Applying IFRS in Retail and Consumer Products

The new revenue recognition standard - retail and consumer products

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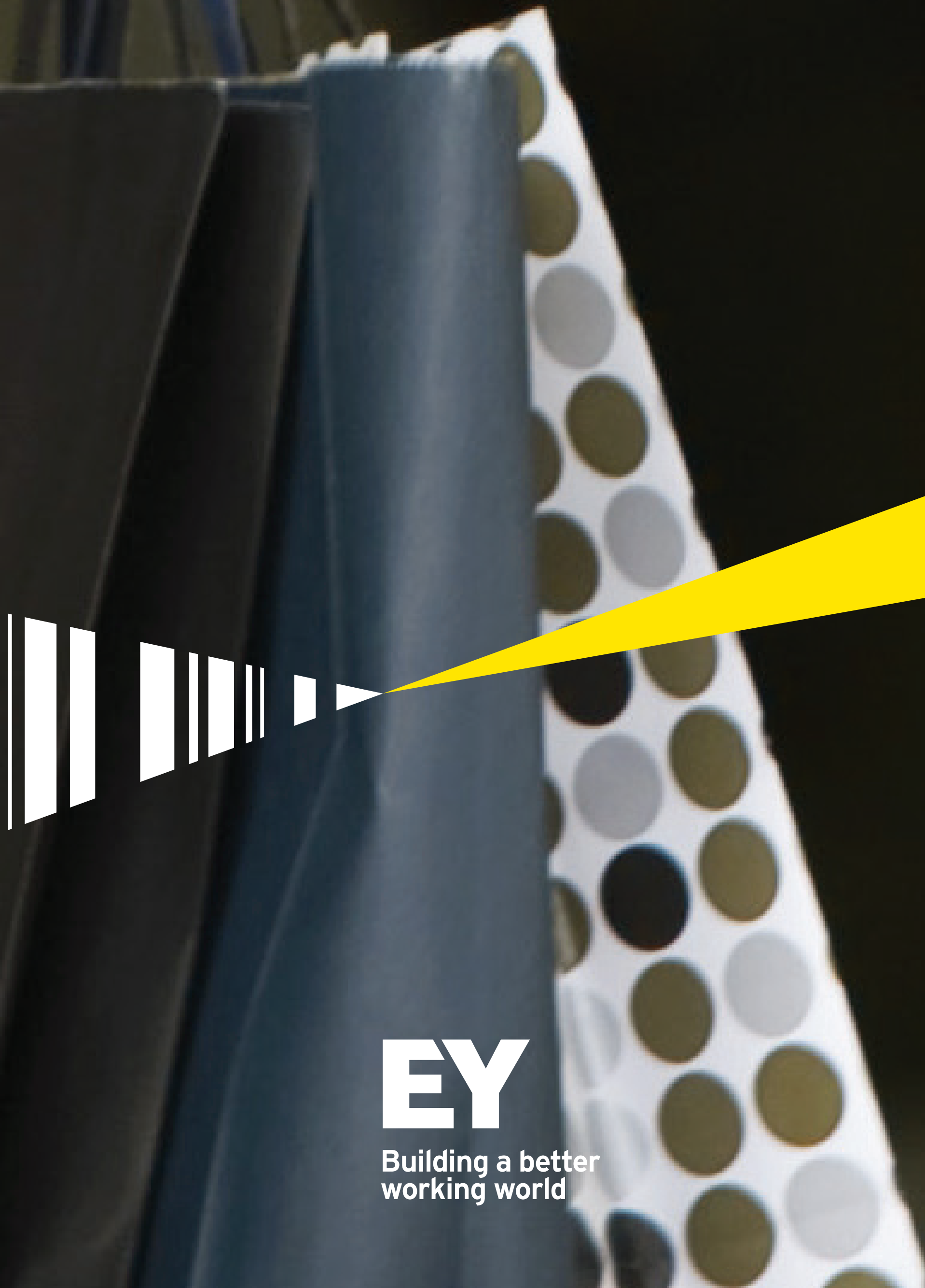

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IFRS 15 creates a single source of revenue requirements for all entities in all industries. The new revenue standard is a significant change from current IFRS.

The new standard applies to revenue from contracts with customers and replaces all revenue standards and interpretations in IFRS, including IAS 11 *Construction Contracts*, IAS 18 *Revenue* and related Interpretations.

IFRS 15 also specifies the accounting treatment for certain items which are not revenue, such as certain costs associated with obtaining and fulfilling a contract and the sale of certain non-financial assets. Application of the new revenue recognition standard will require retail and consumer products entities to exercise greater judgement.

Entities will need advance preparation for the increase in new disclosures that are required under IFRS 15. Entities need to ensure that they have the appropriate systems, processes, internal controls, policies and procedures in place to collect and disclose the required information.

The standard is effective for annual periods beginning on or after 1 January 2017, with early adoption permitted.

Overview

Retail and consumer products entities may need to change their revenue recognition policies and practices as a result of a new revenue recognition standard. IFRS 15 *Revenue from Contracts with Customers*, issued by the International Accounting Standards Board (the IASB), was the result of a joint project with the Financial Accounting Standards Board (the FASB) (collectively, the Boards). The new standards, which are substantially consistent, will supersede virtually all revenue recognition standards in IFRS and US Generally Accepted Accounting Principles (US GAAP).

IFRS 15 specifies the accounting treatment for all revenue arising from contracts with customers. It affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other IFRS requirements, such as IAS 17 *Leases*). The standard also provides a model for the recognition and measurement of gains and losses on the sale of certain non-financial assets, such as property and equipment and intangibles.

The standard may not significantly change the amount and timing of revenue that retail and consumer products entities recognise, but they will need to carefully evaluate all of their contracts to determine the effects of the standard and exercise greater judgement when accounting for revenue than they currently do. For example, retail and consumer products entities will need to use more judgement when accounting for consideration paid or payable to customers (such as slotting fees), reseller arrangements, and licensing and franchising agreements. Furthermore, aspects of IFRS 15 that may cause changes for retail and consumer products entities include the requirements to: account for material rights granted to customers; the control principle when evaluating whether the entity is acting as a principal or an agent in a transaction; and the recording of return assets on a gross basis separately from refund liabilities.

This publication provides an overview of the revenue recognition model in IFRS 15 and highlights key considerations for retail and consumer products entities. It expands on our earlier *IFRS Developments for Retail and Consumer Products*[1]: *The new revenue recognition standard* (September 2014). This publication also supplements our *Applying IFRS*, *A closer look at the new revenue recognition standard* (June 2014)[1] (general publication) and should be read in conjunction with that publication.

Retail and consumer products entities may also want to monitor the discussions of the Boards' Joint Transition Resource Group for Revenue Recognition (TRG).[2] In supporting stakeholders with implementation of the new standard, the Boards established the TRG to assist them in determining whether additional interpretation, application guidance or education is needed on implementation issues and other matters submitted by stakeholders. The TRG does not make formal recommendations to the Boards or issue application guidance. Any views produced by the TRG are non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyse the standard and as entities begin to apply it, and our views may evolve during that process.

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1 Available on www.ey.com/ifrs

2 *IFRS Developments* and *Applying IFRS* covering the discussions of the TRG are available on www.ey.com/ifrs

1. Summary of the new standard

IFRS 15 specifies the requirements an entity must apply to measure and recognise revenue and the related cash flows. The core principle of the standard is that an entity will recognise revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring promised goods or services to a customer.

The principles in IFRS 15 are applied using the following five steps:

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

An entity will need to exercise judgement when considering terms of a contract, including implied contract terms.

An entity will need to exercise judgement when considering the terms of the contract(s) and all of the facts and circumstances, including implied contract terms. An entity also will have to apply the requirements of IFRS 15 consistently to contracts with similar characteristics and in similar circumstances. On both an interim and annual basis, an entity will generally need to disclose more information than it does under current IFRS. Annual disclosures will include qualitative and quantitative information about the entity's contracts with customers, significant judgements made (and changes in those judgements) and contract cost assets.

2. Scope, transition and effective date

IFRS 15 applies to all contracts with customers to provide goods or services in the ordinary course of business, except for the following contracts which are specifically excluded from the scope:

- Lease contracts within the scope of IAS 17
- Insurance contracts within the scope of IFRS 4 *Insurance Contracts*
- Financial instruments and other contractual rights or obligations within the scope of IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement*, IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IAS 27 *Separate Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*
- Non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers

IFRS 15, as issued in May 2014, is effective for annual periods beginning on or after 1 January 2017. Early adoption is permitted for IFRS preparers and first-time adopters of IFRS. At the time of publication, the IASB has proposed a one-year deferral of IFRS 15 with early application permitted.[3]

[3] IFRS Developments Issue 107*: IASB issues an exposure draft proposing a one-year deferral of its new revenue standard*

All entities will be required to apply the standard retrospectively, either using a full retrospective or a modified retrospective approach. The Boards provided certain practical expedients to make it easier for entities to use a full retrospective approach.

