

Applying IFRS

IASB – proposed standard

Revenue from contracts with customers – the revised proposal

January 2012

What you need to know

- ▶ The IASB and the FASB have issued a second exposure draft of their converged revenue model that is closer to current IFRS and US GAAP than their 2010 proposal.
- ▶ The proposed model would apply to revenue from contracts with customers in all entities in all industries and would replace all of the revenue standards and interpretations in IFRS. This includes replacing IAS 11 *Construction Contracts*, IAS 18 *Revenue*, IFRIC 13 *Customer Loyalty Programmes*, IFRIC 15 *Agreements for the Construction of Real Estate*, IFRIC 18 *Transfers of Assets from Customers* and SIC 31 *Revenue – Barter Transaction involving Advertising Services*.
- ▶ The proposal would align the accounting treatment for sales of certain non-financial assets (e.g., disposals of property, plant and equipment) with the new model.
- ▶ The model is based on a set of principles that would require entities to make numerous estimates and use judgement.
- ▶ The proposal would significantly increase disclosure requirements.
- ▶ Comments are due by 13 March 2012.

Overview

The International Accounting Standard Board (the IASB) and the US Financial Accounting Standards Board (the FASB) (collectively, the Boards) have jointly issued a proposed standard to supersede virtually all existing revenue standards and interpretations under IFRS and US GAAP. The Exposure Draft *Revenue from Contracts with Customers* (ED) is being issued for a second time. While the Boards have retained their five-step model from their initial ED in June 2010, significant changes were made during redeliberations to the application of each step.

The Boards believe the new model would accomplish the following:

- ▶ Remove the inconsistencies and weaknesses in the current revenue recognition literature
- ▶ Provide a better framework for addressing revenue recognition issues
- ▶ Improve comparability of revenue recognition practices among industries, entities within those industries, jurisdictions and capital markets
- ▶ Reduce the complexity of applying revenue recognition requirements, particularly under US GAAP, by reducing the current requirements to a single principles-based standard
- ▶ Provide more useful information to investors through improved disclosure requirements

Revenue is currently defined in IFRS as “the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants”.¹ While this single definition of revenue exists, the current revenue requirements in IFRS can be difficult to understand and apply to complex transactions. In addition, IAS 18 has limited application guidance on important topics such as revenue recognition for multiple-element arrangements. As a result, some entities have developed their IFRS accounting policies by referring to parts of US GAAP. However, the authoritative US GAAP guidance for revenue recognition in the Accounting Standards Codification (ASC) was codified from more than 200 individual pieces of literature issued by multiple standard setters. Most of the existing US GAAP guidance is specific to certain transactions or certain industries and focuses on very detailed matters. For many other topics, there is no US GAAP guidance or the guidance is unclear.

¹ IAS 18.7.



The ED specifies the accounting is for all revenue arising from contracts with customers. This affects all entities that enter into contracts to provide goods or services to their customers (unless those contracts are in the scope of other IFRSs, such as the leasing standard). The proposed requirements would also provide a model for the measurement and timing of recognition of gains and losses on the sale of certain non-financial assets, such as property, plant and equipment and intangible assets.

Furthermore, the ED outlines the principles an entity would apply to report decision-useful information about the measurement and timing of revenue and the related cash flows.

The core principle is that an entity would recognise revenue to depict the transfer of goods or services to customers at an amount that reflects the consideration the entity expects to receive in exchange for those goods or services. This is achieved through the application of the following five steps:

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

In applying these steps, an entity would be required to exercise judgement when considering the terms of the contract(s) and all surrounding facts and circumstances, including any implied contractual terms. An entity will also have to consistently apply the requirements of the proposed model to contracts with similar characteristics and in similar circumstances.

The Boards are proposing that entities adopt the new standard retrospectively for all periods presented in the period of adoption, although the ED provides limited relief from full retrospective adoption. The ED states that the effective date would be no earlier than annual periods beginning on or after 1 January 2015. The Boards will determine the exact date during further redeliberations. Early adoption of the final standard would be available for IFRS preparers and first-time adopters of IFRS, but not under US GAAP.

This publication highlights some of the more significant implications of the proposed revenue recognition model. In the coming weeks, we also will issue industry-specific publications that address, in further detail, significant changes to current practice in those industries. We encourage preparers and users of financial statements to read this publication and the industry-specific publications carefully and consider the potential effects of the proposal. The issues discussed in this publication are intended to help entities formulate feedback to the Boards that can help them develop a high-quality final standard.

The discussions within this publication represent preliminary thoughts, and additional issues may be identified through continued analysis of the exposure draft, or as elements of the ED change upon further deliberation by the Boards.

The comment period ends on 13 March 2012. Interested parties should refer to the ED on either of the Boards' websites for instructions on submitting comment letters.

Next steps

Entities should apply the proposal in the ED to their common transactions to identify any situations in which the accounting does not appear to reflect the substance of a transaction and to identify potential implementation issues and communicate those issues to the Boards



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1. Scope, transition and internal control considerations

1.1 Scope

The scope of the proposed standard includes all contracts with customers to provide goods or services in the ordinary course of business, except for the following types of contracts, which are excluded from the ED's scope:

- ▶ Lease contracts within the scope of IAS 17 *Leases*
- ▶ Insurance contracts within the scope of IFRS 4 *Insurance Contracts*
- ▶ Contractual rights or obligations (i.e., financial instruments), such as receivables, debt and equity securities and derivatives, within the scope of IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement*
- ▶ Non-monetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange

Entities may enter into transactions that are partially within the scope of the proposed revenue recognition standard and partially within the scope of another standard. Under the proposed standard, if a contract is partially within the scope of the proposed revenue standard and partially within the scope of another standard, entities would first apply the separation and measurement requirements of the other standard. If the other standard does not specify how to separate and/or initially measure any parts of the contract, the entity would then apply the proposed revenue standard to separate and/or initially measure those parts of the contract.

What's changing from current IFRS?

Generally, entities entering into transactions that fall within the scope of multiple accounting standards currently separate those transactions into the elements to account for them under different standards. The ED does not propose to change this practice. However, the ED does clarify that any separation guidance in other IFRSs takes precedence over the model in this ED.

IAS 18 currently provides guidance regarding the recognition and measurement of interest and dividends. Under the ED, interest and dividend income would be excluded from the scope. Instead, the relevant recognition and measurement requirements would be included in IFRS 9 or IAS 39.

1.1.1 Definition of a customer

The proposed standard states that 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 many transactions, the entity's customer is easily identifiable. However, in certain transactions involving multiple parties, it is less clear which counterparties are the customers of the entity. For example, is a third-party a designee of the customer in an arrangement or is a customer of the entity's customer considered "a customer" for purposes of the ED? The illustration below expands on this concept.

The ED does not define what constitutes ordinary activities, as this notion is already widely used in existing IFRS.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

Illustration 1-1: Identification of a customer

A credit card company offers a loyalty programme to its credit card users whereby the credit card company gives the credit card user points for amounts purchased from merchants when using the credit card. These points may be accumulated and redeemed for a number of different goods or services, including cash-back.

The credit card company separately enters into arrangements with merchants under which the credit card company provides the financing for the transaction between the merchant and the credit card user, in return for which the credit card company receives a stated fee from the merchant.

When the credit card user uses the credit card to make a purchase from a merchant, the credit card company honours its agreement with the merchant and advances the merchant the funding for the amount of the transaction after deducting the fee to which the credit card company is entitled. However, as a result of that transaction, the credit card company now also has an obligation to the credit card user to provide the specified number of points in the loyalty programme.

It is unclear under the proposed model whether the credit card company's obligation arising from the loyalty programme is an element in the revenue transaction with the merchant. One view is that because the credit card user is a customer of the merchant (who is the credit card company's customer), any obligation arising from the loyalty programme is essentially a promised good or service under the arrangement with the merchant as well. This view would require the identification of two performance obligations and the fee being allocated to both. An alternative view, however, is that the obligation associated with the loyalty programme arises from a separate agreement with the credit card user, and therefore is not an element within the arrangement with the merchant. This view would likely require the expected cost of the loyalty programme to be accrued at the time of the transaction with the merchant, but would not result in any revenue from the transaction with the merchant being allocated to this obligation.

1.1.2 Collaborative arrangements

The ED also explains that a counterparty may not always be a customer. Instead, the counterparty may be a collaborator or partner that shares in the risks and benefits of developing a product to be marketed. These collaborative arrangements are common in the pharmaceutical, biotechnology, oil and gas and health care industries.

The Boards decided not to provide further guidance for determining whether revenue-generating collaborative arrangements would be in the scope of the proposed standard. In the Basis for Conclusions, the Boards explain that it would not be possible to provide application guidance that applies to all collaborative arrangements. Therefore, the parties to the arrangement would need to consider all of the facts and circumstances to determine whether a supplier-customer relationship exists that would be subject to the proposed standard.

How we see it

The final standard is unlikely to address the current difficulties that arise in identifying contracts with customers under current IFRS. As discussed above, identifying the customers within an arrangement can require significant judgement when multiple parties are involved.

Furthermore, the proposed standard is clear that transactions among partners in collaboration arrangements are out of scope. As no new guidance is being provided, we believe that entities would reach the same conclusions they do today about whether a contract is a revenue-generating transaction or an arrangement with a collaborator or a partner. However, what is unclear is how those transactions should be accounted upon the finalisation of this standard. Many entities account for those transactions in accordance with, or by analogy to, the current revenue recognition standards. Would the removal of these transactions from the scope of the revenue standard make analogy unacceptable going forward?

Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

1.2 Transition

The Boards concluded that the final revenue standard would be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, which they believe would provide users of financial statements with useful comparative information for each year presented. However, the Boards agreed to provide the following relief from full retrospective application:

Extract from the ED

C3. An entity may use one or more of the following practical expedients when applying this [draft] IFRS. For the purposes of the expedients, the date of initial application is the start of the reporting period in which an entity first applies this [draft] IFRS.

- (a) For contracts completed before the date of initial application, an entity need not restate contracts that begin and end within the same annual reporting period.
- (b) For contracts completed before the date of initial application and that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
- (c) An entity need not evaluate whether a performance obligation is onerous before the date of initial application unless an onerous contract liability was recognised previously for that contract in accordance with the requirements that were effective before the date of initial application. If an entity recognises an onerous contract liability at the date of initial application, the entity shall recognise a corresponding adjustment to the opening balance of retained earnings for that period.
- (d) For all periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to remaining performance obligations and an explanation of when the entity expects to recognise that amount as revenue (as specified in paragraph 119).

Entities could elect to apply some or all of this relief. For entities that choose not to apply any of the relief, the proposed standard would allow full retrospective application. Entities that choose to adopt the final standard using some or all of the offered relief would be required to provide additional qualitative disclosures, such as which types of relief the entity has chosen and the likely effects of applying them.

The ED also proposes an exemption to IFRS 1 *First-time Adoption of International Financial Reporting Standards* to permit a first-time adopter to apply the first two items of relief outlined above for periods prior to the first IFRS reporting period. In addition, first-time adopters would not be required to disclose the maturity analyses of remaining performance obligations (see paragraph C3(d) in the above extract from the ED) for periods before the first IFRS reporting period. However, no relief would be granted for first-time adopters in relation to the onerous test.

While the Boards noted that retrospective application could be burdensome for some entities, particularly those with a large number of long-term arrangements, they ultimately rejected a prospective or limited retrospective application. The Boards believed that prospective application would not provide decision-useful information because the recognition and measurement principles applied to new contracts would not be comparable with those applied to existing contracts. While the Boards also considered the possibility of limited retrospective application, they were unable to identify a specific date for limiting the retrospective application of the final standard that would, on a cost-beneficial basis, be preferable to full retrospective application. The Boards believe preparers would have the time and flexibility to apply the final standard retrospectively because of the relief provided in the ED, the long lead time between the issuance of a final standard and its effective date (which would be no sooner than 1 January 2015), and exceptions to retrospective application allowed under IAS 8 (where applicable).

Existing IFRS preparers and first-time adopters of IFRS would have the option to early adopt the final standard. However, the FASB concluded that early adoption would not be permitted for US GAAP preparers.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

How we see it

We believe the effort required to adopt this proposal would be significant for many entities, including media and entertainment and software entities that commonly have long-term licences, asset management entities, and construction firms and others that fulfil performance obligations over extended periods.

In addition, certain other industries that anticipate the proposed changes in revenue recognition to be significant, such as the telecommunications industry, will also likely find the effort of adoption to be significant. The Boards acknowledge that retrospective adoption may be burdensome for certain preparers.

Under a full retrospective approach, an entity would have to prepare all estimates based on information known at inception of the contract or during the course of the contract when revising estimates based on new information. The Boards acknowledged that estimating the transaction price without using hindsight (i.e., actual experience with variable consideration) and estimating standalone selling prices would be difficult for many entities. They attempted to address this by providing that such estimates would have to be made only for contracts that are in process on the effective date. This helps, but does not alleviate all of the challenges.

- ▶ Whether a performance obligation is satisfied over time or satisfied at a point in time (see Chapter 6)
- ▶ Onerous performance obligations (see Section 7.2)
- ▶ Forward-looking information included in disclosures about the expected timing of the future satisfaction of performance obligations (see Section 8.2)

Estimation processes typically have higher levels of inherent risk than routine data processes and, therefore, require more internal controls. While these changes would affect all entities, public entities subject to internal control evaluation and reporting requirements may need to report on changes in internal control in addition to assessing whether control over financial reporting remains effective. The proposal would also significantly increase disclosure requirements (discussed further in Chapter 8).

1.4 Sale of non-financial assets

The proposed measurement and recognition requirements in the ED would also apply to the sale of certain non-financial assets that are not an output of the entity's ordinary activities (i.e., not revenue). This includes sales of intangible assets; property, plant and equipment; and investment properties (if the cost model is applied in accordance with IAS 40 *Investment Property*).

The ED includes proposed consequential amendments to IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IAS 40 that would require an entity to measure the consideration and recognise any resulting gain or loss associated with the sale of such assets in accordance with the final revenue standard. The Boards' rationale for applying the ED's recognition and measurement requirements to these types of transactions is the lack of clear guidance currently available for the derecognition of intangible assets; property, plant and equipment; and investment properties when the sale is not part of an entity's ordinary activities.

How we see it

Based on the ED, we believe that an entity would be required to derecognise the asset when the buyer obtains control of the asset. Furthermore, the entity would recognise the gain or loss from the transaction based on the difference between the transaction price and the asset's carrying amount. Consistent with the proposed requirements, determination of the transaction price would take into consideration a number of factors, and any gain would be limited to the amounts that are reasonably assured.

1.3 Internal control considerations

When considering the potential effects of the proposal, entities should consider not only changes in accounting policies and accounting systems (which would be significant for many entities), but also changes they would need to make to internal control processes and procedures. The model's use of principles rather than prescriptive requirements would require entities to make use of numerous estimates and judgements in the application of the proposed standard.

Significant new estimates and judgements could include:

- ▶ Whether a promised bundle of goods or services is highly interrelated and significant customisation or modification is required and therefore should be treated as a single performance obligation (see Chapter 3)
- ▶ Variable consideration (e.g., royalties, milestone payments, payments for optional services) included in the estimated transaction price and determining whether the entity is reasonably assured to be entitled to those amounts (see Section 4.1)
- ▶ Estimated standalone selling price of performance obligations that are not sold separately (see Section 5.1)



2. Identify the contract with the customer

To apply the proposed model, an entity must first identify the contract, or contracts, to provide goods and services to its customer. Any contracts that create enforceable rights and obligations fall within the scope of the proposed standard, and they may be written, oral or implied by the entity's customary business practice. For example, an entity's past business practices may influence its determination of the timing of when an arrangement must be accounted for. An entity that has an established practice of starting performance based on oral agreements with its customers may determine that such oral agreements meet the definition of a contract. As a result, under the proposed standard the entity may have to account for these arrangements as soon as performance begins (whereas under current practice, all revenue recognition would likely be delayed until the arrangement is documented in a signed contract). Certain arrangements may require a written contract to comply with jurisdictional law or trade regulation, which should be considered in determining whether a contract exists.

Extract from the ED

14. An entity shall apply this [draft] IFRS to a contract with a customer only if all of the following criteria are met:
- the contract has commercial substance (ie the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract);
 - the parties to the contract have approved the contract (in writing, orally, or in accordance with other customary practices) and are committed to perform their respective obligations;
 - the entity can identify each party's rights regarding the goods or services to be transferred; and
 - the entity can identify the payment terms for the goods or services to be transferred.

Illustration 2-1: Oral contract

IT Support Co. provides online technology support for consumers remotely via the internet. For a flat fee, it will scan a customer's personal computer (PC) for viruses, optimise the PC's performance and solve any connectivity problems. When a customer calls to obtain the scan services, IT Support Co. describes the services it can provide and states the price for those services. When the customer agrees to the terms stated by the representative, payment is made over the telephone. IT Support Co. then provides the customer the information needed to obtain the scan services (e.g., an access code for the website) and provides the services when the customer connects to the internet and logs onto IT Support Co.'s website (which may be that day but may also be at a future point in time).

In this example, IT Support Co. and its customer are entering into an oral agreement for IT Support Co. to repair the customer's PC and for the customer to provide consideration by transmitting a valid credit card number and authorisation over the telephone. The ED's four criteria, above, are all met, with the last three criteria all met via the telephone conversation and the charge to the customer's credit card. This agreement would be within the scope of the proposed revenue standard at the time of the telephone conversation, even if IT Support Co. has not yet performed the scan services.

The Boards included the commercial substance attribute due to perceived abuses that artificially inflated revenue. Some entities in high-growth industries engaged in transactions in which goods and services were transferred back and forth between the same entities in an attempt to show higher transaction volume and gross revenue (sometimes known as 'round-tripping'). Determining whether commercial substance exists may require significant judgement. In all situations, the entity should be able to demonstrate a substantive business purpose for the nature and structure of its transactions.

The Boards also made clear that identifying the payment terms does not require that the transaction price be fixed or stated in the contract with the customer. As long as there is an enforceable right to payment and the contract contains sufficient information such that the entity is able to estimate the transaction price (see further discussion on estimating the transaction price in Chapter 4), the contract would qualify for accounting under the proposed standard.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

Illustration 2-2: Unpriced change orders

XYZ is a specialty contractor that entered into a fixed price contract with ABC Hospital for the construction of a new facility. During construction, ABC Hospital chooses to upgrade the flooring for its new facility and submits a change order to XYZ. Based on the documentation underlying the change order, the scope of the work to be performed is clear, and both parties authorise the change. However, the change to the transaction price as a result of the change order is not known at the date the change order is authorised, so the parties agree to settle on a final price at the conclusion of the project.

Although a fixed price for the change has not been determined, the change order would still meet the definition of a contract because each party can identify its rights and obligations, the change order has commercial substance, both parties have approved the contract and the payment terms are known. The Boards explain in the ED that as long as there is an enforceable right to payment and the contract contains sufficient information such that the entity is able to estimate the transaction price, the contract would qualify for accounting under the proposed standard.

Termination clauses are an important consideration when determining whether a contract exists. Any arrangement in which the vendor has not provided any of the contracted goods or services and has not received or is not entitled to receive any of the contracted consideration is considered to be a “wholly unperformed” contract. If each party has the unilateral right to terminate a “wholly unperformed” contract without compensating the counterparty, then the proposed standard states that a contract does not exist and its accounting and disclosure requirements would not apply. However, if only one party has the right to terminate a contract, such a contract is within the scope of the proposed standard and the accounting (e.g., onerous contracts) and disclosure requirements of the proposed standard would apply.

What's changing from current IFRS?

Current IFRS does not provide specific application guidance on oral contracts. However, entities are required to give attention to the underlying substance and economic reality of an arrangement and not merely its legal form. Paragraph BC3.26 of *The Conceptual Framework for Financial Reporting* states that “representing a legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation”. Despite the focus on substance over form in IFRS, considering oral or implied agreements to be contracts may be a significant change in practice for some entities. For other entities, it may lead to earlier consideration of oral agreements, i.e., not waiting to begin accounting for oral agreements until such agreements are formally documented.

2.1 Combining contracts

In most cases, entities would apply the five-step model to individual contracts with a customer. However, there may be situations in which the entity would combine multiple contracts for purposes of revenue recognition. For example, the proposed standard states that an entity can account for a portfolio of similar contracts together if the entity expects that the result will not be materially different from the result of applying the proposed standard to the individual contracts.

Extract from the ED

17. An entity shall combine two or more contracts entered into at or near the same time with the same customer (or related parties) and account for the contracts as a single contract if one or more of the following criteria are met:

- (a) the contracts are negotiated as a package with a single commercial objective;
- (b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- (c) the goods or services promised in the contracts (or some goods or services promised in the contracts) are a single performance obligation in accordance with paragraphs 27 - 30.

What's changing from current IFRS?

The proposed standard provides more guidance on when to combine contracts than is included in IAS 18. IFRS reporters that currently apply IAS 11 have a similar requirement in that standard. The primary difference between IAS 11 and the proposed standard is criteria (c) (see paragraph 17(c) in the extract from the ED above), which considers a performance obligation bundle across different contracts. In contrast, IAS 11 considers concurrent or sequential performance. Overall, the proposed criteria are generally consistent with the underlying principles in the current revenue standards on combining contracts. However, the proposed standard would explicitly require an entity to combine contracts if the criteria in paragraph 17 are met. Therefore, some entities that do not currently combine contracts may need to do so.

Scope, transition
and internal control
considerations

Identify the contract
with the customer

Identify the separate
performance obligations
in the contract

Determine the
transaction price

2.2 Contract modifications

When the parties to an arrangement agree to subsequently modify the scope or price of their contract, the vendor must determine whether the modification creates a new contract or whether it should be accounted for as part of the existing contract.

If a contract modification changes only the transaction price (but not the performance obligations), the entity would apply the requirements for allocating changes in transaction price (see Section 5.5).

When a modification meets the criteria for a contract described in the introduction to this chapter and the modification changes the scope of an arrangement or the scope and pricing of an arrangement, the proposed standard would require the entity to account for the incremental goods or services as a separate contract if the modification results in the addition to the contract of both of the following:

- ▶ Promised goods and services that are distinct, as described in Chapter 3
And
- ▶ The entity's right to receive an amount of consideration that reflects the entity's standalone selling price of the promised additional goods or services as well as any appropriate adjustments to that price to reflect the facts and circumstances of that particular contract.

Although the ED states that when the additional goods or services are at a standalone selling price, the modification is considered a separate contract, under certain circumstances the ED allows a departure from this requirement. For example, a vendor may give a current customer a discount on additional goods because the vendor would not incur selling-related costs that it typically incurs for new customers. In this example, the transaction price is not equal to the standalone selling price of that good or service if the good or service were sold to a new customer. However, despite this, the vendor might determine that the incremental consideration is reflective of the standalone selling price of the added good or service given the discounts that would typically be provided to this particular customer. Therefore, the vendor might conclude that this price would constitute a standalone selling price for this customer.

