costs for products to be sold under these arrangements continue to be expensed as they are incurred. However, the costs are recognized as an asset if there is a contractual guarantee for reimbursement. Design and development costs for molds, dies, and other tools that an entity owns and that are used in producing the products under a long-term supply arrangement continue to be capitalized as part of the molds, dies, and other tools – unless the design and development involves new technology, in which case they are expensed as they are incurred under the accounting for R&D costs.

926-20; 928-340;
350-40

In addition, the new standard does not amend the current guidance for accounting for film costs, advance royalties paid to a music artist, or internal-use software costs.

6 SEC Speech, "Remarks Before the 2003 AICPA National Conference on Current SEC Developments," by Russell P. Hodge, Professional Accounting Fellow at the SEC, available at www.sec.gov.

6.3 Amortization

340-40-35-1
(IFRS 15.99)

Requirements of the new standard

An entity amortizes the asset recognized for the costs to obtain and/or fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates. This can include the goods or services in an existing contract, and also those to be transferred under a specific anticipated contract – e.g., goods or services to be provided following the renewal of an existing contract.

Example 31

Amortization of costs over specifically anticipated contracts

Company X enters into a contract with Customer Z to install a proprietary home security system and provide two years of monitoring services for an amount of 30 per month. Company X determines that the equipment is not distinct, because Company X does not sell the equipment on a stand-alone basis and Customer Z cannot benefit from the equipment without the monitoring service. Therefore, there is only one performance obligation. Company X incurs installation costs of 500. Based on historical experience and customer analysis, Company X expects Customer Z to renew the contract for an additional three years – i.e., it expects to provide five years of monitoring services in total.

Company X recognizes an asset of 500 for the set-up costs associated with installing the system and amortizes that asset over the five-year period – i.e., on a systematic basis consistent with the pattern of satisfaction of the performance obligation, and including specifically anticipated renewal period performance obligations.

Observations

Amortization period may need to include anticipated contracts

Under the new standard, a capitalized contract cost asset is amortized based on the transfer of goods or services to which the asset relates. In making this determination, the new standard notes that those goods or services could be provided under an anticipated contract that the entity can specifically identify.

The new standard does not prescribe how an entity should determine whether one or more anticipated contracts are specifically identifiable, such that practice is likely to develop over time. Relevant factors to consider may include the entity's history with that customer class, and predictive evidence derived from substantially similar contracts. In addition, an entity may consider the available information about the market for its goods or services beyond the initial contract term – e.g., whether it expects the service still to be in demand when renewal would otherwise be anticipated. Judgment will be involved in determining the amortization period of contract cost assets, but entities should apply consistent estimates and judgments across similar contracts, based on relevant experience and other objective evidence.

Anticipated contracts included when determining whether practical expedient applies

Under the new standard, an entity assesses the amortization period to determine whether it is eligible to apply the practical expedient not to recognize an asset for the incremental costs to obtain a contract. For example, a cable television company incurs incremental costs to obtain contracts with customers that have an initial term of one year. However, a significant proportion of customers renew the contracts at the end of the initial term. In this case, the company cannot assume that it is eligible for the practical expedient, but instead has to determine the amortization period.

Judgment required when contracts include recurring commissions

Some entities pay sales commissions on all contracts executed with customers, including new contracts – i.e., new services and/or new customers – and renewal or extension contracts. If the commission paid by an entity on a new contract will be followed by corresponding commissions for each renewal period – i.e., the salesperson will receive an incremental commission each time the customer renews, or does not cancel, the contract – then the entity applies judgment to determine whether the original commission on the new contract should be amortized only over the initial contract term, or over a longer period. The entity should consider the period for which it expects to benefit from the commissions.

No correlation with accounting for nonrefundable up-front fees

The amortization pattern for capitalized contract costs (i.e., including the term of specific anticipated contracts) and the revenue recognition pattern for nonrefundable up-front fees (see 10.6) (i.e., the existing contract plus any renewals for which the initial payment of the up-front fee provides a material right to the customer) are not symmetrical under the new standard. Therefore, there is no requirement under the new standard for the recognition pattern of these two periods to align, even where contract costs and nonrefundable up-front fees are both deferred on the same contract.

Comparison with current U.S. GAAP

No correlation with accounting for nonrefundable up-front fees

Current SEC guidance on revenue recognition indicates that registrants are required to defer nonrefundable up-front fees if they are not in exchange for goods delivered or services performed that represent the culmination of a separate earnings process. These fees are deferred and recognized as revenue over the expected period of performance, which may include expected renewal periods if the expected life of the contract extends beyond the initial period. Similarly, that guidance states that an entity may elect an accounting policy of deferring certain set-up costs or customer acquisition costs.

If the amount of deferred up-front fees exceeds the deferred costs, these two amounts are recognized over the same period and in the same manner. However, if the amount of deferred costs exceeds the deferred revenue from any up-front fees, the net deferred costs are amortized over the shorter of the estimated customer life and the stated contract period.

The new standard effectively decouples the amortization of contract fulfillment costs from that for any nonrefundable up-front fees in the contract (see 10.6). The capitalization of qualifying fulfillment costs is not a policy election (see 6.2). The amortization period for contract cost assets is determined in a manner substantially similar to that under current guidance when up-front fees result in an equal or greater amount of deferred revenue – i.e., the existing contract plus any anticipated renewals that the entity can specifically identify. However, contract costs that were previously deferred without any corresponding deferred revenue may be amortized over a longer period under the new standard than under current U.S. GAAP.

SEC SAB Topic 13

6.4 Impairment

340-40-35-3
[IFRS 15.101]

Requirements of the new standard

An entity recognizes an impairment loss to the extent that the carrying amount of the asset exceeds the recoverable amount. The recoverable amount is defined as:

- the remaining expected amount of consideration to be received in exchange for the goods or services to which the asset relates; *less*
- the costs that relate directly to providing those goods or services and that have not been recognized as expenses.

340-40-35-4
[IFRS 15.102]

When assessing an asset for impairment, the amount of consideration included in the impairment test is based on an estimate of the amounts that the entity expects to receive. To estimate this amount, the entity uses the principles for determining the transaction price, with two key differences:

- it does not constrain its estimate of variable consideration – i.e., it includes its estimate of variable consideration, regardless of whether the inclusion of this amount could result in a significant revenue reversal if adjusted; and
- it adjusts the amount to reflect the effects of the customer's credit risk.

Observations

Topic 330; Topic 360;
985-20
[IAS 2; IAS 36]

New impairment model for capitalized contract costs

The new standard introduces a new impairment model that applies specifically to assets that are recognized for the costs to obtain and/or fulfill a contract. The Boards chose not to apply the existing impairment models in U.S. GAAP or IFRS, in order to have an impairment model that focuses on contracts with customers. An entity applies this model in addition to the existing impairment models.

350-20-35-31 to 35-32;
Topic 350; Topic 360
[IAS 36.22]

The entity applies, in order:

- any existing asset-specific impairment guidance – e.g., for inventory;
- the impairment guidance on contract costs under the new standard; and
- the impairment model for cash-generating units (IFRS), or for asset groups or reporting units (U.S. GAAP).

For example, if an entity recognizes an impairment loss under the new standard, it is still required to include the impaired amount of the asset in the carrying amount of the relevant cash-generating unit or asset group/reporting unit if it also performs an impairment test under IAS 36, or in applying current property, plant, and equipment, intangibles, or impairment guidance under U.S. GAAP.

Consideration that an entity expects to receive is calculated based on the goods or services to which the capitalized costs relate

The new standard specifies that an asset is impaired if the carrying amount exceeds the remaining amount of consideration that an entity expects to receive, less the costs that relate directly to providing those goods or services that have not been recognized as expenses. The TRG discussed impairment at its first meeting in July 2014, and most of its members expressed a view that cash flows from specific anticipated contracts should be included when determining the consideration expected to be received in the contract costs impairment analysis. They believed that an entity should exclude from the amount of consideration the portion that it does not expect to collect, based on an assessment of the customer's credit risk.

For certain long-term contracts that have a significant financing component, the estimated transaction price may be discounted. In these cases, it is unclear whether the estimated remaining costs to fulfill the contract and the contract cost asset should also be discounted for the purpose of performing the contract cost asset impairment analysis, even though the contract cost asset is not presented on a discounted basis in the entity's statement of financial position.

Difference between IFRS and U.S. GAAP**Reversal of an impairment loss**

The requirements on a reversal of an impairment loss are different under the U.S. GAAP and IFRS versions of the new standard, to maintain consistency with the existing respective U.S. GAAP and IFRS impairment models. Under U.S. GAAP, an entity does not recognize a reversal of an impairment loss that has previously been recognized. By contrast, under IFRS an entity recognizes a reversal of an impairment loss that has previously been recognized when the impairment conditions cease to exist. Any reversal of the impairment loss is limited to the carrying amount, net of amortization, that would have been determined if no impairment loss had been recognized.

340-40-35-6
[IFRS 15.104]

7 Contract modifications

Overview

A contract modification occurs when the parties to a contract approve a change in its scope, price, or both. The accounting for a contract modification depends on whether distinct goods or services are added to the arrangement, and on the related pricing in the modified arrangement. This section discusses both identifying and accounting for a contract modification.

7.1 Identifying a contract modification

606-10-25-10
[IFRS 15.18]

Requirements of the new standard

A contract modification is a change in the scope or price of a contract, or both. This may in practice be described as a change order, a variation, or an amendment. When a contract modification is approved, it creates or changes the enforceable rights and obligations of the parties to the contract. Consistent with the determination of whether a contract exists in Step 1 of the model, this approval may be written, oral, or implied by customary business practices, and should be enforceable under law.

If the parties have not approved a contract modification, an entity continues to apply the requirements of the new standard to the existing contract until approval is obtained.

606-10-25-11
[IFRS 15.19]

If the parties have approved a change in scope, but have not yet determined the corresponding change in price – i.e., an unpriced change order – then the entity estimates the change to the transaction price by applying the guidance on estimating variable consideration and constraining the transaction price (see 5.3.1).

Observations

605-35-25-25 to 25-31
[IAS 11.13 to 14]

Applicable to all revenue contracts with customers

There is currently guidance on contract modifications for industries that have construction and production-type contracts in both IFRS and U.S. GAAP; however, neither revenue recognition framework includes a general framework for accounting for contract modifications.

Under the new standard, the guidance on contract modifications applies to all contracts with customers, and may therefore result in a change in practice for entities in industries without construction- and production-type contracts – and even for industries *with* such contracts, depending on the type of modification.

Some entities will need to develop new processes – with appropriate internal controls over those processes – to identify and account for contract modifications on an ongoing basis under the new guidance.

Assessment focuses on enforceability

The assessment of whether a contract modification exists focuses on whether the new or amended rights and obligations that arise under the modification are enforceable. This determination requires an entity to consider all related facts and circumstances, including the terms of the contract and relevant laws and regulations. This may require significant judgment in some jurisdictions or for some modifications – particularly if the parties to the contract have a dispute about the scope or the price. In cases of significant uncertainty about enforceability, written approval and legal representation may be required to support a conclusion that the parties to the contract have approved the modification.

Additional criteria to evaluate, including probability of collection

The new standard's guidance on contract modifications does not explicitly address whether the entity should assess the collectibility of consideration when determining that a modification has been approved. However, the objective of the guidance and its focus on whether the modification creates enforceable rights and obligations is consistent with the guidance on identifying a contract in Step 1 of the model (see 5.1). Under that guidance, the following criteria are used to determine whether a contract exists and therefore to help assess whether a modification exists.



* The threshold differs under IFRS and U.S. GAAP due to different meanings of the term 'probable'.

Relevant considerations when assessing whether the parties are committed to perform their respective obligations, and whether they intend to enforce their respective contract rights, may include:

- whether the contractual terms and conditions are commensurate with the uncertainty, if any, about the customer performing in accordance with the modification;
- whether there is experience about the customer (or class of customer) not fulfilling its obligations in similar modifications under similar circumstances; and
- whether the entity has previously chosen not to enforce its rights in similar modifications with the customer (or class of customer) under similar circumstances.

No specific guidance on accounting for contract claims

Currently, both U.S. GAAP and IFRS contain guidance on recognizing revenue related to construction contract claims, which are described as amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or other parties. Claims may arise from customer-caused delays, errors in specifications or design, contract terminations, change orders that are in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs.

ASU 2014-09 BC39,
BC81
[IFRS 15.BC39, BC81]

The new standard does not retain specific guidance; rather, contract claims are evaluated using the guidance on contract modifications. Assessing whether a contract modification related to a claim exists may require a detailed understanding of the legal position, including third-party legal advice, even when a master services agreement or other governing document prescribes the claim resolution process under the contract. The assessment may be more straight forward if an objective framework for resolution exists – e.g., if the contract includes a defined list of cost overruns that will be eligible for reimbursement and a price list or rate schedule. Conversely, the mere presence of a resolution framework – e.g., a requirement to enter into binding arbitration rather than to enter into litigation – will generally not negate an entity's need to obtain legal advice to determine whether its claim is legally enforceable. If enforceable rights do not exist for a contract claim, a contract modification has not occurred and no additional contract revenue is recognized until there has been approval or until legal enforceability is established.

An entity's accounting for any costs incurred before approval of a contract modification will depend on the nature of the costs. In some circumstances, those costs will be expensed as incurred, while in others an entity will need to consider whether the expectation of costs without a corresponding increase in the transaction price requires the recognition of an onerous contract provision (see 10.7). In yet other cases, a contract modification may be considered a specifically anticipated contract such that the costs incurred before approval of the contract modification – i.e., pre-contract costs – may be considered for capitalization based on the new standard's fulfillment cost guidance (see 6.2).

Comparison with current IFRS

A new framework

IAS 11 includes specific guidance on the accounting for claims and variations in a construction contract, as follows.

[IAS 11.14]

Claims

A claim is an amount that the entity seeks to collect from the customer (or another party) as reimbursement for costs not included in the contract price. A claim is included in contract revenue only when:

- negotiations have reached an advanced stage;
- it is probable that the customer will accept the claim; and
- the amount can be measured reliably.

[IAS 11.13]

Variations

A variation is an instruction from a customer to change the scope of work to be performed. A variation is included in contract revenue when:

- it is probable that the customer will approve the variation; and
- the amount of revenue can be measured reliably.

This specific guidance is not carried forward into the new standard. Instead, claims and variations in construction contracts are accounted for under the new standard's general guidance on contract modifications.

The criteria in the new standard for recognizing a contract modification, and for applying the general requirements about variable consideration to some contract modifications, may change the timing of recognition of revenue from claims and variations. Whether the new guidance will accelerate or defer revenue recognition will depend on the specific facts and circumstances of the contract.

Comparison with current U.S. GAAP

New general framework replaces specific guidance

605-35-15

Current U.S. GAAP on long-term construction- and production-type contracts includes guidance for unpriced change orders, contract options and additions, and claims. The new standard replaces this guidance with general guidance on contract modifications that applies to all entities, including those whose contracts were previously outside the scope of the guidance on construction- and production-type contracts. The new guidance also applies to contracts where performance obligations are satisfied at a point in time, over time, or a combination of both.

605-35-25-25, 25-28,
25-87

Unpriced change orders arise when the work to be performed is defined, but the adjustment to the contract price is to be negotiated later. Under current U.S. GAAP, unpriced change orders are reflected in the accounting for a contract if recovery is probable. Some of the factors to consider in evaluating whether recovery is probable include:

- the customer's written approval of the scope of the change order;
- separate documentation for change order costs that are identifiable and reasonable; and
- the entity's experience in negotiating change orders, especially as they relate to the specific type of contract and change orders being evaluated.

605-35-25-30 to 25-31

Currently, a claim is included in contract revenue if it is probable that the claim will result in additional contract revenue that can be reliably estimated. This requirement is satisfied if all of the following conditions exist:

- the contract or other evidence provides a legal basis for the claim, or a legal opinion has been obtained;
- additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance;
- costs associated with the claim are identifiable or otherwise determinable; and
- the evidence supporting the claim is objective and verifiable.

The contract modification guidance in the new standard requires an entity to assess whether the modification creates new, or changes, enforceable rights and obligations. Similar to current U.S. GAAP, this assessment includes an evaluation of the collectibility of the consideration for an unpriced change order or claim; however, a number of additional criteria included in the new standard also need to be considered when evaluating whether a contract modification exists. These criteria may or may not have been incorporated into an entity's evaluation of the probability of recovery under current U.S. GAAP, and may therefore change the timing of revenue associated with contract modifications. For example, when determining whether and when to recognize revenue from contract claims, an entity should consider whether there are differences between there being a legal basis for a claim and the modification being legally enforceable.

7.2

Accounting for a contract modification

606-10-25-12
[IFRS 15.20]

606-10-25-13
[IFRS 15.21]

Requirements of the new standard

To faithfully depict the rights and obligations arising from a modified contract, the new standard requires that an entity accounts for modifications either on a prospective basis (when the additional goods or services are distinct) or on a cumulative catch-up basis (when the additional goods or services are not distinct).

A contract modification is treated as a separate contract (prospective treatment) if the modification results in:

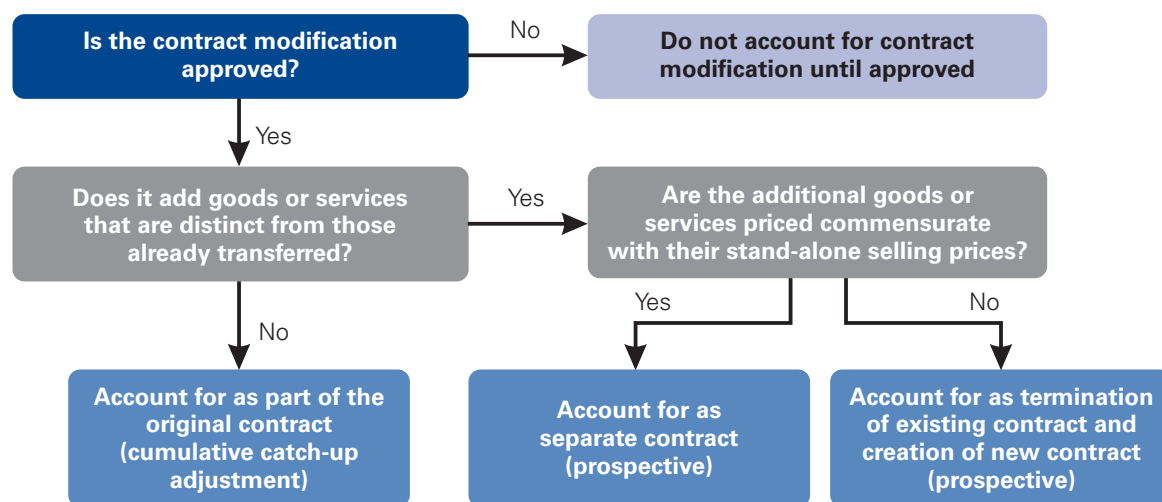
- a promise to deliver additional goods or services that are distinct (see 5.2.1); and
- an increase to the price of the contract by an amount of consideration that reflects the entity's stand-alone selling price of those goods or services adjusted to reflect the circumstances of the contract.

If these criteria are not met, the entity's accounting for the modification is based on whether the remaining goods or services under the modified contract are distinct from those goods or services transferred to the customer before the modification. If they are distinct, the entity accounts for the modification as if it were a termination of the existing contract and the creation of a new contract. In this case, the entity does not reallocate the change in the transaction price to performance obligations that are completely or partially satisfied on or before the date of the contract modification. Instead, the modification is accounted for prospectively and the amount of consideration allocated to the remaining performance obligations is equal to:

- the consideration included in the estimate of the transaction price of the original contract that has not been recognized as revenue; plus or minus
- the increase or decrease in the consideration promised by the contract modification.

If the modification to the contract does not add distinct goods or services, the entity accounts for the modification on a combined basis with the original contract, as if the additional goods or services were part of the initial contract – i.e., a cumulative catch-up adjustment. The modification is recognized as either an increase in or reduction to revenue at the date of modification.

The key decision points to consider when determining whether a contract modification should be accounted for prospectively or through a cumulative catch-up adjustment are illustrated in the flow chart below.



606-10-32-45
(IFRS 15.90)

If the transaction price changes after a contract modification, an entity applies the guidance on changes in the transaction price (see 5.4.3).

Example 32

Contract modified to include additional goods or services

Construction Company G enters into a contract with Customer M to build a road for a contract price of 1,000. During the construction of the road, Customer M requests that a section of the road be widened to include two additional lanes. Construction Company G and Customer M agree that the contract price will be increased by 200.

In evaluating how to account for the contract modification, Construction Company G first needs to determine whether the modification adds distinct goods or services.

- If the road widening is not distinct from the construction of the road, then it becomes part of a single performance obligation that is partially satisfied at the date of the contract modification, and the measure of progress is updated using a cumulative catch-up method.
- If the road widening is distinct, then Construction Company G needs to determine whether the additional 200 is commensurate with the stand-alone selling price of the distinct good.
 - If the 200 reflects its stand-alone selling price, then construction of the additional two lanes is accounted for separately from the original contract for construction of the road. This will result in prospective accounting for the modification as if it were a separate contract for the additional two lanes.
 - If the 200 does not reflect its stand-alone selling price, then the agreement to construct the additional two lanes is combined with the original agreement to build the road and the unrecognized consideration is allocated to the remaining performance obligations. Revenue is recognized when or as the remaining performance obligations are satisfied – i.e., prospectively.

Observations

Different approaches for common types of contract modifications

To determine the appropriate accounting under the new standard, an entity will need to evaluate whether the modification adds distinct goods or services, and, if so, whether the prices of those distinct goods or services are commensurate with their stand-alone selling prices. This determination will depend on the specific facts and circumstances of the contract and the modification, and may require significant judgment.

Companies entering into construction-type contracts or project-based service contracts (e.g., a service contract with a defined deliverable such as a valuation report) may often account for contract modifications on a combined basis with the original contract; however, modifications to other types of contracts for goods (e.g., a sale of a number of distinct products) or services (e.g., residential television or internet services, or hardware/software maintenance services) may often result in prospective accounting.

ASU 2014-09 BC115
[IFRS 15.BC115]

Distinct goods or services in a series that are treated as a single performance obligation are considered separately

When applying the contract modifications guidance in the new standard to a series of distinct goods or services that is accounted for as a single performance obligation, an entity considers the distinct goods or services in the contract, rather than the single performance obligation.

Interaction of new contracts with pre-existing contracts needs to be considered

Any agreement with a customer where there is a pre-existing contract with an unfulfilled performance obligation may need to be evaluated to determine whether it is a modification of the pre-existing contract.

Comparison with current IFRS

Similarities to current practice

[IAS 11.13 to 14]

Although current IFRS does not include general guidance on the accounting for contract modifications, IAS 11 includes specific guidance on the accounting for contract claims and variations. When a claim or variation is recognized, the entity revises its measure of contract progress or contract price. Because the basic approach in IAS 11 is that the entity reassesses the cumulative contract position at each reporting date, this effectively results in a cumulative catch-up adjustment, although IAS 11 does not use this term.

[IAS 11.9]

Conversely, if an entity enters into a new construction contract with a customer that does not meet the contract combination criteria in IAS 11, then the entity accounts for the new construction contract as a separate contract. This outcome arises under the new standard when a contract modification adds a distinct good or service at its stand-alone selling price.