Under the modified retrospective approach, financial statements are prepared for the year of adoption using IFRS 15, but prior periods are not adjusted. Instead, an entity will recognise a cumulative catch-up adjustment to opening retained earnings (or other appropriate component of equity) at the date of initial application for contracts that still require performance by the entity (i.e., contracts that are not completed). In addition, an entity will disclose all line items in the year of adoption as if they were prepared under current IFRS (i.e., IAS 18, IAS 11 and related Interpretations).

For more information about the effective date and transition options, see our general publication.

3. Identify the contract with the customer

The model in IFRS 15 applies to each contract with a customer. Contracts may be written, oral or implied by an entity's customary business practices, but must be legally enforceable and meet specified criteria. An entity is required to combine two or more contracts that it enters into at, or near, the same time with the same customer and account for them as a single contract, if they meet specified criteria.

An assessment of collectability is included as one of the criteria for determing whether a contract with a customer exists. That is, an entity must conclude that it is probable that it will collect the consideration to which it will be entitled. The amount of consideration to which an entity expects to be entitled (i.e., the transaction price) may differ from the stated contract price (e.g., if an entity intends to offer a concession and accept an amount less than the contractual amount). When performing the collectability assessment, an entity only considers the customer's ability and intention to pay the expected consideration when due. Example 2 from IFRS 15 illustrates the assessment of collectability at inception of the contract.

Extract from IFRS 15

Example 2 – Consideration is not the stated price – implicit price concession (IFRS 15.IE7-IE9)

An entity sells 1,000 units of a prescription drug to a customer for promised consideration of CU1 million. This is the entity's first sale to a customer in a new region, which is experiencing significant economic difficulty. Thus, the entity expects that it will not be able to collect from the customer the full amount of the promised consideration. Despite the possibility of not collecting the full amount, the entity expects the region's economy to recover over the next two to three years and determines that a relationship with the customer could help it to forge relationships with other potential customers in the region.

Extract from IFRS 15 (cont'd)

When assessing whether the criterion in paragraph 9(e) of IFRS 15 is met, the entity also considers paragraphs 47 and 52(b) of IFRS 15. Based on the assessment of the facts and circumstances, the entity determines that it expects to provide a price concession and accept a lower amount of consideration from the customer. Accordingly, the entity concludes that the transaction price is not CU1 million and, therefore, the promised consideration is variable. The entity estimates the variable consideration and determines that it expects to be entitled to CU400,000.The entity considers the customer's ability and intention to pay the consideration and concludes that even though the region is experiencing economic difficulty, it is probable that it will collect CU400,000 from the customer. Consequently, the entity concludes that the criterion in paragraph 9(e) of IFRS 15 is met based on an estimate of variable consideration of CU400,000. In addition, on the basis of an evaluation of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 9 of IFRS 15 are also met. Consequently, the entity accounts for the contract with the customer in accordance with the requirements in IFRS 15.

An entity in the situation illustrated in Example 2 also needs to determine whether it has entered into a valid arrangement with a customer. If, at contract inception, an entity determines that it is not probable that it will collect the estimated transaction price from the customer (which may be lower than the stated contract price), it cannot conclude that the contract is valid, and the model in the standard will not apply.

This step of the model also includes requirements for contract modifications. A contract modification is a change in the scope or price (or both) of a contract. An entity must determine whether the modification needs to be accounted for as a separate contract or as part of the existing contract. Two criteria must be met for a modification to be considered a separate contract:

- The additional goods or services are distinct from the goods or services in the original contract
- The consideration expected for the added goods or services reflects the standalone selling prices of those items

A contract modification that does not meet the criteria to be accounted for as a separate contract is considered a change to the existing contract. It is treated as either the termination of the original contract and the creation of a new contract or as a continuation of the original contract, depending on whether the remaining goods or services to be provided after the contract modification are distinct.

How we see it

For retail and consumer products entities, identifying the contract with the customer under IFRS 15 is not expected to result in a change from current practice. However, entities will need to evaluate the legal enforceability of all their contracts and their collectability. A contract generally exists at the point of sale, when the goods or services are delivered or when a sales agreement is executed. However, some consumer products entities may find it challenging to distinguish between implied price concessions and customer credit risk at contract inception. In particular, it may be difficult to determine whether a partial payment is: (a) a contract with an implied price concession; (b) an impairment loss; or (c) an arrangement lacking sufficient substance to be considered a contract to which the model in the standard applies.

Entities will need to carefully evaluate all facts and circumstances that were available at contract inception, as well as subsequent events affecting the customer's ability to pay. Significant judgement will be required when making this determination. Entities should develop clear policies and procedures for these evaluations to ensure consistent application across all transactions.

Furthermore, retail and consumer products entities that enter into other contracts, such as franchise or licensing arrangements, will need to evaluate the terms of each contract to see whether or when the criteria in IFRS 15 are met.

4. Identify the performance obligations in the contract

Once an entity has identified the contract with a customer, it evaluates the contractual terms and its customary business practices to identify all the promised goods or services within the contract and determine which of those promised goods or services (or bundles of promised goods or services) will be treated as separate performance obligations.

Promised goods and services represent separate performance obligations if the goods or services are:

- Distinct (by themselves or as part of a bundle of goods and services)

  Or
- Part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer

A good or service (or bundle of goods and services) is distinct if the customer can benefit from the good or service on its own or together with other readily available resources (i.e., the good or service is capable of being distinct) and the good or service is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract). In many cases, identifying the performance obligations within the contract will be straightforward for retail and consumer products entities, such as in a point-of-sale transaction or the sale of a manufactured good. In other cases, it may be more complex. For example, a contract may include an option for additional goods or services (e.g., a contract renewal) or a licence of intellectual property (e.g., a trademark). When a reseller is involved, entities will also need to consider whether they are acting as the principal or agent in the transaction. These complexities are discussed further below.

During the development of IFRS 15, the Boards had considered providing entities with relief from accounting for performance obligations that the entity considers to be inconsequential or perfunctory (e.g., set-up fees in franchise agreements). However, the Boards decided not to provide this type of relief because all goods or services promised to a customer, as a result of a contract, give rise to performance obligations. The Boards determined that those promises were made as part of the negotiated transaction between the entity and its customer. This issue has been raised by stakeholders and discussed at the January 2015 TRG meeting and subsequently discussed by the Boards at the February 2015 joint meeting.The IASB decided not to make any changes to requirements in IFRS 15, believing that the requirements are sufficiently clear. However, the FASB decided that some clarifications were necessary and directed their staff to draft new language that would allow entities to disregard promises that are deemed to be immaterial to the contract.[4]

4.1 Customer options for goods or services

Retail and consumer products entities frequently give customers the option to purchase additional goods or services. These options come in many forms, including sales incentives (e.g., coupons with a limited distribution, competitor price matching programmes aimed at only some customers, gift cards issued by a retailer as a promotion), customer award credits (e.g., loyalty or reward programmes), contract renewal options (e.g., waiver of certain fees, reduced future rates) or other discounts on future goods or services.

IFRS 15 states that when an entity grants a customer the option to acquire additional goods or services, that option is a separate performance obligation if it provides a material right that the customer would not receive without entering into the contract.[5] For example, an entity may give a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market. While the Boards did not provide any bright lines about what constitutes a 'material' right, they indicated in the Basis for Conclusions that the purpose of this requirement is to identify and account for options that customers are essentially paying for (often implicitly) as part of the transaction.[6] If the discounted price offered in the option reflects the stand-alone 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 standard states that this is the case even if the option can be exercised only because the customer entered into the earlier transaction. Several issues have been submitted to the TRG on material rights and the TRG is expected to discuss these issues in the coming months.[7]

The assessment of whether the entity has granted its customer a material right could require significant judgement.

The assessment of whether the entity has granted its customer a material right could require significant judgement. Retail and consumer product entities frequently offer discounts on future purchases to customers who spend a specified amount by means of a loyalty programme or voucher. For example, an entity may give customers who spend currency unit (CU)100 or more, during a specified period, a CU15 discount on a future purchase and the discount may be in the form of a coupon/voucher or gift card to be used within two weeks of the sale date. An entity will have to determine whether this offer represents a

[4] Refer to IFRS Developments Issue 102: *Boards reach different decisions on some of the proposed changes to the new revenue standards* for more details.
[5] IFRS 15.B40
[6] IFRS 15.BC 386
[7] *IFRS Developments* and *Applying IFRS* covering the discussions of the TRG are available on www.ey.com/ifrs

material right and, if so, allocate a portion of the transaction price to it on a relative stand-alone selling price basis.