Any contract modifications that do not meet the criteria above would not be treated as separate contracts, nor would contract modifications that modify or remove previously agreed to goods and services. An entity would account for the effects of these modifications differently, depending on which of the following scenarios is most applicable:

- ▶ The goods and services not yet provided (including remaining goods and services changed as a result of the modified arrangement) are distinct from the goods and services provided prior to the modification of the arrangement – in this scenario, the entity would allocate any consideration not yet recognised as revenue to the remaining separate performance obligations. In effect, this approach treats the contract modification as a termination of the old contract and the creation of a new contract. While not explicitly stated in the ED, we believe that under this approach an entity would have to also reflect in the allocation of the revised transaction price any changes in the standalone selling prices of the remaining goods and services from the original contract.
- ▶ All of the promised goods and services are part of a single performance obligation (i.e., the goods and services not yet provided are not distinct from the goods and services that have been provided) and that performance obligation is partially satisfied as of the date of the modification – in this scenario, the entity would account for the modification as if it were part of the original contract and would recognise the effect of the modification on a cumulative catch-up basis. This approach effectively treats the modification as if it were part of the original contract.
- ▶ The goods and services not yet provided are a combination of the two scenarios above – in this scenario, the entity would allocate all remaining consideration to the unsatisfied (including partially unsatisfied) performance obligations. The entity would exclude any completely satisfied performance obligations from this allocation. To perform this reallocation, we believe entities would have to update their estimates of the standalone selling price for each separate performance obligation. For those performance obligations being satisfied over time that are partially satisfied as of the date of the modification/reallocation, the entity would update the measure of progress based on any changes in the performance obligations and allocated transaction price on a cumulative catch-up basis.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

Illustration 2-3: Contract modification – performance obligations satisfied at a point in time

Entity A contracts with its customer to deliver an imaging device and 50 replacement cartridges to be used with the device. The contract price for the device is CU100,000, and the cartridges, which are expected to be delivered over six months, are priced at CU1,000 each. The standalone selling price for the device is CU100,000, and the standalone selling price for each replacement cartridge is CU1,250. The allocation of the transaction price based on the relative selling prices is as follows:

	Standalone selling price	% of total	Contract price	Allocation
Imaging device	CU100,000	61.5%	CU100,000	CU92,250
Cartridges	62,500	38.5%	50,000	57,750
	CU162,500	100%	CU150,000	CU150,000

After Entity A has delivered the imaging device and 40 cartridges, the parties agree to modify the contract to increase the total number of cartridges. Entity A's estimate of the standalone selling price for the cartridges has not changed.

Scenario A

Entity A agrees to increase the number of cartridges by 50 units at a price of CU1,250 each. Under the proposed standard, as the additional goods are distinct and the selling price for those cartridges is equal to their standalone selling price, Entity A would account for the obligation to deliver an additional 50 units as a separate contract. As a result, Entity A would not change the accounting for the original contract.

Scenario B

Entity A agrees to increase the number of cartridges by 50 units at the original contract price of CU1,000 each. Although the additional cartridges are distinct, Entity A would have to evaluate whether the price for those cartridges was reflective of the standalone selling price, after giving consideration to any adjustments that would be made based on the facts and circumstances.

Entity A may determine that the discounted price of CU1,000 each for the additional cartridges is not reflective of the standalone selling price. For example, Entity A may have agreed to sell incremental units at less than their standalone selling price to retain the customer, who had expressed dissatisfaction with Entity A's service under the contract so far. In that circumstance, Entity A would not treat the contract modification as a separate contract. Instead, Entity A would modify the accounting for the original contract by allocating the revised transaction price, less the amounts allocated to the imaging device and all previously delivered cartridges to all of the undelivered cartridges as illustrated below:

Revised transaction price	CU200,000
Subtract amounts allocated to:	
Previously delivered imaging device	(92,250)
Previously delivered cartridges	(46,200)
Allocatable transaction price	CU61,550
Number of remaining performance obligations:	60
Allocation to each promised cartridge	CU1,026

Alternatively, Entity A may determine that the CU1,000 per unit price is reflective of the standalone selling price, after giving consideration to any adjustments that would be made based on the facts and circumstances. Since transactions with existing customers require little selling effort, it may determine it is willing to sell re-orders of cartridges to the customer at a discounted price of CU1,000 each. In reaching this conclusion, Entity A may also consider the expected volume of sales to this customer. If Entity A concluded that the discounted price is representative of the standalone selling price, it would account for this contract modification as a separate contract.



Illustration 2-4: Contract modification – performance obligations are satisfied over time

Entity B is an outsourced human resources provider that has been retained by its customer to manage the recruitment programme and on-boarding activities (including employee induction and training) necessary to fully staff a manufacturing facility being constructed in a new operating region. The contract provides Entity B with a period of 18 months to recruit and hire 1,200 employees for total consideration of CU4.8 million. Entity B will collect its compensation upon completion of the on-boarding activities, which include payroll setup, benefits enrolment and training for each employee.

Assume that Entity B determines that it has a single performance obligation (see Chapter 3) and that the performance obligation is satisfied over time, based on the criteria for continuous revenue recognition (see Chapter 6). Entity B also determines the most appropriate measure of progress under the contract would be based on the hiring activity (an output method, including completion of required training). Entity B will recognise revenue of CU4,000 for each new hire upon completion of training.

Nine months into the recruitment programme, Entity B and its customer reach an agreement to add an additional 150 employees to the hiring totals and increase the total compensation under the contract. Due to difficulties in identifying qualified candidates in the local market, Entity B was forced to expand its recruitment efforts to other markets, which had a significant effect on Entity B's costs to identify candidates. To compensate Entity B for these additional costs and for the additional fulfilment request, the customer agrees to increase the total consideration to CU5.7 million.

Entity B concludes that the additional CU900,000 of compensation under the arrangement is in excess of the standalone selling price for hiring 150 employees. Since Entity B has concluded its promised services under the arrangement represent a single performance obligation, it would likely determine that the additional promised goods and services are not distinct. Therefore, the proposed standard would require Entity B to update the transaction price and the measure of progress toward satisfaction of the performance obligation as of the date of the modification, rather than treating the modification as a separate contract.

Up to the date of the modification, Entity B had hired and on-boarded 900 employees. Therefore, Entity B would have determined it was 75% complete in providing the promised services (900 / 1,200) and had recorded CU3.6 million in revenue (75% x CU4.8 million). Based on the revised number of employees to be hired under the adjusted agreement, Entity B determines it is 67% complete (900 / 1,350 employees). Accordingly, Entity B determines cumulative revenue to date should be CU3.8 million, compared with the CU3.6 million recorded to date, and recognises an adjustment to increase revenue by CU200,000. Going forward, Entity B would recognise CU4,222 for each additional new hire following the modification to the contract.

What's changing from current IFRS?

Current IFRS does not provide detailed application guidance on how to determine whether a change in contractual terms should be treated as a separate contract or a modification to an existing contract. Therefore, the proposed requirements in the ED could result in a change in practice for some entities.

It is important to note, however, that the assessment of how to account for the contract modification has to consider how any revisions to promised goods or services fit in with the rest of the arrangement. That is, although a contract modification may add a new good or service that would be distinct in a standalone transaction, the new performance obligation may not be distinct when it is part of a contract modification. For example, in a building renovation project, a customer may request a contract modification to add a new room. The construction firm may commonly sell the construction of an added room on a standalone basis, which would indicate the service is distinct. However, when that service is added to an existing arrangement and the entity has already determined that the entire project is a single performance obligation, the added goods and services would be combined with the existing bundle of goods and services.

How we see it

The proposed requirements for dealing with contract modifications appear to add an unnecessary layer of complexity to the overall revenue model. While some modifications would be allocated to all performance obligations in an arrangement, including those that are fully satisfied at the time of the modification (i.e., modifications that result in only a change in price), other modifications are only accounted for on a prospective basis in connection with performance obligations that have not yet been satisfied. Furthermore, as discussed in Chapter 5, it is unclear how the proposed contract modification requirements apply when arrangements include variable consideration.

3. Identify the separate performance obligations in the contract

A performance obligation is defined in the ED as “a promise in a contract with a customer to transfer a good or service to the customer.” The proposed standard would require an entity to identify all promised goods and services and determine whether to account for each good or service as a separate performance obligation.

The ED provides the following requirements with respect to identifying the performance obligations in a contract:

Extract from the ED

24. A performance obligation is a promise in a contract with a customer to transfer a good or service to the customer. Performance obligations include promises that are implied by an entity's customary business practices, published policies, or specific statements if those promises create a valid expectation of the customer that the entity will transfer a good or service.

25. Performance obligations do not include activities that an entity must undertake to fulfil a contract unless the entity transfers a good or service to the customer as those activities occur. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Hence, those promised setup activities are not a performance obligation.

26. Depending on the contract, promised goods or services may include, but are not limited to, the following:

- (a) goods produced by an entity for sale (for example, inventory of a manufacturer);
- (b) goods purchased by an entity for resale (for example, merchandise of a retailer);
- (c) providing a service of arranging for another party to transfer goods or services to the customer (for example, acting as an agent of another party as discussed in paragraphs B16-B19);
- (d) standing ready to provide goods or services (for example, when-and-if-available software products);
- (e) constructing, manufacturing, or developing an asset on behalf of a customer;
- (f) granting licences or rights to use intangible assets;
- (g) granting options to purchase additional goods or services (when those options provide the customer with a material right as discussed in paragraphs B20-B22); and
- (h) performing a contractually agreed-upon task (or tasks) for a customer.



The Boards make it clear that when an entity identifies performance obligations, it should consider whether a promise creates a valid expectation on the part of the customer that the entity will provide a good or service. That is, the notion of a performance obligation also includes constructive performance obligations based on factors outside of a written contract (e.g., past business practice, industry norms). Performance obligations can also arise from warranties offered on goods produced and services delivered, depending on the nature of the warranty provided (see Section 7.1).

Illustration 3-1: Constructive performance obligations

Entity A is a retailer that sells and installs carpeting and wood and tile flooring for its customers. Entity A and its competitors routinely haul away and dispose of the old flooring that is replaced in customers' homes. Although the sales contract addresses only the new product and does not address the disposal of old flooring, industry norms and Entity A's past business practice may provide evidence that a performance obligation exists related to that additional service.

How we see it

Properly identifying performance obligations within a contract is a critical component of the proposed standard because revenue allocated to each performance obligation is recognised as the obligation is satisfied.

Current IFRS does not specifically address contracts with multiple deliverables, focusing instead on indentifying the transaction; as a result, many IFRS preparers have looked to US GAAP for guidance in this area. Current US GAAP requires entities to identify the "deliverables" within an arrangement, but includes no guidance on determining whether something is a deliverable or whether an arrangement includes multiple deliverables. While we believe having the examples in paragraph 26 will be helpful, we expect the identification of performance obligations to be challenging in some circumstances.

After identifying the promised goods and services within an arrangement, an entity would determine which of those would be accounted for as separate performance obligations. That is, the entity would identify the distinct goods and services representing individual units of account. The proposed standard outlines a two-step process for making this determination: consideration at the level of the individual goods and services and consideration of how those goods and services have been bundled.

3.1 Consideration of individual goods and services

The ED provides the following requirements to determine whether a good or service is distinct:

Extract from the ED

28. Except as specified in paragraph 29, a good or service is distinct if either of the following criteria is met:

- (a) the entity regularly sells the good or service separately; or
- (b) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer. Readily available resources are goods or services that are sold separately (by the entity or by another entity) or resources that the customer already has obtained (from the entity or from other transactions or events).

What's changing from current IFRS?

The determination of whether the goods or services are individually distinct is not an explicit requirement in current IFRS. For those entities that have developed their accounting policies by reference to US GAAP, the proposal is relatively consistent with the guidance included in current US GAAP in ASC 605-25 *Revenue Recognition - Multiple Element Arrangements*. However, entities that developed their accounting policy by reference to other US GAAP guidance, such as the software revenue recognition guidance in ASC 985-605 *Software - Revenue Recognition*, may reach different conclusions regarding whether promised goods and services can be considered distinct.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

3.2 Consideration of how goods and services have been bundled in an arrangement

Once an entity determines whether the goods and services would be distinct based on their individual characteristics, the entity then has to consider if the manner in which the goods and services have been bundled in an arrangement would require the entity to account for two or more goods or services as one performance obligation. This determination would be required regardless of whether or not those goods and services were determined to be distinct on their own. The ED provides the following requirements to make this determination:

Extract from the ED

29. Notwithstanding the requirements in paragraph 28, a good or service in a bundle of promised goods or services is not distinct and, therefore, the entity shall account for the bundle as a single performance obligation if both of the following criteria are met:

- (a) the goods or services in the bundle are highly interrelated and transferring them to the customer requires that the entity also provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted; and
- (b) the bundle of goods or services is significantly modified or customised to fulfil the contract.

It is important to note that while the two criteria specified in paragraph 29 appear similar, they actually address different scenarios and both of these criteria must be met to treat the bundled goods and services as a single performance obligation.

The examples below illustrate how an entity may consider each of the criteria.

Illustration 3-2: Multiple goods and services

Entity A, a specialty construction firm, enters into a contract with Entity B to design and construct a multi-level shopping centre with a customer car parking facility located in sub-levels underneath the shopping centre. Entity B solicited bids from multiple firms on both phases of the project – design and construction.

The design and construction of the shopping centre and parking facility involves multiple goods and services from architectural consultation and engineering through procurement and installation of all of the materials. Several of these goods and services could be considered separate performance obligations because Entity A frequently sells the services, such as architectural consulting and engineering services, as well as standalone construction services based on third party design, separately.

Scenario A

Entity A concludes that it will be required to continually alter the design of the shopping centre and parking facility during construction as well as continually assess the propriety of the materials initially selected for the project. Therefore, the design and construction phases are highly dependent on one another (i.e., the two phases are highly interrelated). Entity A also determines that significant customisation and modification of the design and construction services is required in order to fulfil the performance obligation under the contract. As such, Entity A concludes that the design and construction services will be bundled and accounted for as one performance obligation.

Scenario B

Entity A concludes that the design of the shopping centre and parking facility is expected to be completed prior to the construction, and that it will not require any significant modification during the construction phase. Although the construction is dependent on the design, the design is not dependent on the construction. Furthermore, the design services and construction services are fulfilled with separate resources. Based on the weight of the evidence, Entity A concludes that the design and construction phases are not highly interrelated. As the proposed standard requires both criteria to be met (highly interrelated and significant customisation or modification) to treat goods and services within a bundle as a single performance obligation, Entity A concludes the design and construction phases each would be accounted for as separate performance obligations.



Illustration 3-3: Multiple goods and services

Scenario A

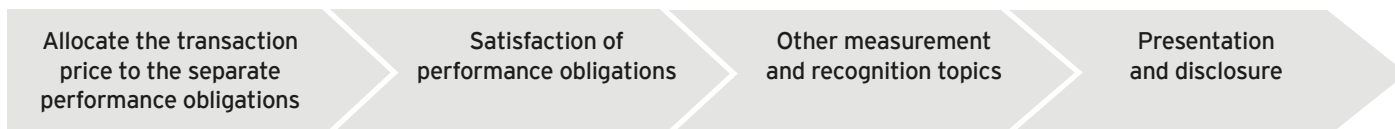
ITCo, a software development firm, contracts with a customer to provide the customer a “customised business solution” that will ultimately provide full back-office support and online order processing. This solution will include a suite of software products, as well as the professional services necessary to tailor the software to meet the customer’s business needs. The software developed by ITCo will require a high level of customisation to operate properly with other software packages that ITCo will be selling to the customer and the customer’s existing software that it will retain.

The delivery of this customised software solution requires the delivery of multiple software licences and customisation of the software packages to allow them to function together. ITCo determines the software licences and customisation services are highly interrelated and that it is providing a significant service of integrating the software packages and the packages are highly customised to suit the customer’s needs. Therefore, ITCo concludes that it will account for the bundle of goods and services as one performance obligation under the contract – to provide a fully functioning suite of software products that will function as one system to support back-office operation and online order processing.

Scenario B

ITCo contracts with a customer to provide the customer a “customised business solution” that will ultimately provide full back-office support and online order processing. This solution will include a suite of software products as well as the professional services necessary to integrate the software into the customer’s existing information technology environment. However, while it will require significant effort to integrate the software into the entity’s existing environment (and therefore the software and professional services are highly interrelated), the software will not be significantly modified as part of this integration. As a result, ITCo may determine that the software and the professional services are not a single performance obligation.





As illustrated in the following example, we believe that entities may end up treating the same goods and services differently from contract to contract, depending on how those goods and services have been bundled within an arrangement.

Illustration 3-4: Multiple goods and services – integrated

Entity A is in the business of outfitting office space with telephone and computer networking infrastructure and computer hardware. The entity has recently contracted with three customers to provide outfitting services at three different levels. The table below illustrates the goods and services under contract with each customer:

	Customer 1	Customer 2	Customer 3
Custom design	X		
Transfer of the equipment	X	X	X
Installation	X	X	
Employee training	X		

Entity A must evaluate whether the goods or services under each contract are highly interrelated, whether transferring them to the customer requires a significant integration service and whether the bundle of goods or services is significantly modified or customised to fulfil the contract. The conclusion for each customer contract would be as follows:

Customer 1 – This arrangement is with a large international customer that has complex requirements for its networking infrastructure. As a result, Entity A concludes that providing a full solution from design of the systems through a customised installation also requires the entity to manage the integration of each of the components. Therefore, Entity A would account for the design-to-installation project as a single performance obligation – the delivery of a customised, fully implemented telephone and IT network. As employee training is not a component that is integrated in providing the network to the customer, Entity A would analyse that performance obligation for separability from the other components using the criteria described above.

Customer 2 – This arrangement is with a customer that does not require Entity A to develop the design of the networking infrastructure. However, the project will require a significant integration effort by Entity A to get all of the components to work together. Therefore, Entity A will have to determine if, in order to satisfy the requirements of the arrangement, they are either significantly modifying or customising the equipment as part of the installation. If significant modification or customisation is required, then the entire arrangement would be treated as a single performance obligation. If not, the entity may conclude that the equipment can be accounted for as a separate performance obligation from the installation efforts.

Customer 3 – Entity A is providing goods only, which includes delivery to the site. It would account for the individual goods separately.

The ED also provides a practical expedient allowing an entity to account for multiple distinct goods or services as one performance obligation when the underlying goods and services have the same pattern of transfer. Furthermore, in the Basis for Conclusions, the ED indicates that the same pattern of transfer does not strictly relate to two or more performance obligations that are transferred simultaneously. We believe that performance obligations transferred consecutively with a similar pattern may also be combined as one performance obligation under this provision. See also Section 3.4 below.



3.3 Goods or services that are not distinct

If a good or service is not distinct from the other goods and services in the contract, the entity is required to combine that good or service with other promised goods or services until a bundle of goods or services is distinct for purposes of applying the proposed requirements. The combination of multiple non-distinct goods or services could, in certain circumstances, result in the entity accounting for all of the goods or services promised in the contract as a single performance obligation.

Illustration 3-5: Bundling inseparable goods and services

Entity Z is a software development firm that provides hosting services to a variety of consumer products entities. The entity offers an inventory management software product that requires the customer to purchase proprietary hardware from Entity Z. In addition, customers may purchase professional services from Entity Z to migrate historical data and create interfaces with existing back office accounting systems. The entity always delivers the hardware first, followed by professional services and, finally, the ongoing hosting services.

Scenario A – All goods and services sold separately

Entity Z determines that all of the individual goods and services in the contract are distinct because the entity regularly sells each component of the contract separately. Entity Z also determines that the manner in which these goods and services have been bundled does not change the determination of whether or not they are distinct because it is not providing a significant service of integrating the goods and services and the level of customisation is not significant. Accordingly, the hardware, professional services and hosting services are each accounted for as separate performance obligations.

Scenario B – Hardware not sold separately

Entity Z determines that the professional services are distinct because it frequently sells those services on a standalone basis (e.g., Entity Z performs professional services related to other hardware and software). Furthermore, Entity Z determines that the hosting services are also distinct because it also sells those services on a standalone basis. For example, customers that have completed their initial contractual term and elect each month to continue purchasing the hosting services are purchasing those services on a standalone basis. The hardware, however, is always sold in a package with the professional and hosting services and the customer cannot use the hardware on its own or with resources that are readily available to it. As a result, Entity Z determines the hardware is not distinct.

Entity Z must determine which goods and services in the contract to bundle with the hardware, which is not distinct. Entity Z likely would conclude that because the hardware is integral to the delivery of the hosted software, the hardware and hosting services should be accounted for as one performance obligation while the professional services, which are distinct, would be a separate performance obligation.

How we see it

The requirement to determine whether the promised goods or services in an arrangement are distinct from the other goods or services is a critical component of the proposed standard. This is an area in which respondents raised concerns with the approach proposed in the 2010 ED and the Boards made changes to address those concerns. Entities should consider the revised approach carefully and consider whether application of this model will result in the identification of performance obligations that align with the economics of the transaction.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

3.4 Long-term service arrangements

Entities frequently enter into arrangements to provide services on a long-term basis, such as multi-period maintenance agreements or multi-period asset management arrangements. Under the proposed standard, it is unclear how an entity should identify the performance obligations in those arrangements.

For example, should a three-year maintenance agreement be considered a single performance obligation representing the entire contractual period, or should it be broken into smaller periods (daily, monthly or yearly)? Example 2 in paragraph IE3 in the illustrative examples of the ED seems to suggest that it is appropriate to treat a three-year services contract as three separate one-year performance obligations, but it does not provide an explanation as to why three annual periods were selected rather than some other period or periods. One explanation might be that the contract can be renewed or cancelled by either party at discrete points in time (that is, at the end of each service year). As described in BC37 of the ED, the entity would separately account for its rights and obligations for each period in which the contract cannot be cancelled by either party.

In long-term service agreements when the consideration is fixed, the accounting generally will not change regardless of whether a single performance obligation or multiple performance obligations are identified. However, in arrangements involving variable consideration, this issue could have a significant effect, especially if the entity believes it is appropriate to allocate the variable consideration to a single performance obligation. See Section 5.3 for a further discussion on allocating variable consideration.

How we see it

Given the potentially significant effect the determination of separate performance obligations can have on the allocation and recognition of variable consideration, we believe the Boards should provide further clarity around how an entity should make this determination for long-term service arrangements.

3.5 Principal versus agent considerations

Some contracts result in an entity's customer receiving goods or services from another entity that is not a direct party to the contract. The ED states that when other parties are involved in providing goods or services to an entity's customer, the entity must determine whether its performance obligation is to provide the good or service itself (i.e., the entity is a principal) or to arrange for another party to provide the good or service (i.e., the entity is an agent). The determination of whether the entity is acting as a principal or an agent affects the amount of revenue the entity recognises. That is, when the entity is the principal in the arrangement, revenue is recognised based on the gross amount to which the entity expects to be entitled. When the entity is the agent, the revenue recognised is the net amount the entity is entitled to retain in return for its services as the agent.

The principal's performance obligations in a transaction differ from an agent's performance obligations. Since the principal controls the goods or services before delivery to the customer, its performance obligation is to transfer those goods or services to the customer in accordance with the contract. The agent only facilitates the sale of goods or services to the customer in exchange for a fee or commission and does not control the goods or services. Therefore, the agent's performance obligation is to arrange for another party to provide the goods or services to the customer.