Comparison with current U.S. GAAP

Potential changes in practice for some entities

605-35-25-27

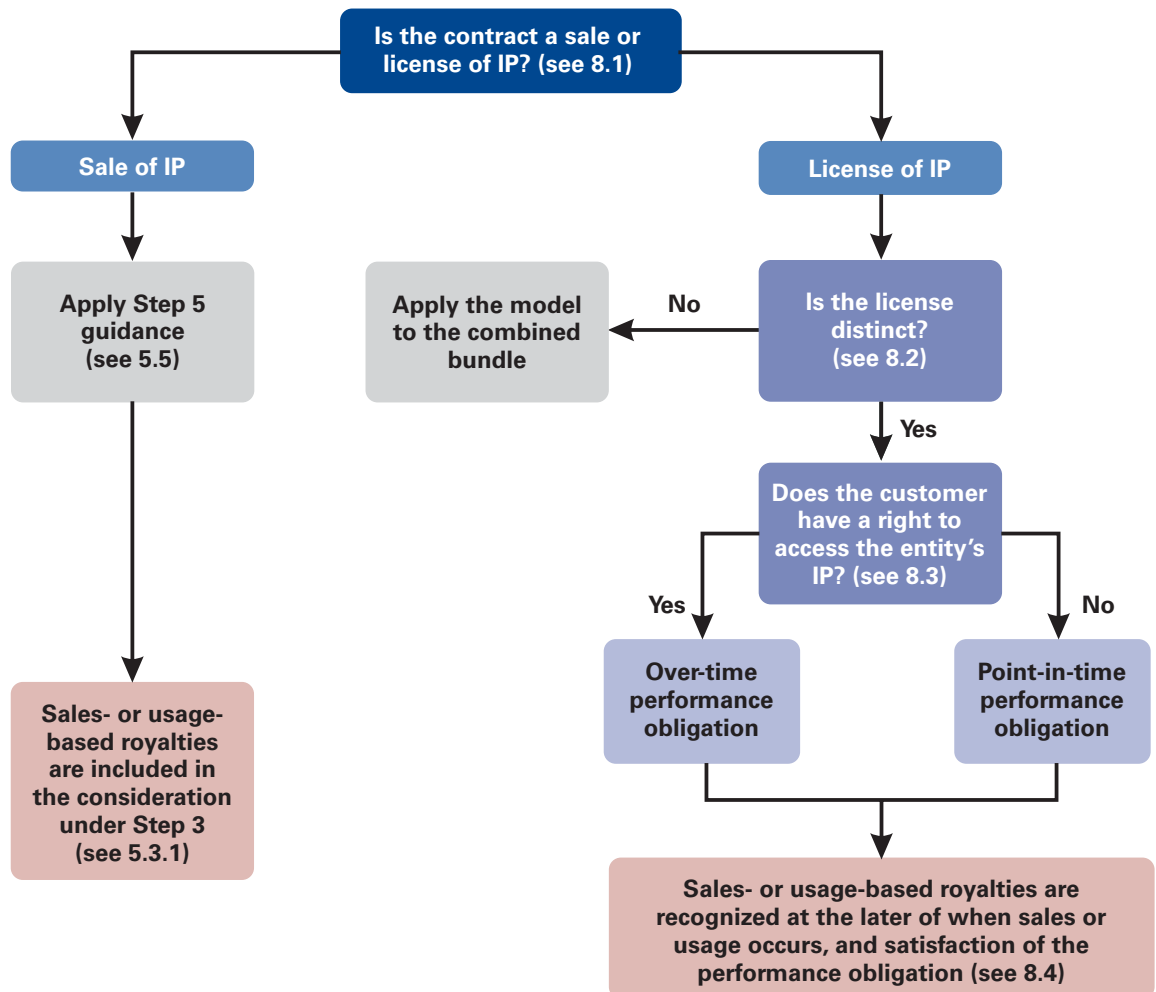
Current U.S. GAAP contains very limited guidance on the accounting for contract modifications other than for contracts that are in the scope of the guidance for construction- and production-type contracts. Entities with long-term construction- and production-type contracts generally account for contract modifications on a cumulative catch-up basis – i.e., updating their measure of progress under the contract for the effects of the modification. For contracts that are in the scope of other ASC Subtopics, practice may be mixed. Because the new standard provides guidance that applies to all contracts with customers, practice under U.S. GAAP is likely to change for some entities.

8 Licensing

Overview

The new standard provides specific application guidance on when to recognize revenue for distinct licenses of intellectual property (IP). If the license is not distinct from other promised goods or services in the contract, then the general model is applied. Otherwise, an entity assesses the nature of the license to determine whether to recognize revenue at a point in time or over time. However, an exception exists for sales- or usage-based royalties on licenses of IP.

The following decision tree summarizes the application of Step 5 of the model to licenses of IP under the new standard.



8.1 Licenses of intellectual property

606-10-55-54
[IFRS 15.B52]

Requirements of the new standard

A license establishes a customer's rights to the IP of another entity. Examples of IP licenses include:

- software and technology;
- franchises;
- patents and trademarks;
- movies, music, and video games; and
- scientific compounds.

Observations

Different accounting for a license and sale of IP

A license establishes a customer's rights to a licensor's IP and its obligations to provide those rights. In general, the transfer of control to all of the worldwide rights on an exclusive basis in perpetuity for all possible IP applications may be considered to be a sale. If the transferor limits the use of the IP – e.g., by geographic area, length of use, or type of application – or if substantial rights to the IP have not been transferred, then the transfer is generally a licensing arrangement.

If a transaction represents a sale of IP, then it is subject to the applicable steps of the new revenue recognition model. This includes applying the guidance on variable consideration and the constraint to any sales- or usage-based royalties. Conversely, specific application guidance is available for recognizing revenue from licensing transactions, including sales- or usage-based royalties (see 8.4).

No definition of intellectual property

The term 'intellectual property' is not defined in the new standard. In some cases, it will be clear that an arrangement includes IP – e.g., a trademark. In other cases, it may be less clear and the accounting may be different depending on that determination. Therefore, an entity may need to apply judgment to determine whether the guidance on licenses applies to an arrangement.

8.2 Determining whether a license is distinct

606-10-55-55
[IFRS 15.B53]

Requirements of the new standard

A contract to transfer a license to a customer may include promises to deliver other goods or services in addition to the promised license. These promises may be specified in the contract or implied by an entity's customary business practices.

606-10-55-56 to 55-57
[IFRS 15.B54 to B55]

ASU 2014-09 BC406
[IFRS 15.BC406]

Consistent with other types of contracts, an entity applies Step 2 of the model (see 5.2) to identify each of the performance obligations in a contract that includes a promise to grant a license in addition to other promised goods or services. This includes an assessment of:

- whether the customer can benefit from the license on its own or together with other resources that are readily available; and
- whether the license is separately identifiable from other goods or services in the contract.

If a license is not distinct, an entity recognizes revenue for the single performance obligation when or as the combined goods or services are transferred to the customer. An entity applies Step 5 of the model (see 5.5) to determine whether the performance obligation containing the license is satisfied over time or at a point in time.

Examples of licenses that are not distinct include the following.

Type of license	Example
License that forms a component of a tangible good and is integral to the functionality of the good	Software embedded in the operating system of a car
License from which the customer can benefit only in conjunction with a related service	Software related to online storage services that can only be used by accessing the entity's infrastructure

If a license is distinct from the other promised goods or services, and is therefore a separate performance obligation, then an entity applies the criteria in the application guidance to determine whether the license transfers to a customer over time or at a point in time (see 8.3).

Observations

Assessing whether a license is distinct may require significant judgment

The evaluation of whether a license is distinct is often complex and requires assessment of the specific facts and circumstances that are relevant to a contract. The new standard provides illustrative examples that may be helpful in evaluating some specific fact patterns.

606-10-55-141 to 55-150
[IFRS 15.IE49 to IE58]

Example and industry	Type of contract	Description	Observations
Example 11 Technology	Contract to transfer a software license, installation services, and unspecified software updates and technical support	Two cases are provided to illustrate differences in identifying performance obligations depending on whether the software will be substantially customized or modified as part of the installation services	Installation services involving the customization or modification of a software license may result in a conclusion that the license is not distinct Determining whether installation services involve significant customization or modification may require significant judgment
Example 55 Technology	Contract to license IP related to the design and production processes for a good	The customer is contractually required to obtain updates for new designs or production processes The updates are essential to the customer's ability to use the license, the entity does not sell the updates separately, and the customer does not have the option to purchase the license without the updates The example concludes that the license and the updates are highly interrelated and that the promise to grant the license is not distinct	There may be diversity in views about the kinds of technology to which the fact pattern, analysis, and outcome may apply in practice

606-10-55-364 to 55-366
[IFRS 15.IE278 to IE280]

606-10-55-367 to 55-374
[IFRS 15.IE281 to IE288]

Example and industry	Type of contract	Description	Observations
Example 56 Life sciences	Contract to license patent rights to an approved drug, which is a mature product, and to manufacture the drug for the customer	Two cases are provided, to illustrate differences in identifying performance obligations depending on whether the manufacturing process is unique or specialized, whether the license can be purchased separately, or whether other entities can also manufacture the drug	Manufacturing services that can be provided by another entity are an indication that the customer can benefit from a license on its own

The examples highlight the potential difficulty of determining whether services and IP are highly dependent on, or highly interrelated with, each other. For example, an entity may license a video game and provide additional online services that are not sold on a stand-alone basis. The entity will need to determine the degree to which the service is interrelated with the video game. The entire arrangement may be a single performance obligation, or alternatively, if the video game can be used on a stand-alone basis without the additional online services, they may be separate performance obligations.

License may be primary or dominant component of goods or services transferred to customer

ASU 2014-09 BC406 to BC407
[IFRS 15.BC406 to BC407]

In some cases when a license is not distinct, the Boards believe that the combined goods or services transferred to the customer may have a license as their primary or dominant component. When the output that is transferred is a license, or when the license is distinct, the entity evaluates the nature of the license based on the new standard's application guidance. However, 'primary' and 'dominant' are not defined in the new standard, and there may be diversity in views about how this will be applied in practice. The TRG discussed this concept in its discussion of sales- or usage-based royalties at its first meeting in July 2014. For further discussion, see 8.4.

Comparison with current IFRS

Similarities to current practice

[IAS 11.7 to 10;
IAS 18.13]

Current IFRS does not contain specific guidance on separating a license of IP from other components of an arrangement. Instead, a transaction involving a transfer of rights to IP is subject to the general guidance on combining and segmenting contracts, and identifying separate components within a contract that applies to other revenue-generating transactions.

As discussed in 5.2, the new standard's guidance on identifying distinct goods or services is more detailed and more prescriptive than the guidance on identifying separate components under current IFRS. This is likely to increase the consistency with which a license component is separated from other goods or services in the arrangement.

Comparison with current U.S. GAAP

Software licenses

985-605; 606-10-55-54
to 55-64

Under current U.S. GAAP, software licenses are potentially separate units of account unless the services constitute the significant modification, customization, or production of the software that are essential to the functionality of that software. If the separation criteria are met, the license may still not be separated from the other services unless the entity has VSOE of the stand-alone selling price of the undelivered elements.

It is unclear whether the new standard's guidance on whether a license is distinct within the context of the contract is intended to yield a similar analysis to the current evaluation of whether the services are essential to the functionality of the software. Therefore, it is possible that there will be instances in which services are combined with the license under the new standard where they are not combined under current U.S. GAAP.

If the services and license are determined to be distinct under the new standard, there is no additional requirement that the entity has VSOE of the stand-alone selling price of the undelivered elements – e.g., the implementation services, telephone support, or unspecified upgrades – to separate those services from the license. As a consequence, if the license and services are distinct, the new standard will result in more cases where the revenue attributable to a license is recognized separately from the other goods or services in an arrangement than under current U.S. GAAP.

Cloud-computing arrangements

985-605-55-121 to
55-123

Under current U.S. GAAP, an entity evaluates cloud-computing arrangements to determine whether the customer has the right to take possession of the software at any time without incurring a significant financial or functional penalty during the hosting period. If so, the arrangement includes both a software license and a hosting service. If not, the arrangement is entirely a hosting service.

The new standard, by way of an example, states that a license from which the customer can benefit only in conjunction with a related service – e.g., an online hosting service provided by the entity – is not distinct from the hosting service. In addition, it may be that the hosting service is highly interrelated with the software, even if the customer may take possession of the software. Depending on the specific facts and circumstances of an arrangement, it is possible that for some arrangements that are hosting services under current U.S. GAAP, the software license is not distinct from the hosting services under the new standard.

Pharmaceutical arrangements

Under current U.S. GAAP, a biotech entity evaluates whether a drug license has stand-alone value apart from R&D services. The analysis often requires an evaluation of any contractual limitations on the license – e.g., for sub-licensing – and whether the services are highly specialized or proprietary. If a customer is contractually restricted from reselling the technology, the fact that the R&D services are not proprietary and can be performed by other entities is an indication that the license has stand-alone value. Under the new standard, in arrangements to transfer a biotech license and provide R&D services, both the license and R&D services are evaluated to determine whether they are distinct. It is unclear whether the new standard's guidance on whether a license is distinct within the context of the contract will result in a conclusion similar to current practice – i.e., to what extent substantive contractual prohibitions on the ability to sub-license, and the requirement for the entity to provide R&D services, will impact the assessment.

8.3 Determining the nature of a distinct license

606-10-55-58
[IFRS 15.B56]

606-10-55-59
[IFRS 15.B57]

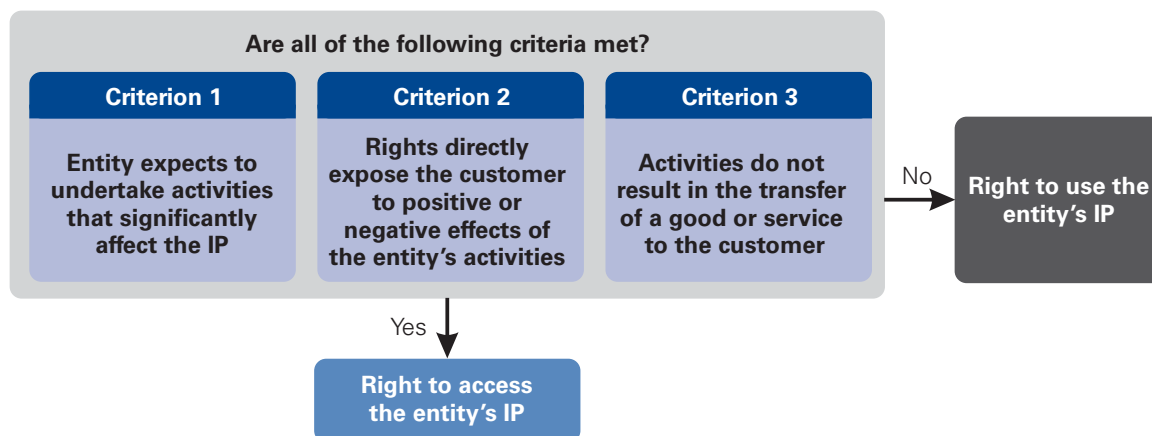
606-10-55-60
[IFRS 15.B58]

Requirements of the new standard

A distinct license of IP is treated as a separate performance obligation and an entity applies specific criteria to determine whether the license represents a right to:

- access the entity's IP as it exists throughout the license period; or
- use the entity's IP as it exists at a point in time.

To determine the nature of the license, an entity considers whether the entity continues to be involved with the IP and undertakes activities that significantly affect the IP to which the customer has rights. This is not the case when the customer can direct the use of, and obtain substantially all of the remaining benefits from, a license at the point in time at which it is granted. To make this assessment an entity considers three criteria. If all three are met, the nature of the entity's promise is to provide the customer with the right to access the entity's IP.



606-10-55-61
[IFRS 15.B59]

To determine whether a customer may reasonably expect the entity to undertake activities that significantly affect the IP, the entity should consider its customary business practices, published policies, and specific statements, and whether there is a shared economic interest between the entity and the customer.

606-10-55-64
[IFRS 15.B62]

The following factors are not considered when applying the above criteria:

- restrictions of time, geography, or use of the license; and
- guarantees provided by the licensor that it has a valid patent to the underlying IP and that it will maintain and defend that patent.

606-10-55-62
[IFRS 15.B60]

When the nature of the license is a right to access the entity's IP, it is a performance obligation satisfied over time. The guidance in Step 5 of the model is used to determine the pattern of transfer over time (see 5.5.3).

606-10-55-63
[IFRS 15.B61]

When the license represents a right to use the entity's IP, it is a performance obligation satisfied at the point in time at which the entity transfers control of the license to the customer. The evaluation of when control transfers is made using the guidance in Step 5 of the model (see 5.5.4). However, revenue cannot be recognized for a license that provides a right to use the entity's IP before the beginning of the period during which the customer is able to use and benefit from the IP.

Example 33**Assessing the nature of a license**

Software Company X licenses a software application to Customer Y. Under the agreement, the underlying code and its functionality remain unchanged during the license period because they are saved and maintained by Customer Y for the duration of the license term. Software Company X issues regular updates or upgrades that Customer Y can choose to install. In addition, the activities of Software Company X in providing updates or upgrades transfer a promised good or service to Customer Y – i.e., when-and-if available upgrades – and are therefore not considered in determining the nature of the license granted to Customer Y. In this example, the software license is a right to use because the activities do not change Customer Y's IP under the current license and those activities transfer a promised good or service.

Observations**Some factors are not considered to differentiate the nature of a license**

ASU 2014-09 BC411
[IFRS 15.BC411]

The Boards believe that provisions in a license arrangement relating to exclusive rights, restrictions relating to time, and extended payment terms will not directly affect the assessment as to whether the IP license is satisfied at a point in time or over time.

Franchise licenses may provide a right to access

606-10-55-375 to 55-382
[IFRS 15.IE289 to IE296]

It is generally believed that, under the new standard, franchise rights may be considered to provide a right to access the underlying IP. This is because the franchise right is typically affected to some degree by the licensor's activities of maintaining and building its brand. For example, the licensor generally undertakes activities to analyze changing customer preferences and enact changes to the IP – e.g., product improvements – to which the customer has rights. Example 57 of the new standard illustrates a 10-year franchise arrangement in which the entity concludes that the license provides access to its IP throughout the license period.

Significant complexity and judgment in assessing whether the ongoing activities of the licensor affect the IP licensed to the customer

The evaluation under the new standard of whether the ongoing activities of the licensor significantly affect the IP to which the customer has rights is complex, and requires significant judgment in evaluating the individual facts and circumstances.

The evaluation could be particularly challenging for entertainment and media companies. The following questions illustrate situations that may be complex and require significant judgment:

- whether the ongoing efforts to produce subsequent seasons of a television series are viewed as an activity that could significantly positively or negatively affect the licensed IP relating to completed seasons; and
- whether a license of a sports team's logo is impacted by its ongoing activities to field a competitive team during the license term.

Based on discussions at the first TRG meeting in July 2014, there appears to be some diversity in views about how this criterion should be evaluated. It is possible that the TRG will be asked to consider this issue at a subsequent meeting.

ASU 2014-09 BC409
[IFRS 15.BC409]

Does the licensor consider its cost and effort to undertake activities?

Criterion 2, which concerns the customer being exposed to the effects of the licensor's activities, emphasizes the fact that it is not sufficient for the entity to undertake significant activities as described in Criterion 1. These activities also have to directly expose the customer to their effects. When the activities do not affect the customer, the entity is merely changing its own asset – and although this may affect the entity's ability to provide future licenses, it does not affect the determination of what the license provides to the customer or what the customer controls. Because Criterion 2 focuses on shared risks between the entity and the customer, it further raises the question, discussed above, about whether Criterion 1's focus should be determined by whether the activities are changing the underlying IP or merely its value to the customer.

606-10-55-383 to 55-388
[IFRS 15.IE297 to IE302]

Example 58 of the new standard illustrates that when making this assessment, an entity should focus on whether its activities directly affect the IP already licensed to the customer – e.g., updated character images in a licensed comic strip – rather than the significance of the cost and effort of the entity's ongoing activities. Similarly, in the earlier observation involving a media company licensing completed seasons and simultaneously working on subsequent seasons, the evaluation would focus on whether those subsequent seasons affect the IP associated with the licensed season, and not merely on the significance of the cost or efforts involved in developing the subsequent seasons.

ASU 2014-09 BC410
[IFRS 15.BC410]

Only consider licensor's activities that do not transfer a good or service to the customer

Criterion 3, which concerns the licensor's activities not transferring a good or service to the customer, emphasizes the fact that the activities that may affect the IP do not by themselves transfer a separate good or service to the customer as they occur. In some respects, Criterion 3 might be seen as stress-testing the conclusion that the license is distinct from the other goods or services in the contract. If all of the activities that may significantly affect the IP are goods or services that are distinct from the license, it is more likely that the performance of those other goods or services will transfer a separate good or service to the customer, and that this criterion will not be met. This will result in the license being a point-in-time performance obligation.

For example, a contract that includes a software license and a promise to provide a service of updating the customer's software does not, without evaluating other factors, result in a conclusion that the licensor is undertaking activities that significantly affect the IP to which the customer has rights. This is because the provision of updates constitutes the transfer of an additional good or service to the customer.

Comparison with current IFRS

The pattern of revenue recognition from licenses may change

[IAS 18.IE18 to IE20]

Under current IFRS, license fees and royalties are recognized based on the substance of the agreement.

In some cases, license fees and royalties are recognized over the life of the agreement, similar to over-time recognition under the new standard. For example, fees charged for the continuing use of franchise rights may be recognized as the rights are used. IAS 18 gives the right to use technology for a specified period of time as an example of when, as a practical matter, license fees and royalties may be recognized on a straight-line basis over the life of the agreement.

In other cases, if the transfer of rights to use IP is in substance a sale, the entity recognizes revenue when the conditions for a sale of goods are met, similar to point-in-time recognition under the new standard. This is the case when the entity assigns rights for fixed consideration and has no remaining obligations to perform, and the licensee is able to exploit the rights freely. IAS 18 includes two examples of when this may be the case:

- a licensing agreement for the use of software when the entity has no obligations after delivery; and
- the granting of rights to distribute a motion picture in markets where the entity has no control over the distributor and does not share in future box office receipts.

Although these outcomes are similar to over-time and point-in-time recognition under the new standard, an entity is required to review each distinct license to assess the nature of the license under the new standard. It is possible that revenue recognition will be accelerated or deferred compared with current practice, depending on the outcome of this assessment.

Comparison with current U.S. GAAP

The pattern of revenue recognition from licenses may change

Current U.S. GAAP contains industry-specific guidance for licenses in certain industries – e.g., films, music, software, and franchise rights. For other licenses – e.g., patents, trademarks, copyrights, and pharmaceutical and biotechnology applications – and for other intangible assets, there is no specific U.S. GAAP guidance about whether license revenue is recognized over the license term or at inception of the license period. Current SEC guidance indicates that revenue for licenses of IP is recognized: “in a manner consistent with the nature of the transaction and the earnings process”.

As a consequence, for licenses for which there is no specific current U.S. GAAP guidance, there is diversity in practice as entities evaluate their particular facts and circumstances to conclude what manner of revenue recognition is consistent with the nature of the transaction and the earnings process. Therefore, the new standard could change current practice for entities following specialized industry guidance, as well as other entities with an accounting policy for recognizing license revenue that differs from the application of Criteria 1, 2, and 3 in the new standard. In addition, because the criteria for concluding that a license is distinct in Step 2 of the model differ from some current industry-specific guidance, the outcome under the new standard could differ from current practice.

Industry	Guidance
Franchisors	Under current U.S. GAAP, the up-front franchise fee is recognized as revenue when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor (which is often when the store opens). Example 57 of the new standard suggests that distinct franchise licenses will often meet the access criteria, and therefore the up-front fee may be recognized over the term of the franchise agreement.

926-605; 928-605;
952-605; 985-605;
SEC SAB Topic 13;
606-10-55-54 to 55-64

Industry	Guidance
Technology and software	<p>If the license is distinct, applying the criteria in the new standard may often accelerate revenue because the entity no longer needs to have VSOE of the undelivered elements to separately recognize revenue for the delivered software license (which will generally be a right-to-use license under the new standard).</p> <p>If payment of a significant portion of the licensing fee is not due until after the expiration of the license or more than 12 months after delivery, the arrangement fee under current U.S. GAAP is presumed not to be fixed or determinable, and revenue is generally recognized when the amounts are due and payable. Under the new standard, extended payment terms may not preclude up-front revenue recognition; however, entities will need to determine whether the arrangement contains a significant financing component (see 5.3.2).</p>
Pharmaceutical arrangements	<p>Under current U.S. GAAP, when an entity licenses a compound that has stand-alone value, revenue is recognized either at the point of delivery or over the license period, depending on the entity's assessment of the nature of the transaction and the earnings process. Under the new standard, if a pharmaceutical license is distinct, then determining its nature will likely involve significant judgment based on the characteristics of the licensing arrangement, including whether it is an early-stage or mature application related to the IP.</p> <p>Certain distribution licenses may be akin to franchise licenses if:</p> <ul style="list-style-type: none"> • they require the distributor to sell and/or produce only the most recent version of the licensed drug product; but • the license is for a drug product that is not mature and the license will be satisfied over the license term. <p>However, in some of these arrangements the other services – e.g., R&D – may not be distinct from the license, and therefore the guidance on licenses may not apply.</p> <p>Conversely, a license for a mature drug that is commercially ready for sale and requires no significant additional activities by the licensor may qualify as a license transferred at a point in time.</p>
Entertainment and media companies	<p>Under current U.S. GAAP, film licensors recognize revenue on:</p> <ul style="list-style-type: none"> • the existence of persuasive evidence of an arrangement; • the film being complete and delivered or available for delivery; • the license period having commenced; • the arrangement fee being fixed or determinable; and • collection being reasonably assured. <p>Under the new standard, significant judgment will be required to evaluate whether a distinct film or television show license qualifies as a right to use or a right to access the film-related IP.</p>

8.4 Sales- or usage-based royalties

606-10-55-65
[IFRS 15.B63]

Requirements of the new standard

For sales- or usage-based royalties that are attributable to a license of IP, the amount is recognized at the later of:

- when the subsequent sale or usage occurs; and
- the satisfaction or partial satisfaction of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.