In determining the stand-alone selling price of the coupon/voucher or gift card, it is unclear whether the selling price of the gift card can be used as stand-alone selling price for this transaction. That is, an entity likely would have an observable stand-alone selling price for gift cards, which could be different from an estimated stand-alone selling price for a coupon or voucher of equal value because, for example, the estimate would likely include estimates of breakage.

IFRS 15 provides the following example to illustrate how retail and consumer products entities may determine whether an option represents a material right.

Extract from IFRS 15

Example 49 – Option that provides the customer with a material right (discount voucher) (IFRS 15.IE250-IE253)

An entity enters into a contract for the sale of Product A for CU100. As part of the contract, the entity gives the customer a 40 percent discount voucher for any future purchases up to CU100 in the next 30 days. The entity intends to offer a 10 percent discount on all sales during the next 30 days as part of a seasonal promotion. The 10 percent discount cannot be used in addition to the 40 percent discount voucher.

Because all customers will receive a 10 percent discount on purchases during the next 30 days, the only discount that provides the customer with a material right is the discount that is incremental to that 10 percent (that is, the additional 30 percent discount). The entity accounts for the promise to provide the incremental discount as a performance obligation in the contract for the sale of Product A.

To estimate the stand-alone selling price of the performance obligation for the discount voucher in accordance with paragraph B42 of IFRS 15, the entity estimates an 80 percent likelihood that a customer will redeem the voucher and that a customer will, on average, purchase CU50 of additional products. Consequently, the entity's estimated stand-alone selling price of the discount voucher is CU12 (CU50 average purchase of additional products x 30 percent incremental discount x 80 percent likelihood of exercising this option). The stand-alone selling prices of Product A and the discount voucher and the resulting allocation of the CU100 transaction price are as follows:

Performance obligations	Stand-alone selling price
	CU
Product A	100
Discount voucher	12
Total	112

	Allocated transaction price	
Product A	89	(CU100 ÷ CU112 × CU100)
Discount voucher	11	(CU12 ÷ CU112 × CU100)
Total	100	

The entity allocates CU89 to Product A and recognises revenue for Product A when control transfers. The entity allocates CU11 to the discount voucher and recognises revenue for the voucher when the customer redeems it for goods or services or when it expires.

How we see it

The accounting treatment under IFRS 15 may be more complex for retail and consumer product entities that grant options to customers to purchase additional goods or services. Entities will need to use significant judgement to determine which options provide material rights to the customers. Entities that provide material rights to customers will need processes and systems to estimate the stand-alone selling price and allocate the transaction price to the current and future purchases based on that estimate.

4.2 Customer loyalty programmes

When a retail or consumer products entity determines that a loyalty or reward programme creates a performance obligation (because it provides a material right to the customer), it will allocate a portion of the transaction price to the loyalty programme. Revenue will be recognised when the performance obligation is satisfied (e.g., when the loyalty points are redeemed or expire, applying the breakage concepts discussed below in section 7.2).

Example 52 in the standard illustrates the accounting for a customer loyalty programme in a retail or consumer product arrangement.

Extract from IFRS 15

Example 52 – Customer loyalty programme (IFRS 15.IE267-IE270)

An entity has a customer loyalty programme that rewards a customer with one customer loyalty point for every CU10 of purchases. Each point is redeemable for a CU1 discount on any future purchases of the entity's products. During a reporting period, customers purchase products for CU100,000 and earn 10,000 points that are redeemable for future purchases. The consideration is fixed, and the stand-alone selling price of the purchased products is CU100,000. The entity expects 9,500 points to be redeemed. The entity estimates a stand-alone selling price of CU0.95 per point (totalling CU9,500) on the basis of the likelihood of redemption in accordance with paragraph B42 of IFRS 15.

The points provide a material right to customers that they would not receive without entering into a contract. Consequently, the entity concludes that the promise to provide points to the customer is a performance obligation.The entity allocates the transaction price (CU100,000) to the product and points on a relative stand-alone selling price basis as follows:

	CU	
Product	91,324	[CU100,000 × (CU100,000 stand-alone selling price ÷ CU109,500)]
Points	8,676	[CU100,000 × (CU9,500 stand-alone selling price ÷ CU109,500)]

At the end of the first reporting period, 4,500 points have been redeemed, and the entity continues to expect 9,500 points to be redeemed in total. The entity recognises revenue for the loyalty points of CU4,110 [(4,500 points ÷ 9,500 points) x CU8,676], and recognises a contract liability of CU4,566 (CU8,676 - CU4,110) for the unredeemed points at the end of the first reporting period.

Extract from IFRS 15 (cont'd)

At the end of the second reporting period, 8,500 points have been redeemed cumulatively. The entity updates its estimate of the points that will be redeemed and now expects that 9,700 points will be redeemed. The entity recognises revenue for the loyalty points of CU3,493 {[(8,500 total points redeemed ÷ 9,700 total points expected to be redeemed) x CU8,676 initial allocation] – CU4,110 recognised in the first reporting period}. The contract liability balance is CU1,073 (CU8,676 initial allocation – CU7,603 of cumulative revenue recognised).

How we see it

The accounting for customer loyalty programmes under IFRS 15 is largely consistent with the current requirements in IFRIC 13 *Customer Loyalty Programmes.* However, under IFRS 15, entities are required to allocate transaction price to the points awarded, based on relative stand-alone selling price, instead of the allocation methodologies allowed under IFRIC 13. This will likely require changes to an entity's accounting policies, accounting systems and/or internal controls.

4.3 Principal versus agent considerations

Retailers typically enter into contracts with third parties to provide goods or services to be sold through their sales channels to their customers. Under IFRS 15, 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. When the entity is the principal in the contract, the revenue recognised is the gross amount to which the entity expects to be entitled. When the entity is the agent, the revenue recognised is the net amount (i.e., the amount to which the entity is entitled in return for its services as the agent). The entity's fee or commission may be the net amount of the consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

A principal's performance obligations in a contract differ from an agent's performance obligations. For example, if an entity obtains control of the goods or services of another party before it transfers those goods or services to the customer, the entity's performance obligation may be to provide the goods or services itself. Therefore, the entity is likely to be acting as a principal and would recognise revenue in the gross amount to which it is entitled. An entity that obtains legal title of a product only momentarily before legal title is transferred to the customer is not necessarily acting as a principal. In contrast, if an agent 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 for any length of time, the agent's performance obligation is to arrange for another party to provide the goods or services to the customer.

Because it can be challenging at times to identify the principal in a contract, the standard provides indicators to help an entity make this determination. While these indicators are based on indicators included in current IFRS, they have a different purpose because they are based on the concepts of identifying performance obligations and the transfer of control of goods or services. Appropriately identifying the entity's performance obligation in a contract is fundamental in determining whether the entity is acting as an agent or a principal. The following extract includes the indicators discussed in IFRS 15:

Extract from IFRS 15

B37. Indicators that an entity is an agent (and therefore does not control the good or service before it is provided to a customer) include the following:

(a) another party is primarily responsible for fulfilling the contract;

(b) the entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return;

(c) the entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited;

(d) the entity's consideration is in the form of a commission; and

(e) the entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.

Although a principal may be able to transfer its 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). Examples 45-48 illustrate the application guidance on principal versus agent (IFRS 15.IE230-IE248).[8]

How we see it

Consistent with current practice, entities will need to carefully evaluate whether a gross or net presentation is appropriate. IFRS 15 includes application guidance on determining whether an entity is a principal or agent in an arrangement that is similar to current IFRS. Entities may, therefore, reach similar conclusions to those under current IFRS. However, the standard includes the notion of considering whether an entity has control of the goods or services as part of the evaluation, which adds an overarching principle for entities to evaluate, in addition to the indicators. This may affect the assessment of whether an entity is a principal or agent in an arrangement.

Retailers will have to carefully consider the effect on their principal-agent analysis when they control goods only momentarily (i.e., when they have 'flash title') before selling goods to an end-customer. This may occur when the retailer operates a store within a store or has an agreement in which the vendor is responsible for stocking, rotating and otherwise managing the product until the final point of sale (e.g., some greeting card arrangements).