The identification of the principal in a contract is not always clear. Therefore, the Boards have provided application guidance in the ED with indicators that a performance obligation involves an agency relationship. Indicators that the entity is an agent and should recognise revenue based on the net amount retained include:

- ▶ The other party is primarily responsible for fulfilling the contract.
- ▶ The entity does not have inventory risk before or after the customer order, during shipping or on return.
- ▶ The entity does not have latitude in establishing prices for the other party's goods or services and, hence, the benefit that the entity can receive from those goods or services is constrained.
- ▶ The entity's consideration is in the form of a commission.
- ▶ The entity does not have customer credit risk for the amount receivable in exchange for the other party's goods or services.

Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

Although a principal may be able to transfer the obligation to provide goods or services to another party, the Boards have indicated that such a transfer may not always satisfy the performance obligation. Instead, the entity evaluates whether it has created a new performance obligation to obtain a customer for the entity that assumed the obligation (i.e., whether the entity is now acting as an agent).

How we see it

The proposed principles for assessing whether an entity is acting as a principal or an agent when goods or services are transferred to end customers are similar to the principles in current IFRS. As a result, entities will have to continue to exercise significant judgement in some cases, especially for transactions involving intangible goods, such as digital content, for which many of the criteria are either not applicable or are unclear. Inconsistencies in practice would likely continue.

3.6 Consignment arrangements

Entities frequently deliver inventory on a consignment basis to other parties (e.g., distributor or dealer). By shipping on a consignment basis, consignors are able to better market products by moving them closer to the end user. However, they do so without selling the goods to the intermediary (consignee).

Entities entering into a consignment arrangement must determine, upon delivery of the inventory to the consignee, whether control of the inventory has passed to the consignee. Typically, a consignor will not relinquish control of consignment inventory until the inventory is sold to the end consumer or, in some cases, when a specified period expires. Consignees commonly do not have any obligation to pay for the inventory other than to pay the consignor the agreed portion of the sale price once the consignee sells the product to a third party. As a result, revenue generally would not be recognised for consignment arrangements when the goods are delivered to the consignee because control has not yet transferred (i.e., the performance obligation to deliver goods to the customer has not been satisfied). In these arrangements, it is the end customer with which the consignor is transacting. The consignee's contract with the consignor is that of the provision of services, i.e. facilitating the sale for the consignor.

3.7 Customer options to purchase additional goods or services

Many sales contracts give customers the option to purchase additional goods or services. These additional goods or services may be priced at a discount or may even be free of charge. Options to acquire additional goods or services at a discount can come in many forms, including sales incentives (e.g., free telephones), customer award credits (e.g., frequent flyer programmes), contract renewal options (e.g., waiver of certain fees or reduced future rates) or other discounts on future goods or services.

The proposed standard states that when an entity grants a customer the option to acquire additional goods or services, that option is a separate performance obligation only if it provides a material right to the customer. The right would be material only if it results in a discount that the customer would not receive otherwise (e.g., a discount that 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). If the discounted price in the option reflects the standalone selling price (separate from any existing relationship or contract), the entity is deemed to have made a marketing offer rather than having granted a material right. The proposed standard states that this is the case even if the option can be exercised only because of entering into the earlier transaction. The assessment of whether the entity has granted its customer a material right could require the exercise of significant judgement in some situations.

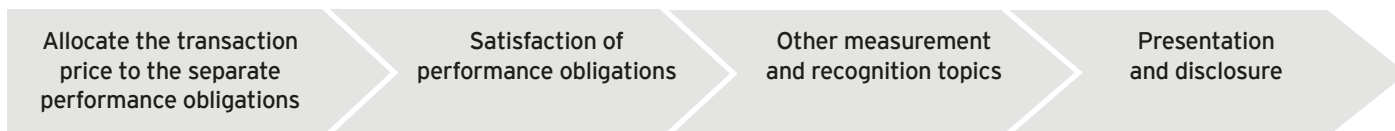


Illustration 3-6: Determining whether an option is a separate performance obligation

Scenario A – Option is not a separate performance obligation

A telecommunications entity provides its customers the option to purchase additional minutes in excess of the amount allotted in the customers' contracts, but the rate per minute is consistent for all customers with that particular usage plan, including those that are not currently subject to a minimum contractual term (i.e., "month-to-month" customers). In this circumstance, the telecommunications entity would likely decide that the option for additional minutes does not provide its customers with a material right and, therefore, does not represent a separate performance obligation in the arrangement.

Scenario B – Option is a separate performance obligation

A bio-technology entity enters into an arrangement with a pharmaceutical entity. Under the terms of the agreement, the bio-technology entity out-licenses certain intellectual property (IP), provides research and development services to further develop the IP and agrees to manufacture a drug for the pharmaceutical entity. The manufacturing of the drug will be at cost, but will only be required if successful development of the IP and relevant regulatory approval is achieved.

In this fact pattern, the bio-technology entity would likely determine that the option for the pharmaceutical entity to receive the manufactured drug at the bio-technology entity's cost represents a material right. As a result, the bio-technology entity would treat that option as a separate performance obligation. Under the proposed standard, the bio-technology entity would estimate the standalone selling price of that option (taking into consideration the likelihood of successful development efforts). Based on the relative standalone selling price allocation, the portion of the transaction price allocated to the option would be recognised as revenue when either the pharmaceutical entity exercises the option (i.e., over the period in which the benefit is realised as the drug is manufactured) or the option expires.

[Note, this example does not address whether or not this type of arrangement would be within the scope of the proposed standard. As discussed in Section 1.1.2, the proposed standard indicates that arrangements in which the counterparty is a collaborator rather than a customer would be excluded from the scope of the proposed standard.]

How we see it

Currently IFRS does not provide application guidance on how to distinguish between an option and a marketing offer. Nor does it address how to account for options that provide a material right. As a result, some entities may have effectively accounted for such options as marketing offers. The proposal would establish requirements for accounting for options. Under the proposed requirements, careful assessment of contractual terms will be important to distinguish between options and marketing offers as this could impact the timing of revenue recognition for the portion of the transaction price allocated to an option. The proposed requirements on how much of the transaction price should be allocated to that option is significantly different from current practice due to the lack of guidance in IFRS. See Section 5.1.1 for further discussion.

Scope, transition
and internal control
considerations

Identify the contract
with the customer

Identify the separate
performance obligations
in the contract

Determine the
transaction price

3.8 Sale of products with a right of return

An entity may provide its customers with a right to return a transferred product. A right of return may be contractual, an implicit right that exists due to the entity's customary business practice, or a combination of both (e.g., an entity has a stated return period but generally accepts returns over a longer period). A customer exercising its right to return a product may receive a full or partial refund, a credit that can be applied to amounts it owes to the vendor, a credit applied to the purchase of other goods or services, a different product in exchange or any combination of these items.

Offering a right of return in a sales agreement obliges the selling entity to stand ready to accept a returned product. The Boards decided that such an obligation would not represent a separate performance obligation. Instead, the Boards concluded that an entity makes an uncertain number of sales when it provides goods with a return right. That is, until the right of return expires, the entity is not certain how many sales will fail. Therefore, consistent with current practice, the Boards concluded that an entity should not recognise revenue for sales that are expected to fail as a result of the customer exercising its right to return the goods (this concept is discussed further in Section 6.4).

The Boards point out that exchanges by customers of one product for another of the same type, quality, condition and price (e.g., one colour or size for another) are not considered returns for the purposes of applying the proposed requirements.

What's changing from current IFRS?

The proposed standard is not significantly different from current IFRS. We do not expect the net impact of these arrangements to materially change measurement. However, the presentation of customers' rights of return may change for some entities as the proposed standard appears to require the presentation of the return asset separately from inventory. In addition, the proposed standard would require the refund liability to be presented separately from the corresponding asset (on a gross basis rather than a net basis).



4. Determine the transaction price

The ED defines the transaction price as “the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (e.g., sales taxes).” In many cases, the transaction price is readily determined because the entity receives payment at the same time it transfers the promised goods or services and the price is fixed. Determining the transaction price may be more challenging when it is variable in amount, when payment is received at a time different from when the entity provides goods or services, or when payment is in a form other than cash. Consideration paid or payable by the vendor to the customer may also affect the determination of transaction price. However, it is important to note that, in a change from the 2010 ED, the proposed standard no longer requires collectibility to be considered when determining the transaction price (see Section 7.4).

Determining the transaction price is an important step because this amount is then allocated to the identified performance obligations and, subject to certain limitations, is recognised as revenue as those performance obligations are satisfied. Furthermore, the amounts allocated to the performance obligations would be the basis for the onerous test (see Section 7.2), when applicable.

4.1 Variable consideration

The transaction price reflects an entity’s expectations about the consideration it will be entitled to from the customer. A portion of the transaction price could vary in amount and timing due to discounts, rebates, refunds, credits, incentives, bonuses, penalties, contingencies or concessions. For example, a portion of the transaction price would be variable at contract inception if it requires meeting specified performance conditions and there is uncertainty regarding the outcome of such conditions.

An entity would estimate the transaction price using either the “expected value” or the “most likely amount” approach, whichever better predicts the ultimate consideration to which the entity will be entitled. The entity would apply the selected method consistently throughout the contract and would update the estimated transaction price at each balance sheet date.

Under the expected value approach, the entity identifies the possible outcomes of a contract and the probabilities of those outcomes. The Boards indicated the expected value approach may be the better predictor of expected consideration when an entity has a large number of contracts with similar characteristics. The Boards also clarified that an entity preparing an expected value calculation is not required to consider all possible outcomes, even if the entity has extensive data and can identify many possible outcomes. Instead, the Boards indicated that in many cases, a limited number of discrete outcomes and probabilities can provide a reasonable estimate of the expected value.

The alternative “most likely” approach would predict the most likely outcome and use that amount as the basis for revenue recognition. The Boards indicated this approach may be the better predictor when the entity expects to be entitled to only one of two possible amounts (e.g., a contract in which an entity is entitled to receive all or none of a specified performance bonus, but not a portion of that bonus).

The proposed standard states that in applying either of the approaches above, an entity should consider all information (historical, current and forecast) that is reasonably available to the entity. While not explicitly stated, it appears there is a presumption in the proposed standard that an entity will always have the ability to estimate anticipated amounts of variable consideration (although there are some restrictions on the amounts of estimated variable consideration that can actually be recognised in revenue, as discussed further in Chapter 6).



Illustration 4-1: Performance bonus

Scenario A

A contractor enters into an arrangement that states the contractor will receive a CU100,000 performance bonus if the contractor meets specified performance targets. The contractor has performed a number of these types of contracts in the past, and has a number of similar contracts currently underway. Based on its experiences, the contractor has determined it is 80% likely to be entitled to the entire performance bonus, and 20% likely to be entitled to none of the bonus.

Because the contractor has a number of similar contracts, the contractor considers the likelihood of obtaining the performance bonuses on both an individual contract and considering the entire portfolio. As a result, the contractor determines that a probability-weighted estimate is the better predictor of the total arrangement consideration. Using that approach, the contractor would include CU80,000 [(CU100,000 x 80%) + (CU0 x 20%)] in the transaction price associated with this potential performance bonus.

Scenario B

A contractor enters into an arrangement that states the contractor will receive a CU100,000 performance bonus if the contractor meets specified performance targets. The contractor has performed a number of these types of contracts in the past, but has few such contracts currently underway. The contractor believes it is 80% likely to be entitled to the entire bonus amount.

Because of the limited population of contracts underway with this type of clause and the binary nature of the outcome (the contractor either will or will not earn the performance bonus), in this scenario the contractor determines that the “most likely” approach is the better predictor and includes CU100,000 in the transaction price.

What's changing from current IFRS?

For a number of entities, the treatment of variable consideration under the proposed standard could represent a significant change from current practice.

Currently, IFRS preparers often defer measurement of variable consideration until revenue is reliably measurable, which could be when the uncertainty is removed or when payment is received. The proposal would require entities to estimate variable consideration at contract inception. In addition, the proposed standard would allow variable consideration to be allocated to performance obligations. The proposed standard only provides a restriction on recognising variable amounts that are not reasonably assured. This concept is more fully discussed in Section 6.3. As a result, entities may recognise revenue sooner for variable amounts (see Illustration 4-2 for an example of this).

For some industries, the reasonable assurance constraint may lead to delayed recognition compared with current practice. Entities that earn performance-based incentive fees (e.g., asset managers and management entities) and currently recognise variable consideration based on an interim measurement in interim periods, may conclude that performance incentives are not reasonably assured until the end of the performance period.

Allocate the transaction price to the separate performance obligations

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Illustration 4-2: Accelerated revenue recognition compared with current practice

Entity A operates outsourced call centres for retail and manufacturing entities. It is compensated through fixed minimum amounts plus variable amounts based on average customer wait times. Entity A negotiates a new three-year contract with a customer it has been serving for the past three years. The contract states that the fixed amounts payable for annual services are CU12 million per year and CU10 per call for calls in excess of 1.2 million. Entity A also is able to earn a semi-annual bonus payment of CU600,000 if the average customer wait time is less than 4 minutes.

Entity A determines that the call centre service for 1.2 million calls annually is the only performance obligation in the arrangement. That is, the option to obtain services on additional calls, because it is priced at the same rate per call as the 1.2 million calls, is not an option that provides the customer a material right. Furthermore, based on historical experience, Entity A does not expect the volume of calls to exceed 1.2 million calls annually.

To estimate the total transaction price, Entity A would consider all reasonably available information, including its past performance on similar contracts. Based on that information, Entity A expects the average wait time to be less than 4 minutes throughout the year. Therefore, the entity estimates the transaction price as CU13,200,000 (CU12,000,000 + (CU600,000 x 2)) in each year. Entity A would account for each year as a separate performance obligation (see Section 3.4 for a discussion of identifying separate performance obligations for services) and would recognise revenue based on the proportion of calls completed to the total number of calls expected up to 1.2 million calls. In the first year, Entity A determines that it is reasonably assured to be entitled to the full estimated transaction price; thus, it would recognise as revenue CU11 (CU13,200,000 / 1,200,000) per call as the service is provided. Note, if Entity A expected the volume of calls to exceed 1.2 million calls annually, Entity A would have to include those calls (and the expected consideration) in the total transaction price so that the expected incremental consideration from the calls in excess of 1.2 million is allocated across all expected calls. Previously, IFRS reporters may have deferred recognition of the bonus element to a later date and only recognised the fixed revenue of CU10 (CU12,000,000 / 1,200,000) per call.

Illustration 4-3: Most likely amount from multiple outcomes

Entity A provides transportation to theme park customers to and from area lodging under a one-year agreement. It is required to provide scheduled transportation throughout the year for a fixed fee of CU400,000 annually. Entity A is also entitled to performance bonuses for on-time performance and achieving specified average customer wait times. Its performance may yield one of four potential outcomes under the contract. Based on its history with the theme park and customer travel patterns, Entity A estimates the probabilities for each level of bonus as follows:

Bonus amount	Probability of outcome
CU0	30%
CU200,000	30%
CU400,000	35%
CU600,000	5%

Analysis

Expected value

Because Entity A believes that there is no one amount among the possible outcomes that is more likely than not to be received, Entity A determines that the expected value approach is more appropriate. As a result, Entity A includes CU230,000 ((CU200,000 x 30%) + (CU400,000 x 35%) + (CU600,000 x 5%)) in the estimated transaction price for the variable consideration.

Most likely amount

Because there is only a limited number of outcomes for the amount of bonus that can be received, Entity A is concerned that a probability-weighted estimate may result in an amount that is not a potential outcome. Therefore, Entity A determines that estimating the transaction price by identifying the most likely outcome would be the better predictor.

However, the proposed standard is not clear about how an entity would determine the most likely amount when there are more than two potential outcomes and none of the potential outcomes is significantly more likely than the others. A literal reading of the ED might suggest that, in this example, Entity A should select CU400,000 as that is the amount with the highest estimated probability. However, this could result in including variable amounts in an estimated transaction price that have only a slightly greater likelihood than other potential outcomes, as illustrated above. As a result, we believe it would be difficult to support a conclusion that the most likely outcome approach is the better predictor in this circumstance.

Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

4.1.1 Constraining the cumulative amount of revenue recognised

Although an entity would estimate the transaction price (without any particular constraint on the estimate), the amount of revenue the entity could recognise would be constrained, or limited. The ED states that the cumulative amount of revenue an entity would be able to recognise for a satisfied performance obligation is limited to the amount to which the entity is reasonably assured to be entitled (refer to Section 6.3 for further guidance on determining when the amount to which an entity expects to be entitled is reasonably assured). Additionally, the ED specifies that an entity is not reasonably assured to be entitled to certain sales-based royalties until the uncertainty is resolved (refer to Section 6.3.1).

4.2 Time value of money

For certain transactions, the timing of the payment does not match the timing of the transfer of goods or services to the customer (e.g., the consideration is prepaid or is paid well after the services are provided). When the customer pays in arrears, the entity is effectively providing financing to the customer. Conversely, when the customer pays in advance, the entity has effectively received financing from the customer. To the extent a transaction includes a financing component that is significant to the contract, an entity must adjust the transaction price to reflect the time value of money so the amount ultimately recognised as revenue reflects what the cash selling price would have been if the customer paid cash at the time the goods or services were transferred.

However, the Boards agreed that an entity would not be required to assess whether the arrangement contains a significant financing component unless the period between the customer's payment and the entity's satisfaction of the performance obligation is expected to be greater than one year. While not entirely clear in the proposed standard, we believe the Boards' intent was that entities make this assessment at the contract level, rather than the performance obligation level.

When there is a difference between timing of customer payment and the transfer of the promised goods and services, the proposed standard states that an entity should consider various factors in determining whether the financing component is significant to the contract, including but not limited to, the following:

- ▶ Whether the amount of customer consideration would be substantially different if the customer paid in cash at the time of transfer (or promptly in accordance with typical credit terms) of the good or service

- ▶ The expected length of time between the provision of goods and services and the receipt of payment
- ▶ The interest rate within the contract (implicit or explicit) compared with prevailing market rates

When an entity concludes that a financing component is significant to the contract, it would determine the transaction price by discounting the amount of promised consideration. The entity would use the same discount rate that it would use if it were to enter into a separate financing transaction with the customer, independent of providing other goods or services. Using the risk-free rate or a rate explicitly stated in the contract that does not correspond with a separate financing rate would not be acceptable. Instead, the discount rate would have to reflect the credit characteristics of the borrower in the arrangement.

While not explicitly stated in the proposed standard, we believe an entity would have to consider the expected term of the financing as well in determining the discount rate. The entity would not update the discount rate for changes in circumstances or interest rates after contract inception. However, an entity would re-evaluate the effects of the time value of money when there is a change in the estimated timing of the transfer of goods or services to the customer.

4.2.1 Financial statement presentation of financing component

The financing component of the transaction price is required to be presented separately from the revenue recognised. Upon satisfaction of the performance obligations, an entity would recognise the present value of the promised consideration as revenue. The financing component is recognised as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears). The interest income or expense would be recognised over the financing period using the effective interest method in accordance with IFRS 9 or IAS 39.

In addition to the effects on presentation of revenue and interest income (expense), bifurcating the transaction would have an effect on the presentation of any expected impairment losses. The presentation of any impairment losses on a long-term receivable would be consistent with the presentation for other financial assets in the scope of IFRS 9 or IAS 39. This would differ from the presentation of impairment losses on short-term receivables or contract assets, which would be reflected as a separate line item adjacent to revenue in the statement of comprehensive income.

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Illustration 4-4: Arrangement includes financing component

Note: the following illustration provides an example of an arrangement in which a customer receives financing from the vendor. The ED also provides an example of an arrangement in which the customer provides financing to the vendor in the form of an advance payment (Example 9 at IE8).

Entity A is a home improvement store that, through a special promotion, offers no-interest financing for 24 months on a new heating and air conditioning system. Entity A sells a new CU10,000 system to a customer who chooses the no-interest financing.

Analysis

Entity A would first bifurcate the transaction into the financing component and the sale of the heating and air conditioning system. Based on a credit check performed by Entity A, the customer would typically qualify for a 6.5% rate in a separate financing transaction. The entity calculates that the financing component is CU1,183 ($CU10,000 - ((CU10,000 / 1.065) / 1.065)$) and the remainder represents the product sale. Therefore, CU8,817 would be recognised and classified as revenue from the sale of the heating and air condition system. Entity A would recognise interest income of CU1,183 over the two year period.

Entity A would record the following journal entries assuming a sales price of CU10,000 and Entity A's cost is CU8,000:

Dr. Long-term receivable	8,817	
Cr. Revenue		8,817
To record the initial sale.		
Dr. Cost of sales	8,000	
Cr. Inventory		8,000
To derecognise the inventory sold and recognise the cost of that sale.		
Dr. Interest receivable	573	
Cr. Interest income		573
To record interest income for the first year of financing ($CU8,817 \times 0.065$).		
Dr. Interest receivable	610	
Cr. Interest income		610
To record interest income for the second year of financing ($((CU8,817 + 573) \times 0.065)$).		

How we see it

Determining a customer-specific discount rate could be challenging. The proposed standard requires that the discount rate be similar to a rate which the entity would use in a separate financing transaction with the customer. Since most entities are not in the business of entering into freestanding financing arrangements with their customers, they may find it difficult to identify an appropriate rate. However, most entities perform some level of credit analysis before financing purchases for a customer, so the vendor would have some information about credit risk of the customer. For entities that have differential pricing for products depending on the time of payment (e.g., cash discounts), the proposed standard indicates that the appropriate discount rate could be determined by identifying the rate that discounts the nominal amount of the promised consideration to the cash sales price of the good or service.

Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

4.3 Non-cash consideration

Customer consideration might be in the form of goods, services or other non-cash consideration. When an entity receives, or expects to receive, non-cash consideration, the transaction price is equal to the fair value of the non-cash consideration. We note that this only applies to transactions that are in the scope of the proposed standard. Non-monetary exchanges between entities in the same line of business that are arranged to facilitate sales to third parties (i.e., the entities involved in the exchange are not the end consumer) are excluded from the scope of the proposed standard.

An entity would measure fair value of the non-cash consideration in accordance with IFRS 13 *Fair Value Measurement*. If an entity cannot reasonably estimate the fair value of non-cash consideration, it would measure the non-cash consideration indirectly by reference to the estimated selling price of the promised goods or services.

In some transactions, a customer contributes goods or services, such as equipment or labour, to facilitate the fulfilment of the contract. If the entity obtains control of the contributed goods or services, it should consider them as non-cash consideration and account for that consideration as described above.

What's changing from current IFRS?

The concept of accounting for non-cash consideration at fair value is consistent with current IFRS. IAS 18 currently requires non-cash consideration to be measured at the fair value of the goods or services received. When this amount cannot be measured reliably, non-cash consideration is measured at the fair value of the goods or services given up.² IFRIC 18 also requires any revenue recognised as a result of a transfer of an asset from a customer to be measured consistent with this requirement in IAS 18. Therefore, we would not expect the proposal to result in a change to current practice.

² IAS 18.12.