Observations

Exception for sales- or usage-based royalties aligns accounting for different license types

A key practical effect of the exception for sales- or usage-based royalties is that it may reduce the significance of the distinction between the two types of licenses. In particular, if the consideration for a license consists solely of a sales- or usage-based royalty, then an entity is likely to recognize it in the same pattern, irrespective of whether the license is an over-time or point-in-time performance obligation.

Applicability of exception for sales- or usage-based royalty unclear

Licenses of IP are often bundled with other goods or services, with the consideration taking the form of a sales- or usage-based royalty for all goods or services in the contract. For example:

- software licenses are commonly sold with PCS, other services – e.g., hosting or implementation services – or hardware where there is a composite consideration in the form of a sales- or usage-based royalty;
- franchise licenses are frequently sold with consulting or training services or equipment, with ongoing consideration in the form of a sales-based royalty;
- biotechnology and pharmaceutical licenses are often sold with R&D services and/or a promise to manufacture the drug for the customer, with composite consideration in the form of a sales-based royalty; or
- licenses to digital media, with composite consideration in the form of a sales-based royalty.

At its first meeting in July 2014, the TRG discussed three possible alternative views on the applicability of the exception for sales- or usage-based royalties.

Alternative	Description
A	The exception applies to all licensing transactions, even if the royalty also relates to another non-license good or service
B	The exception only applies when the royalty relates solely to a license and that license is a separate performance obligation
C	The exception applies when the royalty relates: <ul style="list-style-type: none"> • solely to a license of IP; or • to a license and one or more other non-license goods or services, but the license is the primary or dominant component to which the royalty relates

In addition, when either the sales- or the usage-based royalty does not solely relate to the license, or the license is not a primary or dominant component, there are diverse views about whether that royalty needs to be allocated into portions that qualify for the exception and those that do not.

606-10-55-378 to 55-379
[IFRS 15.IE292 to IE293]

Example 57 of the new standard indicates that a sales- or usage-based royalty is allocated among the performance obligations in the contract using the guidance in Step 4 of the model (see 5.4).

Which payments qualify for the sale- or usage-based royalty exception?

In some cases, it may not be clear whether the payment structure qualifies for the sales- or usage-based royalty exception. For example, arrangements in the life sciences industry often include a license of IP to a drug and an obligation to perform R&D services, with a substantial portion of the fee being contingent on achieving milestones such as regulatory approval of the drug. The entity will need to determine whether the milestone fee falls within the exception from estimating a sales- or usage-based royalty, considering the diversity of views above.

A software entity may have an arrangement with payments that change depending on the usage by the customer or may be fixed for a wide range of users. For example, the royalty per user may be 10 for the first 1,000 users but then 8 for the next 1,000 users. Alternatively, the royalty may be fixed at 100,000 for the first 1,000 users and then increase to 190,000 for up to 2,000 users, etc. There seem to be differing views as to whether the usage-based exception was meant to apply to these fact patterns.

Comparison with current IFRS

[IAS 18.IE20]

Under current IFRS, if receipt of a license fee or royalty is contingent on a future event, an entity recognizes revenue only when it is probable that the fee or royalty will be received. This is normally when the future event triggering the payment of the fee or royalty occurs.

In many cases, the accounting outcome under the new standard's exception for a sales- or usage-based royalty will be the same as under current IFRS. However, the new standard prohibits the recognition of a sales- or usage-based royalty until the sale or usage occurs, even if the sale or usage is probable. Therefore, an entity that currently recognizes a sales- or usage-based royalty before the sale or usage occurs, on the grounds that receipt is probable, will recognize revenue later under the new standard.

As noted in the observation above, it is not always clear when the new standard's exception for a sales- or usage-based royalty will apply. This is not generally an issue under current IFRS, which applies more widely to any license fee or royalty that is contingent on a future event.

*SEC SAB Topic 13;
605-28*

Comparison with current U.S. GAAP

Under current U.S. GAAP, a sales- or usage-based royalty – irrespective of whether it relates to the licensing of IP or other goods or services – is recognized only on subsequent sale or usage. This is because the fee is not fixed or determinable until that point. In addition, current U.S. GAAP specifies that substantive milestone fees may be recognized once the milestone is achieved.

Under the new standard, the portion of the sales- or usage-based royalty that is attributable to the non-license element of the arrangement may be included in the arrangement consideration sooner than under current U.S. GAAP.

9 Sale or transfer of nonfinancial assets that are not part of an entity's ordinary activities

Overview

Certain aspects of the new standard apply to the sale or transfer of nonfinancial assets, such as intangible assets and property, plant, and equipment that are not an output of the entity's ordinary activities – i.e., transactions that are not with customers. Although the guidance under the new standard is converged, differences remain in the accounting for some sales and transfers of nonfinancial assets under IFRS and U.S. GAAP, including assessing when to apply the derecognition guidance.

9.1 General requirements

Requirements of the new standard

610-20
 [IAS 16; IAS 38; IAS 40]

When an entity sells or transfers a nonfinancial asset that is not an output of its ordinary activities, it derecognizes the asset when control of that asset transfers to the recipient, using the guidance on transfer of control in the new standard (see 5.5.1).

The resulting gain or loss is the difference between the transaction price measured under the new standard (using the guidance in Step 3 of the model) and the asset's carrying amount. In determining the transaction price (and any subsequent changes to the transaction price), an entity considers the guidance on measuring variable consideration – including the constraint, the existence of a significant financing component, noncash consideration, and consideration payable to a customer (see 5.3).

The resulting gain or loss is not presented as revenue. Likewise, any subsequent adjustments to the gain or loss – e.g., as a result of changes in the measurement of variable consideration – are not presented as revenue.

Observations

Judgment required to identify ordinary activities

ASU 2014-09 BC53
 [IFRS 15.BC53]

Under the new standard, a 'customer' is defined as a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. Because 'ordinary activities' is not defined, evaluating whether the asset transferred is an output of the entity's ordinary activities may require judgment. An entity may consider how 'ordinary activities' is currently interpreted in the FASB's *Statements of Financial Accounting Concepts* and the IASB's *Conceptual Framework for Financial Reporting*.

In many cases, this judgment will be informed by the classification of a nonfinancial asset – e.g., an entity that purchases a tangible asset may assess on initial recognition whether to classify the asset as property, plant, and equipment or as inventory. Typically, the sale or transfer of an item that is classified as property, plant, and equipment will result in a gain or loss that is presented outside of revenue, while the sale or transfer of inventory will result in the recognition of revenue.

Accounting for a non-current or long-lived nonfinancial asset held for sale may result in a gain or loss on transfer of control because consideration may differ from fair value

360-10

[IFRS 5]

When the carrying amount of a non-current nonfinancial asset is expected to be recovered principally through a sale (rather than from continuing use), the asset is classified as held for sale if certain criteria are met.

610-20-55-2 to 55-4

The new standard does not amend the current measurement and presentation guidance applicable to non-current assets that are held for sale. Under this guidance, assets that are held for sale are measured at the lower of fair value less costs to sell and the carrying amount, which may differ from the expected transaction price as determined under the new standard. If the sale or transfer includes variable consideration that is constrained under the new standard, then the resulting transaction price that can be recognized could be less than fair value. This could result in the recognition of a loss when control of the asset transfers to the counterparty, even though the carrying amount may be recoverable through subsequent adjustments to the transaction price. In these situations, an entity may consider providing an early warning disclosure about the potential future recognition of a loss.

Little difference in accounting for sales of real estate to customers and noncustomers

610-20; 360-20

[IAS 16; IAS 40]

Because an entity applies the guidance to measure the transaction price for both customer and noncustomer transactions, the difference in accounting for an ordinary (customer) versus a non-ordinary (noncustomer) sale of real estate is generally limited to the presentation in the statement of comprehensive income (revenue and cost of sales, or gain or loss).

Until control of the asset transfers, current U.S. GAAP and IFRS guidance remains applicable for the initial recognition, measurement, and presentation of the assets.

9.2

Application under IFRS

Requirements of the new standard

[IAS 16; IAS 38; IAS 40]

Under the IFRS version of the new standard, the guidance on measurement and derecognition applies to the transfer of a nonfinancial asset that is not an output of the entity's ordinary activities, including:

- property, plant, and equipment in the scope of IAS 16;
- intangible assets in the scope of IAS 38; and
- investment property in the scope of IAS 40.

[IFRS 10; IAS 28]

When calculating the gain or loss on the sale or transfer of a subsidiary or associate, an entity will continue to refer to the guidance in IFRS 10 and IAS 28 respectively.

Example 34

Sale of a single-property real estate entity

[IFRS 3; IFRS 10; IAS 40]

Consulting Company X decides to sell an apartment building to Customer Y. Consulting Company X owns the building through a wholly owned subsidiary whose only asset is the building. The transaction is outside of its ordinary consulting activities. Title transfers to Customer Y at closing and Consulting Company X has no continuing involvement in the operations of the property – e.g., through a leaseback, property management services, or seller-provided financing.

The arrangement consideration includes a fixed amount paid in cash at closing, plus an additional 5% contingent on obtaining a permit to re-zone the property as a commercial property. Consulting Company X believes there is a 50% chance that the re-zoning effort will be successful.

Under IFRS, Consulting Company X applies the deconsolidation guidance in IFRS 10 because the apartment building is housed in a subsidiary.

In this example, the accounting under U.S. GAAP and IFRS may differ if the entity is deemed an in-substance nonfinancial asset under U.S. GAAP. Under IFRS, the seller follows the deconsolidation guidance and measures the contract consideration at fair value. Under U.S. GAAP, if the entity is an in-substance nonfinancial asset, the seller applies the new standard and the variable consideration is subject to the constraint (see 9.3).

Observations

Applying the new standard to the transfer of a group of nonfinancial assets that represents a business may result in different accounting

[IFRS 10.25]

IFRS does not explicitly address how to calculate the gain or loss on the sale of a group of nonfinancial assets that represents a business and is not housed in a subsidiary. Whether an entity currently applies the deconsolidation guidance or IAS 18 is not decisive, because the consideration is measured at fair value under both approaches. However, the approach may differ under the new standard, because an entity applies the guidance on the transaction price – i.e., variable consideration is subject to the constraint, and may therefore be measured at a lower amount than fair value.

No concept of in-substance nonfinancial assets, unlike U.S. GAAP

The consequential amendments to IFRS do not refer to in-substance nonfinancial assets. Therefore, unlike U.S. GAAP, the guidance on deconsolidation applies to a subsidiary and the entity does not assess whether it is an in-substance nonfinancial asset. This may result in different accounting under IFRS and U.S. GAAP for similar transactions.

[IAS 16.68A; IAS 40.58]

Transfers to inventory still possible if specific criteria are met

If an entity sells or transfers an item of property, plant, and equipment or an investment property, it recognizes a gain or loss on disposal outside of revenue. However, in limited circumstances it remains possible that an item may be transferred to inventory before sale, in which case an entity recognizes revenue on disposal – for example:

- an entity that, in the course of its ordinary activities, routinely sells items of property, plant, and equipment that it has held for rental to others transfers these assets to inventory when they cease to be rented and become held for sale; and
- an entity transfers investment property to inventory when there is a change of use evidenced by the start of development with a view to sale.

[IAS 16; IAS 18.14;
IAS 38; IAS 40]**Comparison with current IFRS****Change in timing of derecognition**

Under current IFRS, if an entity sells or transfers an item of property, plant, and equipment, an intangible asset, or an investment property, then it determines the date of disposal by applying the conditions for recognizing a sale of goods under IAS 18 – i.e., it applies a risk-and-reward test to identify the date of disposal. Changing to the new standard's control-based model may result in a change in the date of disposal, if risks and rewards transfer at a different date to control. This may be the case if the consideration includes a deferred or variable payment and the entity retains risks and rewards through that variability.

An entity may also need to assess when control passes in jurisdictions in which the legal process for the sale of real estate includes two or more stages. For example, in some jurisdictions the entity and the counterparty may initially commit to buy and sell a property and fix the transaction price. However, the counterparty will not gain physical possession of the property until a later date – typically, when some or all of the consideration is paid. In such cases, a risk-and-reward-based analysis may result in a different date of disposal than a control-based analysis.

Change in gain or loss on disposal

Under current IFRS, if an entity sells or transfers an item of property, plant, and equipment, an intangible asset, or an investment property, then it measures the consideration received or receivable at fair value. Under the new standard, the entity applies the guidance on the transaction price, including variable consideration and the constraint. This may result in the consideration initially being measured at a lower amount, with a corresponding decrease in any gain – particularly if the constraint applies. In extreme cases, an entity may recognize a loss on disposal even when the fair value of the consideration exceeds the carrying amount of the item immediately before disposal.

9.3 Application under U.S. GAAP

Requirements of the new standard

610-20-40-1

For non-ordinary sales or transfers of nonfinancial assets, an entity applies:

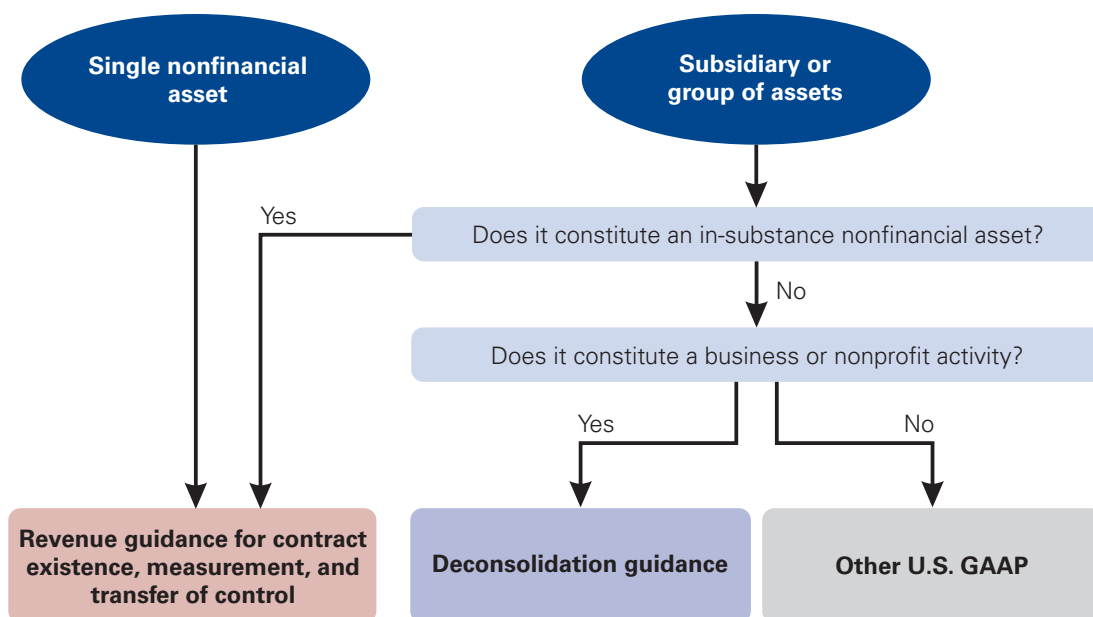
- the transfer of control and measurement guidance under the new standard; and
- the guidance in Step 1 of the model in the new standard to determine whether a contract exists (and, if not, the guidance on the accounting for consideration received in advance of having a contract – see 5.1.2).

610-20-15-2

The guidance for derecognizing nonfinancial assets under U.S. GAAP also extends to derecognizing an ownership interest in a subsidiary (or a group of assets) that is an in-substance nonfinancial asset – e.g., the sale of a subsidiary with just one nonfinancial asset, such as a building or a machine. If the transferred subsidiary (or group of assets) is not an in-substance nonfinancial asset, the entity assesses whether it constitutes a business or nonprofit activity. If it does, then the transaction is in the scope of the deconsolidation guidance.

Topic 860

If the transferred subsidiary (or group of assets) does not constitute an in-substance nonfinancial asset, a business or nonprofit activity, then other U.S. GAAP generally applies – e.g., it may constitute an in-substance financial asset for which the guidance on derecognition of financial assets applies. If no other guidance specifically applies, the deconsolidation guidance is generally applied.



Example 35**Sale of a single-property real estate entity with transaction price including variable consideration***360-10; 810-10*

Consider the same fact pattern as presented in Example 34 of this publication.

Under U.S. GAAP, Company X first assesses whether the entity is an in-substance nonfinancial asset. If so, Company X applies the contract existence, measurement and transfer of control guidance in the new standard. Because the building is the entity's only asset, Company X concludes that it is an in-substance nonfinancial asset.

Company X concludes that a contract exists and that control transfers at closing, and therefore recognizes the sale (and derecognizes the building) at that time.

The 5% fee that is contingent on re-zoning is variable consideration that is subject to the constraint guidance. Company X cannot demonstrate that it is probable that a significant reversal of the transaction price will not occur if the contingent amount is recognized as profit at the date of the sale. Therefore, Company X limits the transaction price to the fixed amount received at closing. Company X will continue to evaluate the variable consideration until final resolution, and will adjust the transaction price (and ultimately true it up) when the contingency is resolved.

Observations**Contract existence may be difficult to establish for some contracts***610-20-40-1;**350-10-40-3;**360-10-40-3C*

Contract existence (and the counterparty's commitment to perform under a contract) may be difficult to establish when the seller provides significant financing to the purchaser. If the arrangement does not meet the requirements for concluding that a contract exists in Step 1 of the model, then the entity continues to report the nonfinancial asset in its financial statements, recognize amortization or depreciation expense (unless it is held for sale), and apply the impairment guidance.

Determining when a subsidiary (or a group of assets) is an in-substance nonfinancial asset requires judgment*610-20; 810-10*

The new standard's guidance on transfers of nonfinancial assets also applies to transfers of in-substance nonfinancial assets. However, it does not define 'in-substance nonfinancial asset' or provide guidance on how an entity should determine whether a subsidiary (or a group of assets) is an in-substance nonfinancial asset.

For example, it is unclear whether the evaluation should:

- be based on the relative fair values of the various assets in the subsidiary (or group of assets); or
- include unrecognized nonfinancial assets – e.g., internally developed intangible assets.

Therefore, this evaluation will often require significant judgment.

Additionally, in some cases a subsidiary (or a group of assets) may be both an in-substance nonfinancial asset and a business – e.g., an operating real estate or technology business. In this case, the guidance on sale or transfer of an in-substance nonfinancial asset appears to take precedence over the guidance on the derecognition of a business. It is therefore unclear when the guidance on the deconsolidation or derecognition of a business applies – i.e., under what circumstances a business will be neither an in-substance nonfinancial asset nor an in-substance financial asset.

Comparison with current U.S. GAAP

Lack of current derecognition guidance

Topic 610

Other than the guidance on the accounting for real estate sales, there is little guidance in current U.S. GAAP on the derecognition of nonfinancial assets that:

- are not an output of an entity's ordinary activities; and
- do not constitute a business or nonprofit activity accounted for under the deconsolidation guidance.

Transfer of in-substance nonfinancial assets

810-10

A sale or transfer of a subsidiary (or a group of assets) that constitutes a business or nonprofit activity continues to be accounted for using deconsolidation guidance only when it does not also constitute a transfer of an in-substance nonfinancial asset.

932-360

In these cases, portions of the new standard apply and may result in differences in the derecognition date and/or the measurement of the gain or loss. In addition, an entity does not apply the new standard to conveyances of oil and gas mineral rights.

Sale-leaseback transactions

360-20; 840-40

The current real estate sale guidance in U.S. GAAP continues to apply to sale-leaseback transactions involving real estate. The current leasing guidance applies to disposals through sale-leaseback transactions involving non-real-estate transactions.

Sales of real estate

360-20

The new standard differs significantly from current U.S. GAAP for sales of real estate. Current U.S. GAAP requires a number of criteria to be met in order to recognize the full amount of profit on a sale of real estate. For example, full profit recognition is not permitted if the seller finances the purchase price and the buyer's initial or continuing investment does not meet specified quantitative thresholds. Under the new standard, as long as it is probable that the seller will collect the consideration to which it expects to be entitled – i.e., a contract exists – revenue or a gain is recognized when control of the property transfers. Although there is no *prescribed* level of initial or continuing investment, the amount of initial or continuing investment will impact the assessment of whether a contract exists – i.e., as it increases there is a greater likelihood that the entity will conclude that a contract exists.

In addition, the new standard changes the effect of continuing involvement by the seller on profit recognition. Continuing involvement under current U.S. GAAP can prevent or delay derecognition of the property and/or affect the pattern of profit recognition on the overall arrangement. Under the new standard, continuing involvement with the transferred property will often be accounted for on its own as either:

- a separate unit of account that is subject to other guidance – e.g., seller guarantees; or
- a separate performance obligation from the transfer of the property – e.g., providing ongoing property management services, support operations, or development services.

For example, in a sale of land that includes a promise of future development, an entity evaluates whether each promise in the contract – i.e., delivery of the land and the development services – is distinct. If so, the revenue or gain related to the land sale is recognized when it is sold, and the revenue or gain allocated to the development performance obligation is recognized either over the development period or when development is completed, depending on whether the over-time criteria are met for the development performance obligation.

The new standard generally applies to real estate sales or transfers, including the sale or transfer of an in-substance nonfinancial asset. If selling real estate represents an ordinary activity of the seller, it recognizes revenue and expense based on the transaction price and the carrying amount of the asset, respectively. Conversely, if selling real estate is not an ordinary activity, the seller recognizes a gain or loss based on the difference between the transaction price and the carrying amount of the asset.

Accounting for sales of real estate may require more judgment than under current U.S. GAAP because the new standard is less prescriptive – e.g., in evaluating the effects of the buyer's investment and certain types of continuing involvement by the seller.

Partial sales

Current U.S. GAAP defines a real estate sale as a partial sale if the seller retains an equity interest in the property or has an equity interest in the buyer. An entity recognizes profit on the sale equal to the difference between the sales value and the proportionate cost of the partial interest sold if:

- the buyer is independent of the seller;
- collection of the sales price is reasonably assured; and
- the seller will not be required to support the operations of the property or its related obligations to an extent greater than its proportionate interest.

If these conditions are not met, the seller may be unable to derecognize the property or may need to delay profit recognition – e.g., by applying either the installment or cost recovery method.

The new standard does not include amendments to the guidance in current U.S. GAAP on partial sales of real estate. Therefore, it is unclear whether *all* partial sales are to be accounted for similarly under the new standard. The FASB may further address issues related to partial sales of real estate, among others, in the context of its project on clarifying the definition of a business, although the timing of that project is unclear.

360-20; 970-323

10 Other issues

10.1 Sale with a right of return

Overview

Under the new standard, when an entity makes a sale with a right of return it recognizes revenue at the amount to which it expects to be entitled by applying the variable consideration and constraint guidance set out in Step 3 of the model (see 5.3). The entity also recognizes a refund liability and an asset for any goods or services that it expects to be returned.

Requirements of the new standard

An entity applies the accounting guidance for a sale with a right of return when a customer has a right to:

- a full or partial refund of any consideration paid;
- a credit that can be applied against amounts owed, or that will be owed, to the entity; or
- another product in exchange (unless it is another product of the same type, quality, condition, and price – i.e., an exchange).

In addition to product returns, the guidance also applies to services that are provided subject to a refund. An entity does not account for its obligation to provide a refund as a performance obligation.

The guidance does not apply to:

- exchanges by customers of one product for another of the same type, quality, condition, and price; and
- returns of faulty goods or replacements, which are instead evaluated under the guidance on warranties (see 10.2).

When an entity makes a sale with a right of return, it initially recognizes the following.

Item	Measurement
Revenue	Measured at the gross transaction price, less the expected level of returns calculated using the guidance on estimating variable consideration and the constraint (see 5.3)
Refund liability	Measured at the expected level of returns – i.e., the difference between the cash or receivable amount and the revenue as measured above
Asset	Measured by reference to the carrying amount of the products expected to be returned, less the expected recovery costs
Cost of goods sold	Measured as the carrying amount of the products sold less the asset as measured above
Reduction of inventory	Measured as the carrying amount of the products transferred to the customer

606-10-55-22
[IFRS 15.B20]

606-10-55-23 to 55-24
[IFRS 15.B21 to B22]

606-10-55-28 to 55-29
[IFRS 15.B26 to B27]

606-10-55-23, 55-25,
55-27
[IFRS 15.B21, B23, B25]

606-10-55-26 to 55-27
[IFRS 15.B24 to B25]

The entity updates its measurement of the refund liability and asset at each reporting date for changes in expectations about the amount of the refunds. It recognizes:

- adjustments to the refund liability as revenue; and
- adjustments to the asset as an expense.