[8] The IASB has proposed amendments for the guidance relating to principal versus agent considerations. Refer to IFRS Developments 108: *Principal versus agent: IASB to propose amendments to IFRS 15*

At its first meeting in July 2014, the TRG discussed a number of principal-agent issues, including how to apply the indicators to the sale of intangible goods or services (e.g., vouchers for events or travel services, electronic gift cards) and whether certain items billed to customers (e.g., shipping and handling, reimbursement of out-of-pocket expenses, taxes, other assessments) should be presented as revenue or as a reduction of costs. The Boards have asked their staffs to research whether there are specific improvements they could make to help entities make judgements in the principal versus agent assessment for arrangements involving certain intangible goods or services.

5. Determine the transaction price

The transaction price is the amount of consideration that an entity expects to be entitled to in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties (e.g., some sales taxes).

Under the new standard, entities will need to continue to evaluate all taxes collected in all jurisdictions where they operate in order to determine whether a tax is levied on the entity or whether the entity is collecting the amount on behalf of its customer (i.e., as an agent for a government or other taxing authority). While sales taxes may be the most common type of consideration collected by retail and consumer products entities on behalf of third parties, an entity will need to carefully consider other amounts that may be collected (e.g., certain tariffs on the cross-border movement of goods that may be imposed on the seller) to determine the appropriate accounting.

When determining the transaction price, an entity should consider the effects of all of the following: (1) variable consideration; (2) a significant financing component (i.e., the time value of money); (3) non-cash consideration; and (4) consideration payable to a customer.

Prices for goods sold to customers by retail and consumer products entities are typically established or stated (e.g., manufacturer’s suggested retail price, list price). However, it is customary for retail and consumer products entities to provide return rights and price concessions, which are items that cause consideration to be variable under IFRS 15. In addition, consideration payable to a customer is common. Each of these items may make determining the transaction price more challenging.

5.1 Variable consideration

An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. Consideration can also vary if it is contingent on the occurrence of a future event (e.g., right of return, achievement of a milestone).

Under IFRS 15, an entity is required to estimate variable consideration using either the ‘expected value’ method or the ’most likely amount‘ method, based on whichever better predicts the amount of consideration to which the entity is entitled. The entity applies the selected method consistently throughout the contract and for similar types of contracts.

IFRS 15 limits the amount of variable consideration an entity can include in the transaction price to the amount for which it is highly probable that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. That is, the standard requires an entity to apply a constraint on variable consideration. This determination includes considering both the likelihood and magnitude of a revenue reversal. The estimate of variable consideration, including the amount subject to the constraint, is updated at the end of each reporting period.

The standard provides the example below to illustrate how retail and consumer products entities may account for variable consideration related to volume discounts:

Extract from IFRS 15

Example 24 – Volume discount incentive (IFRS 15.IE124-IE128)

An entity enters into a contract with a customer on 1 January 20X8 to sell Product A for CU100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to CU90 per unit. Consequently, the consideration in the contract is variable.

For the first quarter ended 31 March 20X8, the entity sells 75 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 1,000-unit threshold required for the volume discount in the calendar year.

The entity considers the requirements in paragraphs 56–58 of IFRS 15 on constraining estimates of variable consideration, including the factors in paragraph 57 of IFRS 15. The entity determines that it has significant experience with this product and with the purchasing pattern of the entity. Thus, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (ie CU100 per unit) will not occur when the uncertainty is resolved (ie when the total amount of purchases is known). Consequently, the entity recognises revenue of CU7,500 (75 units x CU100 per unit) for the quarter ended 31 March 20X8.

In May 20X8, the entity's customer acquires another company and in the second quarter ended 30 June 20X8 the entity sells an additional 500 units of Product A to the customer. In the light of the new fact, the entity estimates that the customer's purchases will exceed the 1,000-unit threshold for the calendar year and therefore it will be required to retrospectively reduce the price per unit to CU90.

Consequently, the entity recognises revenue of CU44,250 for the quarter ended 30 June 20X8. That amount is calculated from CU45,000 for the sale of 500 units (500 units x CU90 per unit) less the change in transaction price of CU750 (75 units x CU10 price reduction) for the reduction of revenue relating to units sold for the quarter ended 31 March 20X8 (see paragraphs 87 and 88 of IFRS 15).

How we see it

We anticipate that entities may find it challenging to apply the constraint on variable consideration, especially determining when it is highly probable that a significant revenue reversal will not occur. Retail and consumer products entities will need to apply judgement and evaluate their specific facts and circumstances when implementing this aspect of the standard. Over time, best practices may emerge and application guidance may be needed to help entities apply the constraint.

5.2 Rights of return

Retail and consumer products entities typically provide rights of return to customers. The rights of return may be contractual, implicit due to 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). The Boards decided that standing ready to accept a returned product does not represent a performance obligation in a contract. Instead, the potential for customer returns is considered when an entity estimates the transaction price because potential returns are a component of variable consideration.

Consistent with current IFRS, the Boards determined 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 IFRS 15.

Under IFRS 15, an entity will estimate the transaction price and apply the constraint to that estimate. In doing so, it will consider the products expected to be returned to determine the amount to which it expects to be entitled (excluding the products expected to be returned). Retail and consumer products entities may find that the amount of estimated returns under the new standard is generally consistent with amounts estimated under current IFRS. However, entities may need to adjust their processes or update their documentation to appropriately apply the new requirements (e.g., an entity may need to adjust its calculation of expected returns to use an 'expected value' or 'most likely amount' method instead of calculating an amount based on historical returns).

Entities will recognise the amount of expected returns as a refund liability, representing their obligation to return the customer's consideration. Entities will also recognise a return asset (and adjust cost of sales) for the right to recover the goods returned by the customer. They will initially measure this asset at the former carrying amount of the inventory, less any expected costs to recover the goods. At the end of each reporting period, they will remeasure the refund liability and update the measurement of the refund asset for any revisions to the expected level of returns, as well as any potential decreases in the value of the returned products. That is, a returned item should be recognised at the lower of the original cost, less the cost to recover the asset, or the fair value of the asset at the time of recovery.

Under current IFRS, revenue is recognised at the time of sale for a transaction that provides a customer with a right of return, provided the seller can reliably estimate future returns. In addition, the seller is required to recognise a liability for the expected returns.

However, there may be some differences as IAS 18 does not specify the presentation of a refund liability and the corresponding debit.The new requirements requires the return asset to be recorded separately from inventory to provide greater transparency. It also requires the carrying value of the return asset (i.e., the product expected to be returned) to be subject to impairment testing on its own, separately from inventory on hand.

The new standard also requires the refund liability to be presented separately from the corresponding asset (on a gross basis, rather than a net basis). The return asset and refund liability are also subject to additional disclosure requirements.

Example 22 in the standard (IFRS 15.IE110-IE115) illustrates how to account for a right of return.

How we see it

Entities will have to assess whether their current models for estimating returns are appropriate given the required methods for estimating the transaction price (i.e., the expected value or the most likely amount method) and the requirement to apply the constraint on variable consideration. While the method for estimating expected returns may be different for some entities, the outcome may remain the same.

5.3 Price concessions and extended payment terms

Consumer products entities often offer price concessions to their customers. Under current IFRS, entities generally estimate the amount of price concessions to be offered based on past history and record it as a reduction of revenue. Under the new standard, an entity's intention, or willingness, at the outset of the arrangement to offer a price concession is a form of variable consideration. As such, it must be considered when estimating the transaction price.

An entity may have an established practice of providing price concessions or the entity enters into a contract with the expectation of collecting less than the stated contractual amount. If so, such actions may represent implied or granted concessions that should be reflected in the transaction price, rather than as bad debt expense. Example 23 in the standard (IFRS 15.IE116-IE123) illustrates the accounting for a price concession.

Extended payment terms will require consideration of whether the terms create variability in the transaction price and whether a significant financing component exists.

Consumer products entities may also provide extended payment terms to their customers. An entity will need to carefully evaluate contracts that include such terms to determine whether the entity has an intention, or a valid expectation, that it will provide a price concession over the financing term. Under IFRS 15, when a contract provides the customer with extended payment terms, an entity will need to consider whether those terms create variability in the transaction price and whether a significant financing component exists.[9] For example, a consumer product entity may have a business practice of providing price concessions in contracts that include extended payment terms in order to negotiate a contract renewal with customers. Such price concessions are a form of variable consideration, which are required to be estimated at contract inception and deducted from the transaction price.

[9] In the coming months, the TRG is expected to discuss whether an interest-free financing arrangement would contain a significant financing component. Retail and consumer products entities that offer such payment arrangements to their customers may want to monitor the TRG's discussions.