How we see it

While the concept of considering non-cash consideration is not a change from current practice, it is unclear from the ED when this fair value measurement should occur. That is, should the fair value of the goods or services received be measured at the inception of the contract or when performance occurs? For example, if an entity receives an equity instrument (i.e., a share-based payment) from its customer in return for the services provided, it is unclear whether the value of the equity instrument should be measured at the date of the arrangement, at the date the equity instrument is transferred to the entity or when the entity satisfies the performance obligation (which may be at a point in time or continuously over time). We believe the Boards need to clarify this aspect of the proposed requirements.

4.4 Consideration paid or payable to a customer

Many entities make payments to their customers from time to time. In some cases, the consideration paid or payable represents purchases by the entity of goods or services offered by the customer that satisfy a business need of the entity. In other cases, the consideration paid or payable represents incentives given by the entity to entice the customer to purchase, or continue purchasing, its goods or services.

Consideration paid or payable to customers commonly takes the form of discounts, coupons, free products or services and equity instruments, among others. In addition, some entities make payments to the customers of resellers or distributors that purchase directly from the entity (e.g., manufacturers of breakfast cereals offer coupons to consumers, even though their direct customers are the grocery stores that sell to consumers). Other common forms of consideration paid or payable to customers include the following:

- ▶ Slotting fees, in which a vendor provides consideration to a reseller to “obtain space” for the vendor’s products on the reseller’s store shelves, whether those shelves are physical (i.e., in a building in which the store is located) or virtual (i.e., they represent space in an internet reseller’s online catalogue)

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- ▶ Co-operative advertising arrangements, in which a vendor agrees to reimburse a reseller for a portion of costs incurred by the reseller to advertise the vendor's products
- ▶ Price protection, in which a vendor agrees to reimburse a retailer up to a specified amount for shortfalls in the sales price received by the retailer for the vendor's products over a specified period of time
- ▶ Coupons and rebates, in which an indirect customer of a vendor may receive a return of a portion of the purchase price of the product or service acquired by returning a form to the retailer or the vendor

Furthermore, the promise to pay the consideration might be implied by the entity's customary business practice. To determine the appropriate accounting, an entity must first determine whether the consideration paid or payable to a customer is:

- ▶ A reduction of the transaction price
- ▶ A payment for a distinct good or service
- ▶ A combination of both

For a payment by the entity to a customer to be treated as something other than a reduction of the transaction price, the good or service provided by the customer would have to be considered distinct (as discussed in Chapter 3). For the good or service to be distinct, the customer must regularly sell it separately or the entity must be able to benefit from that good or service either on its own or together with other resources that are readily available to the entity. Otherwise, payments from vendors to customers are considered to be a reduction of the total transaction price.

If the consideration paid or payable to a customer is a discount or refund for goods or services provided to a customer, this reduction of the transaction price (and thus, ultimately, revenue) would be recognised at the later of when the entity transfers the promised goods or services to the customer or the entity promises to pay the consideration. This is true even if the payment is conditional on a future event. For example, if goods subject to a discount through a coupon are already on the shelves of retailers, the discount would be recognised when the coupons are issued. However, if a coupon is issued that can be used on a new line of products that have not yet been sold to retailers, the discount would be recognised upon sale of such product to a retailer.

If the consideration paid or payable to a customer includes variable consideration and is a discount or refund for goods or services provided, an entity would measure the reduction of the transaction price using either the expected value approach or most likely amount to which the entity expects to be entitled (see Section 4.1 for further discussion).

If the consideration paid or payable to a customer is in exchange for a distinct good or service received from the customer, an entity would account for the good or service received in the same way as any other purchases in the normal course of business. The good or service would be capitalised or expensed in accordance with other IFRSs.

In some cases, the amount of consideration received from the customer and any payment of consideration to that customer are linked. For instance, a customer may pay more for goods or services than it would otherwise have paid if it was not also receiving a payment from the entity for other goods or services provided by the customer. This situation is treated as both a reduction in the transaction price and a payment for a distinct good or service. Under the proposed standard, the entity would determine the fair value of the good or service it receives from the customer and compare it to the consideration payable to the customer. Any excess consideration payable over the fair value of the distinct goods or services received would reduce the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, the entity should account for the entire consideration payable to the customer as a reduction of the transaction price.

As consideration paid to a customer can take many different forms, entities will have to carefully evaluate each transaction to determine the appropriate treatment of such amounts. Some common examples of consideration paid to a customer include:

- ▶ Slotting fees – The 2010 ED specifically included this type of transaction as a scenario in which the manufacturer was receiving a distinct good or service from the retailer. However, respondents raised concerns about this conclusion and the revised ED is silent on this topic. Generally, we believe such fees do not provide a distinct good or service to the manufacturer and should be treated as a reduction of the transaction price.

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- ▶ “Pay to play” arrangements – In some arrangements, entities pay an upfront fee to their customers in order to obtain a new contract. In most cases, these payments are not associated with any distinct good or service to be received from the customer and should be treated as a reduction of the transaction price.
- ▶ Purchase of goods or services – Entities often enter into supplier–vendor arrangements with their customers in which their customers provide them a distinct good or service. In such situations, the entity has to give careful consideration to determine if the payment made to the customer is solely for the goods and services received, or if part of the payment is actually a reduction of the transaction price for the goods and services the entity is transferring to the customer.

What’s changing from current IFRS?

The proposed accounting for consideration payable to a customer is generally consistent with current practice. However, the determination of whether a good or service is “distinct” under the proposed standard may result in an entity reassessing whether it has received a distinct good or service from the customer in order to treat the consideration payable to a customer as anything other than a reduction of revenue.

4.5 Non-refundable upfront fees

Entities may receive payments from customers before they render the contracted service or deliver a good. Upfront fees generally relate to the initiation, activation or set-up of a good to be used or a service to be rendered in the future. Upfront fees also may be paid to grant access to or a right to use a facility, product or service. In many cases, the upfront amounts paid by the customer are non-refundable. Examples include fees paid for membership to a health or buying club and activation fees for phone, cable or internet services.

Entities must evaluate whether non-refundable upfront fees relate to the transfer of a good or service. In most situations, the upfront fee does not relate to any actual transfer of a good or service. Instead, it is an advance payment for future goods or services. Additionally, the existence of a non-refundable upfront fee may indicate that the arrangement includes a renewal option for future goods and services at a reduced price (if the customer renews the agreement without the payment of an additional upfront fee).

Illustration 4-5: Non-refundable upfront fees

A customer signs a one-year contract with a health club and is required to pay both a non-refundable initiation fee of CU150 and an annual membership fee in monthly instalments of CU40. The club’s activity of registering the customer does not transfer any distinct service to the customer and, therefore, is not a performance obligation. By not requiring the customer to pay the upfront membership fee again at renewal, the club is effectively providing a discounted renewal rate to the customer.

The club determines that the renewal option is a material right because it provides a renewal option at a lower price than the range of prices typically charged and, therefore, it is a separate performance obligation. Based on historical experience, the club determines that its customers, on average, renew their annual memberships two times before terminating their relationship with the club. As a result, the club determines that the option provides the customer the right to two annual renewals at a discounted price. In this scenario, the club would allocate the total transaction consideration of CU630 (CU150 upfront membership fee + CU480 (CU40 x 12 months)) to the identified performance obligations (monthly services and renewal option) based on the relative standalone selling price method. The amount allocated to the renewal option would be recognised as each of the two renewal periods is either exercised or forfeited.

Alternatively, the club could value the option by “looking through” to the optional goods and services. In that scenario, the club would determine the total transaction price is the sum of the upfront fee plus three years of monthly service fees (or CU150 + CU1,440) and allocate that amount to all of the services expected to be delivered, or 36 months of membership (or CU44.17 per month).

(Refer to Section 3.7 for a more detailed discussion on the treatment of options).

5. Allocate the transaction price to the separate performance obligations

Once the performance obligations are identified and the transaction price has been determined, the proposed standard would require an entity to allocate the transaction price to the performance obligations, generally in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). As a result, any discount within the contract would generally be allocated proportionally to all of the separate performance obligations in the contract.

However, as discussed further below, there would be some exceptions. For example, when variable consideration exists, an entity in certain situations would allocate variable amounts to a single performance obligation (see Section 5.3 below). The proposal also contemplates the allocation of any discount in an arrangement to only certain performance obligations, if certain criteria are met.

5.1 Estimating standalone selling prices

To allocate the transaction price on a relative selling price basis, an entity must first have a standalone selling price for each performance obligation. Under the proposed standard, the standalone selling price would be the price at which an entity would sell a good or service on a standalone basis at contract inception. Although this is not explicitly stated in the ED, we believe a single good or service could have more than one standalone selling price – that is, the entity may be willing to sell a performance obligation at different prices to different customers.

The ED indicates the observable price, when available, of a good or service sold separately provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. For purposes of estimating standalone selling price, the ED specifies the following:

Extract from the ED

73. If a standalone selling price is not directly observable, an entity shall estimate it. When estimating a standalone selling price, an entity shall consider all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity. In addition, an entity shall maximise the use of observable inputs and shall apply estimation methods consistently in similar circumstances. Suitable estimation methods include, but are not limited to, the following:

- (a) Adjusted market assessment approach – An entity could evaluate the market in which it sells goods or services and estimate the price that customers in that market would be willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
- (b) Expected cost plus a margin approach – An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
- (c) Residual approach – If the standalone selling price of a good or service is highly variable or uncertain, then an entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. A selling price is highly variable when an entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts. A selling price is uncertain when an entity has not yet established a price for a good or service and the good or service has not previously been sold.

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While the proposed standard seems to indicate that an entity could rely solely on an expected cost plus a margin approach, we believe that an entity actually would have to consider the adjusted market approach in coming up with its estimate of a standalone selling price. That is, the expected cost plus a margin would not represent a reasonable standalone selling price if an entity could not determine that the market would support the amount of margin used by the entity.

The ability to use a residual technique would provide relief to entities that rarely or never sell goods or services on a standalone basis, such as entities that only sell intellectual property bundled with physical goods or services. For example, assume an entity frequently sells software, professional services and maintenance bundled together at prices that vary widely. The entity also sells the professional services and maintenance deliverables individually at relatively stable prices. The Boards indicated it may be appropriate to estimate the standalone selling price for the software as the difference between the total transaction price and the estimated selling price of the professional services and maintenance.

These would not be the only estimation methods permitted. Any reasonable estimation method would be allowed, as long as it is consistent with the basis of a standalone selling price, maximises the use of observable inputs and is applied on a consistent basis for similar goods and services and customers.

When an entity must estimate the standalone selling price, the proposed standard is clear that the entity should not presume that a contractually stated price or a list price for a good or service is the standalone selling price. For example, a vendor enters into a contract with Customer A to provide good A at CU100, good B at CU75 and good C at no cost. To allocate the transaction price appropriately, the vendor would have to determine the standalone selling prices for each of the goods and not simply use the rates stated in the contract.

What's changing from current IFRS?

The ED proposes requirements for the allocation of the transaction price in multiple-element arrangements that could result in a change in practice for many entities.

IAS 18 does not currently prescribe an allocation method for multiple-element arrangements. IFRIC 13 mentions two allocation methodologies: allocation based on relative fair value and allocation using the residual method. IFRIC 13 does not prescribe a hierarchy. Therefore, currently an entity must use its judgement to select the most appropriate methodology, taking into consideration all relevant facts and circumstances and ensuring the resulting allocation is consistent with IAS 18's objective to measure revenue at the fair value of the consideration.

Given the limited guidance currently in IFRS on multiple-element arrangements, some entities have looked to US GAAP to develop their accounting policies. The requirement to estimate a standalone selling price is not a new concept in US GAAP. While the current requirement in US GAAP, in ASC 605-25, to move through a hierarchy when determining this estimate is being removed, the general principle of estimating a standalone selling price is generally consistent with the proposed standard.

The proposed requirement would be a significant change for entities that have looked to other US GAAP guidance, such as the software revenue recognition guidance, to develop their accounting policies for revenue recognition. Some of these entities may find it difficult to determine a standalone selling price, particularly for goods or services that are never sold independently (e.g., specified upgrade rights for software). However, the inclusion of the residual technique may lead to a result that is consistent with current practice.

For entities for which this requirement represents a significant change from current practice, implementing the change would likely involve personnel beyond just the accounting or finance department, such as marketing personnel involved in an entity's pricing decisions.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

Illustration 5-1: Estimated selling price

Manufacturing Co. enters into a contract with a customer to sell a machine for CU100,000. The total contract price includes installation of the machine and a two-year extended warranty. Manufacturing Co. routinely sells the machine for CU75,000 on a standalone basis without installation or warranty provisions. While Manufacturing Co. rarely provides installation services separately, it is aware that other entities provide this service and charge CU10,000 to CU15,000 for each installation. Manufacturing Co. does not sell warranties on a standalone basis, but customers may purchase the machine without the warranty coverage. Since customers have the option to purchase without the extended warranty, the warranty would be a separate performance obligation (see Section 7.1 for further discussion).

In this example, Manufacturing Co. regularly sells the machine on its own and therefore has evidence of a standalone selling price of CU75,000. Management uses the expected cost plus a margin approach to estimate the price of the installation services. Under this approach, the entity considers its internal cost structure plus a reasonable margin, which results in an estimated selling price of CU14,000. Since this price falls within the range of pricing offered by its competitors, Manufacturing Co. determines its estimate of standalone selling price is appropriate. To estimate the price of the warranty service, Manufacturing Co. estimates its cost and adds a margin, taking into account the amount of margin the market will bear. The result is an estimated selling price of CU20,000.

The entity would allocate revenue to each separate performance obligation using the relative standalone selling price method and recognise as revenue the amount allocated to each performance obligation as each performance obligation is satisfied.

The proposed standard would allow the use of a residual technique to estimate the standalone selling price of a separate performance obligation (see Illustration 5-2 for further discussion). Therefore, any estimated selling price determined using a residual technique would then be used to allocate the transaction price using the relative selling price method. This differs from the current use of a residual allocation method under current US GAAP. However, as demonstrated by the following example, this appears to be a distinction without a difference, as the end result would be the same under either approach.

Illustration 5-2: Use of a residual technique to estimate selling price

A consulting firm has developed a software package that it licenses to corporate customers in bundled packages with three years of professional consultation services. The transaction price varies significantly as a result of the consulting firm's negotiations with each new customer. The professional services offered are consistent from customer to customer, regardless of the size or complexity of the customer's business, and the selling price is always CU1,000 per month when the firm sells professional services on a standalone basis. The firm determines that the variability in pricing in bundled arrangements is attributable only to the licence.

The consulting firm enters into an arrangement with a customer for the delivery of the software licence and 36 months of professional services for a total transaction price of CU100,000. Using a residual technique to estimate the selling price of the licence, the consulting firm would subtract the selling price of the professional services from the total transaction price, resulting in a selling price of CU64,000 for the licence (CU100,000 - (36 months x CU1,000)). The entity would then allocate the transaction price to each performance obligation using the relative selling price method, resulting in CU64,000 ((CU64,000 / CU100,000) x CU100,000) allocated to the licence and CU36,000 ((CU36,000 / CU100,000) x CU100,000) allocated to the professional services.

Using the residual method of allocating the transaction consideration under current US GAAP, the result would be identical. The standalone selling price of the professional services is known (CU36,000); therefore, that amount is allocated to the professional services ((CU36,000 / CU100,000) x CU100,000). The residual of CU64,000 is then allocated to the delivered item (the software licence).



5.1.1 Measurement of options that are separate performance obligations

An entity that determines that an option is a separate performance obligation (because the option provides the customer with a material right, as discussed further in Section 3.7) would have to determine the standalone selling price of the option. If the standalone selling price is not directly observable, the entity would estimate the standalone selling price, taking into consideration the discount the customer would receive in a standalone transaction and the likelihood that the customer would exercise the option.

The proposed standard also provides an alternative to estimating the standalone selling price of an option when that amount is not observable. An entity would be allowed to “look through” the option and assume that it is going to be exercised. Under this approach, the entity would estimate the transaction price by including any consideration related to the optional goods or services. Furthermore, the transaction price would be allocated to all of the goods and services (including those under option). This practical alternative would apply when the goods or services are: (1) similar to the original goods and services in the contract; and (2) provided in accordance with the terms of the original contract.

Illustration 5-3: Estimating the standalone selling price of an option

A machinery maintenance contract provider offers a promotion to new customers who pay full price for the first year of maintenance coverage that would grant them an option to renew their services for up to two years at a discount. The package regularly sells for CU750 for one year of maintenance services. With the promotion, the customer would be able to renew the annual maintenance services at the end of each year for CU600. The entity concludes this is a material right because the customer would receive a discount that is incremental to any discount available to other customers. The entity also determines that no directly observable standalone selling price exists for the option to renew at a discount.

Scenario A

Because the entity has no directly observable evidence, it has to estimate the standalone selling price of a CU150 discount on the renewal of services in years two and three. In coming up with this estimate, the entity would consider factors such as the likelihood that the option will be exercised, time value of the money (as the discount is only available in future periods) and what comparable discounted offers sell for. For example, the entity may consider the selling price of an offer for a discounted price of similar services found on a “deal of the day” website.

Scenario B

Rather than estimate the standalone selling price of the renewal option, the entity chooses to allocate the transaction price by determining the consideration it expects to be entitled to in exchange for all of the services it expects to provide. Assume the entity obtained 100 new subscribers under the promotion. Based on adjusted historical experience, the entity anticipates approximately 50% attrition annually, after giving consideration to the anticipated effect of the CU150 discount. Therefore, on the entire portfolio of new contracts, the entity expects to provide maintenance services for all 100 customers in the first year, 50 customers in the second year and 25 customers in the third year. The total consideration the entity expects to receive is CU120,000 [(100 x CU750) + (50 x CU600) + (25 x CU600)]. Assuming the standalone selling price for each maintenance contract period is the same, the entity would allocate CU685.71 (CU120,000 / 175) to each maintenance contract sold.

The entity would recognise revenue related to the maintenance services as the services are performed. During the first year, the entity would recognise CU68,571 (100 maintenance contracts sold x the allocated price of CU685.71 per maintenance contract). If the actual renewals in years two and three differ from expectations, the entity would have to update its estimates.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

What's changing from current IFRS?

The requirement to identify and allocate arrangement consideration to an option on a relative selling price basis would likely be a significant change in practice for many IFRS preparers.

For entities that developed their accounting policy for allocation of revenue in a multiple-element arrangement by reference to US GAAP, the proposed requirements are generally consistent with the current guidance in ASC 605-25. However, ASC 605-25 requires the entity to estimate the selling price (unless other objective evidence of the selling price exists) and does not provide the alternative method of "looking through" the option as described above. This proposed requirement also differs from the current US GAAP requirements for software transactions in ASC 985-605. ASC 985-605 contains prescriptive requirements regarding how significant future discounts should be applied to each element. Generally, the approaches within ASC 985-605 result in a higher amount of transaction consideration being allocated to the option than the approach outlined in the ED, as none of the approaches in ASC 985-605 allow an entity to consider the likelihood of exercise of the option.

Illustration 5-4: Option for additional software at a discount

A vendor enters into an arrangement to license software products A and B to a customer for a total of CU20,000. The vendor agrees to provide a discount of CU3,000 for subsequent licences if the customer licences either product C, D or E within a year of entering the arrangement. The estimated selling price of both products A and B is CU10,000. The estimated selling prices of products C, D and E range from CU10,000 for product C to CU40,000 for product E. The vendor determines that the future discount provides a material right to the customer because it rarely discounts products C, D or E.

Under the proposed standard, the vendor would allocate the transaction price to the individual performance obligations within the contract, including the option, in proportion to the standalone selling prices of goods underlying each performance obligation. The amount allocated to the significant and incremental discount would be recognised in revenue when the performance obligation is satisfied (i.e., when the customer purchases products C, D or E or after the option period expires). For example, the vendor may conclude that the standalone selling prices for products A and B and the option to purchase future products at a discount are CU10,000, CU10,000 and CU1,500, respectively. As a result, the vendor would allocate the total arrangement consideration of CU20,000 to Product A, Product B and the option on a relative selling price basis, which is CU9,300, CU9,300 and CU1,400, respectively.

5.2 Applying the relative standalone selling price method

Once an entity has determined the standalone selling price for the separate goods and services in an arrangement, the entity would allocate the transaction price to those performance obligations. The ED requires an entity to use the relative standalone selling price method to allocate the transaction price except in two specific circumstances, which are described in Sections 5.3 and 5.4 below. Under the relative standalone selling price method, the transaction price would be allocated to each separate performance obligation based on the proportion of the standalone selling price of each performance obligation to the sum of the standalone selling prices of all of the performance obligations in the arrangement.

What's changing from current IFRS?

The proposed method of allocation is not significantly different from the mechanics of applying current methods such as a relative fair value approach. However, the methodology may be complicated when an entity applies one or both of the exceptions provided in the ED (described in the following sections) or the transaction includes contingent consideration.

Illustration 5-5: Relative standalone selling price allocation

Continuing Illustration 5-1, Manufacturing Co. determined the standalone selling prices of the separate performance obligations in the arrangement as follows: machine – CU75,000, installation services – CU14,000, and extended warranty – CU20,000.

The aggregate individual standalone selling price (CU109,000) exceeds the total transaction price of CU100,000, indicating there is a discount inherent in the arrangement. That discount must be allocated to each of the individual performance obligations based on the relative standalone selling price of each performance obligation. Therefore, the amount of the CU100,000 transaction price is allocated to each performance obligation as follows:

Machine – CU68,807 (CU75,000 × (CU100,000 / CU109,000))

Installation – CU12,844 (CU14,000 × (CU100,000 / CU109,000))

Warranty – CU18,349 (CU20,000 × (CU100,000 / CU109,000))

The entity would recognise as revenue the amount allocated to each performance obligation as each performance obligation is satisfied.

Scope, transition
and internal control
considerations

Identify the contract
with the customer

Identify the separate
performance obligations
in the contract

Determine the
transaction price

5.3 Allocating variable or contingent consideration

The Boards proposed two exceptions to the relative selling price method of allocating the transaction price. The first relates to the allocation of variable or contingent consideration (see Section 5.4 for the second exception), which would be allocated entirely to a single performance obligation if both of the following conditions are met:

- ▶ The variable payment terms for the distinct good or service relate specifically to the entity's efforts to transfer that good or service (or to a specific outcome from transferring that good or service).
- ▶ Allocating the variable amount of consideration entirely to the distinct good or service is consistent with the overall principle for allocating consideration (i.e., the amount ultimately allocated to each separate performance obligation results in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each separate performance obligation).

The Boards clarified in BC192 that the objective of providing this exception is to acknowledge that there may be transactions in which allocating contingent amounts to all performance obligations in a contract provides a result that does not reflect the economics of the transaction. In such situations, allocating variable consideration entirely to a distinct good or service may be appropriate when the result is that the amount allocated to that particular good or service is reasonable relative to all other performance obligations and payment terms in the contract.

This proposed approach for variable or contingent consideration would also apply to subsequent changes in the transaction price. It is important to note that this exception related to allocating variable consideration to a single performance obligation would be a requirement, not a policy election. If the above criteria are met, the entity would have to allocate the variable consideration to the related performance obligation.