Example 36

Sale with a right of return

Retailer B sells 100 products at a price of 100 each and receives a payment of 10,000. Under the sales contract, the customer is allowed to return any undamaged products within 30 days and receive a full refund in cash. The cost of each product is 60. Retailer B estimates that three products will be returned and a subsequent change in the estimate will not result in a significant revenue reversal.

Retailer B estimates that the costs of recovering the products will not be significant and expects that the products can be resold at a profit.

Retailer B records the following entries on transfer of the products to the customer to reflect its expectation that three products will be returned.

	Debit	Credit
Cash	10,000	
Refund liability		300 ^(a)
Revenue		9,700
<i>To recognize the sale excluding revenue on products expected to be returned</i>		
Asset	180 ^(b)	
Costs of sales	5,820	
Inventory		6,000
<i>To recognize the cost of sales and the right to recover products from customers</i>		

Notes

(a) 100 x 3 (being the price of the products expected to be returned).

(b) 60 x 3 (being the cost of the products expected to be returned).

Observations

Change in estimation method, but end result broadly similar in many situations

Under current IFRS and U.S. GAAP, an entity records a provision for products that it expects to be returned when a reasonable estimate can be made. If a reasonable estimate cannot be made, then revenue recognition is deferred until the return period lapses or a reasonable estimate can be made.

The new standard's approach of adjusting revenue for the expected level of returns and recognizing a refund liability is broadly similar to current guidance. However, the detailed methodology for estimating revenue may be different. Although revenue could be constrained to zero under the new standard, it is likely that most entities will have sufficient information to recognize consideration for an amount greater than zero.

Net presentation no longer permitted

Under the new standard, the refund liability is presented gross as a refund liability and an asset for recovery. This will represent a change in practice for entities that currently present reserves or allowances for returns net.

Accounting for a sale with a right of return often relies on a portfolio-level estimate

The new standard is generally applied to individual contracts. In some cases, it may be challenging to apply the new standard's requirements on sales with a right of return at an individual contract level when:

- it is not known whether the good or service transferred under a specific contract will be returned; but
- the entity has evidence of returns at a portfolio level.

The new standard includes an example illustrating how to determine the transaction price for a portfolio of 100 individual sales with a right of return. In the example, the entity concludes that the contracts meet the conditions to be accounted for at a portfolio level, and determines the transaction price for the portfolio using an expected value approach to estimate returns. For discussion of the portfolio approach, see 4.4.

605-15-25-1 to 25-4
[IAS 18.16, 17, IE2(b)]

606-10-55-202 to 55-207
[IFRS 15.IE110 to IE115]

10.2 Warranties

Overview

Under the new standard, an entity accounts for a warranty or part of a warranty as a performance obligation if:

- the customer has an option to purchase the warranty separately; or
- additional services are provided as part of the warranty.

Otherwise, warranties will continue to be accounted for under existing guidance.

606-10-55-31

[IFRS 15.B29]

606-10-55-31 to 55-32;

Topic 450

[IFRS 15.B29 to B30;

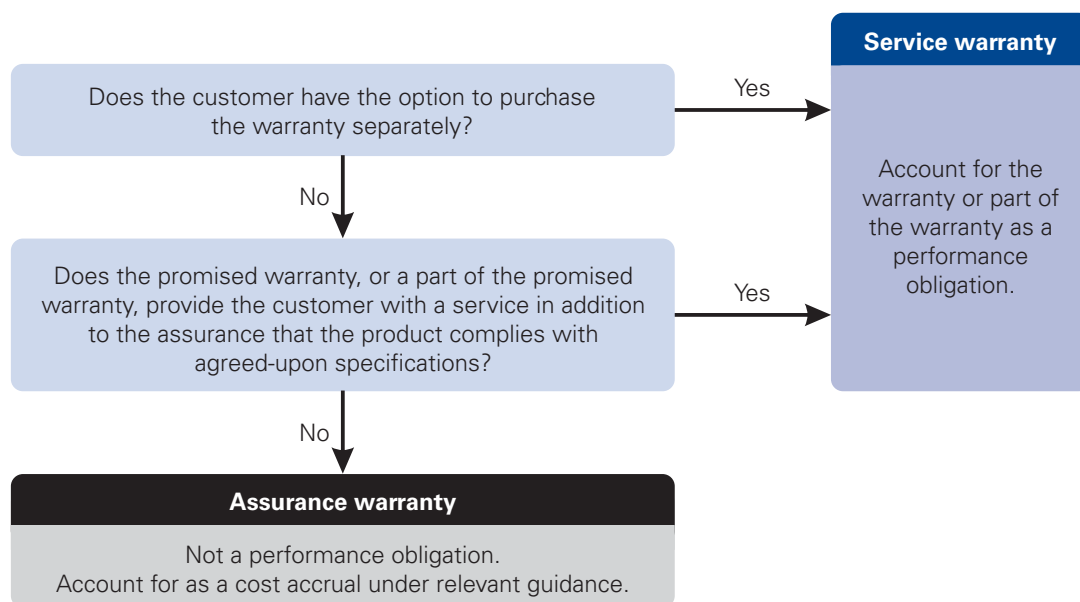
IAS 37]

Requirements of the new standard

Under the new standard, a warranty is considered a performance obligation if the customer has an option to purchase the good or service with or without the warranty.

When a warranty is not sold separately, the warranty or part of the warranty may still be a performance obligation, but only if the warranty – or part of it – provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. A warranty that only covers the compliance of a product with agreed-upon specifications (an 'assurance warranty') is accounted for under other relevant guidance.

An entity distinguishes the types of product warranties as follows.



606-10-55-33

[IFRS 15.B31]

To assess whether a warranty provides a customer with an additional service, an entity considers factors such as:

- whether the warranty is required by law – because such requirements typically exist to protect customers from the risk of purchasing defective products;
- the length of the warranty coverage period – because the longer the coverage period, the more likely it is that the entity is providing a service, rather than just protecting the customer against a defective product; and
- the nature of the tasks that the entity promises to perform.

606-10-55-34

[IFRS 15.B29]

If the warranty – or part of it – is considered to be a performance obligation, then the entity allocates a portion of the transaction price to the service performance obligation by applying the requirements in Step 4 of the model (see 5.4).

606-10-55-34

[IFRS 15.B32]

If an entity provides a warranty that includes both an assurance element and a service element and the entity cannot reasonably account for them separately, then it accounts for both of the warranties together as a single performance obligation.

606-10-55-35; 450-20
[IFRS 15.B33; IAS 37]

A legal requirement to pay compensation or other damages if products cause damage is not a performance obligation, and is accounted for under other relevant guidance.

Example 37

Sale of a product with a warranty

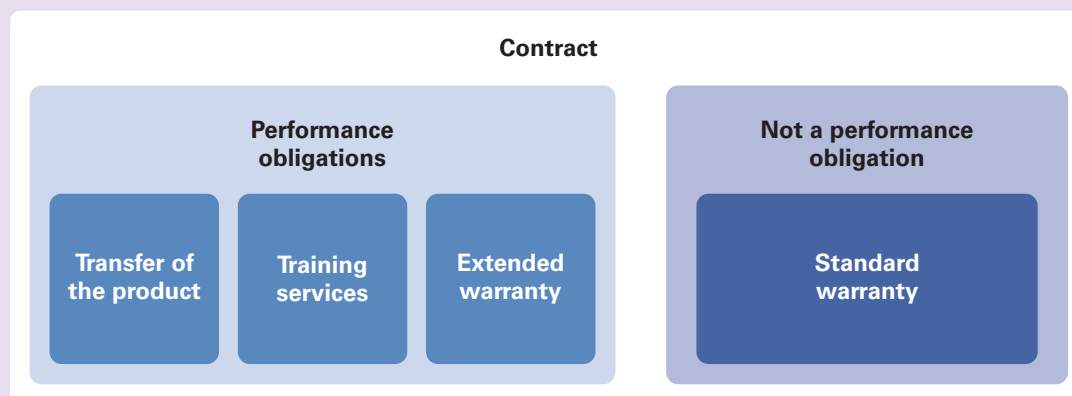
606-10-55-309 to 55-315
[IFRS 15.IE223 to IE229]

Manufacturer M grants its customers a standard warranty with the purchase of its product. Under the warranty, Manufacturer M:

- provides assurance that the product complies with agreed-upon specifications and will operate as promised for three years from the date of purchase; and
- agrees to provide up to 20 hours of training services to the customer.

In addition to the standard warranty, the customer also chooses to purchase an extended warranty for two additional years.

In this example, Manufacturer M concludes that there are three performance obligations in the contract, as follows.



The training services are a performance obligation because they provide a distinct service in addition to ensuring that the product complies with specifications.

The extended warranty is a performance obligation because it can be purchased separately.

The component of the standard warranty that provides assurance that the product complies with stated specifications is an assurance-type warranty, and therefore it is not a performance obligation. As a consequence, Manufacturer M accounts for it as a cost accrual when the product is sold under other relevant guidance.

Observations

'Reasonably account' threshold is undefined

The new standard requires an entity that cannot reasonably account for a service-type warranty and an assurance-type warranty separately to account for them together as a single performance obligation. It is not clear how the 'reasonably account' threshold is intended to be interpreted.

Limited discussion on applying the guidance to warranties on services

The guidance in the new standard on warranties is intended to apply to services as well as goods. However, the new standard does not further explain how the concept should be applied to services – e.g., when an entity offers a refund to customers who are dissatisfied with the service provided. For services, it may not always be clear how to determine whether the guidance on warranties or on sales with a right of return should apply.

[IAS 18.16(a), 17;
IAS 37.C4]

Comparison with current IFRS

Presence of warranty clause does not preclude recognition of revenue

Under IAS 18, a standard warranty clause in a sales contract that does not result in the seller retaining significant risks does not preclude revenue recognition at the date of sale of the product. In this case, the entity recognizes a warranty provision under IAS 37 at the date of sale, for the best estimate of the costs to be incurred for repairing or replacing the defective products. However, an abnormal warranty obligation could indicate that the significant risks and rewards of ownership have not been passed to the buyer, and that revenue should therefore be deferred.

Unlike current IFRS, the new standard does not envisage that the presence of a warranty would ever preclude the recognition of all of the revenue associated with the sale. This could accelerate revenue recognition in some cases.

Comparison with current U.S. GAAP

Entities will be required to consider factors in addition to considering whether a warranty is separately priced

Under current U.S. GAAP, warranties that are not separately priced are accounted for when the goods are delivered, by recognizing the full revenue on the product and accruing the estimated costs of the warranty obligation. The warranty is only treated as a separate unit of account under current U.S. GAAP if it is separately priced. Under the new standard, an entity evaluates whether the warranty provides a service even when it is not separately priced – and if so, treats it (or part of it) as a separate performance obligation.

Topic 450; Topic 460

Amount of revenue allocated to a separately priced warranty may change

The amount of revenue recognized for some separately priced extended warranties and product maintenance contracts may change if the transaction price is allocated on a relative stand-alone selling-price basis, rather than by deferring the contractually stated amount of the warranty, as required under current U.S. GAAP.

Topic 460; 605-20-25-1
to 25-6

Product recalls

Product recalls occur when a concern is raised about the safety of a product and may be either voluntary or involuntary. These product recalls and liability claims will likely continue to be subject to the U.S. GAAP guidance for contingencies.

Topic 450

10.3 Principal versus agent considerations

Overview

When an entity obtains control of another party's goods or services before transferring control to the customer, the entity's performance obligation is to provide the goods or services itself. Therefore, the entity is acting as a principal.

However, if an entity's performance obligation is not to provide the goods or services itself, then the entity is acting as an agent. The new standard provides a list of indicators for evaluating whether this is the case.

Requirements of the new standard

606-10-55-36
[IFRS 15.B34]

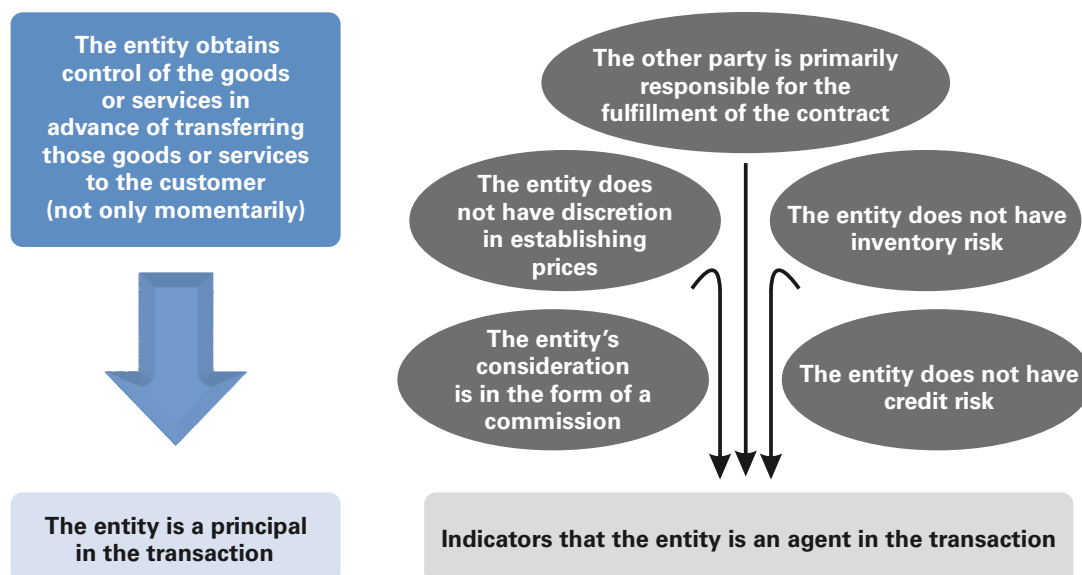
When other parties are involved in providing goods or services to an entity's customer, the entity determines whether the nature of its promise is a performance obligation to provide the specified goods or services itself, or to arrange for another party to provide them – i.e., whether it is a principal or an agent.

606-10-55-37 to 55-38
[IFRS 15.B35 to B36]

If the entity is a principal, then revenue is recognized on a gross basis – corresponding to the consideration to which the entity expects to be entitled. If the entity is an agent, then revenue is recognized on a net basis – corresponding to any fee or commission to which the entity expects to be entitled. An entity's fee or commission might be the net amount of consideration that the entity retains after paying other parties.

606-10-55-39
[IFRS 15.B37]

To determine whether it is a principal or an agent, an entity assesses whether it controls a promised good or service before the good or service is transferred to the customer. The new standard also includes indicators of whether an entity is an agent, as follows.



606-10-55-37, 55-40
[IFRS 15.B35, B38]

An entity that is a principal in a contract may satisfy a performance obligation by itself or it may engage another party – e.g., a subcontractor – to satisfy some or all of a performance obligation on its behalf. However, if another party assumes an entity's performance obligation so that the entity is no longer obliged to satisfy the performance obligation, then the entity is no longer acting as the principal and therefore does not recognize revenue for that performance obligation. Instead, the entity evaluates whether to recognize revenue for satisfying a performance obligation to obtain a contract for the other party – i.e., whether the entity is acting as an agent.

Example 38

Entity arranges for the provision of goods or services

606-10-55-317 to 55-319
[IFRS 15.IE231 to IE233]

Internet Retailer B operates a website that enables customers to buy goods from a range of suppliers that deliver the goods directly to the customers. The website facilitates payment between the supplier and the customer at prices set by the supplier, and Retailer B is entitled to a commission calculated as 10% of the sales price. Customers pay in advance and all orders are nonrefundable.

Retailer B observes that each supplier delivers its goods directly to the customer, and that Retailer B itself does not obtain control of the goods. In addition, Retailer B notes that:

- the supplier is primarily responsible for fulfilling the contract – i.e., by shipping the goods to the customer;
- Retailer B does not take inventory risk at any time during the transaction, because the goods are shipped directly by the supplier to the customer;
- Retailer B's consideration is in the form of a commission (10% of the sales price);
- Retailer B does not have discretion in establishing prices for the supplier's goods and, therefore, the benefit that Retailer B can receive from those goods is limited; and
- neither Retailer B nor the supplier has credit risk with respect to the customer because customers' payments are made in advance (however, Retailer B may have credit risk with respect to the supplier).

Consequently, Retailer B concludes that it is an agent, and that its performance obligation is to arrange for the supplier to provide the goods. When Retailer B satisfies its promise to arrange for the supplier to provide the goods to the customer – which, in this example, is when the goods are purchased by the customer – Retailer B recognizes revenue at the amount of the commission to which it is entitled.

Observations

Control of inventory is the deciding factor

The model for evaluating whether an entity is a principal or an agent under the new standard focuses on whether the entity obtains control of goods or services from another party before transferring them to the customer. The new standard clarifies that if the entity obtains legal title to a product only momentarily before legal title transfers to the customer, then obtaining that legal title is not in itself determinative. However, if the entity has substantive inventory risk, then this may indicate that the entity is the principal, and should therefore recognize revenue on a gross basis.

If it is unclear whether the entity obtains control of the goods or services, then it should consider the new standard's indicators to determine whether it is acting as an agent and should therefore recognize revenue on a net basis, or as a principal and should therefore recognize revenue on a gross basis. When an entity sells a non-physical item – e.g., virtual goods or intellectual property – the question of whether the entity obtains control may be difficult to determine and the entity will need to evaluate all relevant facts and circumstances for the arrangement.

No specific guidance on allocation of discount when entity is principal for part of arrangement and agent for other part of arrangement

The new standard does not include specific guidance on how an entity allocates a discount in an arrangement in which it is a principal for some goods or services and an agent for others.

Comparison with current IFRS

From risk and reward to transfer of control

There is a similar principle in current IFRS that amounts collected on behalf of a third party are not accounted for as revenue. However, determining whether the entity is acting as an agent or a principal under the new standard differs from current IFRS, as a result of the shift from the risk-and-reward approach to the transfer-of-control approach. Under current IFRS, the entity is a principal in the transaction when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. The Boards note that the indicators serve a different purpose from those in current IFRS, reflecting the overall change in approach. However, it is not clear whether the IASB expects this conceptual change to result in significant changes in practice.

[IFRS 15.BC382;
IAS 18.8, IE21]

Comparison with current U.S. GAAP

Less guidance under new standard

Some of the indicators in current U.S. GAAP for assessing whether a party is a principal or an agent are not included in the new standard – e.g., discretion in selecting a supplier or in determining the product or service specifications. It is unclear what effect, if any, these changes may have on the principal versus agent evaluation. Also, the new standard does not identify any of the agent indicators as being more important than others, whereas current U.S. GAAP specifies that the primary obligor is a strong indicator.

In addition, the new standard does not contain explicit principal versus agent guidance for shipping costs and cost reimbursement, as exists under current U.S. GAAP. Under the new standard, an entity may need to assess whether shipping is a separate performance obligation in a contract if it is determined to be the principal for this service.

Finally, an entity can no longer elect an accounting policy to present sales taxes on a gross or net basis. Instead, the entity applies the principal versus agent guidance under the new standard on a case-by-case basis in each jurisdiction.

605-45

10.4 Customer options for additional goods or services

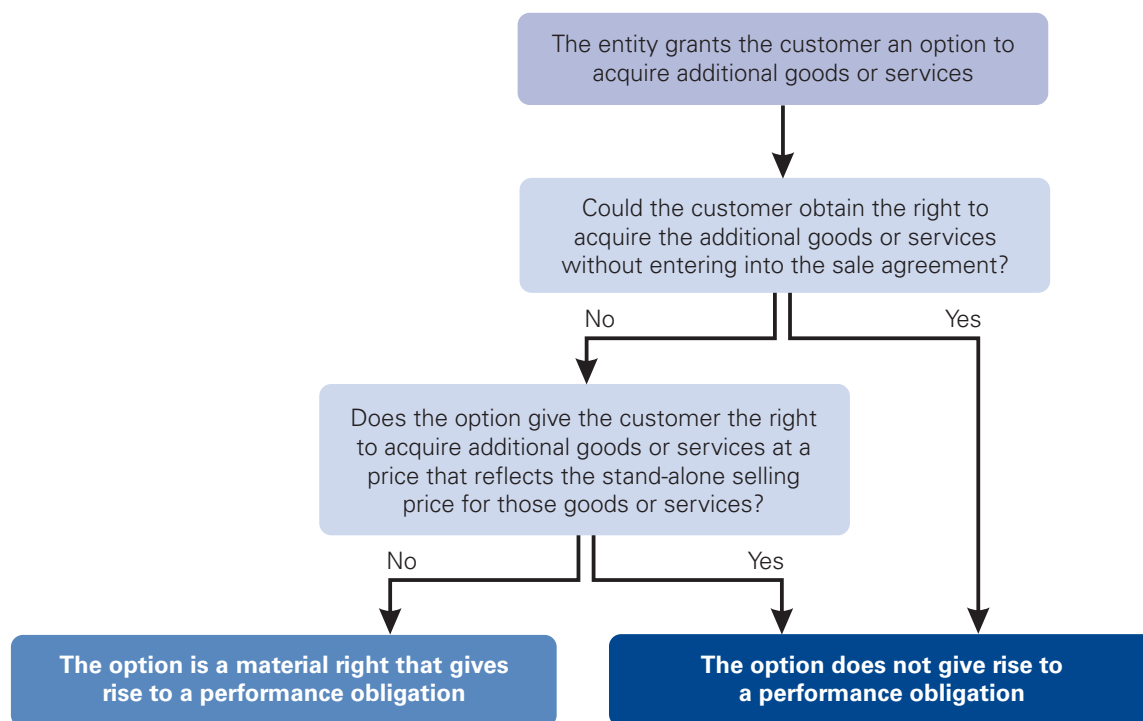
Overview

An entity accounts for a customer option to acquire additional goods or services as a performance obligation if the option provides the customer with a material right. The new standard provides guidance on calculating the stand-alone selling price of a customer option.

Requirements of the new standard

When an entity grants the customer an option to acquire additional goods or services, that option gives rise to a performance obligation in the contract if the option provides a material right that the customer would not receive without entering into that contract.

The following flow chart helps analyze whether a customer option is a performance obligation.



If the stand-alone selling price for a customer's option to acquire additional goods or services that is a material right is not directly observable, then an entity will need to estimate it. The estimate of the stand-alone selling price for a customer's option to acquire additional goods or services reflects the discount that the customer will obtain when exercising the option, adjusted for:

- any discount that the customer would receive without exercising the option; and
- the likelihood that the option will be exercised.

606-10-55-42
[IFRS 15.B40]

606-10-55-42 to 55-43
[IFRS 15.B40 to B41]

606-10-55-44
[IFRS 15.B42]

606-10-55-45

[IFRS 15.B43]

If the goods or services that the customer has a material right to acquire are similar to the original goods in the contract – e.g., when the entity has an option to renew the contract – then an entity may allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding consideration expected to be received.

Example 39

Customer loyalty points program

606-10-55-353 to 55-356

[IFRS 15.IE267 to IE270]

Retailer C offers a customer loyalty program at its store. Under the program, for every 10 that customers spend on goods, they will be rewarded with one point. Each point is redeemable for a cash discount of 1 on future purchases during the next six months. Retailer C expects 97% of customers' points to be redeemed. This estimate is based on Retailer C's historical experience, which is assessed as being predictive of the amount of consideration to which it will be entitled. During the reporting period, customers purchase products for 100,000 and earn 10,000 points. The stand-alone selling price of the products to customers without points is 100,000.

The customer loyalty program provides the customers with a material right, because the customers would not receive the discount on future purchases without making the original purchase, and the price that they will pay on exercise of the points on future purchases is not the stand-alone selling price of those items. Because the points provide a material right to the customers, Retailer C concludes that the points are a performance obligation in each sales contract – i.e., the customers paid for the points when purchasing products. Retailer C determines the stand-alone selling price of the loyalty points based on the likelihood of redemption.

Retailer C allocates the transaction price between the products and the points on a relative selling price basis as follows.

Performance obligation	Stand-alone selling price	Selling price ratio	Price allocation	
Products	100,000 ^(a)	91%	91,000	(100,000 × 91%)
Points	9,700 ^(b)	9%	9,000	(100,000 × 9%)
Total	109,700	100%	100,000	

Notes

(a) Stand-alone selling price for the products.

(b) Stand-alone selling price for the points (10,000 × 1 × 97%).

Observations

Customer loyalty programs that provide a material right are treated as a performance obligation

The new standard may significantly affect entities in industries that offer customer loyalty programs – e.g., retail, airline, and hospitality. This is because under the new standard, a customer loyalty program that provides a customer with a material right is a performance obligation of the contract. Entities will therefore need to consider whether their customer loyalty programs provide customers with a material right – if they do, then the entity will be required to allocate a portion of the consideration in a contract to that material right.