5.4 Consideration paid or payable to a customer

Many consumer products entities make payments to their customers. Common examples of consideration paid to a customer include:

- Slotting fees
- Co-operative advertising arrangements
- Buy downs or price protection
- Coupons and rebates
- 'Pay-to-play' arrangements
- Purchase of goods or services

In addition, some entities make payments to the customers of resellers or distributors that purchase directly from them. For example, manufacturers of breakfast cereals offer coupons to consumers, even though their direct customers are the grocery stores that sell on to end-customers. Furthermore, the promise to pay the consideration might be implied by the entity's customary business practice.

To determine the appropriate accounting treatment, an entity must first determine whether the consideration paid or payable to a customer is a payment for a distinct good or service, a reduction of the transaction price or a combination of both. In order for an entity to treat its payment to a customer as something other than a reduction of the transaction price, the good or service provided by the customer must be distinct.

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, therefore, revenue) is 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, taking into account the entity's customary business practices (i.e., the promise could be implied). This is true even when the payment is contingent upon a future event.

For example, if goods subject to a discount through a coupon are already delivered to the retailers, the discount would be recognised when the coupons are issued. However, if a coupon is issued that can be used with a new line of products that have not yet been sold to retailers, the discount would be recognised upon the sale of that product to the retailer.

If the consideration paid or payable to a customer includes variable consideration in the form of a discount or refund for goods or services provided, an entity will apply the variable consideration requirements. That is, it would use either an expected value method or a most likely amount method to estimate the amount to which the entity expects to be entitled and apply the constraint to the estimate to determine the estimate of the discount or refund. The entity must choose the estimation approach that it believes best predicts the revenue to which it expects to be entitled.

The standard includes the following example of consideration paid to a customer:

Extract from IFRS 15

Example 32 – Consideration Payable to a Customer (IFRS 15.IE160-IE162)

An entity that manufactures consumer goods enters into a one-year contract to sell goods to a customer that is a large global chain of retail stores. The customer commits to buy at least CU15 million of products during the year. The contract also requires the entity to make a non-refundable payment of CU1.5 million to the customer at the inception of the contract. The CU1.5 million payment will compensate the customer for the changes it needs to make to its shelving to accommodate the entity's products.

The entity considers the requirements in paragraphs 70–72 of IFRS 15 and concludes that the payment to the customer is not in exchange for a distinct good or service that transfers to the entity. This is because the entity does not obtain control of any rights to the customer's shelves. Consequently, the entity determines that, in accordance with paragraph 70 of IFRS 15, the CU1.5 million payment is a reduction of the transaction price.

The entity applies the requirements in paragraph 72 of IFRS 15 and concludes that the consideration payable is accounted for as a reduction in the transaction price when the entity recognises revenue for the transfer of the goods. Consequently, as the entity transfers goods to the customer, the entity reduces the transaction price for each good by 10 per cent (CU1.5 million ÷ CU15 million). Therefore, in the first month in which the entity transfers goods to the customer, the entity recognises revenue of CU1.8 million (CU2.0 million invoiced amount less CU0.2 million of consideration payable to the customer).

The requirements for recognising consideration payable to a customer appear to be inconsistent with the requirements to consider implied price concessions as variable consideration. The TRG discussed this issue in the January and March 2015 meetings and TRG members noted a conflict in the standard. That is, the standard requires entities to estimate all potential variable consideration and reflect it in the transaction price at contract inception and as the entity performs. However, the requirements for consideration payable to a customer indicate that such amounts are recognised as a reduction of revenue when the related sales are recognised or the entity makes the promise to provide such consideration, whichever is later. TRG members generally agreed that entities will reach different conclusions on the timing of recognition of certain incentives (e.g., new incentive programmes offered after a good or service is transferred to the customer), unless the standard is clarified.[10]

[10] *IFRS Developments* and *Applying IFRS* covering the discussions of the TRG are available on www.ey.com/ifrs

How we see it

Since consideration paid to a customer can take many forms, entities will have to carefully evaluate each transaction, or type of transaction, to determine the appropriate accounting treatment. Entities will also have to determine whether to incorporate consideration paid or payable to a customer in the transaction price at contract inception or at a later date.

IFRS 15's requirements for consideration payable to a customer are generally consistent with current IFRS. However, the requirement to determine whether a good or service is 'distinct' in order to treat the consideration payable to a customer as anything other than a reduction of revenue is new. While it is implied in many of the illustrative examples to IAS 18, it is not explicitly discussed in current IFRS. As such, some entities may need to reassess their current accounting treatment of consideration paid or payable to a customer.

6. Allocate the transaction price to the performance obligations

Once the performance obligations have been identified and the transaction price has been determined, an entity will allocate the transaction price to the performance obligations, generally in proportion to their stand-alone selling prices (i.e., on a relative stand-alone selling price basis), with limited exceptions. Firstly, the standard permits an entity to allocate variable consideration to one or more, but not all, performance obligations in some situations. Secondly, IFRS 15 contemplates the allocation of any discount in a contract to one or more, but not all, performance obligations, if specified criteria are met. The transaction price is not reallocated to reflect changes in stand-alone selling prices after contract inception.

When determining stand-alone selling prices, an entity must use observable information, if available. If stand-alone selling prices are not directly observable, an entity will need to make estimates based on information that is reasonably available. Possible estimation approaches include an adjusted market assessment approach, an expected cost plus a margin approach or a residual approach. An entity is required to apply estimation methods consistently in similar circumstances.

How we see it

The stand-alone selling prices for goods sold by retail and consumer products entities are often directly observable because many of the goods are regularly sold on a stand-alone basis.

7. Satisfaction of performance obligations

An entity recognises revenue only when it satisfies a performance obligation by transferring control of a promised good or service to the customer. Control may be transferred over time or at a point in time. A performance obligation is satisfied at a point in time unless it meets one of the following criteria for being satisfied over time:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date

When a performance obligation is satisfied over time, the standard requires an entity to select a single method, either an input method or an output method, to measure progress for each performance obligation that best depicts the pattern of the entity's performance in transferring the good or service.

For most retail and consumer products entities, revenue generally will be recognised at a point in time when the product is delivered (i.e., at the point in time when control is transferred to the customer). These entities also may provide services, for which revenue would be recognised when (or as) the service is performed.

7.1 Reseller and distributor arrangements

The new standard could change practice for entities that sell their products through distributors or resellers.

The standard could change practice for entities that sell their products through distributors or resellers (collectively, resellers). It is common for retail and consumer product entities to provide resellers with greater rights than end-customers in order to maintain a mutually beneficial relationship and maximise future sales opportunities through the reseller. For example, an entity may provide a reseller with price protection and extended rights of return.

Entities will need to evaluate when control of the product transfers to its customer. To do this, entities may need to first assess whether their contracts with resellers are consignment arrangements. Retail and consumer products entities frequently deliver inventory on a consignment basis to other parties (e.g., resellers, retailers). Shipping on a consignment basis helps consignors better market the products by moving them closer to the end–customer. However, they do so without selling the goods to the intermediary (consignee).

In the retail industry, consignment arrangements are typically described as 'scan-based trading'. The vendor's goods are showcased on a retailer's sales floor or website, but the vendor retains title of the goods until the product is sold to the end-customer (i.e., the point of sale). At that point, the retailer has an obligation to pay the vendor for the goods sold and the vendor recognises revenue.

Entities entering into a consignment arrangement must determine the nature of the performance obligation (i.e., whether the obligation is to transfer the inventory to the consignee or to transfer the inventory to the end-customer). Under IFRS 15, this determination is based on whether control of the inventory has passed to the consignee upon delivery. Typically, a consignor will not relinquish control of consignment inventory until the inventory is sold to the end-customer 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-upon portion of the sale price once the consignee sells the product to the end-customer.

As a result, revenue generally would not be recognised for consignment arrangements when the goods are delivered to the consignee because control has not transferred. In other words, the performance obligation to deliver goods to the end-customer has not yet been satisfied. The entity would wait until the reseller sells the product to an end-customer to recognise revenue, which would be considered the point in time that the entity has transferred control of the product. The result would be similar to IAS 18.14, which requires revenue to be recognised only when the significant risks and rewards of ownership have been transferred to the end-customer.

If an entity concludes that its contract with a reseller is not a consignment arrangement, the reseller will likely be considered a customer of the entity. The entity would be required to recognise revenue upon the transfer of control of the promised goods in the amount to which the entity expects to be entitled. Under current IFRS, some entities wait until the product is sold to the end-customer to recognise revenue because they do not meet all of the criteria in IAS 18 to recognise revenue when they deliver the product to the reseller. For example, if an entity cannot reliably measure the future price changes resulting from price protection that will be provided to the reseller, the amount of revenue would not be considered reliably measured. Therefore, revenue would not be recognised until the reseller sells the product to an end-customer.