Illustration 5-6: Allocating a variable transaction price to one performance obligation

A manufacturer offers Products A, B and C for CU60 plus a sales-based royalty related to the technology used in Product C. Products A and B are frequently sold separately for CU30 each and Product C is frequently sold separately for CU50. The manufacturer estimates the transaction price to be CU125 for all three items, which includes CU65 in royalties related to Product C.

It is not entirely clear from the requirements in the ED how to allocate arrangement consideration when the transaction has both fixed and variable consideration, and the entity believes the variable consideration should be allocated to a single performance obligation. One approach would be that the manufacturer allocates CU30 each to Products A and B and the entire variable amount of CU65 to Product C. Although the manufacturer expects to earn a premium on the contract as a whole due to the favourable terms of the royalty arrangement for Product C, none of the premium is allocated to Products A and B because the contingent amount relates specifically to the outcome of the performance obligation to transfer Product C. Furthermore, the estimated value of the contingent consideration, while not equal to the estimated standalone selling price of Product C, is reasonable in relation to the standalone selling price of Product C. The manufacturer would recognise revenue of CU30 each upon transfer of control of Products A and B. Product C also is transferred at a point in time, but the ED provides that the amount the entity is entitled to receive for royalty arrangements is not reasonably assured until the customer completes the subsequent sales. Therefore, the revenue related to the sales-based royalty would be recognised as the underlying sales related to the technology used in Product C occur.

Illustration 5-7: Allocating a variable transaction price to more than one performance obligation

Biotech agrees to license intellectual property to Pharma and to provide Pharma ongoing research and development (R&D) efforts for the further development of that intellectual property. In exchange, Pharma agrees to pay Biotech an upfront fee of CU20 million, a fee of CU300,000 per year per full-time equivalent (FTE) of R&D provided by Biotech and milestone payments if certain development targets are met. Management views each annual period of R&D services to be separate performance obligations because the contract for R&D services can be renewed or cancelled by either party at the end of each year. Management has also determined that the licence represents a separate performance obligation.

Biotech determines that any milestone payments received should be attributable to the goods and services already provided to Pharma at the time they are received. That is, Biotech believes the receipt of the milestone payment relates specifically to the efforts already provided (e.g., the licence and the completed R&D services). However, since the licence and the completed R&D services are not a single performance obligation within the arrangement, it is unclear if this treatment would be acceptable under the proposed standard.

Illustration 5-8: Treatment of fixed consideration in an arrangement involving variable consideration

Assume the same facts as Illustration 5-7. Biotech determines that it is appropriate to allocate the variable payments (e.g., the milestone payments) to the licence. However, it is unclear from the ED whether, if Biotech makes that determination, it should also allocate a portion of the fixed consideration (the CU20 million upfront fee) to the licence.

While allocating a portion of the upfront fee seems to be an appropriate approach for this arrangement, contrast this example with Illustration 5-6 above, where a different approach was used. In that example, the performance obligation receiving the variable fee (Product C) was excluded from the allocation of the CU60 fixed fee.

It is unclear from the ED if both of these approaches are acceptable.

How we see it

Allocating variable consideration to a single performance obligation would be a change from current practice for many entities. For example, the allocation methods currently used for multiple-element arrangement would likely result in an entity allocating all identified consideration (whether variable or fixed) to the identified performance obligations. The requirement to allocate such consideration to a single performance obligation could significantly change the timing of revenue recognition from current practice.

In addition, we have concerns about how this concept is applied in certain specific situations. For example:

- ▶ The ED suggests that the variable consideration, and subsequent changes in variable consideration, be allocated to a single performance obligation. It is not clear whether this exception can be applied if the variability in the total transaction price is attributable to more than one but not all of the performance obligations in the arrangement. See Illustration 5-7.
- ▶ It is not clear how an entity treats the fixed consideration in the arrangements in which the variable consideration is allocated to a single performance obligation. That is, would the entity also allocate any of the fixed consideration to that performance obligation, or is the entity precluded from doing that because the entity determined the variable consideration relates to that performance obligation? See Illustration 5-6 and 5-8.
- ▶ For entities that have multiple payment streams that are all variable, is it possible to determine that some of the variable payment streams are related to only certain performance obligations, but the other variable payment streams are related to all of the goods and services in the arrangement?
- ▶ As discussed further below (Section 5.3.1), it is unclear how this exception interacts with the proposed requirements for contract modifications.

We believe the Boards need to provide additional clarity or application guidance to address these scenarios.

Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

5.3.1 Interaction of contract modification requirements with the variable consideration requirements

The proposed requirements for changes to the scope of an arrangement (with or without changes in the contract price) do not appear to contemplate modifications of contracts that involve variable consideration. As discussed in Section 2.2, there are potential differences in how a change in the scope of an arrangement is treated. Specifically, if certain criteria are met, the change in contract scope would be treated as a separate contract. The treatment of the variable consideration appears clear for those scenarios.

Conversely, changes in contract scope that do not meet the criteria in paragraph 17 of the ED would not be treated as separate contracts. In those situations, the accounting for the arrangement depends on whether the entity has transferred control of any of the promised goods and services at the time of the modification and whether the remaining goods and services are distinct from those already provided. Essentially, the proposed standard requires that when the arrangement has distinct goods or services that are fully satisfied at the time of the change in the scope of the contract, none of the effects from the change in scope are allocated to those satisfied goods or services. That is, the proposed standard would treat the contract modification as a termination of the old contract and the creation of a new contract.

However, in situations in which the entity is supposed to “freeze” the accounting on the completed distinct goods or services, and only allocate the effects of the contract modifications to the remaining distinct goods or services, it is unclear how variable consideration should be treated. The example in Illustration 5-9 illustrates this concept further.

Illustration 5-9: Modification affecting variable consideration

Entity A entered into a contract to license its proprietary formula to a foreign soft drinks maker. Entity A provided the formula on the date the contract was signed, fully satisfying the performance obligation. Entity A is entitled to a sales-based royalty for use of the formula. As such, Entity A allocates all of the sales-based royalties to this performance obligation and recognises revenue as the sales are reported to the entity. The contract also requires Entity A to provide marketing-related activities for a fixed fee while the licensee is party to the licence agreement, which is accounted for as a separate performance obligation.

Entity A subsequently renegotiates the scope of the marketing-related activities and the amounts the foreign soft drink maker will pay for those ongoing activities. The re-negotiations do not result in a new, distinct performance obligation.

The proposal in the ED for contract modifications would require the entity to allocate any changes in expected consideration as a result of the contract modification, and any future consideration yet to be received related to satisfied performance obligations, to the remaining performance obligations in the contract. In this example, a literal read of the ED suggests that Entity A would be required to allocate all future amounts to which it is entitled (including sales-based royalties) to the marketing activities that have not yet been provided. However, it seems more appropriate to continue to allocate the amounts related to the sales-based royalty to the satisfied performance obligation (i.e., providing the formula).

5.4 Allocating a discount

Another proposed exception to the relative selling price allocation method (see Section 5.3 for the first exception) relates to allocating discounts inherent in the contract. When an entity sells a bundle of goods and services, the selling price of the bundle is often less than the sum of the standalone selling prices of the individual components. Using a relative standalone selling price allocation method, this discount would be allocated proportionately to all of the separate performance obligations.

The ED would allow an entity to allocate a discount inherent in a bundle of goods and services to an individual performance obligation (or smaller bundle of goods and services) when the pricing of that good or service is largely independent of others in the contract. That is, an entity would be able to effectively “carve off” an individual performance obligation to allocate a discount to that performance obligation if the entity determines the discount is specific to that good or service. The ED states that the price of goods and services would be largely independent of other goods and services in the contract when both of the following are met:

- ▶ The entity regularly sells each good or service (or each bundle of goods or services) in the contract on a standalone basis.
- ▶ The observable selling prices from those standalone sales provide evidence of the performance obligation(s) to which the entire discount in the contract belongs.

This is illustrated in Illustration 5-10.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

Illustration 5-10: Allocating a discount

Golf Corp is a full service golf shop that offers lessons and custom club making and sells retail equipment and apparel. It regularly sells private lessons on a standalone basis for CU150 per one-hour session. However, when a customer purchases a new set of custom clubs (irons only), the entity offers a one-hour lesson for half price. The lesson is generally scheduled when the clubs are ready and delivered together.

Golf Corp sells a custom irons package (i.e., custom irons with a free lesson) along with a number of retail items to a customer and delivers all of the retail items on the date ordered. The customer arranges to pick up the irons and take her lesson one month later. The package price and standalone selling prices of each item are as follows:

Item	Standalone selling price	Price when bundled	Bundling discount
Lessons (per session)	CU150	–	–
Custom irons	900	CU975	CU75
Retail putter	125	125	–
Retail bag	175	175	–
Retail woods	650	650	–
	CU2,000	CU1,925	CU75

Due to the timing of delivery, Golf Corp accounts for two performance obligations – all retail items and the custom irons/private lessons bundle. Since Golf Corp regularly sells the lessons and custom irons together for CU975 and all other retail items at their standalone selling prices, the entity has observable evidence that the CU75 discount inherent in the package is attributable to the custom irons/private lesson bundle. Golf Corp, therefore, allocates 100% of the discount to the custom irons/private lesson bundle, which is reflected in the following allocation:

Allocated amounts	
Custom irons/private lesson	CU975
Retail clubs and bag	950
Total	CU1,925

This example assumes the discount for the larger bundle of goods and services is exactly equal to the discount for a lessons/custom irons bundle (CU75). It is unclear how an entity would treat a discount of more than CU75 for the larger bundle. For example, if the discount on the larger bundle totalled CU125, it is unclear whether CU75 would be allocated to the lessons and custom irons, with the remainder allocated to the other three items, or if the entire CU125 discount would be allocated to all of the performance obligations based on the relative standalone selling prices (i.e., the entity would not be able to use the exception to allocate a discount to only certain performance obligations).

Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

How we see it

The requirement to allocate discounts to a single performance obligation would be a significant change from current practice. While providing this exception may give entities the ability to better reflect the economics of the transaction in limited circumstances, we believe this exception introduces unnecessary complexity to the proposed requirements. We believe the Boards should work to minimise the number of exceptions to the overall principles.

5.5 Changes in transaction price after contract inception

Under the proposed standard, the standalone selling price would be determined only at contract inception. While the amounts allocated to performance obligations would be updated to reflect changes in the estimated transaction price as goods and services are delivered, the standalone selling prices used to perform the allocation would not be updated to reflect changes in the standalone selling prices after contract inception. This means that changes in the total transaction price would be allocated to the separate performance obligations on the same basis as the initial allocation, irrespective of whether allocated using the relative selling price or as an allocation to individual performance obligations based on the requirements discussed above.



Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

6. Satisfaction of performance obligations

Under the proposed standard, an entity would recognise revenue only when it satisfies an identified performance obligation by transferring a promised good or service to a customer. A good or service is generally considered to be transferred when the customer obtains control. The ED states that “control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset.” Control also includes the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service.

For purposes of applying the proposed standard, the transfer of control to the customer represents the transfer of the rights with regard to the good or service. The customer’s ability to receive the benefit from the good or service is represented by its right to substantially all of the cash inflows, or the reduction of cash outflows, generated by the goods or services. For example, upon transfer of control, the customer has sole possession of the right to use the good or service for the remainder of its economic life or to consume the good or service in its own operations.

The proposed standard indicates that certain performance obligations are satisfied as of a point in time. Therefore, revenue would be recognised at the point in time that control transfers to the customer. However, other performance obligations are satisfied over time, and therefore the associated revenue is recognised over the period the performance obligation is satisfied. These concepts are explored further in the following sections.

6.1 Performance obligations satisfied over time

Frequently, entities transfer the promised goods and services to the customer over time. While the determination of whether or not goods or services are being transferred over time is straightforward in some arrangements (e.g., many service contracts), the Boards acknowledge that it is more difficult in many other arrangements. To help entities determine whether control transfers over time (rather than at a point in time), the Boards provided the following criteria:





Extract from the ED

35. An entity transfers control of a good or service over time and, hence, satisfies a performance obligation and recognises revenue over time if at least one of the following two criteria is met:

- (a) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced. An entity shall apply the requirements on control in paragraphs 31-33 and paragraph 37 to determine whether the customer controls an asset as it is created or enhanced; or
- (b) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and at least one of the following criteria is met:
 - (i) the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs.
 - (ii) another entity would not need to substantially re-perform the work the entity has completed to date if that other entity were to fulfil the remaining obligation to the customer. In evaluating this criterion, the entity shall presume that another entity fulfilling the remainder of the contract would not have the benefit of any asset (for example, work in progress) presently controlled by the entity. In addition, an entity shall disregard potential limitations (contractual or practical) that would prevent it from transferring a remaining performance obligation to another entity.
 - (iii) the entity has a right to payment for performance completed to date, and it expects to fulfil the contract as promised. The right to payment for performance completed to date does not need to be for a fixed amount. However, the entity must be entitled to an amount that is intended to at least compensate the entity for performance completed to date even if the customer can terminate the contract for reasons other than the entity's failure to perform as promised. Compensation for performance completed to date includes payment that approximates the selling price of the goods or services transferred to date (for example, recovery of the entity's costs plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract is terminated.

36. When evaluating whether an asset has an alternative use to the entity, an entity shall consider at contract inception the effects of contractual and practical limitations on the entity's ability to readily direct the promised asset to another customer. A promised asset would not have alternative use to an entity if the entity is unable, either contractually or practically, to readily direct the asset to another customer. For example, an asset would have an alternative use to an entity if the asset is largely interchangeable with other assets that the entity could transfer to the customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract. Conversely, the asset would not have an alternative use if the contract has substantive terms that preclude the entity from directing the asset to another customer or if the entity would incur significant costs (for example, costs to rework the asset) to direct the asset to another customer.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

Examples of each of the above criteria are included in the following sections.

6.1.1 Customer controls asset as it is created or enhanced

One important criterion in the determination of whether control of a good or service is being transferred over time is whether the customer controls the asset as it is being created or enhanced. For example, a contract to develop an IT system on the customer's premises would be accounted for as a service under paragraph 35(a) because the customer controls the system while it is being developed or enhanced. Additionally, many construction contracts with the government contain clauses indicating that the government owns the work-in-progress as it is being built. The Boards believe the customer's control over the asset as it is being created or enhanced indicates that the entity's performance transfers goods or services to a customer.

Illustration 6-1: Customer controls asset

An entity enters into an agreement to provide for the design and construction of a specialised piece of equipment. During the design phase, the entity works extensively with the customer to configure the customised equipment to the customer's wishes. The customer has legal title to the equipment as it is constructed and has the right to take possession of the equipment at any time subject to payment of amounts due to the entity. The customer also makes non-refundable payments to the entity. In this scenario, the entity determines it has one performance obligation, the integration of goods and services to provide a single asset to the customer. Since the customer controls the asset as it is constructed, the entity determines that the performance obligation is satisfied continuously over time.

6.1.2 Alternative use

Another important criterion in the determination of whether control of a good or service is being transferred continuously over time is the notion of "alternative use" included in paragraph 35(b). An entity would not have an alternative use for the good or service if the contract precludes the entity from transferring the good or service to another customer (because it is legally obligated to direct the asset to the customer). A good or service that does not have an alternative use must also meet one of the additional criteria in paragraph 35(b) in order to determine that control of the good or service transfers continuously. Examples of transactions that would meet the criteria in paragraph 35(b) include:

- ▶ Training or consulting services that are consumed immediately by the customer (with or without any final deliverable) are most likely addressed by paragraph 35(b)(i).
- ▶ Shipping services would typically fall under paragraph 35(b)(ii) because a new vendor would only have to perform the incremental services to deliver a package to its destination from the point the new vendor took possession of the package.
- ▶ Legal or other services for which vendors are compensated based on time incurred rather than an outcome or deliverable would typically fall under paragraph 35(b)(iii).

It is important to note that, even when an entity meets one of the criteria listed above (e.g., the entity has a right to payment for performance completed to date), if the good or service being created has an alternative use to the entity, the entity would not be permitted to determine that control of that good or service transfers continuously to the customer.

If the entity is unable to demonstrate that control transfers over time, the presumption would be that control transfers at a point in time (see Section 6.2 below).

How we see it

The concept of alternative use would have a significant effect on the pattern of revenue recognition for a large number of entities. The Boards have concluded a good has no alternative use when its use is contractually restricted, whether or not the customer has a compelling reason to request such a restriction. It appears that this provision could create structuring opportunities to achieve specific accounting outcomes.

Scope, transition
and internal control
considerations

Identify the contract
with the customer

Identify the separate
performance obligations
in the contract

Determine the
transaction price

6.1.3 Measuring progress

When an entity has determined that a performance obligation is satisfied over time, the proposed standard would require the entity to select a single revenue recognition method for the relevant performance obligation that best depicts the continuous transfer of goods and services. The performance obligation would be accounted for under the selected method until it has been fully satisfied.

The ED provides two types of methods for recognising revenue on arrangements involving the continuous transfer of goods and services:

- ▶ Output methods that recognise revenue on the basis of units produced or delivered, contract milestones or surveys of goods or services transferred to date relative to the total goods or services to be transferred. Output methods often result in the most faithful depiction of the transfer of goods or services. However, other methods may also provide a faithful depiction but at a lower cost.

If the entity has a right to invoice a customer in an amount that corresponds directly with the value to the customer for the entity's performance completed to date, then the entity would recognise revenue in the amount to which the entity has a right to invoice. This method of measuring progress may be applicable to a services contract in which the entity bills a fixed amount for each hour of service provided (hence, it is an output method).

- ▶ Input methods that recognise revenue on the basis of efforts expended to date (e.g., resources consumed, labour hours expended, costs incurred, time lapsed and machine hours used) relative to total efforts expected to be expended. Inputs often are more directly observable than outputs. However, a significant drawback of input methods is that there may not be a direct relationship between the efforts expended and the transfer of goods or services because of deficiencies in the entity's performance or other factors. When using an input method, an entity would exclude the effects of any inputs that do not depict the transfer of goods or services to the customer (e.g., the costs of abnormal amounts of wasted materials, labour or other resources to fulfil the contract).

The proposed standard does not indicate a preference for either type of method, but does clarify that the selected method would be applied to similar arrangements containing similar performance obligations.

The proposed standard does not include passage of time as a separate method of measuring progress. However, we believe the passage of time could be viewed as a subset of or proxy for an input or output measure if it appropriately depicts the pattern of transfer. For example, the Boards specifically included "time lapsed" as an example of a type of input measure an entity may use.

If an entity does not have a reasonable basis to measure its progress towards complete satisfaction of a performance obligation, the Boards decided that too much uncertainty exists and, therefore, revenue should not be recognised until progress can be measured. If an entity can determine that a loss will not be incurred, but cannot reasonably estimate the amount of profit, the proposed standard would allow the entity to recognise revenue only up to the amount of the costs incurred until the entity is able to reasonably measure the outcome or until the performance obligation becomes onerous.

Illustration 6-2: Choosing the measure of progress

A ship building entity enters into an arrangement to build its customer 15 vessels over a three-year period. The customer played a significant role in the design of the vessels, and the entity has not built a vessel of this type in the past. As a result, the arrangement includes both design and production services. Additionally, the entity expects that the first vessels may take longer to produce than the last vessels because, as the entity gains experience building the vessels, it expects that experience will enable it to construct the vessels more efficiently.

Assume that the entity has determined that the design and production services represent a single performance obligation. In such situations, the entity would likely not choose a "units of delivery" method as a measure of progress because that method would not capture accurately the level of performance (as it would exclude the efforts of the entity during the design phase of the arrangement). In such situations, an entity would likely determine that an input method, such as a "actual cost-to-total expected cost" approach, is more appropriate.

Conversely, assume that after the first 15 vessels were delivered, the customer ordered five additional vessels. For these vessels, the entity does not have to undertake additional design efforts. Therefore, the entity may conclude that the individual vessels each represent a separate performance obligation. Alternatively, if the entity concludes that the arrangement represents a single performance obligation, the entity may determine that a "units of delivery" method provides the best depiction of the continuous transfer.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

Illustration 6-3: Only certain goods and services within an arrangement are transferred continuously

Software Co. enters into an arrangement to provide its customer hardware and customised software. In analysing the arrangement, Software Co. determines that the hardware and customised software each represent separate performance obligations. Furthermore, Software Co. concludes that control of the hardware transfers when it delivers the product. However, due to the extensive customisation efforts, control over the software transfers continuously. Control of the support services also transfers continuously.

Under the proposed standard, revenue for the hardware would be recognised upon delivery, while revenue for the customised software would be recognised continuously over the performance period. Under current IFRS, the specific facts and circumstances of the arrangement may have led entities to use IAS 11, IAS 18 or a combination of both. If an entity currently makes use of IAS 11, application of the proposed standard could result in a materially different pattern of revenue recognition for performance obligations satisfied at a point in time.

Illustration 6-4: Uninstalled materials

A construction firm enters into a contract to construct a warehouse and distribution centre for a large grocery retailer. The warehouse is designed to include a heating and cooling system ("HVAC") and multiple cooling units to provide cold storage for refrigerated and frozen goods in the warehouse and staging areas of the distribution centre. The construction firm has concluded that it is providing a service of integrating multiple goods and services for the delivery of a completed asset to the customer. Therefore, the design, construction and all materials are considered a single performance obligation, which is satisfied continuously based on the criteria in the proposed standard. The construction firm determines that an input measure is the most appropriate measure of progress and will use the actual-cost to total-expected-cost method to determine revenue recognition over the course of the project.

The estimated transaction price for the project is CU5.7 million, with the costs to fulfil the performance obligation expected to total CU5.2 million. Of the CU5.2 million in total cost, the HVAC and cooling units represent a cost of CU1,350,000.

The HVAC and cooling units are delivered to the construction site by the third-party vendor and stored in the warehouse while the external walls and roof are constructed. It will be approximately three to six months before the units are integrated into the building. Based on the proposed standard, the measure of progress to complete satisfaction of the performance obligation would exclude the costs related to the HVAC. Instead, the cost and revenue equal to the cost of the HVAC are recognised separately, thereby deferring the construction firm's margin on the HVAC.

Immediately before the delivery of the HVAC and cooling units, the construction firm has incurred CU2,000,000 of the CU3,850,000 total projected costs excluding the cost of the HVAC. Through that period, the firm has recognised revenue of CU2,259,740 ($(\text{CU}2,000,000 / \text{CU}3,850,000) \times \text{CU}4,350,000$). Once the HVAC units are delivered, an additional CU1,350,000 of revenue and cost would be recognised.

6.1.4 Uninstalled materials

When an entity applies an input method (e.g., an actual-cost to total-expected-cost method) for purposes of measuring progress towards completion of a performance obligation comprised of goods and services, there may be situations in which the customer obtains control of the goods before the services related to those goods are provided. In these situations, the Boards concluded that the measurement of progress toward completion may be inappropriately affected by the delivery of such goods, if the following criteria are met:

- ▶ The cost of the transferred goods is significant in relation to the total expected costs of the contract
- ▶ The entity merely procures the goods and is not significantly involved in their design or manufacture
- ▶ The amount of time between the transfer of control of the goods and the transfer of the related services is significant

Therefore, the Boards made clear that the delivery of goods must contribute to the completion of the performance obligation to be included in the measurement of progress. When that is not the case, the Boards concluded that an entity using an input method (e.g., an actual-cost to total-expected-cost method) would record revenue at an amount equal to the cost of the good.

Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

What's changing from current IFRS?

The proposal for accounting for uninstalled materials may cause a significant change from current practice for some entities. IAS 11 contains a requirement that when the stage of completion is determined by reference to the contract costs incurred to date, only those contract costs that reflect work performed are included in these costs. Hence, costs related to future activities, such as costs of materials (that do not have a high specificity to the contract) that have been delivered to a contract site or set aside for use in a contract, but not yet installed, would not form part of the assessment of costs incurred to date. When installed, these would be included in the costs incurred to date. Under the proposed standard, any margin related to the uninstalled materials would be shifted to the other goods and services and recognised as the costs for those goods and services are incurred.

6.2 Control transferred at a point in time

For performance obligations that are not transferred continuously over time, control is by default transferred as of a point in time. In many situations, the determination of when that point in time occurs is relatively straightforward. However, in other circumstances, this determination is more complex. To help entities determine whether a customer has obtained control of a particular good or service, the ED states the following:

Extract from the ED

37. If a performance obligation is not satisfied over time in accordance with paragraphs 35 and 36, an entity satisfies the performance obligation at a point in time. To determine the point in time when a customer obtains control of a promised asset and an entity satisfies a performance obligation, the entity shall consider the requirements for control in paragraphs 31-33. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

- (a) The entity has a present right to payment for the asset – if a customer presently is obliged to pay for an asset, then that indicates that the customer has obtained control of the asset in exchange.
- (b) The customer has legal title to the asset – legal title often indicates which party to a contract has the ability to direct the use of and obtain the benefits from an asset or to restrict the access of other entities to those benefits. Hence, the transfer of legal title of an asset indicates that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity are protective rights and do not preclude a customer from obtaining control of an asset.
- (c) The entity has transferred physical possession of the asset – the customer's physical possession of an asset indicates that the customer has the ability to direct the use of and obtain the benefits from the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. To account for a repurchase, consignment, or bill-and-hold arrangement, an entity shall apply the application guidance in paragraphs B38-B54.
- (d) The customer has the significant risks and rewards of ownership of the asset – the transfer of the significant risks and rewards of ownership of an asset to the customer indicates that control of the asset has been transferred. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall consider any risks that may give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional separate performance obligation to provide maintenance services related to the transferred asset.
- (e) The customer has accepted the asset – the customer's acceptance of an asset indicates that it has obtained the ability to direct the use of and obtain the benefits from the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the application guidance in paragraphs B55-B58.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

None of the indicators above are meant to individually determine whether the customer has gained control of the good or service. An entity must consider all of the relevant facts and circumstances in determining whether control has transferred. The Boards also made clear that the indicators are not intended to be a checklist. That is, not all of the indicators must be present to determine the customer has gained control.

6.3 Constraining the cumulative amount of revenue recognised

Under the proposed standard, an entity would estimate the transaction price (without any constraint on the estimate). However, once the estimated transaction price has been allocated to the identified performance obligations, the entity would be constrained, or limited, in the amount of revenue it could recognise upon satisfying a performance obligation.

As described in the following extract from the ED, the recognisable revenue would be limited to the amount to which the entity is reasonably assured to be entitled.

Extract from the ED

81. If the amount of consideration to which an entity expects to be entitled is variable, the cumulative amount of revenue the entity recognises to date shall not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount of consideration allocated to satisfied performance obligations only if both of the following criteria are met:

- (a) the entity has experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities); and
- (b) the entity's experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations.

82. Indicators that an entity's experience (or other evidence) is not predictive of the amount of consideration to which the entity will be entitled include, but are not limited to, the following:

- (a) The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors include volatility in a market, the judgement of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.
- (b) The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- (c) The entity's experience (or other evidence) with similar types of performance obligations is limited.
- (d) The contract has a large number and broad range of possible consideration amounts.





When an entity determines that it is not reasonably assured to be entitled to the amounts allocated to satisfied performance obligations, the cumulative revenue recognised for all satisfied performance obligations would be limited to the amount of the transaction price that is reasonably assured. It is important to note that the presence of any one of the indicators cited in paragraph 82 above does not necessarily mean that the entity is not reasonably assured to be entitled to an amount of consideration. However, if one of these indicators were present, we believe an entity would need strong evidence to demonstrate that it is reasonably assured to be entitled to that amount.

The proposed standard provides few specific examples of the types of variable consideration that an entity would or would not be reasonably assured to be entitled. The examples cited in the ED where there is more uncertainty about reasonable assurance are sales-based royalties associated with the licence to use intellectual property (discussed further below) and asset management fees based on the value of the underlying assets at a defined measurement date in the future. In addition to those examples, we believe there are certain types of variable consideration frequently included in arrangements that may not be reasonably assured because it is unlikely that an entity's experience can predict the outcome, given the inherent uncertainty in the basis for the variable payment:

- ▶ Payment contingent on some sort of regulatory approval (e.g., regulatory approval of a new drug)
- ▶ Long-term commodity supply arrangements that settle based on market prices at the future delivery date
- ▶ Contingency fees based on litigation or regulatory outcomes (e.g., fees earned based on the positive outcome of litigation or the settlement of claims with government agencies)

What's changing from current IFRS?

The proposal to allow the cumulative recognition of revenue up to the total amount in an arrangement that is reasonably assured is likely a significant change in practice for most entities. Current IFRS permits recognition of contingent consideration, but only if it is probable that the economic benefits associated with the transaction will flow to the entity and the amount of revenue can reliably measured. Some entities have, therefore, deferred recognition until the contingency is resolved. Currently, US GAAP significantly limits recognition of contingent consideration, although certain industries have industry-specific literature that allows for recognition of contingent amounts.

Therefore, under both IFRS and US GAAP, the proposed approach in the ED would generally result in the earlier recognition of revenue, although this is not the case in all circumstances. The following example illustrates any example of earlier recognition.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

Illustration 6-5: Contingent revenue – earlier recognition from current practice

Wireless Co offers a 400 minute wireless plan for CU40 a month over a two-year contract period. Wireless Co offers two handsets: a cell phone model that has been on the market for 18 months that the operator is offering for free (standalone selling price is CU350) and the new version with new features for which the operator would charge CU160 (standalone selling price is CU480). For purposes of this example, assume the standalone selling price of the 400-minute wireless plan is CU40. Customer A selects the older model phone, and Customer B selects the new one. Wireless Co does not provide any rebates, incentives or other discounts.

Under IFRS, telecommunication entities have generally developed accounting policies similar to current US GAAP, whereby Wireless Co is limited to recognising the amount received upfront (i.e., the discounted purchase price) as revenue upon the delivery of the handset. When the phone is provided at no charge, Wireless Co is prevented from recognising any revenue upon delivery of the handset. This is because the remaining transaction consideration is contingent on Wireless Co providing the monthly wireless service, which cannot be allocated to the first delivered item.

The following table illustrates the differences in the allocation of the transaction price and revenue recognised between current practice and the proposed standard:

	Current practice		Proposed standard	
	Customer A	Customer B	Customer A	Customer B
Handset revenue	CU - [Free – no cash received]	CU160 [CU160 cash received]	CU256 [CU350/(960 + 350) x 960]	CU373 [CU480/(960 + 480) x 1,120]
Service revenue	CU960 [CU40/month x 24 months]	CU960 [CU40/month x 24 months]	CU704 [CU960/(960 + 350) x 960]	CU747 [CU960/(960 + 480) x 1,120]
Total revenue	CU960	CU1,120	CU960	CU1,120

Under the proposed standard, the total expected transaction consideration would be allocated to the identified performance obligations (handset and monthly service) on the relative standalone selling price basis. Furthermore, because the variable amounts in the arrangement (monthly service fees) are reasonably assured of being received, there is no limitation on the entity's ability to recognise this consideration. As a result, amounts allocated to each performance obligation would be recognised as revenue as that performance obligation is satisfied. Additionally, some of the transaction consideration allocated to the handset would be recognised as revenue before the consideration is actually due from the customer.

Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

In some cases, revenue would be recognised later than under current practice, such as the recognition of performance-based incentive fees in investment management contracts. Under the ED, performance-based fees would be recognised as revenue only when an entity is considered to be reasonably assured to be entitled to them. Since many of these fees in investment management contracts are based on the market performance of the related assets, they would not meet the reasonably assured threshold until a point that is closer to when all contingencies have been resolved.

6.3.1 Sales-based royalties on intellectual property licences

The proposed standard provides the following specific requirement related to the licence of intellectual property when the customer promises to pay the entity a variable amount based on the customer's sales of a product that uses the licensed intellectual property (e.g., sales-based royalties).

Extract from the ED

85. Notwithstanding the requirements in paragraphs 81-83, if an entity licences intellectual property (see paragraph B33) to a customer and the customer promises to pay an additional amount of consideration that varies on the basis of the customer's subsequent sales of a good or service (for example, a sales-based royalty), the entity is not reasonably assured to be entitled to the additional amount of consideration until the uncertainty is resolved (i.e., when the customer's subsequent sales occur).

The Boards explain in the application guidance that licensing transactions subject to paragraph 85 include an entity granting to its customer the right to use, but not own, its intellectual property. The application guidance also provides the following examples of intellectual property subject to the requirements in paragraph 85:

- ▶ Software and technology
- ▶ Motion pictures, music, and other forms of media and entertainment
- ▶ Franchises
- ▶ Patents, trademarks and copyrights

Transaction prices based on the customer's future sales or future use of licensed intellectual property are common. Without the reasonable assurance constraint on recognition, the transfer of a good or service to the customer would result in immediate revenue recognition in many cases. However, constraining recognition as described above for these types of payments results in recognition over time, similar to current IFRS for many of these transactions.





Illustration 6-6: Recognising revenue with fixed and variable consideration – more than one performance obligation

A software entity enters into a contract to license to a retail entity an existing software product for the management of online sales and to provide professional services to build the retailer a customised website interface between the software and the retailer’s existing website. The interface will provide the retailer some additional features not normally found in the software. However, the retailer can gain full access to the licensed software immediately, without the completion of the professional services. As a result, the entity determines the software licence and the professional services are two separate performance obligations.

The entity delivers the software licence shortly after finalising the agreement (and the retail entity has full use of that licence immediately). However, the entity will be studying certain purchasing patterns of the retailer’s customer before completing the customised interface. As a result it anticipates it will not complete those services for six-to-eight months.

In return for providing the licence and the professional services, the entity will be entitled to CU12,000 in fixed fees plus 0.05% of the revenue generated from the retailer’s website sales for the 15 months after finalising the arrangement (payable monthly). Based on the historical sales of the retailer, the entity estimates it will receive CU55,000 in sales-based royalties (for a total transaction price of CU67,000).

The entity does not believe the sales-based (variable) amounts are attributable to a single performance obligation; therefore, it applies the relative selling price method to allocate the estimated transaction price. The entity determines the standalone selling price of the professional services is CU45,000 (based on the expected hours that it anticipates will be necessary to complete the customisation) and the standalone selling price for the licence is CU15,000 (based on other licensing agreements).

The entity allocates CU50,250 $((CU45,000 / (CU45,000 + CU15,000)) \times CU67,000)$ to the professional services and CU16,750 $((CU15,000 / (CU45,000 + CU15,000)) \times CU67,000)$ to the software licence.

As the arrangement includes variable fees, the entity is limited to recognising cumulative revenue only up to the amounts that are reasonably assured. However, the entity concludes that the variable fees (sales-based royalties) are associated with the licence of the software (but not solely attributable to the related performance obligation). Because of the association with the software licence, the entity is unable to conclude that any of those variable amounts are reasonably assured due to the specific requirement in paragraph 85 that sales-based royalties on intellectual property arrangements are not reasonably assured until the sales occur.

Therefore, at the time the entity transfers the software licence to the retailer, although the entity has allocated CU16,750 to the licence, it is limited to recognising CU12,000. As the sales-based royalties are received, and assuming there are no changes in the estimated variable consideration, the entity will recognise those amounts as revenue until a total of CU16,750 is recognised. Once the entity has recognised all amounts allocated to the licence, additional royalty payments received will be deferred until the professional services commence. However, because the professional services will be completed before all of the royalty payments are received, the entity will not be able to recognise all amounts allocated to those services at the time the services are provided, but will have to wait until the royalty payments are received.



Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

How we see it

We believe that the Boards' conclusion on sales-based royalties is reasonable given that the underlying sales are in the control of the counterparty to the arrangement (and not in the control of the entity). This conclusion would also bring the proposed accounting in line with practice for sales-based royalties under current IFRS (i.e., recognition as received).

However, we believe the limitation of this conclusion to only sales-based royalties associated with intellectual property would result in inconsistencies with other transactions that are similar economically. For example, the ED provides an example of trailing commissions for an insurance broker in which the broker is paid an initial commission upon the successful sale of an insurance policy on behalf of an insurance entity. Additionally, the broker earns a smaller commission for each subsequent annual policy renewal, which does not require further effort on the part of the broker. In this example, while the broker's past experience provides evidence about the expected amount of consideration to be received, the customer's decision regarding renewal would be based on factors outside of the broker's control. In our view, this transaction and the intellectual property arrangements illustrated above are not economically dissimilar.

The Boards' conclusion about sales-based royalties requires both the type of performance obligation and the nature of the consideration to meet certain conditions. However, it is not clear why the type of performance obligation is relevant to whether variable consideration is reasonably assured.

6.4 Recognising revenue when a right of return exists

As discussed in Section 3.8, the ED provides that a right of return would not represent a separate performance obligation. Instead, the existence of a right of return affects the amount of revenue an entity can recognise for satisfied performance obligations, as the entity must determine whether the customer will return the transferred product.

Under the proposed standard, an entity would estimate the transaction price and recognise revenue based on the amounts to which the entity is reasonably assured to be entitled through the end of the return period (considering the products expected to be returned). The entity would recognise the amount of expected returns as a refund liability, representing its obligation to return the customer's consideration. If the entity is unable to estimate returns, revenue would not be recognised until returns can be reasonably estimated, which may be at the end of the return period.

As part of updating of its estimate of amounts the entity expects to be entitled to under an arrangement, an entity would have to update its assessment of expected returns and the related refund liabilities. This re-measurement would be performed at each financial reporting date and would reflect any changes in assumptions about expected returns. Any adjustments made to the estimate would result in a corresponding adjustment to amounts recognised as revenue for the satisfied performance obligations (e.g., if the entity expects the number of returns to be higher than originally estimated, it would have to decrease the amount of revenue recognised and increase the refund liability).

Finally, when customers exercise their rights of return, the entity may receive the returned product in saleable or repairable condition. Under the proposed standard, when the initial sale is recognised as revenue, the entity would also recognise a return asset (and adjust cost of sales) for its right to recover the goods returned by the customer. The entity would initially measure this asset at the former carrying amount of the inventory less any expected costs to recover the goods. Along with re-measuring the refund liability at each financial reporting date, the entity would update the measurement of the asset recorded for any revisions to its expected level of returns, as well as any potential decreases in the value to the entity of the returned products.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

Illustration 6-7: Sale of a product with a right of return

Pharma sells 1,000 units of Product A to Distributor (Pharma's customer) for CU100 each. Payment is due to Pharma 30 days after the units are transferred to Distributor. Pharma allows its customers to return Product A six months before or after the designated expiration date for a full refund. The cost of each unit is CU50.

Pharma estimates that 4% of sales of Product A will be returned by the customer for a full refund. Therefore, 4% of the sale to Distributor would be recognised as a refund liability rather than revenue ($4\% \times (1,000 \text{ units} \times \text{CU}100) = \text{CU}4,000$).

However, Pharma also expects that 90% of any returned product will have no value because it will be returned after the expiration date. Therefore, Pharma would recognise a return asset for CU200 ($\text{CU}50,000 \times 4\% \times 10\%$).

Upon the transfer of control of Product A to Distributor, Pharma would record the following entries:

Dr. Accounts receivable	100,000	
Cr. Revenue		96,000
Cr. Refund liability		4,000

To record revenue and the refund liability.

Dr. Cost of sales	49,800	
Dr. Return asset	200	
Cr. Inventory		50,000

To record the cost of sales, relief of inventory and the asset expected to be returned.

After the initial transfer of Product A, Pharma determines that it now expects Distributor to return 5% of the units of Product A rather than the 4% originally estimated. Changes in estimated returns are recognised as an adjustment to revenue and cost of sales, with corresponding recognition of a refund liability and return asset. Therefore, the following entries would be recorded:

Dr. Revenue	1,000 [(5% - 4%) x (1,000 units x CU100)]	
Cr. Refund liability		1,000

To adjust refund liability for change in estimated returns.

Because Pharma continues to expect 90% of any returned product to have no value, the entity would adjust the return asset for the change in estimated returns (including the effect of potential decreases in the value of the returned products) as follows:

Dr. Return asset	50 [(5% - 4%) x (1,000 units x CU50 cost) x (10%)]	
Cr. Cost of sales		50

To adjust return asset for change in estimated returns.

Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

What's changing from current IFRS?

While the proposed accounting for rights of return would not be a significant shift from current practice, there are some notable differences. The main difference is the accounting for the right of return asset. Under current IFRS, the carrying value associated with any product expected to be returned typically remains in inventory. The proposed standard requires the asset to be recorded separately from inventory to provide greater transparency. The proposed standard is clear that the carrying value of the return asset (i.e., the product expected to be returned) is subject to impairment testing on its own, separate from inventory on hand. Under current IFRS, expected returns remain within inventory, and they are not subject to separate impairment testing (although when the value of returned product is expected to be zero, inventory is fully expensed at the time of sale).

6.5 Repurchase agreements

Some agreements executed by entities include repurchase provisions, either as a component of a sales contract or as a separate contract that relates to the same or similar goods in the original agreement. The ED addresses whether a customer has obtained control of an asset in arrangements containing such repurchase provisions. Paragraph B39 of the ED identifies three main forms of these provisions:

1. An entity's unconditional obligation to repurchase the asset in the original contract (essentially a forward contract)
2. An entity's unconditional right to repurchase the asset in the original contract (essentially a purchased call option)
3. An entity's unconditional obligation to repurchase the asset at the customer's request (essentially a written put option)

6.5.1 Forward contract or call option held by the entity

If the entity has an unconditional obligation or right to repurchase the asset, the customer would not have obtained control of the asset because it is limited in its ability to direct the use of that asset. Therefore, the transaction likely would be a lease or a financing transaction rather than a sale.

The proposed standard indicates that if the entity is obligated, or has the right, to repurchase the asset at a price less than the original sales price (taking into consideration the effects of the time value of money), the entity would account for the transaction as a lease in accordance with IAS 17. If the entity is obligated, or has the right, to repurchase the asset at a price equal to or greater than the original sales price (considering the effects of the time

value of money), the entity would account for the arrangement as a financing. In the case of a financing arrangement, the entity would continue to recognise the asset and record a financial liability for the consideration received from the customer. The difference between the consideration received from the customer and the consideration subsequently paid to the customer upon repurchase would represent the interest and holding costs, as applicable, that are recognised over the term of the financing.

How we see it

The proposed standard treats all forwards and call options the same, and does not consider the likelihood of exercise of a call option held by the entity in determining the accounting treatment. Therefore, we believe the potential exists for counterintuitive accounting results. In certain transactions, an entity may have an unconditional right to repurchase an asset at an amount equal to or greater than the original sales price. For example, some luxury designers have the right to repurchase their handbags at an amount equal to the original sales price. This call option serves as a protective right over the reputation of the brand although it is unlikely that the designers will find it necessary to exercise the option. The proposed standard would require the entity to account for all such transactions as a financing, even in situations in which it is highly unlikely the entity will exercise the call option.

Illustration 6-8: Vendor obligation to repurchase a good at a price greater than the original sales price (i.e., forward)

Can Manufacturer enters into an agreement to sell a customer aluminium ingots. As part of the agreement, Can Manufacturer also agrees to repurchase the ingots in 60 days at the original sales price plus 2%. Since Can Manufacturer has an unconditional obligation to repurchase the ingots at an amount greater than the original sales price, the transaction would be treated as a financing under the proposed standard. If the selling price of the ingots was CU200,000, Can Manufacturer would record the following entry when it receives the consideration from the customer:

Dr. Cash	200,000	
		Cr. Financial liability
		200,000

Furthermore, since the entity has to pay CU204,000 (CU200,000 x 1.02) to repurchase the ingots, the entity would recognise the CU4,000 difference as interest costs over the 60-day period.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

Illustration 6-9: Vendor obligation to repurchase a good at a price less than the original sales price (i.e., forward)

A manufacturer of lift equipment enters into an agreement to sell six scissor lifts to a customer. As part of that agreement, the manufacturer agrees to repurchase the equipment from the customer in three years at 70% of the original purchase price. Since the entity has an unconditional obligation to repurchase the assets at a price less than the original purchase price, the proposed standard requires this transaction to be accounted for as a lease.

How we see it

The proposal in relation to written put options provides application guidance where there is none currently for IFRS reporters. However, it does not provide any guidance on determining whether “a significant economic incentive” exists and judgement would be required to make this determination.

What's changing from current IFRS?

Consistent with the current requirements in IFRS, the proposed standard requires an entity to consider a repurchase agreement together with the original sales agreement when they are linked in such a way that the substance of the arrangement cannot be understood without reference to the series of transactions as a whole. Therefore, for most entities, the requirement to consider the two transactions together would not change. However, the ED provides more specific requirements in determining how to account for repurchase agreements, either as a lease or a financing arrangement depending on the nature of the agreement. These requirements may impact accounting policies that have been selected by IFRS reporters.

6.5.2 Written put option held by the customer

The proposed standard indicates that if the customer has the ability to require the entity to repurchase the asset, the entity would have to assess whether the customer has a significant economic incentive to exercise that right. If no such economic incentive exists, the customer would have obtained control of the asset (i.e., the customer has the ability to direct the use of the asset) and a sale would be recorded. These arrangements would be treated essentially the same as a sale with the right of return (discussed in Sections 3.8 and 6.4). Therefore, upon recognising the sale, the entity also would recognise a liability for the expected returns, and an asset for the items expected to be returned.

However, the Boards concluded that if the customer has a significant economic incentive to exercise its right to require the seller to repurchase the asset, the customer is effectively paying the entity for the right to use the asset for the option period. The entity would account for such transactions under the leasing standard. In making a determination of whether a significant economic incentive exists, the ED indicates the entity would consider various factors, such as the relationship of the repurchase price to the expected market value of the asset at the repurchase date and the amount of time until the put option expires.

6.5.3 Sales with residual value guarantees

An entity that sells equipment may utilise a sales incentive programme under which it contractually guarantees that the customer will receive a minimum resale amount at the time the equipment is disposed of. Current IFRS precludes the entity from recognising a sale on the equipment if it guarantees the resale value of the equipment to the purchaser and instead requires the arrangement to be accounted for as a lease.

However, under the proposed standard, an entity may be able to conclude that sale treatment is appropriate depending on whether the repurchase agreements requirements, in B38 – B48 of the ED, apply. For example, if the customer has the right to require the entity to repurchase equipment two years after the date of purchase at 85% of the original purchase price, the entity would have to determine whether the customer has a significant economic incentive to exercise that right. If the entity concluded that there is no significant economic incentive, the transaction would be accounted for as a sale in accordance with the proposed standard. Alternatively, if the entity concludes there is a significant economic incentive for the customer to exercise his right, the transaction would be accounted for as a lease as discussed above.