No specific guidance for credit card loyalty programs

The new standard does not provide any specific guidance on its application to credit card loyalty programs. Additional complexities can arise with credit card loyalty programs, as there are typically at least three parties involved: the card issuer, a retailer, and the end customer. Therefore, judgment will be required to determine whether a credit card loyalty program gives rise to a performance obligation of the card issuer. If it does, a portion of the interchange fee will need to be allocated to the performance obligation and deferred until redemption occurs.

Comparison with current IFRS

Treatment of customer loyalty programs broadly the same

The current IFRS guidance on customer loyalty programs is broadly similar to the guidance in the new standard. However, entities should consider whether the allocation method that they currently apply remains acceptable under the new standard. Under current IFRS, entities have a free choice of method to allocate the consideration between the sales transaction and the award credits. By contrast, under the new standard the residual approach can only be applied if certain criteria are met (see 5.4.1.2).

[IFRIC 13]

Comparison with current U.S. GAAP

Currently no authoritative guidance on accounting for customer loyalty programs

There is currently no authoritative U.S. GAAP guidance on the accounting for customer loyalty programs, and practice is mixed. Some companies accrue the direct and incremental costs of providing the goods or services underlying the loyalty program while recognizing the full amount of revenue at the point of the initial sale; others, however, defer a portion of the revenue from the transaction that generates the points. The new standard requires entities to follow the latter approach when the points or other benefits issued to customers constitute a performance obligation.

Options in software arrangements

The evaluation under the new standard of whether a discount offered on future purchases provides a customer with a material right is similar to, but not the same as, current U.S. GAAP – and could lead to different units of accounting. Under current U.S. GAAP, an offer of a discount on future purchases of goods or services in a software arrangement is accounted for separately if it is significant and incremental to both:

- the range of discounts reflected in the pricing of other elements in that contract; and
- the range of discounts typically given to other similarly situated customers in comparable transactions.

To assess whether an option gives the customer a material right under the new standard, an entity needs only to determine whether the discount on future purchases of goods or services is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market, and not whether the discount is also incremental to the discount in the current arrangement.

985-605-55-82 to 55-85

10.5 Customers' unexercised rights (breakage)

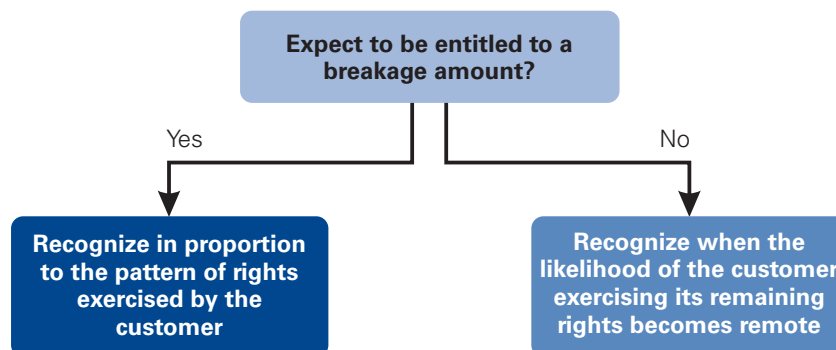
Overview

An entity may receive a nonrefundable prepayment from a customer that gives the customer the right to receive goods or services in the future. Common examples include gift cards or vouchers, and nonrefundable tickets. Typically, some customers do not exercise their right – this is referred to as 'breakage'.

Requirements of the new standard

An entity recognizes a prepayment received from a customer as a contract liability, and recognizes revenue when the promised goods or services are transferred in the future. However, a portion of the contract liability recognized may relate to contractual rights that the entity does not expect to be exercised – i.e., a breakage amount.

The timing of revenue recognition related to breakage depends on whether the entity expects to be entitled to a breakage amount – i.e., if it is probable (highly probable for IFRS) that recognizing breakage will not result in a significant reversal of the cumulative revenue recognized.



An entity considers the variable consideration guidance to determine whether – and to what extent – the constraint applies (see 5.3.1.2). It determines the amount of breakage to which it is entitled as the amount for which it is considered probable (highly probable for IFRS) that a risk of significant reversal will not occur in the future.

If an entity is required to remit the amount that is attributable to customers' unexercised rights to a government entity – e.g., under applicable unclaimed property or escheatment laws – then it recognizes a financial liability until the rights are extinguished, rather than revenue.

606-10-55-46 to 55-47
[IFRS 15.B44 to B45]

606-10-55-48
[IFRS 15.B46]

606-10-55-48
[IFRS 15.B46]

606-10-55-49
[IFRS 15.B47]

Example 40**Sale of a gift card**

Retailer R sells a gift card to Customer C for an amount of 100. On the basis of historical experience with similar gift cards, Retailer R estimates that 10% of the gift card balance will remain unredeemed and that the unredeemed amount will not be subject to escheatment. As Retailer R can reasonably estimate the amount of breakage expected, and it is probable (highly probable for IFRS) that including the amount in the transaction price will not result in a significant revenue reversal, Retailer R will recognize the breakage revenue of 10 in proportion to the pattern of exercise of the customer's rights.

Specifically, when it sells the gift card, Retailer R recognizes a contract liability of 100, as Customer C prepaid for a nonrefundable card. No breakage revenue is recognized at this time.

If Customer C redeems an amount of 45 in 30 days' time, then half of the expected redemption has occurred ($45 / (100 - 10) = 50\%$). Therefore, half of the breakage – i.e., $(10 \times 50\% = 5)$ – is also recognized. On this initial gift card redemption, Retailer R recognizes revenue of 50 – i.e., revenue from transferring goods or services of 45 plus breakage of 5.

Observations**Constraint applies even though consideration amount is known**

If an entity does not have a basis for estimating breakage – i.e., the estimate is fully constrained – the entity recognizes the breakage as revenue only when the likelihood becomes remote that the customer will exercise its rights.

When the entity concludes that it is able to determine the amount of breakage to which it expects to be entitled, it estimates the amount of breakage. To determine the breakage amount, the entity assesses whether it is probable (highly probable for IFRS) that including revenue for the unexercised rights in the transaction price will not result in a significant revenue reversal. Applying the guidance on the constraint in this context is unique – the amount of consideration is known and has already been received, but there is uncertainty over how much of the consideration the customer will redeem for the transfer of goods or services in the future. Conversely, in other situations to which the constraint applies, the total amount of consideration is unknown.

Comparison with current IFRS**The timing of revenue recognition may change**

Current IFRS does not contain specific guidance on the accounting for breakage. However, the new standard may result in changes in the timing of revenue recognition as compared with our current view that an unredeemed amount should be recognized as revenue if:

- the amount is nonrefundable; and
- an entity concludes, based on available evidence, that the likelihood of the customer requiring it to fulfill its performance obligation is remote.

For further discussion of this issue, see 4.2.440.20 of *Insights into IFRS*, 11th Edition.

Comparison with current U.S. GAAP

Removal of policy election

There is currently no authoritative guidance on the accounting for breakage in U.S. GAAP. Practice has developed based on an SEC speech from December 2005,⁷ which stated that it is not acceptable for an entity to recognize breakage immediately on the sale of a gift card. The speech describes three acceptable methods to recognize breakage revenue:

- as the entity is legally released from its obligation – e.g., at redemption or expiration;
- at the point at which redemption becomes remote; or
- in proportion to actual gift card redemptions.

The new standard requires an entity to determine whether it expects to be entitled to a breakage amount and, if so, recognize the breakage amount in proportion to customer redemptions of the gift cards. Because the methods listed above are accounting policies rather than an analysis of the entity's specific facts and circumstances, some entities using either of the first two methods may be required to recognize revenue sooner than under their current accounting policy election.

10.6 Nonrefundable up-front fees

Overview

Some contracts include nonrefundable up-front fees that are paid at or near contract inception – e.g., joining fees for health club membership, activation fees for telecommunication contracts, and set-up fees for outsourcing contracts. The new standard provides guidance to determine the timing of recognition for such fees.

Requirements of the new standard

An entity assesses whether the nonrefundable up-front fee relates to the transfer of a promised good or service to the customer.

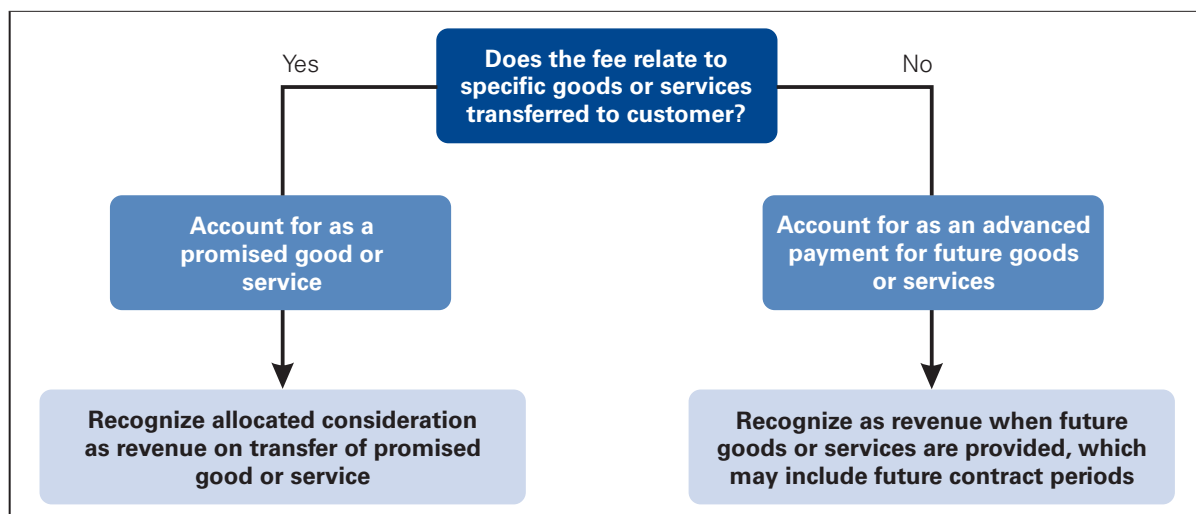
In many cases, even though a nonrefundable up-front fee relates to an activity that the entity is required to undertake in order to fulfill the contract, that activity does not result in the transfer of a promised good or service to the customer. Instead, it is an administrative task. For further discussion on identifying performance obligations, see 5.2.

If the activity does not result in the transfer of a promised good or service to the customer, the up-front fee is an advance payment for performance obligations to be satisfied in the future and is recognized as revenue when those future goods or services are provided.

The revenue recognition period extends beyond the initial contractual period if the entity grants the customer the option to renew the contract and that option provides the customer with a material right (see 10.4).

606-10-55-50 to 55-53
[IFRS 15.B48 to B51]

⁷ SEC Speech, "Remarks Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments," by Pamela R. Schlosser, Professional Accounting Fellow at the SEC, available at www.sec.gov.



Example 41

Nonrefundable up-front fees

Cable Company C enters into a one-year contract to provide cable television to Customer A. In addition to a monthly service fee of 100, Cable Company C charges a one-time up-front installation fee of 10. Cable Company C has determined that its installation services do not transfer a promised good or service to the customer, but are instead a set-up activity that is an administrative task. Customer A can renew the contract each year for an additional one-year period at the then-current monthly service fee rate.

The significance of the up-front fee is considered when evaluating whether the contract renewal grants the customer a material right. By comparing the installation fee of 10 to the total one-year service fees of 1,200, Cable Company C concludes that the nonrefundable up-front fee does not grant Customer A a material right as it is not deemed significant enough to influence Customer A's decision to renew or extend the services beyond the initial one-year term.

As a result, the installation fee is treated as an advance payment on the contracted one-year cable services and is recognized as revenue over the one-year contract term.

Observations

Up-front fee may need to be allocated

Even when a nonrefundable up-front fee relates to a promised good or service, the amount of the fee may not equal the relative stand-alone selling price of that promised good or service, such that some of it may need to be allocated to other performance obligations. For further discussion on allocation, see 5.4.2.

Deferral period for nonrefundable up-front fees depends on whether they provide a material right

A nonrefundable up-front fee may provide the customer with a material right if that fee is significant enough that it would be likely to impact the customer's decision on whether to reorder a product or service – e.g., to renew a membership or service contract, or order an additional product.

ASU 2014-09 BC387
[IFRS 15.BC387]

If the payment of an up-front fee provides a material right to the customer, the fee is recognized over the period for which payment of the up-front fee provides the customer with a material right. Determining that period will require significant judgment, as it may not align with the stated contractual term or other information historically maintained by the entity – e.g., the average customer relationship period.

When the up-front fee is not deemed to provide a material right and the cost amortization period is determined to be longer than the stated contract period, the period over which a nonrefundable up-front fee is recognized as revenue differs from the amortization period for contract costs.

Principle of a material right builds on previous U.S. GAAP guidance

A key question when accounting for an up-front fee in a contract that includes a renewal option is whether the customer receives a material right. The Boards noted that the principle of a material right builds on previous U.S. GAAP guidance, under which the significance of the up-front fee and incremental discount received relative to other customers for a comparable transaction helps to differentiate between an option and a marketing or promotional offer.

Up-front fee may give rise to a significant financing component

Because the nonrefundable up-front fee represents an advance payment for future goods or services, an entity needs to consider whether receipt of the up-front fee creates a significant financing component in the contract. For further discussion on significant financing components, see 5.3.2.

Comparison with current IFRS

[IAS 18.IE17]

Accounting for nonrefundable up-front fees

Under current IFRS, any initial or entrance fee is recognized as revenue when there is no significant uncertainty over its collection and the entity has no further obligation to perform any continuing services. It is recognized on a basis that reflects the timing, nature, and value of the benefits provided. In our experience, such fees may be recognized totally or partially up-front or over the contractual or customer relationship period, depending on facts and circumstances. Under the new standard, an entity needs to assess whether a nonrefundable, up-front fee relates to a specific good or service transferred to the customer – and if not, whether it gives rise to a material right to determine the timing of revenue recognition.

Comparison with current U.S. GAAP

SEC SAB Topic 13

Accounting for nonrefundable up-front fees as a separate performance obligation

Concluding whether a nonrefundable up-front fee represents a payment for a promised good or service under the new standard may involve a similar analysis to that required when determining whether the up-front fee is payment for delivery of a good or service that represents the culmination of a separate earnings process under current SEC guidance. When performing the analysis under the new standard, an entity considers the integration guidance in Step 2 of the model, which is not necessarily the same as current U.S. GAAP.

SEC SAB Topic 13

Deferral period when nonrefundable up-front fees are recognized as advance payments

Under current SEC guidance, the up-front fee is deferred and recognized over the expected period of performance, which can extend beyond the initial contract period. In our experience, this has often resulted in entities recognizing nonrefundable up-front fees over the average customer relationship period.

Under the new standard, an entity assesses the up-front fee to determine whether it provides the customer with a material right – and, if so, for how long. This means that an entity no longer defaults to an average customer relationship period, which may be driven by factors other than the payment of an initial up-front fee – e.g., the availability of viable alternatives, the entity’s customer service, the inconvenience of changing service providers, or the quality of the product or service offering.

922-430; 922-605

Initial hookup fees in the cable television industry

Under current industry-specific U.S. GAAP, initial hookup fees in the cable television industry are recognized as revenue to the extent of the direct selling costs incurred. The new standard has no industry-specific revenue recognition guidance, and so hookup fees are treated like any other nonrefundable up-front fees. In addition, the costs associated with the hookup activity need to be evaluated for deferral under the new standard’s cost guidance. For further discussion on contract costs, see Section 6.

10.7 Onerous contracts

Requirements of the new standard

The new standard does not include specific guidance on the accounting for onerous revenue contracts or on other contract losses. Instead, an entity applies other applicable guidance in U.S. GAAP or IFRS as appropriate.

Observations**No convergence for onerous contracts**ASU 2014-09 BC296
[IFRS 15.BC296]

Although the new standard contains substantially converged guidance on the recognition and measurement of revenue, it does not include specific guidance on the accounting for onerous contracts. This is because the Boards concluded that the current guidance was adequate, and they were not aware of any pressing practice issues resulting from its application.

As a result, entities reporting under U.S. GAAP and IFRS may identify different contracts as being onerous, and may measure any required provisions for onerous contracts in different ways. Although the new standard will facilitate comparisons between the revenue reported under U.S. GAAP and IFRS, differences in accounting for costs and contract losses remain. For further discussion on contract costs, see Section 6.

[IAS 11.36; IAS 37.66
to 69]

Comparison with current IFRS

A single approach to onerous revenue contracts

Current IFRS deals with onerous revenue contracts in two standards.

- IAS 37 includes general guidance on the recognition and measurement of provisions for onerous contracts. An entity recognizes a provision when the unavoidable costs of meeting the obligations under a contract exceed the economic benefits to be received. However, IAS 37 also prohibits the recognition of a provision for future operating losses.
- IAS 11 requires that an expected loss on a construction contract is recognized immediately.

The new standard withdraws IAS 11 so that accounting for onerous contracts will now fall under a single standard – IAS 37.

For contracts other than construction contracts, there is no change in the overall approach to accounting for onerous contracts. However, the new standard is silent on the consequences of withdrawing the specific guidance in IAS 11 on contract losses. It is unclear whether the IASB expects to see a change in measurement for loss-making construction contracts.

Interpretative issues could arise in the following areas.

Unit of account

IAS 37 includes a specific prohibition on recognizing provisions for future operating losses. A common issue in applying IAS 37 is distinguishing between:

- onerous obligations, for which the recognition of a provision is required; and
- future operating losses, for which the recognition of a provision is prohibited.

It is not clear how the prohibition on recognizing provisions will affect the current practice under IAS 11 of recognizing an expected contract loss immediately.

Costs

Under IAS 11, expected contract losses are identified by reference to expected contract costs, which are generally taken to be the full costs of fulfilling the contract – e.g., including attributable overheads etc. Under IAS 37, an entity considers the ‘unavoidable costs’ of fulfilling an obligation when identifying onerous contracts and measuring any required provision. IAS 37 does not explain what is meant by ‘unavoidable costs’. It is unclear whether the IASB believes that the unavoidable costs of fulfilling an obligation are equivalent to the contract costs under IAS 11.

Comparison with current U.S. GAAP

Different onerous contract guidance for different contracts

The current guidance on onerous revenue contracts remains applicable under the new standard. Current U.S. GAAP does not contain general guidance for recognizing a provision for onerous contracts, but instead focuses either on types of contracts or on industry-specific arrangements. Because U.S. GAAP does not provide general guidance on the accrual of losses on onerous contracts, an entity will only accrue such losses when a contract is in the scope of current U.S. GAAP Topics that contain requirements for the accrual of a loss on a contract. The new standard applies to all contracts with customers, such that some entities will need to apply its requirements on the recognition of revenue and certain costs under the new standard, and then also consider the scope of current U.S. GAAP for loss recognition on certain contracts. Current U.S. GAAP addresses the recognition of losses on the following types of arrangements.

605-10-05-4

ASC reference	Losses on ...
605-20	Separately priced extended warranty and product maintenance
605-35	Construction- and production-type contracts
985-605	Certain software arrangements
954-440-35-1 to 35-3	Continuing care retirement community contracts
954-450-30-3 to 30-4	Prepaid health care services
980-350-35-3	Certain long-term power sales contracts
912-20-45-5	Certain federal government contracts

An entity with contracts that are subject to existing industry- or transaction-specific guidance that contains requirements for loss recognition will continue to apply that specific guidance to determine whether a loss should be recognized. Although the specific provisions for loss recognition have not changed, the amount and timing may change if there are differences in the accounting or timing of revenue and costs recognized or the performance obligations identified. For example, a loss on a separately priced extended warranty contract may differ from current practice because under the new standard revenue may be allocated to it based on its relative selling price rather than the stated contractual amount as required by current U.S. GAAP.

In addition, an entity will need to evaluate whether a contract is in the scope of the current U.S. GAAP Codification Topics that are brought forward, even though these Topics no longer apply for determining revenue recognition. An entity with contracts that are not in the scope of any of these industry- or transaction-specific requirements is not permitted to recognize an onerous contract loss provision.

Warranties

The current guidance applies to:

- separately priced contracts for extended warranty; and
- product maintenance contracts that provide warranty protection or product services, and whose contract price is not included in the original price of the product covered by the warranty or service.

These warranties are service-type warranties, and therefore a performance obligation, under the new standard. However, not all service-type warranties under the new standard are in the scope of the current onerous contracts guidance, because warranties can constitute a separate performance obligation without being separately priced under the new standard.

The current onerous contract guidance specifies that: “a loss shall be recognized on extended warranty or product maintenance contracts if the sum of the expected costs of providing services under the contracts and any asset recognized for the incremental cost of obtaining a contract exceeds the related unearned revenue (contract liability).” Losses are first charged directly to operating expense by writing off any assets relating to acquisition costs. Any additional loss is accrued as a liability.

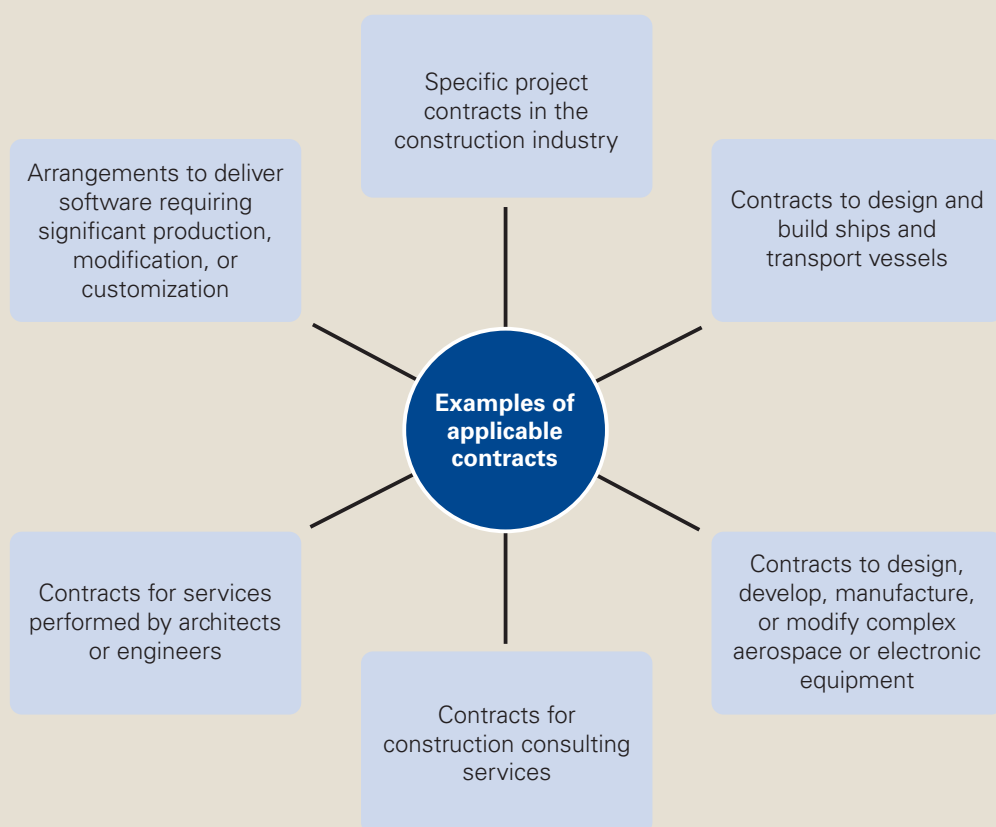
*605-20-25-6;
606-10-55-30 to 55-35*

Current U.S. GAAP requires that costs of services performed for separately priced extended warranty and product maintenance contracts are expensed as incurred. Although the consequential amendments remove the cost guidance for separately priced extended warranties, the new standard will likely result in similar accounting for contracts in the scope of this onerous contract guidance, because the costs will likely not meet the criteria for capitalization of fulfillment costs.

When an entity has a separate performance obligation for a service-type warranty that is not separately priced, the onerous contracts guidance does not apply.

Construction- and production-type contracts

The onerous contracts guidance for construction- and production-type contracts applies to contracts for which the customer provides specifications for the construction of facilities, the production of goods, or the provision of related services.



A loss is recognized when the current estimate of the consideration that an entity expects to receive is less than the current estimate of total costs. The unit of account for the provision is the performance obligation. An entity applies the guidance in the new standard on combining contracts (see 5.1.3) and identifying the performance obligations in a contract (see 5.2).

605-35-05-1, 15-3 to 15-4

605-35-25-46 to 25-47

605-35-25-46 to 25-46A,
25-49

The consideration to be received is based on the guidance in the new standard for determining the transaction price (see 5.3); however, the guidance on constraining estimates of variable consideration is not applied. Instead, current loss guidance has been amended to include variable consideration as a factor to be considered in arriving at the projected loss on a contract. In addition, an entity applies the contract modifications guidance in the new standard to change orders and claims (see Section 7).