In determining the amount to which they expect to be entitled, entities will be required to consider whether they will provide resellers with explicit or implicit concessions (e.g., price protection, expanded return rights, stock rotation rights) that will make the transaction price variable. In these instances, an entity will need to estimate the transaction price and, after applying the constraint, include only the amount for which the entity determines it is highly probable that a significant reversal will not occur. An entity will need to carefully consider whether it can include the variable consideration, resulting from the concessions it offers to its reseller customer(s), in its transaction price. IFRS 15 indicates that, if an entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances, it could increase the likelihood (or magnitude) of a revenue reversal. Entities will need to carefully assess the facts and circumstances of their contracts to determine whether the accounting treatment will change under IFRS 15.

The example below illustrates a consumer product entity's accounting treatment for products sold to a distributor network:

Illustration 7-1 — Sale of products to a distributor

BCB Liquors (BCB) uses a distributor network to supply its products to end-customers. Upon receipt of the products, the distributor receives legal title of the goods and is required to pay BCB for the product. Under their agreements with BCB, the distributors may return unsold product within 90 days. Once the distributors sell the products to the end-customer, BCB has no further obligations in relation to the products, and the distributors have no further return rights.

In this example, BCB has determined its relationship with the distributors is not a consignment agreement. That is, because the distributor has legal title to the products without any restrictions, an obligation to pay for the products when received and BCB cannot make distributors return the products, BCB determines that control has transferred to the distributor when the products are delivered. In addition, because BCB offers a right of return to the distributor, BCB would be required to estimate the transaction price (considering expected returns) and record a liability for the amount of returns expected during the 90-day return period.

Alternatively, if the distributors are not obligated to pay for the products received until they are sold to the end-customer and the distributors have the option to return any unsold products, BCB would conclude that control of the products does not transfer until they are sold to the end-customer. In that case, the contracts with the distributor would be consignment arrangements.

7.2 Gift card breakage

Retailers frequently sell gift cards that may not be partially or fully redeemed, and the unused amount (i.e., the amount attributable to a customer's unexercised rights to future goods or services) is often referred to as breakage. The Boards concluded that when an entity expects to be entitled to a breakage amount, it recognises the expected breakage as revenue in proportion to the pattern of rights exercised by the customer. Because breakage amounts represents a form of variable consideration, when estimating any breakage amount, an entity considers the constraint on variable consideration. That is, an entity does not recognise any estimated breakage amounts until it is highly probable that a significant revenue reversal will not occur.

Expected breakage is recognised as revenue in proportion to the pattern of rights exercised by the customer.

If an entity cannot determine whether breakage will occur, it does not recognise any amounts as breakage until the likelihood of the customer exercising its rights becomes remote. This may be the case when an entity first begins to sell gift cards and has no history of breakage patterns.

Furthermore, regardless of whether a retailer can demonstrate the ability to reliably estimate breakage, no such amounts are estimated and recognised as revenue if the unused balances of gift cards are subject to the unclaimed property laws of local authorities or jurisdictions.

The example below illustrates a contract with a single performance obligation (i.e., the sale of a gift card to a customer).

Illustration 7-2 — Gift card

Good Toys Ltd. (GTL), a toy store, sells a CU75 gift card to a customer. GTL's gift cards have no fees or expiration dates. For the purposes of this example, assume no jurisdictional unclaimed property laws apply.

GTL has sold gift cards for a number of years and has reliable historical evidence of breakage. Using an expected value approach, it estimates that 4% of gift card balances will not be redeemed by the customer. GTL evaluates the constraint on variable consideration and determines it is highly probable that a significant revenue reversal will not occur for the 4% estimated breakage amount.

At the point of sale of the gift card to the customer, GTL would record a contract liability of CU75. One week later, the customer returns to the store and uses the gift card to purchase CU48 worth of goods. GTL recognises CU48 of revenue at that time, with a corresponding decrease to the contract liability. In addition, GTL recognises estimated breakage revenue, with an offset to the contract liability, of CU2 at the time of redemption, calculated, as follows:

(4% X CU75) = CU3 total estimated breakage to be recognised

[CU48/(CU75-CU3)] = 67% estimated redemption to date

(CU3 X 67%) = CU2 breakage to be recognised at the time of redemption

GTL will continue to recognise revenue for breakage amounts as the remaining gift card balance is redeemed by the customer. Once GTL determines that the likelihood of the customer redeeming any remaining balance on the gift card is remote, GTL will recognise revenue and remove the contract liability for the remaining amount.

However, if the prepaid element (e.g., the sale of a gift card, loyalty points) is part of a multiple-element arrangement, it is unclear how the application guidance on breakage is meant to interact with the requirements for determining a stand-alone selling price. That is, the application guidance on breakage suggests that an entity establishes a liability for the full amount of the prepayment and recognises breakage on that liability proportionate to the revenue being recognised. This is straight-forward in contracts with only a single element (e.g., a retailer sells a gift card to a customer).

In multiple-element arrangements, the entity must determine the stand-alone selling price of each performance obligation, including the prepaid element. If the stand-alone selling price for the prepaid component is not directly observable (e.g., the price of loyalty points), the standard requires an entity to estimate it. In making this estimate, entities may take into consideration the likelihood that the customer ultimately will not request the services they have paid for in advance or the potential breakage, as shown in Example 52 in the standard (see Section 4.2 above). Considering the possible lack of redemption when estimating the stand-alone sales price will result in less revenue being allocated to the prepaid component.

How we see it

Retail and consumer product entities currently defer recognising revenue from breakage until the gift card expiration date or when an entity has enough experience to support a conclusion that it is unlikely the balances will be used for future purchases (in which case an estimate of breakage is recorded).

IFRS 15 requires entities to estimate breakage (if they are entitled to breakage) and include such amounts in their transaction price (after adjusting the amounts for the constraint on variable consideration, if necessary). Entities that currently estimate breakage may reach conclusions under the new standard that are similar to those they reach today. Entities that do not estimate breakage currently will face a change in practice when they implement the new standard.

7.3 Omni-channel considerations

As retailers enhance their supply chain by integrating online and mobile sales and inventory channels with traditional brick and mortar locations to create multiple sales channels (e.g., buy from the retailer's website/app or in its physical store), retailers will need to evaluate when control of their product transfers to the customer (i.e., at what point revenue should be recognised for the sale). Retailers will also need to evaluate whether the contract with the customer includes multiple performance obligations.

The example below illustrates the sale of products with multiple sales channels:

Illustration 7-3 –Omni-channel considerations

XYZ Retailer (XYZ), a discount retailer, offers a promotion for customers to purchase a DVD of a new movie ahead of its release to the general public for CU40. The promotion includes the DVD that customers may pick up in stores after the movie is released to the general public and a one-time, on-demand download (available for 24 hours after download) of the movie, which customers can download and view prior to obtaining the DVD version in stores.

Assume XYZ determines there are two performance obligations in the contract with a customer (the DVD and the download) and estimates a transaction price of CU40 (after applying the constraint). Because XYZ routinely sells new release DVDs to its customers, it determines the stand-alone selling price (i.e., observable price) for the DVD is CU30. In addition, through its online television and movie subscription business, XYZ routinely sells new release movies for download and, as a result, determines the stand-alone selling price for the one-time download is CU10. In this example, XYZ will recognise revenue based on the contract amount for each performance obligation because there is no discount in the arrangement.

At the time of purchase, XYZ does not recognise any revenue because XYZ has not satisfied either of its performance obligations. The recognition of the CU10 as revenue for the download of the movie would depend on the application guidance for distinct licences of intellectual property, discussed below. In addition, XYZ will recognise revenue of CU30 for the DVD when the customer obtains control of the physical product (DVD) at the store.

How we see it

Retail and consumer products entities that offer goods or services through multiple-delivery channels will need to consider the promised goods or services to determine whether multiple performance obligations exist. If more than one performance obligation exists, entities will need to determine the number of performance obligations and when each performance obligation has been satisfied (i.e., when revenue should be recognised).

8. Other measurement and recognition topics

8.1 Consideration received from a vendor for manufacturer coupons

Manufacturers will often offer sales discounts and incentives to end-customers on products that are sold through retailers (i.e., resellers). For example, a manufacturer offers a rebate or provides a coupon to the end-customer to stimulate demand for their products. Retailers may honour the manufacturer's incentives as a reduction of the price paid by end-customers and seek reimbursement for the incentive from the manufacturer.

Under IFRS 15, if a retailer receives full reimbursement from the manufacturer for the incentive it has given to the end-customers, the retailer will record the sale for the full selling price (i.e., the gross amount) of the product.