However, if the transaction does not include a repurchase right, but instead includes a residual value guarantee in which the entity will make the customer whole on a qualifying future sale at less than 85% of the initial sale price, it is not clear whether the repurchase agreement requirements would apply, because the entity is not repurchasing the asset. Instead, the transaction may be viewed as including a component of variable consideration. While the economics of a repurchase agreement and a residual value guarantee may be similar, the accounting could be quite different.

Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

6.6 Licensing and rights to use

Granting licences and rights to use are common in the software, media and entertainment, and life sciences industries, as well as many others. A licence granted to a customer represents the customer's right to use the intellectual property (IP) developed or owned by the entity for its intended use. Paragraph B32 of the ED provides the following examples of intellectual property:

- ▶ Software and technology
- ▶ Motion pictures, music and other forms of media and entertainment
- ▶ Franchises
- ▶ Patents, trademarks and copyrights

The proposed requirements for licences and other rights of use (collectively, licences) provides that all promises to grant licences would be accounted for as a single performance obligation in which the entity would recognise revenue at the point in time when the customer obtains the right to use and benefit from the asset.

However, as many of these agreements include uncertain consideration (e.g., royalty payments), the entity would apply the proposed requirements for variable consideration (see Section 5.3) to the transaction. That is, when the consideration related to the licence to which the entity expects to be entitled is reasonably assured, that amount would be recognised as revenue when the customer obtains control of the licence. When uncertain consideration is not reasonably assured at the outset of the agreement, revenue would not be recognised until the amount becomes reasonably assured, assuming control has already been transferred.

The ED states that if promised consideration from a customer that "varies on the basis of the customer's subsequent sales of a good or service (for example, a sales based royalty)," the entity is not reasonably assured to be entitled to the additional amount of consideration until the uncertainty is resolved (i.e., when the customer's sales occur). The ED clarifies that sales-based royalties would not be recognised upon the transfer of a licence, but would be recognised as they become due. See our previous discussion on this topic in Section 6.3.1.

6.7 Bill-and-hold arrangements

Some sales transactions may result in the entity fulfilling its obligations and billing the customer for the work performed, but not shipping the goods until a later date. These transactions, often characterised as "bill-and-hold" transactions, usually are designed this way at the request of the purchaser for a number of reasons, including a lack of storage capacity or delays in its ability to use the goods.

Under the proposed standard, the entity would have to evaluate whether the customer has obtained control of the goods to determine whether the performance obligation has been satisfied and revenue should be recognised. In bill-and-hold arrangements, the customer has not taken possession of the goods. Therefore, the proposed standard includes the following criteria that must be met for a customer to have obtained control of a product in a bill-and-hold arrangement:

- ▶ The reason for the bill-and-hold arrangement must be substantive.
- ▶ The product must be identified separately as belonging to the customer.
- ▶ The product currently must be ready for physical transfer to the customer.
- ▶ The entity cannot have the ability to use the product or to direct it to another customer.

If these conditions are met, the seller essentially no longer controls the goods and instead is acting as a custodian for the customer. As a result, the seller must consider whether custodial services are a separate performance obligation for which a portion of the transaction price should be allocated and recognised as revenue during the custodial period.

What's changing from current IFRS?

The criteria for determining whether a bill-and-hold transaction qualifies for revenue recognition under the proposed standard are similar to the current requirements in IFRS. We expect that most bill-and-hold transactions that would qualify for revenue recognition under current IFRS would also qualify for revenue recognition under the proposed standard. However, consideration of a separate custodial performance obligation may be new to IFRS reporters as this is not addressed in IAS 18.

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

6.8 Customer acceptance

The determination of whether the customer has obtained control of the good or service must consider any customer acceptance clauses that specify that the customer must approve the goods before the customer is obliged to pay. These clauses may be straightforward, giving a customer the ability to accept or reject the goods based on objective criteria specified in the contract (e.g., the goods function at a specified speed) or may be more subjective in nature. If a customer does not accept the goods or services, the seller may not be entitled to consideration, and may be required to take remedial action or may be required to take back the delivered goods.

The proposed standard states that if an entity can objectively determine that a good or service that meets the contractual specifications has been transferred to the customer, customer acceptance is a formality that would not affect an entity's determination of when the customer obtains control of the good or service. Contractually specified height, weight or other measurements are examples of customer acceptance requirements that could be objectively determined.

If the seller cannot objectively determine that the good or service meets the contract's specifications, it would have to wait for the customer to accept the good or service before concluding that the customer obtained control. A clause that allows customers to visually inspect, test and apply judgement to determine whether a good or service is suitable offers examples of criteria that cannot be objectively determined.

The determination of whether the acceptance criteria are objective and whether those criteria have been met often requires professional judgement. However, this is consistent with current practice and is not expected to change under the proposed standard.

6.9 Breakage and prepayments for future goods or services

In certain industries, customers pay for goods or services but may not ultimately exercise their rights (often referred to as breakage). For example, retailers frequently sell gift cards that are not completely redeemed, and airline passengers often allow tickets to expire unused.

The Boards concluded that when an entity is reasonably assured (see Section 6.3) of a breakage amount, the entity should recognise the expected breakage as revenue in proportion to the pattern of transfer of goods or services to the customer. If an entity is not reasonably assured of a breakage amount, it should recognise the expected breakage as revenue when the likelihood of the customer exercising his or her rights on remaining balances becomes remote.



Illustration 6-10: Gift card breakage

Retailer A and Retailer B each sell 10 non-refundable CU100 gift cards that have no stated expiration date. Based on its experience, Retailer A can reasonably estimate that customers will not redeem 3% of the value of the gift cards. Furthermore, Retailer A's experience indicates that customers will use 90% of the monetary value of all gift cards in the 90 days following the date of sale, and an additional 7% in the next 90 days. Any balances unused after 180 days are typically not used by customers.

Retailer B is not able to estimate breakage because it has not tracked gift card usage. However, Retailer B knows that the likelihood of customers redeeming balances unused after 180 days is remote.

Retailer A, using the proportional approach, and Retailer B, using the remote approach, would account for the gift card sales as follows:

Accounting at date of sale:

	Retailer A	Retailer B
Dr. Cash	CU1,000	CU1,000
Cr. Contract liability	1,000	1,000

At the end of the first 90 days following the date of sale:

At the end of the first 90 days following the date of sale:

	Retailer A	Retailer B
Dr. Contract liability	CU900	CU900
Cr. Revenue	900	900

To recognise the redemption of gift cards for goods and (or) services

Dr. Contract liability (CU900/97%) - CU900	CU 28	-
Cr. Revenue	28	-

To recognise estimated breakage on gift cards

At the end of 180 days following the date of sale:

	Retailer A	Retailer B
Dr. Contract liability	CU70	CU70
Cr. Revenue	70	70

To recognise the redemption of gift cards for goods and/or services

Dr. Contract liability (CU70/97%) - CU70	CU2	CU30
Cr. Revenue	2	30

To recognise estimated breakage on gift cards

How we see it

Providing application guidance for breakage is a significant improvement and is generally consistent with current practice, for which there is little or no authoritative literature.

7. Other measurement and recognition topics

7.1 Warranties

Warranties are commonly included in the sale of goods or services, whether explicitly stated or implied based on the entity's customary business practices. The price may be included in the overall purchase price or listed separately as an optional product. The proposed standard identifies two classes of warranties:

- ▶ Warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract (referred to as "service-type warranties")
- ▶ Warranties that promise the customer that the delivered product is as specified in the contract (referred to as "assurance-type warranties")

7.1.1 Service-type warranties

If the customer has the option to purchase the warranty separately or if the warranty provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a service-type warranty. The Boards determined that this type of warranty represents a separate service and would be an additional performance obligation. Therefore, the entity would allocate a portion of the transaction price to the warranty based on the estimated selling price of the warranty. The entity would then recognise revenue related to the warranty over the period the warranty service is provided.

Judgement may be required to determine the appropriate pattern of revenue recognition associated with service-type warranties. For example, an entity may determine that the warranty service is provided continuously over the warranty period (i.e., the performance obligation is an obligation to "stand ready to perform" during the stated warranty period). This determination would likely result in a rateable revenue recognition pattern over the warranty period. An entity also may conclude that a different pattern of recognition is appropriate based on sufficient data that demonstrates a pattern of when such services are provided. For example, an entity might recognise little or no revenue in the first year of a three-year service-type warranty if historical data indicates that warranty services are typically provided in the second and third year of the warranty period.

Similar to the treatments for performance obligations, changes in the estimate of the cost of satisfying service-type warranty performance obligations do not result in a revision to the original relative selling price allocation. For example, an entity may discover two months after a product has been shipped that the cost of a part acquired from a third-party manufacturer has tripled and that it will cost the entity significantly more to replace that part if a warranty claim is made. While this change will not affect the amount of transaction price allocated to the service-type warranty, because the service-type warranty is a performance obligation that is satisfied over time, this situation may result in the warranty becoming an onerous performance obligation (see Section 7.2).

7.1.2 Assurance-type warranties

The Boards concluded that assurance-type warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a quality guarantee. Under the proposed standard, this type of warranty would be accounted for as a warranty obligation, and the estimated cost of satisfying the warranty obligation would be accrued in accordance with the current requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

7.1.3 Determining whether a warranty is an assurance-type or service-type warranty

Certain arrangements may include both an assurance-type warranty and a service-type warranty, which should be accounted for separately. Illustration 7-1 below illustrates this circumstance. However, if an entity provides both an assurance-type and service-type warranty within an arrangement and the warranties cannot be reasonably accounted for separately, they would be accounted for as a single performance obligation (i.e., revenue would be measured for the combined warranty and recognised over the period the warranty services are provided).

Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

In some circumstances, it may be difficult to determine whether a warranty provides a customer with a service in addition to the assurance that the delivered product is as specified in the contract. To help entities make that assessment, the ED provides the following application guidance:

Extract from the ED

B13. In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity should consider facts such as:

- (a) Whether the warranty is required by law – If the entity is required by law to provide a warranty, the existence of that law indicates that the warranty is not a performance obligation, because such requirements typically exist to protect customers from the risk of purchasing defective products.
- (b) The length of the warranty coverage period – The longer the coverage period, the more likely that the warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.
- (c) The nature of the tasks that the entity promises to perform – If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

Illustration 7-1: Service-type and assurance-type warranties

An entity manufactures and sells computers that include an assurance-type warranty for the first 90 days. The entity offers an optional “extended coverage” plan under which it will repair or replace any defective part for three years from the expiration of the assurance-type warranty. Since the optional extended coverage plan is sold separately, the entity determines that the three years of extended coverage represent a separate performance obligation.

The total transaction price for the sale of a computer and the extended warranty is CU3,600, and the entity determines the standalone selling price of each is CU3,200 and CU400, respectively. Furthermore, the entity estimates, based on historical experience, that it will incur CU200 in costs to repair defects that arise within the 90-day coverage period for the assurance-type warranty. The carrying value of the computer in inventory is CU1,440.

Dr. Cash/Receivables	3,600	
Dr. Warranty expense	200	
Cr. Accrued warranty costs (assurance-type warranty)		200
Cr. Contract liability (service-type warranty)		400
Cr. Revenue		3,200

To record revenue and contract liabilities related to warranties.

Dr. Cost of sales	1,440	
Cr. Inventory		1,440

To derecognise inventory and recognise cost of sales.

The entity relieves the contract liability associated with the assurance-type warranty as actual warranty costs are incurred during the first 90 days after the customer receives the computer. The entity recognises the contract liability associated with the service-type warranty as revenue during the contract warranty period and recognises the costs associated with providing the service-type warranty as they are incurred.



What's changing from current IFRS?

The proposal for assurance-type warranties is essentially the same as current practice. The proposal for service-type warranties may differ from current practice, in particular in relation to the amount of transaction price that is allocated to the warranty performance obligation. Currently, entities that provide separate extended warranties typically defer an amount equal to the stated price of the warranty and record that amount as revenue over the warranty period. The proposal would require an entity to defer an allocated amount, based on a relative-selling price allocation.

7.2 Onerous performance obligations

The proposed standard requires that an entity recognise a liability and a corresponding expense (not a reduction of revenue) when certain performance obligations become onerous. The 2010 ED also had a requirement to consider onerous performance obligations. Many respondents raised concerns about the accounting that would result from that requirement. While the Boards ultimately determined that consideration of onerous performance obligations was a necessary component of their proposed revenue model, they observed that limiting the scope would minimise the unintended consequences.

The onerous test is required for performance obligations that are satisfied over time and that period is greater than one year (see Section 6.1). While not explicitly stated in the ED, we believe that this period refers to the time between when performance begins and is completed rather than the time between when the contract is entered into and performance is complete. Performance obligations satisfied at a point in time or satisfied over a period of less than one year (determined at contract inception) would not be subject to the test.

Under the proposed standard, a performance obligation is

deemed onerous when the lesser of the following costs exceeds the allocated transaction price:

- ▶ The costs directly related to satisfying the performance obligation (i.e., direct costs)
- ▶ The amount the entity would pay to exit the performance obligation

The Boards determined that using the lesser of these costs was appropriate because, with all other things being equal, an entity would elect to cancel the performance obligation rather than fulfil it if cancellation were a less expensive option.

Consistent with the proposed requirements for contract costs (see Section 7.3), direct costs would include direct labour, direct materials, allocated costs that relate directly to satisfaction of the performance obligation (e.g., depreciation), costs explicitly chargeable to the customer based on the contract terms and other costs incurred only because the entity entered into the contract with the customer. To consider the amount an entity would pay to exit the performance obligation, an entity must have the contractual right, but not necessarily a commitment, to cancel the performance obligation.

The assessment of potential onerous performance obligations would be performed for each performance obligation within a contract, rather than for the contract as a whole. This approach could result in liabilities recorded for some performance obligations when the overall contract is expected to remain profitable. The Boards acknowledged this and concluded that it was consistent with their objective to reveal different margins on different performance obligations within a contract. Those different margins are revealed by identifying separate performance obligations. Consequently, the Boards felt the same unit of account should apply to test whether those separate performance obligations are onerous.



How we see it

The onerous test would apply only to performance obligations that are satisfied over time and for periods of more than one year. Therefore, an entity could reach different conclusions about nearly identical performance obligations. For example, assume an entity has an arrangement with two performance obligations, both satisfied over time. At contract inception, one performance obligation is expected to take 11 months to satisfy and the other is expected to take 13 months. Two months into the contract, the expected direct costs to fulfil each performance obligation exceed the allocated transaction price. The entity would recognise an onerous liability only for the performance obligation that would be satisfied in 13 months. The entity would not recognise a liability for the potential loss on the other performance obligation.

The recognition of losses at the performance obligation level also could result in the recognition of “day one” losses on a contract. This may occur when an entity includes one or more low-margin services in a contract with multiple goods and services, or when an entity finds a low-margin or loss contract acceptable based on some other continuing customer relationship.

Since the onerous performance obligation calculation is based on the direct costs of satisfying the performance obligation, the calculation does not take into consideration situations in which the overall profitability of the entity is enhanced as a result of the overall contract (because the contract covers variable costs of the contract and a portion of the entity's fixed costs). In such situations, the requirement to recognise potential losses in advance may provide reporting results that do not reflect the underlying economics of the arrangement and its effect on the entity's profitability.

Illustration 7-2: “Day one” loss

Entity A is an IT entity with a proprietary hardware product. The proprietary features of the product and the entity's position in the market support a significant profit margin on the entity's hardware products. Entity A negotiates a contract with Entity B to provide proprietary hardware and consulting services. Entity A anticipates it will complete the consulting services in 18 months, and then deliver the hardware. The contract requires Entity A to provide both the consulting services and hardware for a total transaction price of CU400,000. Entity A determines that the good and the service are separate performance obligations, and that the consulting services are satisfied over time.

The allocation of the transaction price is as follows:

Performance obligation	Cost	Standalone selling price	Allocated transaction price	Margin
		(relative selling price)		
Hardware	CU250,000	CU390,000	CU321,650	CU71,650
Consulting service	85,000	95,000	78,350	(6,650)
	CU335,000	CU485,000	CU400,000	CU65,000

Under the proposed standard, only performance obligations that are satisfied over time are subject to the onerous test. As a result, Entity A would exclude hardware from the assessment because hardware represents a performance obligation that is satisfied at a point in time.

Although the overall contract is profitable, the performance obligation related to the delivery of the consulting services is onerous at inception. That is, based on the relative standalone selling price, the portion of the transaction price allocated to the consulting services is less than the cost of providing the services. Assuming the amount Entity A would have to pay to exit the contract exceeds the cost of satisfying the performance obligation (CU85,000), Entity A would record an onerous performance obligation of CU6,650 at contract inception (with a corresponding increase to cost of sales).

Allocate the transaction price to the separate performance obligations

Satisfaction of performance obligations

Other measurement and recognition topics

Presentation and disclosure

Illustration 7-3: Onerous contract increases profitability of entity

A contractor enters into a long-term arrangement to build several houses in a new sub-division for a developer. While the contractor frequently performs this type of construction, this is the first time that the contractor has entered into an agreement with this developer. As a result, the contractor bids close to break-even to gain future business with this developer. Due to early cost overruns, the contractor is concerned that the contract, which is satisfied over time, may become onerous and performs the required assessment.

Based on its calculation, the contractor determines that the present value of the expected direct costs exceed the transaction consideration by CU40,000 and recognises an onerous performance obligation of CU40,000 (for simplicity, assume the cost to exit the contract is greater than the costs to satisfy the performance obligation).

As required under the proposed standard, the contractor included in direct costs the depreciation cost associated with the equipment needed to perform the job, which is expected to total CU80,000 during the construction period (the construction requires a significant amount of equipment, all of which the contractor already owns).

However, these costs are also fixed costs; if the contractor had not entered into this agreement, it would still incur the depreciation costs. As a result, fulfilling this arrangement would improve the net income of the contractor because the contract would allow the entity to recover at least some of its direct costs. That is, the contractor would incur a loss of CU40,000 as a result of fulfilling the contract, compared with a loss of CU80,000 if the contract had not been entered into.

The proposed standard also requires that once a performance obligation has been determined to be onerous, the entity is required to recognise any impairment loss for the assets related to the contracts (e.g., inventory or costs capitalised under the proposed standard) before recognising any liability to reflect the onerous amount.

How we see it

It is unclear from the proposed standard how the impairment of costs incurred to obtain a contract (e.g., sales commissions) changes the expected cost of fulfilling a performance obligation, which is used in the calculation of an onerous liability. We believe, however, that the Boards' intent was for any capitalised contract acquisition costs written off through an impairment to be removed from the calculation of expected costs to fulfil a performance obligation.

Illustration 7-4: Onerous test with impairment

Entity A enters into an arrangement to provide transaction processing services to Entity Z for two years. The contract price is CU400,000 with an expected cost to satisfy the performance obligation of CU350,000, which includes a sales commission paid to employees of CU20,000 upon execution of the contract. Three months into the contract, Entity A updates its cost estimates and expects to incur CU380,000 to satisfy the remaining performance obligation.

Entity A views the two-year service period as a single performance obligation. As the performance obligation is satisfied over a period greater than one year, this performance obligation is subject to the onerous test under the proposed standard. For purposes of this illustration, assume the amount Entity A would have to pay to exit the contract exceeds the cost to satisfy the remaining performance obligation (CU380,000).

Because the sales commission was initially expected to be recovered, it was capitalised in accordance with contract cost requirements in the proposed standard. Furthermore, Entity A would amortise this contract asset over the period the performance obligation was being satisfied (that is, 24 months).

Once Entity A determines the transaction processing services represent an onerous performance obligation, it is required to assess for impairment the recoverability of any costs to obtain or fulfil the contract that were previously capitalised. As Entity A no longer believes the capitalised sales commissions (remaining balance of CU17,500 after three months of amortisation) are recoverable, the entity would write-off that asset.

Entity A would calculate the amount of the onerous liability and exclude the acquisition costs as those costs have already been written off in earnings. Accordingly, Entity A would compare the transaction price allocated to the remaining performance obligation of CU350,000 (CU400,000 less CU50,000 revenue recognised to date) to the adjusted expected cost of CU362,500 (CU380,000 less the impairment charge of CU17,500).

Using this approach, Entity A would recognise an onerous contract liability of CU12,500.

Once an entity has recorded a liability and corresponding expense for an onerous performance obligation, the proposed standard requires that the measurement of the obligation be updated at each financial reporting date to include changes in assumptions or new information. Changes in the measurement of the liability are recorded as increases or decreases in expense in that period (note that the liability could never become negative, i.e., that is, an asset). When the entity satisfies the onerous performance obligation, the entity would derecognise the related onerous liability.

Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

Illustration 7-5: Onerous test – subsequent measurement

Continuing with the same facts as in illustration 7-4, six months into the contract, Entity A now believes the cost to satisfy its performance obligation with Entity Z is CU320,000 (including the sales commissions). However, while not clearly stated in the proposed standard, we believe that an entity would first consider any prior impairment charges in determining the “adjusted cost basis” for purposes of determining the potential onerous performance obligation.

Therefore, because the entity has already taken an impairment charge of CU17,500 in the prior period, the adjusted cost of fulfilling this performance obligation is CU302,500. Subsequent measurement of the onerous contract liability is as follows:

Performance obligation	Adjusted remaining cost	Allocated transaction price	Margin
Transaction processing	CU302,500	CU300,000*	CU(2,500)

[* = CU350,000 less CU50,000 revenue recognised during the previous 3 months]

Since Entity A already recognised a CU12,500 onerous contract liability in the previous reporting period, it would reduce the recorded onerous contract liability by CU10,000 with the offset being treated as a reduction of expense in the current reporting period.

What’s changing from current IFRS

The proposed standard would require the measurement of a loss for an onerous performance obligation at the performance obligation level rather than at the contract level, as currently required by IAS 37.

The proposed standard could result in significant changes for many other transactions. Under current IFRS, many entities do not recognise losses on executory contracts unless there is a specific standard (such as IAS 37) that requires them to do so.

The proposed standard also indicates that the “direct costs” included in the calculation for determining whether a performance obligation is onerous include allocated costs that relate directly to satisfying the performance obligation, potentially resulting in the recognition of liabilities for onerous performance obligations that contribute to the entity’s net income.

7.3 Contract costs

The proposed standard provides accounting guidance for an entity’s costs incurred in obtaining and fulfilling a contract to provide goods and services to customers for both contracts obtained and contracts under negotiation. This differs from existing IFRS, which generally applies only when an entity has obtained a contract.

7.3.1 Costs to obtain a contract

Under the proposed standard, incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) would be recognised as an asset, but only when the costs are expected to be recovered. Recovery of incremental costs can consider both direct recovery (i.e., through reimbursement under the contract) or indirect recovery (i.e., through the margin inherent in the contract). As a practical expedient, the proposed standard permits immediate expense recognition for contract acquisition costs related to contracts with a duration of one year or less. While this is not explicitly stated, we believe entities would be permitted to choose this approach as an accounting policy election and, if they did so, would have to apply it consistently to all short-term contract acquisition costs.