The loss on a contract is reported as an operating expense (contract cost) and not as a reduction of revenue or a non-operating expense. For a contract on which a loss is anticipated, recognition of the entire anticipated loss is required as soon as the loss becomes evident.

The scope of the loss guidance on construction- and production-type contracts only applies to the contracts specified above, while the scope of the new standard applies broadly to contracts with customers. Entities are required to assess the scope of the guidance on construction- and production-type contracts when determining the need for a loss provision on a contract with a customer. Because the guidance on combining contracts and segmenting contracts – i.e., identifying performance obligations – differs from current U.S. GAAP, the evaluation may differ under the new standard. In addition, because the scope is limited to construction- and production-type contracts, not all over-time performance obligations are in the scope of the current guidance.

Software

985-605-25-7

For software requiring significant production, modification, or customization, a loss is determined by applying the guidance on loss provisions for construction- and production-type contracts described above. The software guidance specifies that a loss is recognized when it is probable that the amount of the transaction price allocated to an unsatisfied or partially unsatisfied performance obligation will result in a loss on that performance obligation.

To determine whether the guidance on loss provisions applies, an entity is still required to determine whether a good or service is software that requires significant production, modification, or customization. Current U.S. GAAP specifies that when a service is essential to the functionality of software, an entity treats the software and service as a single unit of account and applies construction- and production-type contract accounting. However, it is unclear whether the separation guidance in the new standard will result in the same determination as to whether the software is a separate performance obligation from the services. For additional observations on the separation guidance related to software arrangements, see 5.2 and Section 8.

Continuing care retirement community (CCRC) contracts

954-440-35-1 to 35-3

There is specific loss guidance for contracts with CCRC residents. That guidance requires that the obligation to provide future services and the use of facilities to current residents is calculated annually to determine whether a liability is recognized. If the advanced fees and periodic fees charged to the customer are insufficient to meet the costs of providing future services and the use of facilities, the CCRC recognizes a liability for the excess of the anticipated costs over the anticipated revenue. This amount is generally recognized as an operating expense in the income statement.

Although the calculation for a potential loss on CCRC contracts has not changed, the deferred revenue included in that calculation could change as a result of applying the new standard – e.g., if an entity determines that there is a significant financing component in the contract because the customer pays an up-front fee.

Prepaid health care service contracts

[954-450-30-3 to 30-4](#)

There is also specific guidance on loss provisions for prepaid health care service contracts. That guidance uses the 'probable' threshold for recognizing losses when future health care costs and maintenance costs under a group of existing contracts will exceed anticipated future premiums, and stop-loss insurance recoveries on those contracts. These losses are generally recognized as an operating expense in the income statement.

Long-term power sales contracts

[980-350-35-3](#)

Under the guidance for long-term power sales contracts, if such a contract is not accounted for as a derivative, then it is periodically reviewed to determine whether it is a loss contract. If it is determined to be a loss contract, the loss is recognized immediately – generally as an operating expense.

Federal government contracts

[912-20-45-5](#)

The guidance on federal government contracts requires a loss on the termination of a contract for default to be presented as a separate item in the income statement, or disclosed under the loss contingency guidance. These losses are generally recognized as an operating expense in the income statement.

11 Presentation

Overview

This section addresses the presentation requirements for the statement of financial position.

Requirements of the new standard

An entity presents a contract liability or a contract asset in its statement of financial position when either party to the contract has performed. The entity performs by transferring goods or services to the customer, and the customer performs by paying consideration to the entity.



606-10-45-1
[IFRS 15.105]

606-10-45-1 to 45-3
[IFRS 15.105 to 107]

606-10-45-4; Topic 310
[IFRS 15.108; IFRS 9]

606-10-45-5
[IFRS 15.109]

Any unconditional rights to consideration are presented separately as a receivable.

‘Contract liabilities’ are obligations to transfer goods or services to a customer for which the entity has received consideration, or for which an amount of consideration is due from the customer.

‘Contract assets’ are rights to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time.

‘Receivables’ are unconditional rights to consideration. A right to consideration is ‘unconditional’ if only the passage of time is required before payment of that consideration is due. Receivables are presented separately from contract assets. An entity accounts for receivables, including their measurement and disclosure, using current guidance. On initial recognition of a receivable, any difference between the measurement of the receivable and the corresponding amount of revenue recognized is presented as an expense. Any subsequent impairment of the receivable is also accounted for as an expense.

An entity may use alternative captions for the contract assets and contract liabilities in its statement of financial position. However, it should provide sufficient information to distinguish a contract asset from a receivable.

Example 42

Contract liability and receivable for a cancelable contract

On January 1, 2019, Manufacturer D enters into a cancelable contract to transfer a product to Customer E on March 31, 2019. The contract requires Customer E to pay consideration of 1,000 in advance on January 31, 2019. Customer E pays the consideration on March 1, 2019. Manufacturer D transfers the product on March 31, 2019. Manufacturer D accounts for the contract, excluding contract costs, as follows.

606-10-55-284
[IFRS 15.IE198]

March 1, 2019	Debit	Credit
Cash	1,000	
Contract liability		1,000
<i>To record the cash of 1,000 received (cash is received in advance of performance)</i>		
Contract liability	1,000	
Revenue		1,000
<i>To record Manufacturer D's satisfaction of the performance obligation</i>		

Example 43

Contract liability and receivable for a non-cancelable contract

Continuing Example 42 in this publication, assume that Manufacturer D's contract is non-cancelable. Manufacturer D recognizes a receivable on January 31, 2019, because it has an unconditional right to consideration. Manufacturer D accounts for the contract, excluding contract costs, as follows.

January 31, 2019	Debit	Credit
Receivable	1,000	
Contract liability		1,000
<i>To record the amount of consideration due</i>		
Cash	1,000	
Receivable		1,000
<i>To record Manufacturer D's receipt of the cash</i>		
Contract liability	1,000	
Revenue		1,000
<i>To record Manufacturer D's satisfaction of the performance obligation</i>		

Observations

Contract asset and contract liability – based on past performance

The new standard requires that an entity presents a contract asset or contract liability after at least one party to the contract has performed. However, Example 38 in the new standard suggests that an entity recognizes a receivable when it is due if the contract is non-cancelable, because the entity has an unconditional right to consideration. Therefore, an entity may recognize a receivable and a corresponding contract liability before performance occurs.

606-10-55-285 to 55-286
[IFRS 15.IE199 to IE200]

606-10-55-285 to 55-286
[IFRS 15.IE199 to IE200]

606-10-55-287 to 55-290
[IFRS 15.IE201 to IE204]

ASU 2014-09 BC326
[IFRS 15.BC326]

ASU 2014-09 BC317
[IFRS 15.BC317]

ASU 2014-09 BC301
[IFRS 15.BC301]

ASU 2014-09 BC320 to BC321
[IFRS 15.BC320 to BC321]

Receivable – based on unconditional right to consideration

The new standard includes an illustrative example on the difference between a contract asset and a receivable, which portrays a situation where the right to consideration for a delivered product is conditional on the delivery of a second product. Because the right to consideration for the first product is not unconditional, an entity recognizes a contract asset instead of a receivable.

The Boards believe that an entity's possible obligation to refund consideration to a customer in the future will not affect the entity's present right to the gross amount of consideration – e.g., when a right of return exists, an entity recognizes a receivable and a refund liability for the amount of the estimated refund.

Some guidance provided on presentation of contract assets and contract liabilities

A single contract is presented either as a net contract asset or as a net contract liability. However, total contract assets are presented separately from total contract liabilities. An entity does not net the two to present a net position on contracts with customers.

An asset arising from the costs of obtaining a contract is presented separately from the contract asset or liability.

The new standard does not specify whether an entity is required to present its contract assets and contract liabilities as separate line items. Therefore, an entity should apply the general principles for the presentation of financial statements.

Comparison with current IFRS

A consistent, systematic approach to presentation

[IAS 11.42 to 44]

Under current IFRS, entities applying the percentage-of-completion method under IAS 11 present the gross amount due from customers for contract work as an asset, and the gross amount due to customers as a liability. For other contracts, entities present accrued or deferred income, or payments received in advance or on account, to the extent that payment is received before or after performance.

The new standard contains a single, more systematic approach to presentation in the statement of financial position and does not distinguish between different types of contracts with customers.

Comparison with current U.S. GAAP

605-35-45-3 to 45-4

Under current U.S. GAAP for construction- and production-type contracts, an entity applying the percentage-of-completion method recognizes:

- an asset for costs and recognized income not yet billed; or
- a liability for billings in excess of costs and recognized income.

An entity applying the completed-contract method recognizes:

- an asset for the excess of accumulated costs over related billings; or
- a liability for an excess of accumulated billings over related costs.

For other contracts, an entity presents accrued or deferred income, or payments received in advance or on account, to the extent that payment is received before or after performance.

The new standard contains a single, more systematic approach to presentation in the statement of financial position and does not distinguish between different types of contracts with customers. In addition, for performance obligations that are satisfied over time, an entity would not recognize work in progress or its equivalent because the customer controls the asset as it is created or enhanced.

12 Disclosure

Overview

The new standard contains both qualitative and quantitative disclosure requirements for annual and interim periods. There are some differences between the disclosures required in interim financial statements for entities reporting under IFRS and U.S. GAAP. In addition, certain entities applying U.S. GAAP are provided with relief from some of the disclosure requirements.

12.1 Annual disclosure

Requirements of the new standard

The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of the financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

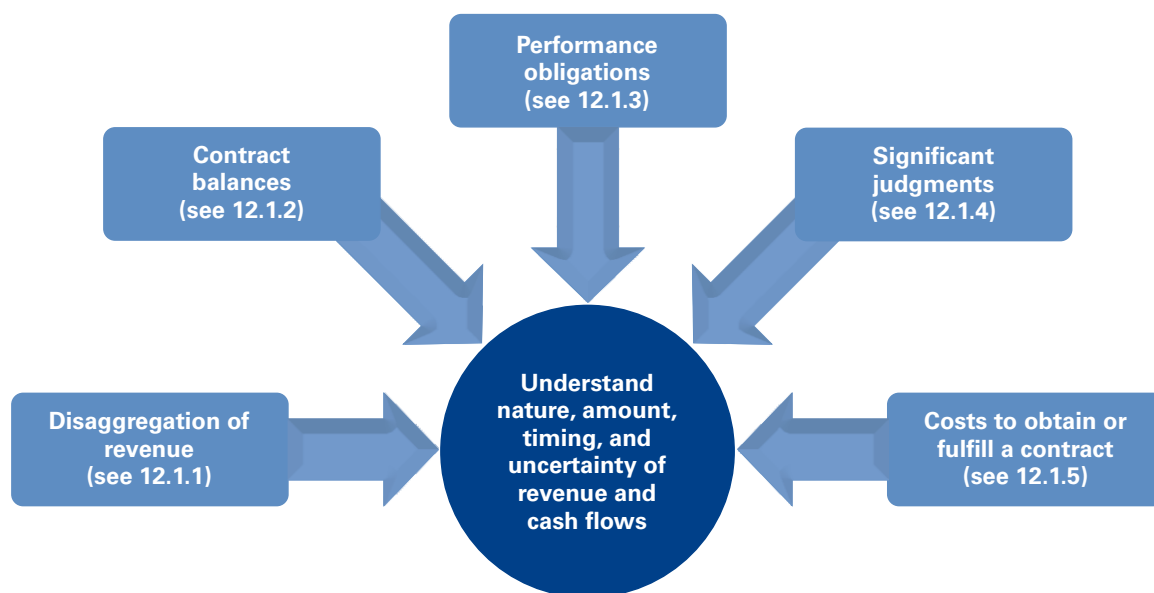
An entity is required to disclose, separately from other sources of revenue, revenue recognized from contracts with customers, and any impairment losses recognized on receivables or contract assets arising from contracts with customers. If an entity elects either the practical expedient not to adjust the transaction price for a significant financing component (see 5.3.2) or the practical expedient not to capitalize costs incurred to obtain a contract (see 6.1), then it discloses that fact.

The new standard includes disclosure requirements on the disaggregation of revenue, contract balances, performance obligations, significant judgments, and assets recognized to obtain or fulfill a contract. For further discussion on the required transition disclosures, see Section 13.

606-10-50-1
[IFRS 15.110]

606-10-50-4, 50-22
[IFRS 15.113, 129]

606-10-50-5 to 50-6,
55-89 to 55-91
[IFRS 15.114 to 115, B87
to B89]



Observations

Extensive new disclosures introduced

Under the new standard, an entity discloses more information about its contracts with customers than is currently required, including more disaggregated information about revenue and more information about its performance obligations remaining at the reporting date. For entities applying U.S. GAAP, much of this disclosure is also required in interim financial statements for public business entities, and not-for-profit entities that are conduit bond obligors. For entities applying IFRS, less extensive disclosures are required in interim financial statements than for public business entities applying U.S. GAAP (see 12.2).

Entities will need to assess whether their current systems and processes are capable of capturing, tracking, aggregating, and reporting information to meet the disclosure requirements of the new standard. For many entities, this may require significant changes to existing data-gathering processes, IT systems, and internal controls.

Entities need to consider the internal controls necessary to ensure the completeness and accuracy of the new disclosures – especially if the required data was not previously collected, or was collected for purposes other than financial reporting. Because the new standard may require new judgments and perhaps different analyses, entities should consider the skill level, resource capacity, and training needs of employees who will be responsible for performing the new or modified controls.

Disclosure of potential effects of the new standard required before adoption

IFRS and SEC guidance require entities to disclose the potential effects that recently issued accounting standards will have on the financial statements when adopted. Therefore, for reporting periods after the issuance of the new standard, entities will be required to provide disclosures about the new standard's potential effects. These disclosures are likely to become more detailed as the effective date approaches.

*SEC SAB Topic 11.M
[IAS 8.30 to 31]*

Comparison with current IFRS

Additional disclosures

The new standard's disclosures are significantly more extensive and detailed than the current requirements in IAS 18 and IAS 11. For example, detailed disclosures about an entity's performance obligations – e.g., when an entity expects to satisfy its performance obligations – and significant payment terms at the level of performance obligations, are currently not required.

*[IAS 11.39 to 45;
IAS 18.35 to 36]*

Comparison with current U.S. GAAP

Disclosures apply to all industries

U.S. GAAP includes disclosure requirements in the general revenue topic and in specific industry revenue topics. For example, specific disclosures are required for multiple-element arrangements, construction- and production-type contracts, franchisors, and health care entities. The disclosure requirements in the new standard apply to all in-scope revenue contracts, regardless of the transaction or industry, and are generally more extensive than the transaction- and industry-specific disclosure requirements.

*605-25-50, 35-50;
952-605-50;
954-605-50*

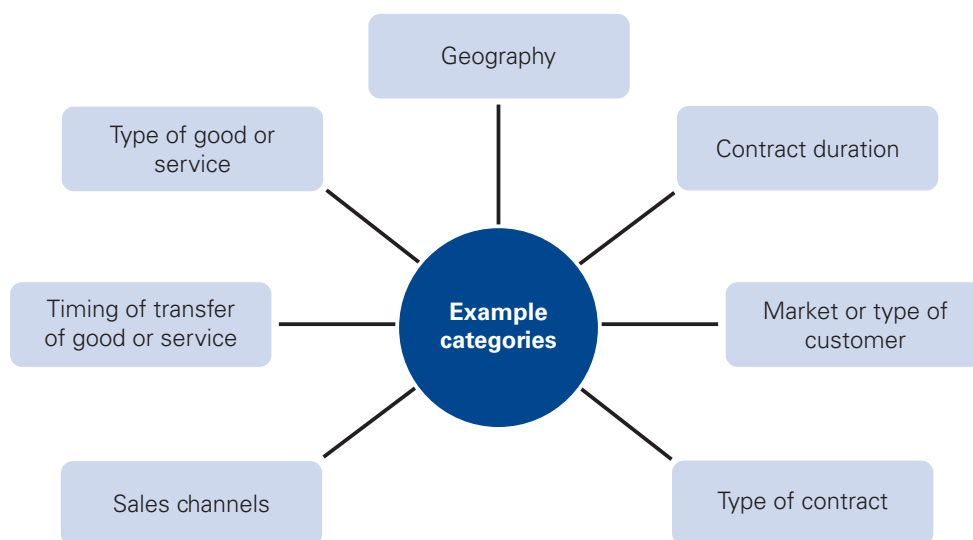
12.1.1

Disaggregation of revenue

606-10-50-5, 55-91
[IFRS 15.114, B89]

Requirements of the new standard

The new standard requires the disaggregation of revenue from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors, and includes examples of such categories.



606-10-50-6,
55-89 to 55-90
[IFRS 15.115,
B87 to B88]

An entity also discloses the relationship between the disaggregated revenue and the entity's segment disclosures.

In determining these categories, an entity considers how revenue is disaggregated, in:

- disclosures presented outside of the financial statements – e.g., earnings releases, annual reports, or investor presentations;
- information reviewed by the chief operating decision maker for evaluating the financial performance of operating segments; and
- other information similar to (a) and (b) that is used by the entity or users of the entity's financial statements to evaluate performance or make resource allocation decisions.

Example 44

Disaggregation of revenue

Company X reports the following segments in its financial statements: consumer products, transportation, and energy. When Company X prepares its investor presentations, it disaggregates revenue by primary geographical markets, major product lines, and the timing of revenue recognition – i.e., separating goods transferred at a point in time and services transferred over time.

Topic 280; 606-10-55-295
to 55-297
[IFRS 8; IFRS 15.IE210
to IE211]

Company X determines that the categories used in the investor presentations can be used for the disaggregation disclosure requirement. The following table illustrates the disaggregation disclosure by primary geographical market, major product line, and timing of revenue recognition. It includes a reconciliation showing how the disaggregated revenue ties in with the consumer products, transportation, and energy segments.

Segments	Consumer products	Transportation	Energy	Total
Primary geographical markets				
North America	990	2,250	5,250	8,490
Europe	300	750	1,000	2,050
Asia	700	260	-	960
	1,990	3,260	6,250	11,500
Major goods/service lines				
Office supplies	600	-	-	600
Appliances	990	-	-	990
Clothing	400	-	-	400
Motorcycles	-	500	-	500
Automobiles	-	2,760	-	2,760
Solar panels	-	-	1,000	1,000
Power plant	-	-	5,250	5,250
	1,990	3,260	6,250	11,500
Segments	Consumer products	Transportation	Energy	Total
Timing of revenue recognition				
Goods transferred at a point in time	1,990	3,260	1,000	6,250
Services transferred over time	-	-	5,250	5,250
	1,990	3,260	6,250	11,500

Observations

No minimum number of categories required

Although the new standard provides some examples of disaggregation categories, it does not prescribe a minimum number of categories. The number of categories required to meet the disclosure objective will depend on the nature of the entity's business and its contracts.

12.1.2

Contract balances

606-10-50-8 to 50-10
[IFRS 15.116 to 118]

Requirements of the new standard

An entity is required to disclose all of the following:

- the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with customers (if not otherwise separately presented or disclosed);
- the amount of revenue recognized in the current period that was included in the opening contract liability balance;
- the amount of revenue recognized in the current period from performance obligations satisfied (or partially satisfied) in previous periods – e.g., changes in transaction price;
- an explanation of how the entity's contracts and typical payment terms will affect its contract asset and contract liability balances; and
- an explanation of the significant changes in the balances of contract assets and contract liabilities, which should include both qualitative and quantitative information – examples could include:
 - changes arising from business combinations;
 - cumulative catch-up adjustments to revenue (and to the corresponding contract balance) arising from a change in the measure of progress, a change in the estimate of the transaction price, or a contract modification;
 - impairment of a contract asset; or
 - a change in the time frame for a right to consideration becoming unconditional (reclassified to a receivable) or for a performance obligation to be satisfied (the recognition of revenue arising from a contract liability).

Observations

Required disclosures already made in some industries

ASU 2014-09 BC346
[IFRS 15.BC346]

Some entities with long-term contracts – e.g., construction contracts – already provide disclosures on unbilled accounts receivable or deferred revenue, which may limit the amount of new information those entities have to gather in order to comply with the new disclosure requirements for contract balances.

12.1.3

Performance obligations

606-10-50-12 to 50-13
[IFRS 15.119 to 120]

Requirements of the new standard

An entity describes the following information about its performance obligations:

- when the entity typically satisfies its performance obligations – e.g., on shipment, on delivery, as services are rendered, or on completion of service;
- significant payment terms – e.g., whether the contract has a significant financing component, the consideration is variable, and the variable consideration is constrained;
- the nature of the goods or services that it has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (if the entity is acting as an agent);
- obligations for returns, refunds, and other similar obligations;
- types of warranties and related obligations; and
- the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied) at the reporting date. The entity also provides either a quantitative (using time bands) or a qualitative explanation of when it expects that amount to be recognized as revenue.

606-10-50-14
[IFRS 15.121]

As a practical expedient, an entity is not required to disclose the transaction price allocated to unsatisfied (or partially unsatisfied) performance obligations if:

- the contract has an original expected duration of one year or less; or
- the entity applies the practical expedient to recognize revenue at the amount to which it has a right to invoice, which corresponds directly to the value to the customer of the entity's performance completed to date – e.g., a service contract in which the entity bills a fixed hourly amount.

606-10-50-15
[IFRS 15.122]

The entity should also disclose whether it is applying the practical expedient and whether any consideration from contracts with customers is not included in the transaction price – e.g., whether the amount is constrained and therefore not included in the disclosure.

Observations

Remaining performance obligation disclosures may differ from current backlog disclosures

ASU 2014-09 BC349
[IFRS 15.BC349]

Some entities, including those with long-term contracts, currently disclose backlog (i.e., contracts received but incomplete or not yet started) either in the footnotes to the financial statements or elsewhere (e.g., management's discussion and analysis). However, the remaining performance obligation disclosure may differ from that which some entities currently disclose as backlog, because it does not include orders for which neither party has performed. Under SEC regulations, backlog is subject to legal interpretation, but the disclosure for remaining performance obligations is based on a GAAP determination of the transaction price for unsatisfied (or partially unsatisfied) performance obligations, which may be different.

Contract renewals only included if they provide a material right

The new standard requires that passive and active renewals are accounted for in the same way, because the customer is making the same economic decision. For example, a one-year service contract with an option to renew for an additional year at the end of the initial term is economically the same as a two-year service contract that allows the customer to cancel the contract at the end of the first year and avoid payment for the second year.

Contracts with passive or active renewals that do not give the customer a material right are not included in the disclosure of remaining performance obligations, but a one-year contract with a renewal period that is a material right will be included. Similarly, a two-year contract that provides the customer with a cancellation provision after the first year will be included in the disclosure of remaining performance obligations if the second year of the contract provides the customer with a material right.

Certain contracts can be excluded from remaining performance obligation disclosures

The practical expedient allows an entity to exclude from the remaining performance obligations disclosure contracts that have an original expected duration of one year or less. However, an entity is not precluded from including all contracts in the disclosure.

Constrained transaction price used in remaining performance obligation disclosures

The transaction price used in the remaining performance obligations disclosure is the constrained amount. An entity also explains qualitatively whether any consideration is not included in the transaction price – e.g., constrained variable consideration – and, therefore, is not included in the remaining performance obligations disclosure.

12.1.4**Significant judgments when applying the new standard****Requirements of the new standard**

606-10-50-17
[IFRS 15.123]

An entity discloses the judgments and changes in judgments made in applying the new standard that affect the determination of the amount and timing of revenue recognition – specifically, those judgments used to determine the timing of the satisfaction of performance obligations, the transaction price, and amounts allocated to performance obligations.

606-10-50-18
[IFRS 15.124]

For performance obligations that are satisfied over time, an entity describes the method used to recognize revenue – e.g., a description of the output or input method and how those methods are applied – and why such methods are a faithful depiction of the transfer of goods or services.

606-10-50-19
[IFRS 15.125]

For performance obligations that are satisfied at a point in time, the new standard requires a disclosure about the significant judgments made to evaluate when the customer obtains control of the promised goods or services.

606-10-50-20
[IFRS 15.126]

An entity also discloses information about the methods, inputs, and assumptions used to:

- determine the transaction price, which includes estimating variable consideration, assessing whether the variable consideration is constrained, adjusting the consideration for a significant financing component, and measuring noncash consideration;
- allocate the transaction price, including estimating the stand-alone selling prices of promised goods or services and allocating discounts and variable consideration; and
- measure obligations for returns and refunds, and other similar obligations.

Observations

Greater specificity provided

ASU 2014-09 BC355
[IFRS 15.BC355]

IFRS and U.S. GAAP currently have general requirements for disclosing an entity's significant accounting estimates and judgments, but the new standard provides specific areas where disclosures about the estimates used and judgments made in determining the amount and timing of revenue recognition should be provided.