In instances in which the retailer does not obtain full reimbursement from the manufacturer (e.g., if the amount of reimbursement varies or is unknown as it is being negotiated with other incentives arrangements with the manufacturer), the transaction price for the sale of the product may include variable consideration. In these circumstances, retailers will need to factor the variability of the reimbursement arrangement with the manufacturer into the estimation of the transaction price for the products sold to the end-customer.

8.2 Licensing arrangements

An entity must determine whether a distinct IP licence transfers to the customer at a point in time or over time.

Many retail and consumer products entities grant licences of intellectual property (IP). These arrangements are typically royalty-based arrangements, under which the entity will provide a third party with a licence to use certain IP (e.g., trademarks, trade names, copyrights) in connection with the operation of a retail store or manufacture and sale of designated products. These contracts may include contractually guaranteed minimum royalty levels or specify that royalty payments will be based on a percentage of actual sales. Under current IFRS, entities generally record revenue from licensing arrangements when the royalties become due within the terms of the underlying contracts.

8.2.1 Sales and usage-based royalties

The standard provides explicit application guidance for recognising sales-based and usage-based royalties from licences of IP. Specifically, the standard creates an exception to the requirement to estimate variable consideration for transactions that involve sales and usage-based royalties resulting from the licences of IP. As a result, these amounts are only recognised at the later of when the sale or usage occurs or the performance obligations (to which some or all of the sales or usage-based royalties have been allocated) have been satisfied (or partially satisfied). This exception may result in an accounting treatment that is similar to current practice.

However, it was unclear how this exception will be applied to contracts that contain more than a licence of intellectual property. For example, it is unclear whether this exception will apply to royalties that relate to both licensed IP and other goods or services in a contract (e.g., a contract with two performance obligations, such as a distinct franchise licence and consulting or training services that would be provided over time and would affect the amount of royalties earned). The TRG discussed a number of views, including whether the exception applies solely to a licence that is a separate performance obligation. The TRG also discussed whether it applies regardless of whether the royalty also relates to a non-licenced good or service or relates to licensed IP that is bundled with another promised good or service in the arrangement.[11]

At the February 2015 joint board meeting, the Boards agreed to amend their standards to clarify when this exception applies to royalties arrangements in which the licence is not the only promise. The Boards agreed that the sales-based royalty exception would be applied to the overall royalty stream when the predominant item within the arrangement is the licence of IP. The Boards also agreed to amend the standards to clarify that a sales-based royalty in these types of arrangements would not be partially within the scope and partially outside the scope of the exception.[12]

8.2.2 Other licensing arrangements

For licensing arrangements that include other forms of consideration (e.g., a licence arrangement with a fixed fee or a guaranteed minimum in a sales-based royalty arrangement), an entity will first have to determine whether the licence of IP is distinct because IFRS 15 includes specific application guidance for distinct licences of IP. For licences that are not distinct, an entity will follow the general requirements in the standard to account for the bundled performance obligation (that contains a licence and at least one other good or service).

For distinct licences of IP, an entity must determine whether the licence transfers to the customer at a point in time or over time by considering the nature of the promise to the customer. The standard states that entities provide their customers with either:

- A right to access the entity's intellectual property as it exists throughout the licence period, including any changes to that intellectual property, which is recognised as revenue over time
- A right to use the entity's intellectual property as it exists at the point in time when the licence is granted, which is recognised as revenue at a point in time

A licence is a promise to provide a *right to access* if all of the following criteria are met:

- The contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights.
- The rights granted by the licence directly expose the customer to any positive or negative effects of the entity's activities.
- The entity's activities do not result in the transfer of a good or a service to the customer as those activities occur (i.e., they do not represent a separate performance obligation).

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11 *IFRS Developments* and *Applying IFRS* covering the discussions of the TRG is available on www.ey.com/ifrs

12 *IFRS Developments* Issue 102: Boards reach different decisions on some of the proposed changes to the new revenue standards.

The Boards noted in the Basis for Conclusions that the existence of a shared economic interest between the parties (e.g., sales or usage-based royalties) may be an indicator that the customer has a reasonable expectation that the entity will undertake such activities.[13]

If the licence does not meet all three criteria, the licence agreement provides a *right to use* the licence and the entity would recognise revenue at the point in time when the control of the licence transfers to the customer.

The example below illustrates the accounting for a licensing arrangement with a sales-based royalty.

Illustration 8-1 – Licensing arrangement (sales-based royalty)

SSR Co. (SSR), a soft drink company, enters in to a licensing arrangement with Fabrics Worldwide Inc. (FWI), an apparel company. The licensing arrangement permits FWI to use the SSR trademarked logo and tagline on a new line of FWI's T-shirts, hats, shorts and other apparel for a three-year period. As consideration, FWI pays SSR a one-off fee of CU1 million at the beginning of the licence term and an 11% sales-based royalty, calculated from the total quarterly sales of apparel items that include the SSR logo. The rights and terms granted by SSR to FWI under the agreement are similar to those granted by SSR in licensing arrangements with other apparel companies. FWI will provide updated sales data on a quarterly basis.

SSR has determined the licence is a distinct performance obligation. Assume for purposes of this example that SSR determines that the licence provides FWI with a right to access the IP (over time) based on the following considerations:

- SSR will undertake activities that will affect the IP to which FWI has rights.
- The rights granted by the licence directly expose FWI to positive or negative effects of changes in the activities on the IP.
- SSR activities do not transfer a separate good or service to FWI as those activities occur, even if FWI may benefit from the activities.

The upfront payment of CU1 million is recognised as the performance obligation (i.e., the licence) is satisfied, which is over the three-year contract period. The sales-based royalties (variable consideration) are excluded from the transaction price until the underlying sales occur, at which point, revenue from the sales-based royalties are recognised.

8.3 Upfront fees in franchising arrangements

Retailers and consumer products entities may have franchising arrangements from which they receive rent and royalties based on a percentage of sales, along with fees received upon opening a new restaurant or granting a new franchise term. Under current IFRS[14], entities generally recognise revenue from rent and sales-based royalties in the period earned (i.e., when sales occur). If a franchising arrangement includes non-refundable upfront fees, entities either: (1) record revenue from the non-refundable upfront fees when the entity has performed all initial services required (if the up-front fees are related to a separate element in the arrangement that is satisfied at the onset of the

[13] IFRS 15.BC413
[14] IAS 18.IE18

Entities must evaluate whether upfront fees relate to the transfer of a promised good or service.

arrangement); or (2) capitalise the upfront fee and recognise the revenue over the contract term or as other identified elements in the contract are satisfied.

Under IFRS 15, entities must evaluate whether upfront fees relate to the transfer of a promised good or service, which could represent an advance payment for future goods or services. Some entities may conclude that the non-refundable upfront fees are related to an initial service (i.e., a performance obligation) that is satisfied at the outset of the arrangement, for which revenue should be allocated and recognised. Others may conclude that the upfront fees received are not related to an initial service, but instead to performance obligations satisfied throughout the life of the franchise agreement.

Alternatively, entities may charge an upfront fee partly as compensation for activities that they must undertake to fulfil a contract (e.g., administrative or set-up activities) that do not transfer a good or service to a customer. For example, a retail or consumer products entity may need to perform various administrative tasks to set up a franchising agreement, such as marketing campaigns, which generally do not transfer a service to the customer as they are performed. The entity disregards such activities when measuring progress toward completion of a performance obligation.

IFRS 15 requires that upfront fees be assessed and allocated to the performance obligations in the contract. That is, treatment of the non-refundable upfront fees is no different from any other consideration received by the entity as part of the arrangement. The example below illustrates the accounting for a franchise arrangement with a non-refundable upfront fee.

Illustration 8-2 — Franchising arrangement with a non-refundable upfront fee

Foodie operates and franchises restaurants around the world. As part of its franchise agreement, Foodie requires a franchisee to pay a non-refundable upfront franchise fee of CU95,000 upon opening a restaurant and ongoing payment of royalties, based on a percentage of sales. As part of the franchise agreement, Foodie provides pre-opening services, including supply and installation of cooking equipment and cash registers, valued at CU30,000 (i.e., the stand-alone selling price of the pre-opening services). In addition, the franchise agreement includes a licence of IP (i.e., Foodie's trademark and trade name) to the franchisee. Assume that Foodie has determined the licence provides a right to access the IP (over time). Foodie has determined the stand-alone selling price of the licence is CU70,000. The franchise agreement has a term of 15 years.