How we see it

The proposals in the ED could represent a significant change for entities that currently expense the costs of obtaining a contract and would be required to capitalise them.

The ED also implies that the unit of account for costs of obtaining a contract is the contract (potentially including contract renewals), which could force some entities to analyse contract acquisition costs in more detail than they currently do.

7.3.2 Costs to fulfil a contract

The proposed standard divides contract fulfilment costs into two categories – those that give rise to an asset and those that should be expensed as incurred. When considering the appropriate accounting treatment for contract fulfilment costs, the proposed standard makes clear that any other applicable standards should be considered first (such as IAS 2 *Inventories*, IAS 16 or IAS 38).



The proposed standard says that contract fulfilment costs that are not eligible for capitalisation under other authoritative literature would be recognised as assets if the costs meet all of the following criteria:

- ▶ The costs relate directly to the contract (or a specific anticipated contract). Costs may include direct labour, direct materials, costs that may be directly allocatable to the activities involved in fulfilling the contract, costs that are explicitly chargeable to the customer under the contract and other costs that were incurred only because the entity entered into the contract (e.g., costs related to the use of sub-contractors).
- ▶ The costs generate or enhance resources of the entity to be used in satisfying performance obligations in the future. Costs may include intangible design or engineering costs that relate to future performance and will continue to provide benefit.
- ▶ The costs are expected to be recovered.

The proposed standard requires that if the costs incurred in fulfilling a contract do not give rise to an asset based on the criteria above, they should be expensed as incurred. Costs that should be expensed as incurred include:

- ▶ Costs that relate to previously satisfied performance obligations - Costs incurred directly related to past performance, for which there is no future benefit should be expensed as incurred.
- ▶ Costs of abnormal amounts of wasted materials, excess labour or other materials used to fulfil the contract - Costs incurred that were not considered in the price of the contract and that do not further the satisfaction of the unfulfilled performance obligation, should be expensed as incurred.

To the extent the entity is unable to determine whether costs relate to past or future performance, and they are not eligible for capitalisation under other IFRSs, those costs would be expensed as incurred.

7.3.3 Amortisation and impairment of capitalised costs

Any capitalised contract costs would ultimately be expensed (generally through amortisation) as the entity transfers the goods or services to the customer. It is important to note that some capitalised costs will relate to multiple goods and services (e.g., design costs). For these costs, the amortisation period could extend beyond a single contract if the capitalised costs relate to goods or services being transferred under multiple contracts, or if the customer is expected to continue to purchase goods or services after the stated contract period.

Illustration 7-6: Amortisation period

Entity A enters into a three-year contract with a customer for transaction processing services. To fulfil the contract, Entity A incurred set-up costs of CU60,000, which it capitalised and will amortise over the term of the contract.

At the beginning of the third year, the customer renews the contract for an additional two years. Entity A will benefit from the set-up costs during the additional two-year period. Therefore, it would change the remaining amortisation period from one to three years and adjust the amortisation expense recognised in accordance with IAS 8 on changes in estimates.

However, under the proposed standard, if Entity A had anticipated the contract renewal at contract inception, Entity A would have amortised the set-up costs over the anticipated term of the contract inclusive of the expected renewal (i.e., five years).

Any asset recorded by the entity would also be subject to an ongoing assessment of impairment in a manner similar to the proposed requirements for onerous performance obligations (see Section 7.2). Costs giving rise to an asset must initially be recoverable to meet the criteria for capitalisation but must also continue to be recoverable throughout the arrangement. An impairment exists if the carrying amount of any asset(s) exceeds the amount of consideration the entity expects to be entitled to in exchange for providing those goods and services less the remaining costs that relate directly to providing those good and services. Note that collectibility issues do not affect the amounts an entity expects to be entitled to (see Section 7.4). Similar to the recognition of a liability for an onerous performance obligation (discussed in Section 7.2), the entity would need to consider impairment losses recognised in accordance with other IFRSs (e.g., IAS 36 *Impairment of Assets*) before recognising an impairment loss on capitalised costs incurred to obtain or fulfil a contract.

The reversal of impairment in subsequent periods is an area of divergence despite the Boards' desire that the ED be a converged standard. For purposes of reporting under US GAAP, the reversal of previous impairments is prohibited. Whereas, the proposed requirements for IFRS permit the reversal of previous impairments when the impairment conditions cease to exist. Consistent with the requirements in IAS 36, reversals of impairment losses would be capped; the increased carrying amount of the asset could not exceed the carrying amount that would have been determined (net of amortisation) had no impairment loss been recognised for the asset in prior periods.

Scope, transition
and internal control
considerations

Identify the contract
with the customer

Identify the separate
performance obligations
in the contract

Determine the
transaction price

7.4 Collectibility

For purposes of this discussion, collectibility refers to the customer's ability to pay the amount of promised consideration. Under the proposed standard, estimates of uncollectible amounts (both at contract inception and subsequent changes to those estimates) are to be presented adjacent to revenue in the income statement. Revenue would always be presented based on the estimated transaction price. However, the proposed standard would not change the manner in which any uncollectible amounts would be measured and recognised. That is, the proposed standard indicates the requirements in IFRS 9 or IAS 39 should be applied to make those determinations.

What's changing from current IFRS?

The proposed standard's requirements on the consideration of collectibility represent a significant change from current practice. While IAS 11 and IAS 18 require an entity to measure revenue at the fair value of the consideration received or receivable (which, arguably, implicitly includes credit risk), these standards do not explicitly address whether the effect of a customer's credit risk should be included in the measurement of revenue, which has resulted in diversity in practice.

Under the proposed standard, any amounts deemed uncollectible would be presented adjacent to revenue in profit or loss. As a result, even when an entity determines that there is considerable uncertainty about a customer's ability to pay, the entity would still recognise revenue for the estimated transaction amount and a separate amount adjacent to revenue for the uncollectible amount measured in accordance with IFRS 9 or IAS 39.

The requirement to present uncollectible amounts adjacent to revenue also would have an effect on gross margins. Today, entities generally record their bad debt expenses below the gross margin line in the income statement.



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8. Presentation and disclosure

8.1 Presentation – Contract assets and contract liabilities

The proposed standard is based on the notion that a contract asset or contract liability is generated when either party to a contract performs. For example, when an entity satisfies a performance obligation by delivering the promised good or service, the entity has earned a right to consideration from the customer and, therefore, has a contract asset. When the customer performs first by, for example, prepaying its promised consideration, the entity has a contract liability.

The proposed standard requires the entity to present these contract assets or contract liabilities in the statement of financial position. In many cases, a contract asset represents an unconditional right to receive the consideration. This is the case when there are no further performance obligations required to be satisfied before the entity has the right to collect the customer's consideration. The Boards concluded that an unconditional right to receive the customer's consideration represents a receivable from the customer that would be classified separately from contract assets. Contract assets exist when an entity has satisfied a performance obligation, but does not yet have an unconditional right to consideration (for example, because the entity first must satisfy another performance obligation in the contract before it is entitled to invoice the customer).

Under the proposed standard, entities are not required to use the terms "contract asset" or "contract liability" but must disclose sufficient information so that users of the financial statements can clearly distinguish between unconditional rights to consideration (a receivable) and conditional rights to receive consideration (a contract asset).

In addition to the contract asset or liability established when either party to the contract performs, an entity could also have recorded other assets (e.g., the incremental costs of obtaining the contract and other costs incurred that meet the criteria for capitalisation) or liabilities (e.g., onerous performance obligations). The proposed standard requires that any such assets and liabilities be presented separately from contract assets and contract liabilities in the statement of financial position (assuming that they are material).

8.2 Disclosure

In response to criticism that the current revenue recognition disclosures are inadequate, the Boards sought to create a comprehensive and coherent set of disclosures. As a result, the proposed standard includes an overall objective that the revenue recognition disclosures should enable users of the financial statements to understand the "nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers." The proposed standard states that preparers would meet that objective by providing both qualitative and quantitative disclosures about:

- ▶ Contracts with customers – These disclosures includes disaggregation of revenue, reconciliation of contract asset and liability balances (including liabilities due to onerous performance obligations) and information about an entity's performance obligations.
- ▶ Significant judgements (including changes in those judgements) – This would include disclosures about judgements that significantly affect the determination of the transaction price, the allocation of the transaction price to performance obligations and the determination of the timing of revenue recognition.
- ▶ Assets recognised from costs incurred to obtain or fulfil a contract.

Each of these disclosure topics is discussed further below. The proposed disclosures are summarised in the Appendix to this publication.

The proposed disclosures are substantially the same as those proposed by the Boards in 2010. In response to that proposal, many preparers raised concerns that they would have to provide extensive disclosures that may not be justified on a cost-benefit basis. The Boards have confirmed that the proposed standard provides a disclosure objective and that the disclosures listed are not meant to be a checklist of minimum requirements. Rather, entities should determine which disclosures are relevant to them. Entities also would not have to disclose items that are not material.

Scope, transition and internal control considerations

Identify the contract with the customer

Identify the separate performance obligations in the contract

Determine the transaction price

The proposed disclosures would be required for and as of each annual period for which a statement of comprehensive income and statement of financial position is presented. The Boards also propose to amend IAS 34 *Interim Financial Reporting* and Topic 270 in US GAAP and have asked constituents to comment on whether the proposed disclosures should be provided in entities' interim and annual financial statements. Current IFRS requires entities to disclose information about changes in financial position and performance since the last annual reporting period. In light of the emphasis placed on information about revenue by users of the financial statements, the Boards believe that specifying the disclosures required in entities' interim and annual financial statements reduces the risk of entities reaching different conclusions about what represents a significant change and how information about that change should be presented in entities' interim financial statements.

How we see it

As discussed more fully below, the proposed standard would significantly increase the volume of required disclosures in entities' interim and annual financial statements.

We believe the Boards need to receive detailed feedback from preparers on the practicability of providing these disclosures in interim and annual financial statements, as applicable, and on their overall usefulness. For example, entities operating in multiple segments with many different product lines may encounter significant difficulties in preparing the proposed disclosures. In addition, despite significantly shorter reporting deadlines for interim reporting periods, entities would be required to provide many of the same disclosures in their interim and annual financial statements. While we agree that many of these disclosures individually would likely provide useful information, we have an overriding concern that the cost of providing these expanded disclosures may be greater than the potential benefit.

8.2.1 Contracts with customers

8.2.1.1 Disaggregation of revenue

The disclosure requirements begin with revenue disaggregated into categories to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. The proposed standard suggests categories such as:

- ▶ Type of good or service
- ▶ Geography in which the goods or services are sold
- ▶ Market or type of buyer, such as government versus private sector
- ▶ Type of contract, such as fixed-price and time-and-materials
- ▶ Duration of the contract, such as short-term and long-term contracts
- ▶ Timing of transfer of the goods and services (for example, revenue from goods or services transferred to customers at a point in time versus over time)
- ▶ Sales channels, such as goods sold directly to customers versus goods sold through intermediaries

The Boards decided not to prescribe a specific characteristic of revenue as the basis for disaggregation because they intend the disaggregation determination to be based on entity-specific and/or industry-specific factors. The Boards acknowledged that an entity may need to use more than one type of category. The Boards also clarified that an entity would not have to duplicate disclosures required by another standard. For example, an entity that provides revenue recognition disclosures as part of its segment disclosures would not have to separately provide disaggregated revenue disclosures if those disclosures are sufficient to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors and are presented on a basis consistent with IFRS.

Entities are not required to disaggregate losses for uncollectible amounts. That must be presented as a separate line item adjacent to revenue. Under the proposed standard, the following is an example disaggregated revenue table that represents the interim and annual disclosure requirement.

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Illustration 8-1: Summary of disaggregated revenue data

	Product A			Product B			Total		
	2011	2010	2009	2011	2010	2009	2011	2010	2009
Segment 1	CUX	CUX	CUX	CUX	CUX	CUX	CUX	CUX	CUX
Segment 2	X	X	X	X	X	X	X	X	X
Segment 3	X	X	X	X	X	X	X	X	X
Segment 4	X	X	X	X	X	X	X	X	X
Total	CUX	CUX	CUX	CUX	CUX	CUX	CUX	CUX	CUX

8.2.1.2 Reconciliation of contract balances

The Boards concluded that users of the financial statements need to understand the relationship between the revenue recognised and changes in the overall balance of an entity's total contract assets and liabilities during each reporting period. As a result, the Boards proposed that an entity should disclose a reconciliation of the net contract asset and contract liability balance. The proposed standard specifies that the reconciliation should be provided in a tabular format to improve understandability by financial statement users and comparability between entities. The roll-forward must include the following, if applicable:

- ▶ Revenue from performance obligations satisfied during the reporting period
- ▶ Revenue from allocating changes in the transaction price to performance obligations satisfied in previous reporting periods (which would be shown separately from revenue from performance obligations satisfied during the period)
- ▶ Cash received
- ▶ Amounts transferred to receivables
- ▶ Non-cash consideration received
- ▶ Contracts acquired in business combinations and contracts disposed

Under the proposed standard, an entity would not be required to include the line items specified above if the change in the contract asset or contract liability related to that line item is immaterial. Conversely, additional line items may be required to help users understand changes in the contract asset or liability during the year (e.g., interest income and expense or the effect of changes in foreign currency exchange rates).

In developing the proposed disclosure, the Boards decided to require disclosure in the aggregate (i.e., on a net asset or liability basis) based on their concern that the cost of preparing and auditing disclosures on a disaggregated basis outweighed the benefits.

Illustration 8-2: Reconciliation of contract balances

The following is an example of what an entity that has a net contract asset in the aggregate might disclose in its interim and annual financial statements.

	2011	2010
Opening asset (liability) balance	CUXXX	CU(XXX)
Amounts included in the Statement of Comprehensive Income:		
Revenue recognised for performance obligations (POs) satisfied during the year	X	X
Revenue recognised resulting from revisions to the estimated transaction prices (amounts allocated to previously satisfied POs)	+/- X	+/- X
Customer consideration received in advance	(X)	(X)
Transfers to accounts receivable	(X)	(X)
Non-cash consideration received in advance	(X)	(X)
Acquisitions (disposals) of contract assets	+/- X	+/- X
Closing asset (liability) balance	CUXXX	CUXXX



8.2.1.3 Performance obligations

As the reconciliation of contract assets and liabilities would be required on a net basis (as discussed in Section 8.2.1.2), the Boards decided that separately disclosing an entity's remaining performance obligations would provide users of the financial statements with better information to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The information required to be disclosed for performance obligations under the proposed standard is both quantitative and qualitative.

Entities are required to disclose the following qualitative items in their annual financial statements:

- ▶ The goods or services the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services when the entity is acting as an agent under the contract
- ▶ When the entity typically satisfies its performance obligations (e.g., upon shipment, upon delivery, as services are rendered (see also Section 8.2.2.2) or upon completion of service)
- ▶ The significant payment terms (such as, whether the consideration amount is variable and whether the contract has a material financing component)
- ▶ Obligations for returns, refunds and other similar obligations
- ▶ Types of warranties and related obligations

For a contract with an original expected duration of more than one year, an entity would also be required to disclose the amount of the transaction price allocated to remaining performance obligations and an explanation of when the entity expects the amount(s) to be recognised as revenue in its interim and annual financial statements. This proposed disclosure was also in the 2010 ED. Some respondents raised concerns that this disclosure implies a greater degree of precision about the expected timing of satisfaction than actually exists. In response, the Boards decided to permit entities to provide the disclosure either on a quantitative basis (e.g., between one and two years, between two and three years), or by disclosing qualitative information.

The Boards also decided to permit a practical expedient in which an entity would not be required to disclose the amount of the remaining performance obligations if the nature of the contract permits the entity to recognise revenue as invoiced. An example would be a services contract in which an entity has a right to invoice the customer a fixed amount for each hour of service provided as specified in the contract.

The following table illustrates this interim and annual disclosure requirement (on a quantitative basis).

Illustration 8-3: Summary of outstanding performance obligations with original durations greater than one year

	2011	2010
Performance obligations expected to be satisfied in one year or less	CU XXX	CU XXX
Performance obligations expected to be satisfied in more than one year but less than two years	XX	XX
Performance obligations expected to be satisfied in more than two years but less than three years	XX	XX
Performance obligations expected to be satisfied in more than three years	XX	XX
Total	CUXXX	CUXXX

8.2.1.4 Onerous performance obligations

Under the proposed standard, the following qualitative and quantitative disclosures relating to onerous performance obligations would be required for the interim and annual financial statements:

- ▶ A description of the nature and amount of the performance obligation(s) for which the liability has been recognised
- ▶ A description of why those performance obligations are onerous
- ▶ An indication of when the entity expects to satisfy the onerous performance obligations

In addition, entities must also disclose a roll-forward of any liabilities recorded for onerous performance obligations in their interim and annual financial statements. The roll-forward must include the following components:

- ▶ Performance obligations that became onerous during the period
- ▶ Amount of the liability that was satisfied during the period
- ▶ Changes in the measurement of the liability that occurred during the reporting period
- ▶ Any additional line items that may be needed to understand the changes in the liability recognised

The proposed disclosure is consistent with the existing onerous contract disclosures currently required by IAS 37.

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The following table illustrates a roll-forward disclosure under the proposed standard.

Illustration 8-4: Reconciliation of onerous performance obligations

Roll-forward of onerous performance obligations	2011	2010
Opening balance	CUXXX	CUXXX
Liability recognised for performance obligations that became onerous during the period	X	X
Amount of liability satisfied	(X)	(X)
Change in measurement of the liability	+/- X	+/- X
Closing balance	CUXXX	CUXXX

8.2.2 Significant judgements

The importance placed on revenue by users of the financial statements means that the proposed standard also requires specific disclosure of significant accounting estimates and judgements made in determining the transaction price, allocating the transaction price to performance obligations and determining the satisfaction of performance obligations. These proposed disclosure requirements exceed the general requirements currently provided under IFRS and are discussed in more detail below.

8.2.2.1 Determining the transaction price and the amounts allocated to performance obligations

Entities will often exercise significant judgement when estimating the transaction prices of their contracts, especially when those estimates involve variable consideration.

Furthermore, significant judgement may be required when estimating the standalone selling prices, returns and onerous performance obligations. The proposed standard requires entities to disclose qualitative information about the methods, inputs and assumptions used for the following in their annual financial statements:

- ▶ Determining the transaction price
- ▶ Estimating the standalone selling prices of promised goods or services
- ▶ Measuring obligations for returns, refunds and other similar obligations
- ▶ Measuring the amount of any liability recognised for onerous performance obligations

8.2.2.2 Determining the timing of satisfaction of performance obligations

The proposed standard also requires entities to provide disclosures about the significant judgements they make in determining the timing of satisfaction of performance obligation. For performance obligations that are satisfied over time, entities must disclose both of the following in their annual financial statements:

- ▶ The methods used to recognise revenue (such as a description of the output methods or input methods)
- ▶ An explanation of why the methods faithfully depict the transfer of goods or services
- ▶ For performance obligations that are satisfied at a point in time, entities would need to disclose the significant judgements made in evaluating when the customer obtains control of the good or service.

8.2.3 Assets recognised from the costs to obtain or fulfil a contract

Under the proposed standard, an entity would have to disclose a reconciliation of the carrying amount of an asset arising from the costs to acquire or fulfil a contract with a customer from the beginning to the end of the period, by major asset classification (e.g., acquisition costs, pre-contract costs, set-up costs, and other fulfilment costs) in both its interim and annual financial statements. Amounts associated with additions, amortisation and impairments would be presented in separate line items. Qualitative disclosures would also be required, such as a description of the method used to amortise the assets.

The 2010 ED did not propose disclosures about the assets arising from costs to obtain a contract (because the 2010 ED required that all such costs be expensed as incurred) or the costs to fulfil a contract. However, some constituents indicated that information about the types of costs an entity recognised as assets and how those costs were subsequently amortised or impaired would be helpful to users of the financial statements.



The following table illustrates a disclosure that would meet this interim and annual requirement.

Illustration 8-5: Roll-forward of assets from contract acquisition or fulfilment costs

	Acquisition costs		Pre-contract costs		Setup costs		Other fulfilment costs	
	2011	2010	2011	2010	2011	2010	2011	2010
Opening balance	CU XX	CU XX	CU XX	CU XX	CU XX	CU XX	CU XX	CU XX
Additions	X	X	X	X	X	X	X	X
Amortisation	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)
Impairment losses recognised	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)
Impairment losses reversed	X	X	X	X	X	X	X	X
Closing balance	CUXX	CUXX	CUXX	CUXX	CUXX	CUXX	CUXX	CUXX



Allocate the transaction price to the separate performance obligations

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Appendix: Disclosure of contracts with customers

Proposed disclosures	
Disaggregation of revenue – Section 8.2.1.1	<p>Disclose disaggregated revenue in categories that meet the disclosure objective (paragraph 114 and 115 of the ED).</p> <p>Disclosures in paragraphs 114-116 of the ED are required for interim and annual reporting periods.</p>
Reconciliation of contract balances – Section 8.2.1.2	<p>Disclose a roll-forward of changes in contract balances during the period (paragraph 117 of the ED).</p> <p>Disclosures required for interim and annual reporting periods.</p>
Performance obligations (POs) – Section 8.2.1.3	<p>Disclose:</p> <ul style="list-style-type: none"> ▶ Qualitative information about POs (paragraph 118) ▶ The amount of transaction price allocated to remaining POs and when the POs will be satisfied for contracts longer than one year (paragraph 119-121 of the ED) <p>Analysis of an entity's remaining performance obligations (paragraphs 119-121 of the ED) are required for interim and annual reporting periods.</p> <p>Qualitative disclosures about performance obligations (paragraph 118 of the ED) are required in annual reporting periods only.</p>
Onerous POs – Section 8.2.1.4	<p>Disclose:</p> <ul style="list-style-type: none"> ▶ The nature and amount of remaining onerous POs, why the PO is onerous and when the PO will be satisfied (paragraph 122 of the ED) ▶ A roll-forward of changes in onerous POs during the period (paragraph 123 of the ED) <p>Applicable disclosures are required for interim and annual reporting periods.</p>
Significant judgements – Sections 8.2.2.1 and 8.2.2.2	<p>Disclose significant judgements made (paragraph 124 of the ED) including:</p> <ul style="list-style-type: none"> ▶ Judgements about the timing of satisfaction of POs (paragraphs 125 and 126 of the ED) ▶ Judgements about the transaction price and amounts allocated to POs (paragraph 127 of the ED) <p>Applicable disclosures are required for interim and annual reporting periods.</p>
Assets recognised from the costs to obtain or fulfil a contract – Section 8.2.3	<p>Disclose:</p> <ul style="list-style-type: none"> ▶ A roll-forward of changes in assets recognised from the costs to obtain or fulfil a contract during the period (paragraph 128 of the ED) ▶ Method to amortise the assets (paragraph 129 of the ED) <p>Analysis of an entity's remaining performance obligations (paragraphs 119-121 of the ED) are required for interim and annual reporting periods.</p> <p>Qualitative disclosures about performance obligations (paragraph 118 of the ED) are required in annual reporting periods only.</p>

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