12.1.5

Assets recognized for costs to obtain or fulfill a contract with a customer

340-40-50-1 to 50-3
[IFRS 15.127 to 128]

Requirements of the new standard

An entity discloses the closing balance of assets that are recognized from the costs incurred to obtain or fulfill a contract with a customer, separating them by their main category – e.g., acquisition costs, pre-contract costs, set-up costs, and other fulfillment costs – and the amount of amortization and any impairment losses recognized in the reporting period. An entity describes the judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer and the method used to determine the amortization for each reporting period.

12.2

Interim disclosures

270-10-50-1A
[IAS 34.16A(g)]

Requirements of the new standard

Both IFRS and U.S. GAAP require entities to include information about disaggregated revenue in their interim financial reporting. U.S. GAAP further requires public business entities, not-for-profit entities that are conduit bond obligors, and employee benefit plans that file or furnish financial statements with the SEC to provide the following disclosures for interim financial reporting, if they are material:

- the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with customers (if they are not otherwise separately presented or disclosed);
- the amount of revenue recognized in the current period that was included in the opening contract liability balance;
- the amount of revenue recognized in the current period from performance obligations that were satisfied (or partially satisfied) in previous periods – e.g., changes in transaction price; and
- information about the entity's remaining performance obligations.

Topic 270
[IAS 34]

Observations

Different interim disclosure requirements under IFRS and U.S. GAAP

IFRS and U.S. GAAP on interim reporting require, as a general principle, an entity to disclose information about significant changes in its financial position and performance since the last annual reporting period. However, the Boards reached different conclusions on the extent to which disclosures required by the new standard in the annual financial statements should also be required in interim financial statements. The IASB is currently undertaking a 'disclosure initiative', which includes a number of implementation and research projects on disclosures, and decided not to make extensive changes to the disclosure requirements of IAS 34 at this time. The FASB decided to require more extensive disclosures in interim financial statements, stating that the information was useful for investors and that the disclosures would not involve significant incremental cost for preparers.

12.3 Disclosures for all other entities (U.S. GAAP only)

606-10-50-7, 50-11,
50-16, 50-21;
340-40-50-4

Requirements of the new standard

Disaggregation of revenue

All other entities that apply U.S. GAAP – i.e., other than public business entities and not-for-profit entities that are conduit bond obligors – can elect not to provide the quantitative disaggregation of revenue disclosures that is required for public business entities (see 12.1.1).

However, they are still required to disclose, at a minimum, information about the disaggregation of revenue, including:

- the timing of the transfer of goods or services – e.g., revenue from goods or services that are transferred to customers at a point in time and revenue from goods or services that are transferred over time; and
- qualitative information about how economic factors – e.g., type of customer, geographical location of customers, and type of contract – and significant changes in those economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows.

Contract balances and contract costs

All other entities can elect not to provide the disclosures about contract balances and the costs to obtain or fulfill a contract with a customer. These entities are required to disclose the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with customers if they are not otherwise separately presented or disclosed in the statement of financial position.

Performance obligations

All other entities can elect not to disclose the amount of the transaction price allocated to remaining performance obligations, including the explanation of when those amounts are expected to be recognized as revenue.

Significant judgments in applying the guidance

All other entities disclose the significant judgments and any changes in judgments when applying the new standard that significantly affect the determination of the amount and timing of revenue from contracts with customers. In meeting this requirement, they explain those judgments that are made in determining:

- the timing of the satisfaction of performance obligations, the transaction price, and the amounts allocated to performance obligations;
- the methods used to recognize revenue – e.g., a description of the output or input methods and how those methods are applied for performance obligations that are satisfied over time; and
- the methods, inputs, and assumptions used when determining whether an estimate of variable consideration is constrained.

These entities can elect not to provide the other qualitative disclosures about their judgments that significantly affect the determination of the amount and timing of revenue from contracts with customers described in 12.1.4.

Interim disclosures

All other entities are not required to apply the revenue-specific interim disclosures described in 12.2.

13 Effective date and transition

Overview

The following table sets out the effective date of the new standard for IFRS and U.S. GAAP entities.

Type of entity	Annual periods commencing on or after
IFRS entities	January 1, 2017
Public business entities and not-for-profit entities that are conduit bond obligors applying U.S. GAAP	December 16, 2016
All other U.S. GAAP entities	December 16, 2017

An entity can elect to adopt the new standard a variety of ways, including retrospectively with a choice of three optional practical expedients (see 13.2), or from the beginning of the year of initial application with no restatement of comparative periods (see 13.3).

The examples used to illustrate the application of the transition methods in this section reflect a calendar year-end entity that applies the new standard as of January 1, 2017 and includes two years of comparative financial statements.

For additional examples on applying the transition methods, refer to our publication [Transition to the new revenue standard](#).

13.1 Effective date

Requirements of the new standard

606-10-65-1(a) to 65-1(b)
[IFRS 15.C1]

The new standard is effective for annual periods beginning after December 15, 2016, and interim reporting periods therein, for public business entities and not-for-profit entities that are conduit bond obligors applying U.S. GAAP⁸ and for annual periods beginning on or after January 1, 2017 for entities applying IFRS.

Difference between IFRS and U.S. GAAP

Early adoption only permitted for IFRS entities

606-10-65-1(a) to 65-1(b)
[IFRS 15.C1]

An entity that applies IFRS may elect to apply the new standard for an annual reporting period beginning earlier than January 1, 2017. If an entity early adopts the new standard, it discloses that fact. Public business entities and not-for-profit entities that are conduit bond obligors applying U.S. GAAP are not permitted to early adopt the new standard. However, other entities applying U.S. GAAP may elect to apply the new standard as of the effective date for public business entities.

8 There is a one-year deferral for annual reporting and a two-year deferral for interim reporting for other entities applying U.S. GAAP (see 13.1.1).

Different effective dates

IFRS has one effective date for all entities adopting the new standard, whereas U.S. GAAP has different effective dates depending on the entity. Entities that are not public business entities or not-for-profit entities that are conduit bond obligors have the option to defer application of the new standard for one year for annual reporting purposes. The effective date of the U.S. GAAP version of the new standard is consistent with its typical mid-month convention, which requires entities with fiscal year-ends near the end of the calendar year – e.g., 52/53 week reporting entities – to adopt the new standard at about the same time as entities with calendar year-end financial reporting dates. The effective date of the IFRS version of the new standard is consistent with its typical beginning-of-year convention.

Observations

Boards reached different decision on early adoption

In deciding to prohibit early adoption for public business entities and not-for-profit entities that are conduit bond obligors, the FASB prioritized comparability between entities reporting under U.S. GAAP. In particular, the FASB wanted to avoid having public business entities in the same line of business reporting under different revenue recognition requirements before 2017.

By contrast, the IASB prioritized the improvements in financial reporting that it believes will be achieved by the new standard. In particular, the IASB believes that the new standard will help resolve certain application issues that arise under current IFRS – e.g., application issues associated with IFRIC 15. On balance, the IASB concluded that the potential improvements in financial reporting outweighed the reduction in comparability between entities before 2017.

13.1.1

All other entities (U.S. GAAP only)

606-10-65-1(b)

Requirements of the new standard

All other entities applying U.S. GAAP – i.e., all entities other than public business entities and not-for-profit entities that are conduit bond obligors – have a one-year deferral for annual reporting on applying the new standard and a two-year deferral for interim reporting. For these entities, the new standard is effective for annual reporting periods beginning after December 15, 2017, and interim reporting periods in fiscal years beginning after December 15, 2018. These entities may elect to early adopt the requirements of the new standard, but no earlier than the effective date for public business entities.

Observations

Multiple adoption date options for all other entities under U.S. GAAP

Entities other than public business entities and not-for-profit entities that are conduit bond obligors may elect to start applying the requirements of the new standard for:

- the annual reporting period beginning after December 15, 2016, including interim reporting periods within that year or interim reporting periods beginning in the following year; or
- the annual reporting period beginning after December 15, 2017, including interim reporting periods within that year or interim reporting periods beginning in the following year.

13.2 Retrospective method

606-10-65-1(c)(1),
65-1(d)(1)
[IFRS 15.C2(a), C3(a)]

606-10-65-1(f)
[IFRS 15.C5]

606-10-65-1(g)
[IFRS 15.C6]

606-10-65-1(e)
[IFRS 15.C4]

Requirements of the new standard

Under the retrospective method, an entity is required to restate each period before the date of initial application that is presented in the financial statements. The 'date of initial application' is the start of the reporting period in which an entity first applies the new standard. For example, if an entity first applies the new standard in its financial statements for the year ended December 31, 2017, then the date of initial application is January 1, 2017. The entity recognizes the cumulative effect of applying the new standard in equity (generally, retained earnings or net assets) at the start of the earliest comparative period presented.

An entity that elects to apply the new standard using the retrospective method can choose to do so on a full retrospective basis or with one or more of the three available practical expedients. The practical expedients provide relief from applying the requirements of the new standard to certain types of contracts in the comparative periods presented. For further discussion on the expedients, see 13.2.1 to 13.2.3.

If an entity applies one or more practical expedients, then it needs to do so consistently for all goods or services for all periods presented. In addition, the entity discloses the following information:

- the expedients that have been used; and
- to the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients.

An entity is also required to comply with applicable disclosure requirements for a change in accounting principle, including the amount of the adjustment to the financial statement line items and earnings per share amounts affected.

Difference between IFRS and U.S. GAAP

Quantitative disclosure only required for immediately preceding annual period under IFRS

Under U.S. GAAP, the change in accounting principle disclosure for the amount of the adjustment to the financial statement line items and earnings per share amounts affected are presented for the year of initial application and for each prior period presented. However, under IFRS only the equivalent disclosures for the period immediately preceding the year of initial application are required, regardless of the number of comparative periods presented.

606-10-65-1(e);
250-10-50-1(b)(2)
[IFRS 15.C4; IAS 8.28(f)]

Example 45

Full retrospective method

Software CompanyY enters into a contract with a customer to provide a software term license and telephone support for two years for a fixed amount of 400. The software is delivered and operational on July 1, 2015.

Under current GAAP, Software CompanyY recognizes revenue for the arrangement on a straight-line basis over the 24-month contract term.

Under the new standard, Software CompanyY determines that the contract consists of two performance obligations: the software license and the telephone support. Software CompanyY allocates 300 of the transaction price to the software license and 100 to the telephone support.

Software CompanyY determines that the telephone support is a performance obligation satisfied over time, and its progress is best depicted by direct labor hours as follows: 2015: 30; 2016: 50; and 2017: 20. The software license is a point-in-time performance obligation, and the 300 is recognized as revenue on the delivery date of July 1, 2015.

Software CompanyY decides to apply the retrospective method and therefore presents the following amounts.

	2015	2016	2017
Revenue	330 ^(a)	50	20

Note

(a) Calculated as 300 for the software license plus 30 for the telephone support.

Software CompanyY does not need to make an opening adjustment to equity at January 1, 2015, because the contract began on July 1, 2015. Software CompanyY also considers the effect of the change in revenue recognition on related cost balances, and makes appropriate adjustments.

Observations

All contracts open and closed under current GAAP require consideration

If an entity applies the new standard on a full retrospective basis, then all contracts with customers are potentially open – even if they are considered closed under current GAAP.

For example, entities with contracts that included after-sale services accounted for as sales incentives will be required to re-analyze those contracts, to:

- determine whether the after-sale service is a performance obligation under the new standard; and
- assess whether any performance obligations identified have been satisfied.

Cost line items may also require adjustment

When making adjustments, the entity may also be required to adjust some cost balances in the financial statements if these are affected by the new requirements – e.g., if the entity is required under the new standard to capitalize and amortize the costs of acquiring a contract, whereas under current GAAP the entity had expensed those costs as incurred.

Regulatory requirements need to be considered

Entities that elect the retrospective method may also need to consider the effect on any additional historical data that forms part of, or accompanies, the financial statements, or that is filed in accordance with regulatory requirements.

Under Regulation S-K,⁹ domestic SEC registrants are required to disclose at least five years of selected financial data to highlight significant trends in financial conditions and the results of operations. The SEC staff recently stated that it will not object if registrants that elect to apply the new standard retrospectively choose to do so only to the periods covered by the financial statements when preparing their selected financial data, provided that they clearly indicate that the earlier periods are prepared on a different basis than the most recent periods.

13.2.1

Practical expedient 1 – Contracts that begin and complete in the same annual reporting period

606-10-65-1(c)(2),
65-1(f)(1)
[IFRS 15.C2(b), C5(a)]

Requirements of the new standard

Under practical expedient 1, for contracts that are completed under current GAAP – i.e., for which the entity has fully performed its obligations under the revenue guidance that is in effect before the date of initial application – an entity need not restate contracts that begin and complete within the same annual reporting period.

Example 46

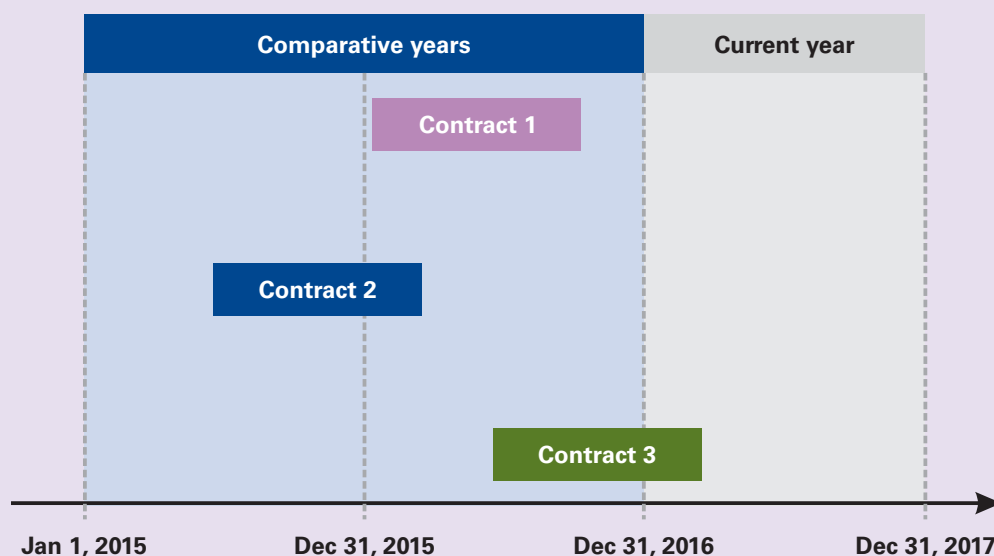
Applying practical expedient 1

Contract Manufacturer X has the following contracts with customers, each of which runs for eight months.

Contract	Starts	Completes
1	January 1, 2016	August 31, 2016
2	May 1, 2015	February 28, 2016
3	May 1, 2016	February 28, 2017

⁹ SEC Regulation S-K, Item 301, *Selected Financial Data*, available at www.sec.gov.

Contract timelines



Contract Manufacturer X determines that practical expedient 1:

- applies to Contract 1, because Contract 1 begins and completes in an annual reporting period before the date of initial application;
- does not apply to Contract 2, because even though Contract 2 is for a period of less than 12 months, it is not completed within a single annual reporting period; and
- does not apply to Contract 3, because Contract 3 is not completed under current GAAP by the date of initial application.

Observations

What relief does practical expedient 1 provide?

This practical expedient might seem to be of limited benefit, because any adjustments are made in the same period as the contract begins and completes, and therefore revenue for the annual period is not affected. However, it can provide relief for some types of transactions – e.g., when:

- additional performance obligations are identified in a contract under the new standard, as compared to current GAAP – e.g., some automotive sales in which the manufacturer provides a free service to the end purchaser of a car and treats this as a sales incentive under current GAAP;
- a contract that was treated as a point in time transaction under current GAAP is treated as an over-time obligation under the new standard – e.g., some construction contracts for apartment sales; and
- a contract begins and completes in the same annual reporting period, but spans one or more interim periods (although in these situations the entity will also need to consider the importance of comparability from one interim period to another).

13.2.2

Practical expedient 2 – Exemption from applying variable consideration requirements

606-10-65-1(f)(2)
[IFRS 15.C5(b)]

Requirements of the new standard

Under practical expedient 2, an entity may use the transaction price at the date on which the contract was completed, rather than estimating the variable consideration amounts in each comparative reporting period.

Example 47

Applying practical expedient 2

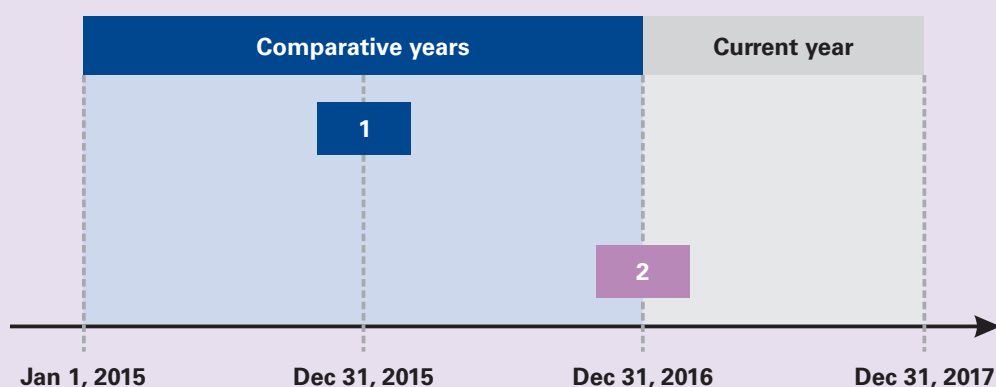
Manufacturer X enters into the following contracts.

Contract	Starts	End of return period	Description
1	October 1, 2015	December 29, 2015	A contract to sell 1,000 products to Customer Y
2	October 1, 2016	December 29, 2016	A contract to sell 2,000 products to Customer Z

Manufacturer X also grants Customer Y and Customer Z the right to return any unused product within 90 days.

In February 2016, Customer Y returns 200 unused products, and in February 2017, Customer Z returns 300 unused products.

Contract timelines



Manufacturer X considers the application of practical expedient 2 to its contracts and determines that:

- it can use the final transaction price for Contract 1; therefore, Manufacturer X recognizes revenue for 800 products (being 1,000 products delivered less 200 products returned) on October 1, 2015 rather than estimating the consideration under Step 3 of the model, because the contract was completed before the date of initial application; and
- it is required to apply the new standard (including Step 3 of the model) to Contract 2, because this contract was not completed under current GAAP before the date of initial application.

Observations

Limited hindsight allowed

Practical expedient 2 only exempts an entity from applying the requirements on variable consideration, including the constraint in Step 3 of the model. The entity is still required to apply all other aspects of the model when recognizing revenue for the contract.

Use of practical expedient may bring forward revenue recognition

The use of this practical expedient will accelerate revenue recognition as compared with the full retrospective approach if the constraint in Step 3 of the model would otherwise have applied. This is because the final transaction price is used from inception of the contract.

13.2.3

Practical expedient 3 – Disclosure exemption

606-10-65-1(f)(3)
[IFRS 15.C5(c)]

Requirements of the new standard

Under practical expedient 3, for all reporting periods presented before the date of initial application an entity need not disclose:

- the amount of the transaction price allocated to the remaining performance obligations; nor
- an explanation of when the entity expects to recognize that amount as revenue.

Example 48

Applying practical expedient 3

Property Developer X has a contract with Customer C, to construct a building on Customer C's land for a fixed amount of 20 million. Construction starts on January 1, 2015 and is expected to take five years to complete. Property Developer X determines that it satisfies its performance obligation over time, and that the cost-to-cost method best depicts performance.

If Property Developer X elects to apply the retrospective method including practical expedient 3, then its annual financial statements for the year ended December 31, 2017 are not required to comply with the remaining performance obligation disclosure requirements for the comparative periods presented (December 31, 2016 and December 31, 2015). Assume that the building is 80% complete on December 31, 2017.

Example disclosure

Transaction price allocated to remaining performance obligations

At December 31, 2017, Property Developer X has yet to recognize as revenue 4 million of the 20 million transaction price for the construction of the building. Property Developer X expects to recognize this amount evenly over the next two years in line with the planned schedule for completion of its construction.

In accordance with the transition requirements of the new standard, Property Developer X has elected not to provide information on the transaction price allocated to remaining performance obligations at December 31, 2016 and December 31, 2015.

606-10-50-13
[IFRS 15.120]

Observations

Disclosure relief only

This expedient is a disclosure exemption only – it does not grant an entity any relief from applying the requirements of the new standard to its contracts retrospectively.

13.3 Cumulative effect method

606-10-65-1(d)(2), 65-1(h)
[IFRS 15.C3(b), C7]

Requirements of the new standard

Under the cumulative effect method, an entity applies the new standard as of the date of initial application, without restatement of comparative period amounts. The entity records the cumulative effect of initially applying the new standard – which may affect revenue and costs – as an adjustment to the opening balance of equity at the date of initial application.

Under the cumulative effect method, the requirements of the new standard apply only to contracts that are open – i.e., not complete – under current GAAP at the date of initial application.

An entity that elects this method is also required to disclose the following information:

- the amount by which each financial statement line item is affected in the current period as a result of applying the new standard; and
- an explanation of the significant changes between the reported results under the new standard and those under current GAAP.

606-10-65-1(i)
[IFRS 15.C8]

Example 49

Cumulative effect method

Modifying Example 45 in this publication, Software CompanyY decides to apply the cumulative effect method, with the following consequences.

- Software CompanyY does not adjust the comparative periods, but records an adjustment to opening equity at the date of initial application (January 1, 2017) for the additional revenue related to 2015 and 2016 that would have been recognized if the new standard had applied to those periods.
- Software CompanyY also considers the effects of the revenue adjustments on related cost balances, and adjusts them accordingly.
- Software CompanyY discloses the amount by which each financial statement line item is affected in the current period as a result of applying the new standard.

The following table illustrates the revenue amounts presented in Software Company Y's financial statements.

	2015	2016	2017
Revenue	100 ^(a)	200 ^(a)	20
Adjustment to opening equity	-	-	80 ^(b)

Notes

- (a) Amounts are not restated, and represent the amounts recognized under current GAAP for those periods.
- (b) Calculated as 300 for the software license plus 80 for the telephone support (for 2015 and 2016) minus 300 recognized under current GAAP (being $400 \times 18 / 24$).

Observations

Dual reporting still required

Because of the requirement to disclose the difference between:

- revenue and costs that would have been recognized under current GAAP in the current period; and
- the amounts that are recognized under the new standard,

an entity electing the cumulative effect method will still be required to maintain dual reporting for the year of initial application of the new standard.

13.4 First-time adoption (IFRS only)

[IFRS 1.D34 to D35]

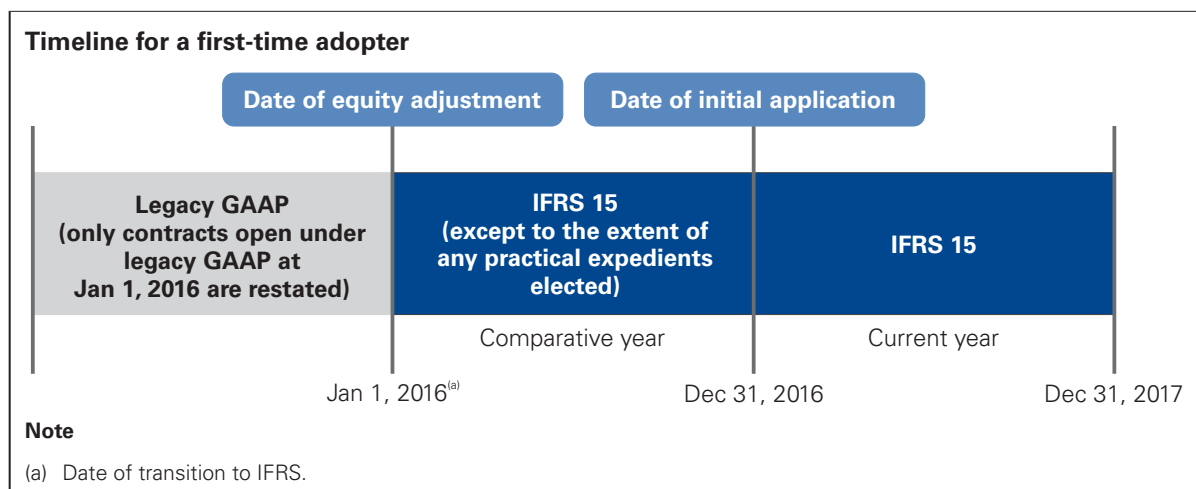
Requirements of the new standard

A first-time adopter of IFRS may adopt the new standard when it adopts IFRS. It is not required to restate contracts that were completed¹⁰ before the date of transition to IFRS – i.e., the earliest period presented.