Foodie evaluates the arrangement and determines it meets the criteria to be accounted for as a contract with a customer. Foodie determines its pre-opening services and licence of IP are each distinct and, therefore, need to be accounted for as separate performance obligations. Foodie recognises CU28,500 [(CU30,000 / CU100,000) × CU95,000] as revenue at the point in time when the performance obligation to supply and install cooking equipment and cash registers is satisfied. Foodie will recognise revenue associated with the licensed IP, CU66,500 [(CU70,000 / CU100,000) × CU95,000], rateably over the 15-year licence term (i.e., the period of time the franchisee will have to the right to access Foodie's IP), as the entity determined the licence provided a right to access the IP over the licence term.

8.4 Warranty arrangements

Retail and consumer products entities often sell products with warranties, which can be either explicitly stated in the contract or implied, based on the entity's customary business practices. The new revenue standard identifies two types of warranties:

- Warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract (i.e., service-type warranties)
- Warranties that promise the customer that the delivered product is as specified in the contract (i.e., assurance-type warranties)

8.4.1 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 distinct service and is a separate performance obligation. Therefore, the entity allocates a portion of the transaction price to the warranty, based on its estimated stand-alone selling price. The entity recognises the revenue allocated to the warranty over the period in which the warranty service is provided. The entity may need to exercise judgement to determine the appropriate pattern of revenue recognition associated with a service-type warranty.

8.4.2 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 guarantee of quality. Under the standard, these types of warranties are accounted for as warranty obligations and the estimated cost of satisfying them is accrued in accordance with the requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Once recorded, the warranty liability is assessed on an ongoing basis to ensure that changes in the seller's environment or obligations are reflected in the recorded liability. The liability is adjusted (with the offset recorded as an adjustment to costs of sales) as changes in estimates occur.

8.4.3 Contracts that contain both assurance and service-type warranties

Retail and consumer products entities may enter into contracts that include both assurance-type and service-type warranties. If an entity provides both types of warranties within a contract, it accrues the expected costs associated with the assurance-type warranty and defers the revenue for the service-type warranty.

If the entity cannot reasonably account for assurance-type and service-type warranties within a contract separately, the warranties are accounted for as a single performance obligation (i.e., revenue would be allocated to the combined warranty and recognised over the period the warranty services are provided).

The example below illustrates the accounting for a contract with a service-type and assurance-type warranty:

Illustration 8-3 — Service-type and assurance-type warranty — consumer products entity

Toolco (TUL), a tool manufacturer, sells 100 cordless electric drills to HWS Hardware Store (HWS) for CU50 each. Each drill costs TUL CU35. TUL includes a warranty with the sale of each drill to a customer, which provides for full replacement of the drill if it fails to work properly within two years of the date of purchase by the consumer. TUL considers any defects in the drills that arise within 90 days of the date of purchase by the consumer to be a failure to comply with the agreed-upon specifications (i.e., related to a defect that existed at the time of sale). TUL considers the warranty it provides beyond the first 90 days to be a distinct service.

In this example, TUL provides both an assurance-type warranty (the warranty covering defects in the first 90 days after the sale) and a service-type warranty (the warranty covering defects arising during the remainder of the two-year warranty period).

The total transaction price for the sale of a drill and the service-type warranty is CU50. TUL estimates the stand-alone selling price of each is CU40 and CU10, respectively. Based on past experience, TUL also estimates that 2% of all electric drills it sells will fail to comply with agreed-upon specifications within the first 90 days, which will require TUL to replace the drills (at a cost of CU35 per drill).

TUL records the following journal entry to record the sale of 100 drills to HWS and the related warranty liabilities:

Dr. Cash/receivables	CU5,000	
Dr. Warranty expense	CU70	
Cr. Revenue		CU4,000
Cr. Warranty liability (assurance-type warranty)		CU70
Cr. Contract liability (service-type warranty)		CU1,000

TUL also records the following journal entry to record the cost of sales and the derecognition of inventory:

Dr. Cost of sales	CU3,500	
Cr. Inventory		CU3,500

TUL will recognise the warranty liability for the assurance-type warranty as actual warranty costs are incurred (to replace the defective drills) during the initial 90-day quality-assurance period. For the service-type warranty, TUL will derecognise the contract liability and recognise revenue over the 21-month warranty period that follows the initial 90-day quality assurance period (presumably on a straight-line basis over the period, unless a different pattern is expected). Costs associated with providing the service-type warranty will be expensed as incurred.

8.4.4 Statutory warranties and product liability laws

It is common in some jurisdictions that local legislation require entities to provide warranties with the sale of its products for the protection of consumers' interests. The laws may require a retailer or manufacter to repair or replace products that develop faults within a specified period from the time of sale. These statutory warranties may appear to be service-type warranties because they cover faults arising some time after purchase, not just defects existing at the time of sale. The Boards clarified in the Basis for Conclusions that such laws must be viewed as operationalising an assurance-type warranty and serve to protect consumers against the risk of purchasing a defective product.[15]

The Boards also noted that product liability laws, which may require an entity to pay compensation if one of its products causes harm or damage, would not give rise to performance obligations. An entity's performance obligation in transactions with customers is the transfer of the product to the customer. Any obligation arising from damage or harm caused by its product would be accounted for in accordance with the requirements for contingent liabilities in IAS 37.[16]

How we see it

Retail and consumer products entities may need to exercise significant judgement when determining whether a warranty is an assurance-type or service-type warranty. This evaluation may be affected by several factors, including common warranty practices within the industry. For example, a manufacturer of televisions may provide a three-year warranty on its high-end 3D HD televisions and a one-year warranty on its low-end plasma televisions. The manufacturer may conclude that the longer warranty period on the high-end televisions is not an additional service because it believes the materials used to construct them are of higher quality and defects would take longer to appear. In contrast, the manufacturer might compare the warranty with those offered by its competitors and conclude the three-year warranty period, or some portion of it, is an additional service that should be accounted for as a service-type warranty.

Retail and consumer products entities may also find it challenging to estimate the stand-alone selling price of a service-type warranty if the warranty is not sold separately.

[15] IFRS 15.BC377

[16] IFRS 15.BC378

9. Disclosures

In response to criticism that revenue recognition disclosures in current IFRS and US GAAP are inadequate, the Boards sought to create a comprehensive and coherent set of disclosures. As a result, and to be consistent with other recent standards, IFRS 15 includes an overall objective for these disclosures, as follows:

Extract from IFRS 15

110. The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

a. its contracts with customers (see paragraphs 113–122);
b. the significant judgements, and changes in the judgements, made in applying this Standard to those contracts (see paragraphs 123–126);

   and
c. any assets recognised from the costs to obtain or fulfil a contract with a customer in accordance with paragraph 91 or 95 (see paragraphs 127–128).

During the development of IFRS 15, many preparers raised concerns that they would need to provide voluminous disclosures at a cost that may outweigh any potential benefits. In IFRS 15, the Boards clarified the disclosure objective and indicated that the disclosures described in the standard are not meant to be a checklist of minimum requirements. That is, entities do not need to include disclosures that are not relevant or are not material to them.

The annual and interim disclosure requirements, as well as consisderation of the disclosures required upon adoption of the new standard, are discussed further in Section 9 *Presentation and Disclosure* of our general publication.

10. Next steps

We encourage retail and consumer products entities to gain an understanding of the new standard and evaluate how it will affect their specific revenue recognition policies and practices.

Entities should perform a preliminary assessment of how they will be affected as soon as possible so that they can determine how best to prepare for implementation of the new standard.

While the effect on entities will vary, some may face significant changes in revenue recognition. All entities will need to evaluate the requirements of the standard and make sure they have processes, systems and controls in place to collect the necessary information to implement it, even if their accounting results may not change significantly.

Entities may also wish to monitor the discussions of the Boards and the TRG to discuss the application of the new standard to common transactions.

Separately, the American Institute of Certified Public Accountants (AICPA) has established 16 industry task forces to help develop a new accounting guide on revenue recognition under US GAAP and to aid industry stakeholders in implementing the standard. Entities may wish to monitor ongoing developments and discussions. Any guidance produced by the AICPA is non-authoritative. Although there is not an industry task force established for retail and consumer products entities, some of the discussions could be relevant for retail and consumer products entities.[17]

Entities should also consider how they will communicate the changes with investors and other stakeholders, including their plan for disclosures about the effects of IFRS 15 required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Entities' disclosures should evolve in each reporting period as more information becomes available.

The EY Thought Center hosted a retail and consumer products sector-specific webcast on the new revenue recognition on 18 November 2014. To access the archived version of the webcast, visit http://www.ey.com/GL/en/Issues/Thought-center-webcasts.

[17] For more information see http://www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/pages/revenuerecognition.aspx

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