A first-time adopter may apply the practical expedients available to an entity already applying IFRS that elects the retrospective method. In doing so, it interprets references to the 'date of initial application' as the beginning of its first IFRS reporting period. If a first-time adopter decides to apply any of the practical expedients, then it discloses:

- the expedients that have been used; and
- to the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients.

¹⁰ For a first-time adopter, a completed contract is a contract for which the entity has transferred all of the goods or services identified under current GAAP.



Example 50

First-time adopter of IFRS

Car Manufacturer M applies IFRS for the first time in its annual financial statements for the year ended December 31, 2016. Car Manufacturer M presents one year of comparative information in its financial statements, and therefore its date of transition to IFRS is January 1, 2015.

Car Manufacturer M sells cars to dealers with a promise to provide one free maintenance service to the end purchaser of a car.

Under current GAAP, Car Manufacturer M treats the free servicing component of the arrangement as a sales incentive, recognizing a provision with a corresponding expense when the vehicle is sold to the dealer. In addition, it recognizes revenue at the invoice price when the car is delivered to the dealer.

Under the new standard, Car Manufacturer M determines that the arrangement consists of two performance obligations – the sale of the car and a right to one free maintenance service. This treatment results in a different pattern of revenue recognition from current GAAP, because a portion of the transaction price is allocated to the free service and recognized as the performance obligation is satisfied.

If Car Manufacturer M elects to apply the new standard only to contracts that are not completed under current GAAP at the date of transition to IFRS, then it applies the new standard to its contracts for the sales of cars as follows.

- Car Manufacturer M makes no opening adjustments at the date of transition for contracts relating to cars that have already been delivered to the dealer, because a first-time adopter is not required to analyze contracts that are completed under current GAAP before the date of transition. This is because the cars have all been delivered and the free services are not considered to be part of the revenue transaction under current GAAP.
- If Car Manufacturer M elects to apply practical expedient 1, it does not restate the comparative period because the car sales were recognized as point-in-time sales under current GAAP.
- If Car Manufacturer M does not elect to apply practical expedient 1, then it restates sales in the comparative period for the effect of allocating the transaction price between the car and the free maintenance service.

- Car Manufacturer M applies the new standard to all car sales, starting on January 1, 2016.

An IFRS entity could achieve the same outcome as described above for a first-time adopter in two ways:

- electing a practical expedient and therefore not restating contracts that begin and complete in the same annual reporting period before the date of initial application; or
- electing to apply the cumulative effect method.

Observations

IFRS 15 can be applied in an entity's first IFRS financial statements

If an entity adopts IFRS before the mandatory effective date of IFRS 15, it will have the option to adopt:

- IAS 18, IAS 11, and related interpretations; or
- IFRS 15

in its first IFRS financial statements. However, it is likely that many first-time adopters will elect to apply IFRS 15 in their first financial statements under IFRS. Given the similarities in transition methods for first-time adopters and entities already applying IFRS, there does not appear to be any significant advantage in adopting IAS 18 and/or IAS 11 first and then transitioning to the new standard shortly afterwards.

A first-time adopter that applies the new standard in its first IFRS financial statements will have to decide precisely how to apply it. Although the cumulative effect method is not available, relevant practical expedients under the retrospective method may be used.

14

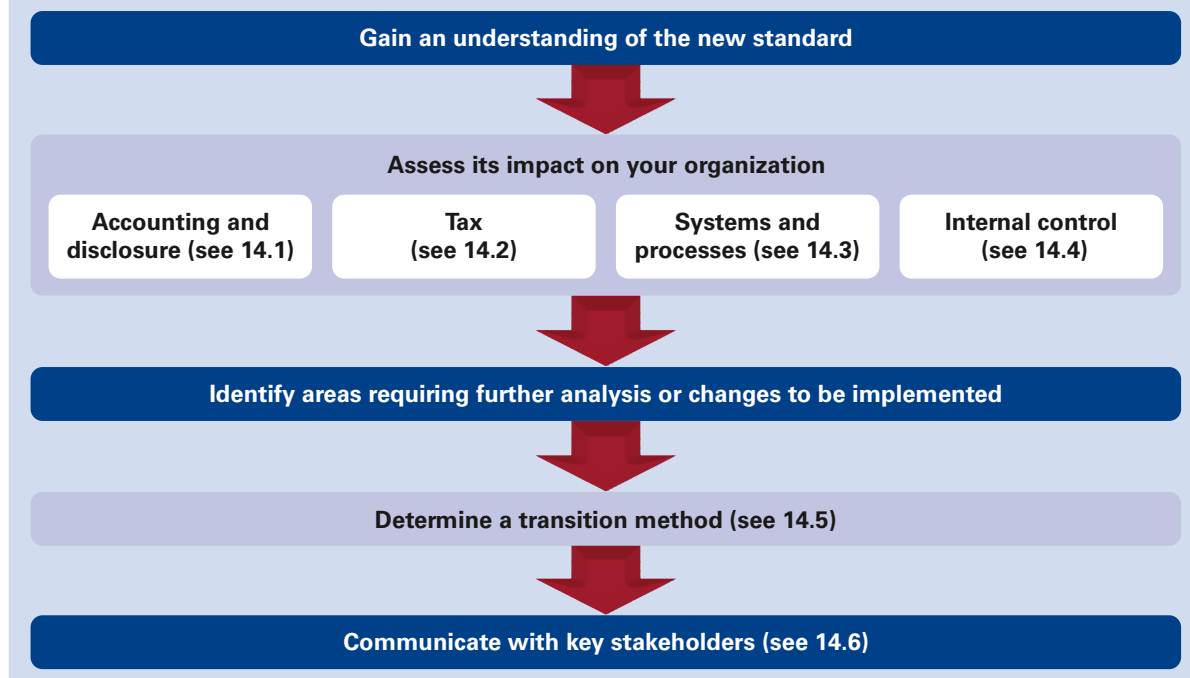
Next steps

Overview

The new standard could have far-reaching impacts – not just changing the amounts and timing of revenue, but potentially requiring changes in the core systems and processes used to account for revenue and certain costs. Entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, and estimates. The change in revenue recognition resulting from implementing the new standard could also impact income tax reporting.

Although the effective date seems a long way off, now is the time for entities to assess how the new requirements will affect their organization. At a minimum, all entities will need to re-evaluate their accounting policies and will be subject to new qualitative and quantitative disclosures. For some, the new standard will have a significant impact on how and when they recognize revenue, while for others the transition may be less noticeable. One key decision that needs to be made soon is how to transition to the new standard.

The next steps that an entity should consider taking are illustrated below, and are discussed in further detail in the sections that follow.



14.1 Accounting and disclosure

Observations

Identifying information gaps for applying new requirements

After gaining an understanding of the new standard, entities should perform an analysis to identify accounting policies that may need to change and additional disclosures that will be required. Factors to consider include:

- customer contracts with unique revenue recognition considerations or terms and conditions;
- the degree of variation in the nature and type of goods or services being offered;
- the degree to which contracts include multiple performance obligations, variable consideration, or licenses of intellectual property;
- the pattern in which revenue is currently recognized – i.e., point-in-time versus over-time;
- the current accounting treatment of costs incurred to acquire or fulfill a contract with a customer;
- arrangements with customers that are currently using transaction- or industry-specific revenue guidance that is being superseded; and
- additional disclosure requirements.

The new standard will require new judgments, estimates, and calculations. For example, entities may need to make judgments about whether a contract exists, the number of performance obligations in a contract, the transaction price when consideration is variable, the stand-alone selling price of performance obligations, whether performance obligations are satisfied over time or at a point in time, and the measure of progress on performance obligations that are satisfied over time. As changes in accounting policies and data availability are identified in the gap analysis, the areas that will require new judgments, estimates, and calculations will need to be identified.

14.2 Tax

Observations

Evaluating tax implications

The change in revenue recognition could impact tax reporting and the related financial reporting for taxes. Examples of impacts include:

- changes in the amount or timing of revenue or expense recognition for financial reporting purposes, which may result in changes to the recognition of taxes or deferred taxes;
- accounting for financial reporting purposes that may not be acceptable for tax purposes, resulting in changes in existing temporary differences or the creation of new temporary differences;
- revisions being required to transfer pricing strategies and documentation;
- changes being required to update policies, systems, processes, and controls surrounding income tax accounting and financial accounting; and
- revisions to sales or excise taxes because revenue may be recharacterized between product and service revenue.

Entities should therefore include representatives from their tax department in their implementation project team. Some next steps to consider may include:

- reviewing expected accounting changes with tax personnel and evaluating the extent to which tax resources will need to be involved in implementation; and
- determining the effects on income tax reporting, compliance, and planning.

For a more detailed discussion on how the new standard may affect the calculation of and financial reporting for income taxes and other types of taxes, particularly in the United States, refer to our publication [Defining Issues No. 14-36, *New Revenue Recognition Standard: Potential Tax Implications*](#).

14.3 Systems and processes

Observations

Updating accounting processes and IT systems

The new requirements will require some entities to gather information that has not historically been required for financial reporting purposes – e.g., costs incurred in obtaining a customer contract or when performance obligations are expected to be satisfied. Processes may also need to be reconsidered to ensure that management judgment is exercised at key points as financial information is prepared.

Preparing an inventory of the incremental information needed and mapping those needs to existing sources will be critical steps early on in the implementation process. Entities should consider what new IT reporting packages, if applicable, may need to be developed to meet the requirements of the new standard and what additional data needs to be captured. To achieve a cost-effective solution, entities could evaluate the best way to source incremental information by:

- establishing the level of effort required to obtain new information from existing feeder systems; and
- determining additional system requirements that might be required.

Entities should also assess how applying the new standard will affect existing processes, including how new contracts or modifications to existing contracts are reviewed and accounted for, and how sales are invoiced.

In particular, changes may arise related to accounting for multiple performance obligations, determining stand-alone selling prices, accounting for variable consideration, adjusting for a significant financing component, identifying and tracking contract modifications, and accounting for contract costs.

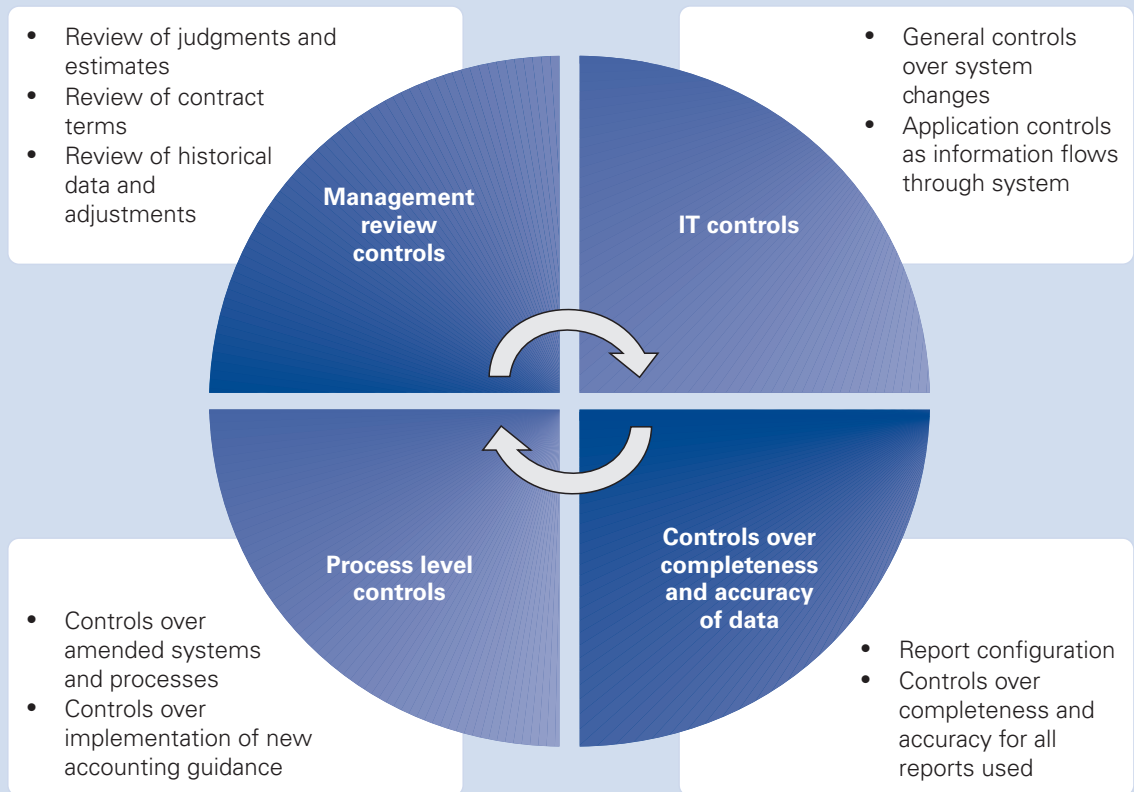
14.4 Internal control

Observations

Design and implementation of new internal controls or modification of existing controls

Entities will need to consider the potential effect of required changes to their systems and processes on their internal control environment, including internal controls over financial reporting. Some entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, and estimates.

New risk points may arise from changes to IT systems and reports that provide data inputs used to support the new estimates and judgments. To the extent that data is needed in order to comply with the new standard, entities will need to consider the internal controls necessary to ensure the completeness and accuracy of this information – especially if it was not previously collected, or was collected outside of the financial reporting system (e.g., projections made by the financial planning and analysis department for estimating variable consideration). Because the new standard may require new judgments and perhaps different analyses, entities should consider the skill level, resource capacity, and training needs of employees who will be responsible for performing the new or modified controls.



SEC registrants will need to consider the potential effect of any changes in internal controls on management's requirement to make certain quarterly and annual disclosures and certifications about disclosure controls, procedures, and internal controls.

Early in their implementation plan, entities should also consider what processes and related internal controls should be designed and implemented to assess the impact of, and record accounting adjustments arising upon, application of the new standard. For example, new internal controls may be required relating to:

- identifying changes to existing accounting policies;
- reviewing contracts for accounting adjustments on application of the new standard;
- recording accounting adjustments that have been identified; and
- preparing new qualitative and quantitative disclosures.

14.5 Determine a transition method

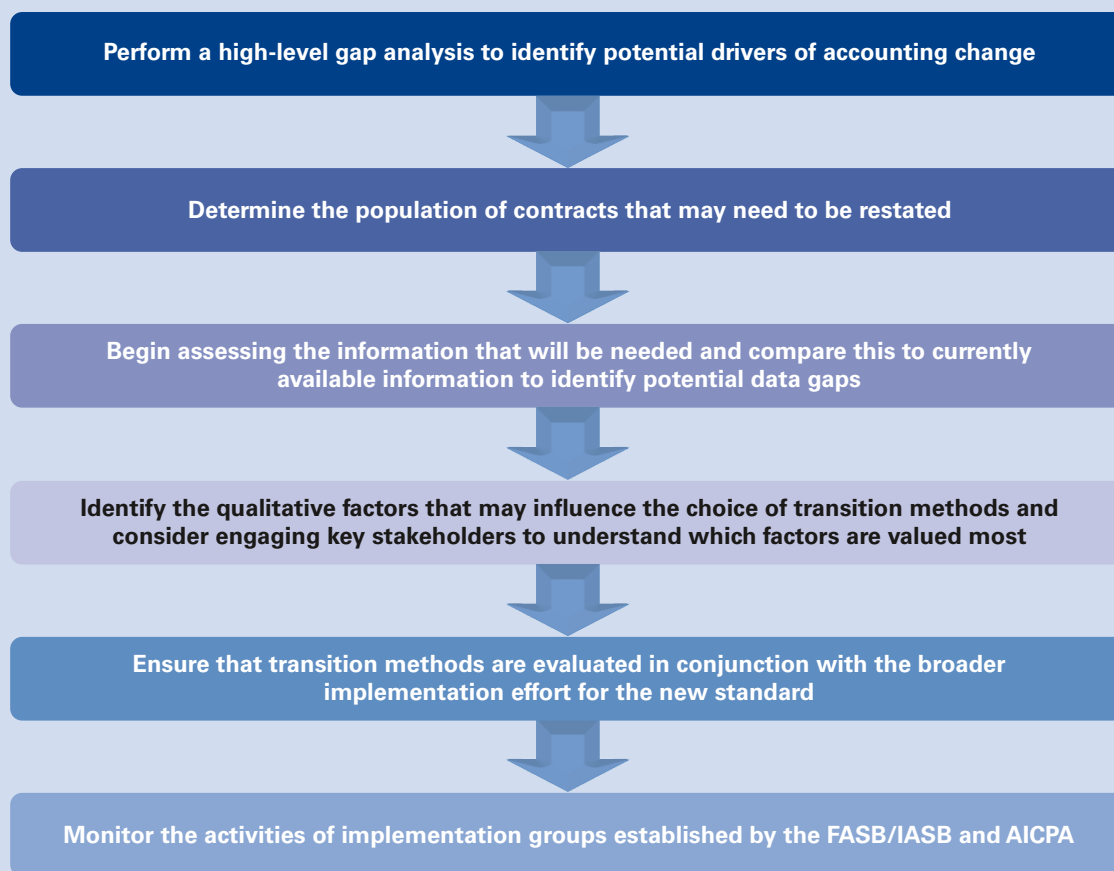
Observations

Early decision needed in developing an efficient implementation plan

The expected transition method (see Section 13) will have a significant impact on the timing of system and process changes. Therefore, determining which transition method should be adopted should be one of the first steps in the implementation process.

An entity should consider both the quantitative effects of each transition method and the relevant qualitative factors. Advanced planning will allow time to address unanticipated complexities and will offer greater flexibility in maximizing the use of internal resources by spreading the implementation effort over a longer period.

Entities should therefore take steps to understand the new standard and then to evaluate the effects of the transition methods on their financial reporting. Some entities may quickly decide that the impacts are minimal, in which case it may be appropriate to wait longer to evaluate the transition options. However, others will be faced with substantial impacts requiring major effort, and should therefore start planning as soon as possible. Entities should consider the following actions during 2014 and early 2015.



Entities may want to consider implementing a sub-group within the overall project team responsible for implementation to focus on transition options.

For additional examples on applying the transition methods, refer to our publication [Transition to the new revenue standard](#).

14.6

Other considerations

Observations

Impact broader than just accounting

Entities should evaluate how the new standard will affect their organization and the users of their financial statements. Among other things, management should consider:

- what training will be required for both finance and non-finance personnel, including the board, audit committee, senior management, and investor relations;
- the potential need to renegotiate current business contracts that include financial measures driven by revenue – e.g., a debt agreement with loan covenants;
- the effect on management compensation metrics if they will be affected by the new standard;
- what changes may be required to forecasting and budgeting processes; and
- communication plans to stakeholders – e.g., investors, creditors, customers, and suppliers.

In situations where there is a significant impact on the entity, effective governance will be a key element of a successful implementation. This includes input from and involvement of the audit committee, a steering committee, and a program management team.

Communication with key stakeholders

Communication between management, the audit committee, and the external auditor is key to ensuring successful implementation. Management may want to discuss key transition considerations with the audit committee, including:

- whether the entity expects a significant change to its current accounting policies and disclosures;
- historical data availability and the importance of showing a consistent story about revenue trends;
- investors' perceptions about revenue that bypasses profit or loss or is reported twice, or about one-time acceleration of an existing trend;
- the entity's readiness for change, including IT systems and accounting, legal, sales, and tax knowledge of the new standard;
- whether the entity has long-term contracts, including their volume, duration, uniqueness, and significance; and
- comparability with industry peers.

As entities proceed with implementing the new standard, they should also consider the timing and content of communications to investors, analysts, and other key stakeholders, including:

- the expected impact of the new standard on the entity;
- the transition method that will be applied; and
- when the new standard will be adopted.

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Guidance referenced in this publication

IFRS guidance referenced in this publication

The Conceptual Framework for Financial Reporting

IFRS 1	First-time Adoption of International Financial Reporting Standards
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IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
IFRS 8	Operating Segments
IFRS 9	Financial Instruments
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint Arrangements
IFRS 14	Regulatory Deferral Accounts
IFRS 15	Revenue from Contracts with Customers
IAS 2	Inventories
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 11	Construction Contracts
IAS 16	Property, Plant and Equipment
IAS 17	Leases
IAS 18	Revenue
IAS 24	Related Party Disclosures
IAS 28	Investments in Associates and Joint Ventures
IAS 32	Financial Instruments: Presentation
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement
IAS 40	Investment Property
IFRIC 12	Service Concession Arrangements
IFRIC 13	Customer Loyalty Programmes
IFRIC 15	Agreements for the Construction of Real Estate
IFRIC 18	Transfers of Assets from Customers
SIC-31	Revenue—Barter Transactions Involving Advertising Services

U.S. GAAP guidance referenced in this publication

FASB Statements of Financial Accounting Concepts

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Topic 270	Interim Reporting
Topic 280	Segment Reporting
Topic 310	Receivables
Topic 330	Inventory
Topic 340	Other Assets and Deferred Costs
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Topic 360	Property, Plant, and Equipment
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Topic 970	Real Estate—General
Topic 980	Regulated Operations
Topic 985	Software

U.S. GAAP guidance referenced in this publication

SEC Staff Accounting Bulletin Topic 11.M, Miscellaneous Disclosures: Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period

SEC Staff Accounting Bulletin Topic 13, Revenue Recognition

SEC Regulation S-K, Item 301, Selected Financial Data

SEC Regulation S-X, Rule 5-03(b), Income Statements

Keeping you informed

More about U.S. GAAP

We have a range of U.S. GAAP publications that can assist you further, including the *Derivatives and Hedging Accounting Handbook*, *Share-Based Payment*, and *Accounting for Business Combinations and Noncontrolling Interests*. In addition to our handbooks, we provide information on current accounting and reporting issues through our Defining Issues, Issues In-Depth, and CFO Financial Forum webcasts, which are available at www.kpmginstitutes.com/financial-reporting-network/.

Offering	Details
Executive Accounting Update	A high-level overview document with industry-specific supplements that identify specific industry issues to be evaluated and a transition supplement that provides considerations for evaluating the transition options.
Defining Issues	A periodic newsletter that explores current developments in financial accounting and reporting on U.S. GAAP.
Issues In-Depth	A periodic publication that provides a detailed analysis of key concepts underlying new or proposed standards and regulatory guidance.
CFO Financial Forum Webcast	Live webcasts, which are subsequently available on demand, that provide an analysis of significant decisions, proposals, and final standards for senior accounting and financial reporting personnel.
Podcasts	A five- to ten-minute audio file of some potential impacts of the new standard on specific industries.
Executive Education Sessions	Executive Education sessions are live, instructor-led continuing professional education (CPE) seminars and conferences in the United States that are targeted to corporate executives and accounting, finance, and business management professionals.

More about IFRS

Visit www.kpmg.com/ifrs to keep up to date with the latest developments in IFRS and browse our suite of publications. Whether you are new to IFRS or a current user of IFRS, you can find digestible summaries of recent developments, detailed guidance on complex requirements, and practical tools such as illustrative disclosures and checklists. For a local perspective, follow the links to the IFRS resources available from KPMG member firms around the world.

All of these publications are relevant for those involved in external IFRS reporting. The *In the Headlines* series and *Insights into IFRS: An overview* provide a high-level briefing for audit committees and boards.

Your need	Publication series	Purpose
Briefing	In the Headlines	Provides a high-level summary of significant accounting, auditing and governance changes together with their impact on entities.
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We would like to acknowledge the efforts of the main contributors to this publication:

Members of the Department of Professional Practice of KPMG LLP

Michael P. Breen
Paul H. Munter
Arturis I. Spencer III

Members of the KPMG International Standards Group

Glenn D'souza
Amy Luchkovich
Brian O'Donovan
Henrik Parker
Anthony Voigt

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Past and present members of the Department of Professional Practice of KPMG LLP

Brian K. Allen
Narayanan Balakrishnan
Mark M. Bielstein
Valerie Boissou
Shoshana H. Feldman
Prabhakar Kalavacherla (PK)
Sam O. Kerlin
Scott A. Muir
Benjamin B. Reinhardt
Brian J. Schilb
Angie S. Storm
Lauren P. Thomas
Christopher Van Voorhies
Billy G. Williams Jr.
Jennifer A. Yruma

Members of the KPMG Global IFRS Revenue Recognition and Provisions Topic Team

Brian K. Allen
Riaan Davel
Phil Dowad
Kim Heng
Prabhakar Kalavacherla (PK)
Graciela Laso
Vijay Mathur
Annie Mersereau
Catherine Morley
Carmel O'Rourke
Thomas Schmid
Sachiko Tsujino



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