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Rising to the challenge

When the IASB and FASB published their new revenue standard in 2014, we predicted that the real work was just beginning. And that has proven to be the case.

The past two years have seen companies wrestle with implementation issues. In response, the Boards have issued their substantive amendments to the new standard and deferred the effective date to 2018.

While helping our clients to navigate through this period, we’ve gained extensive insight and hands-on experience in the United States and globally. And we are delighted to share our experience with you in this second edition of Revenue – Issues In-Depth. It’s almost twice as long as the first edition, with more examples and discussion of the areas that companies have found most complex, as well as the latest IASB and FASB developments.

Many companies have been surprised at the length and complexity of the assessment and implementation phases for the new revenue standard. If you have not already made a start, it’s time to engage – to meet the expectations of stakeholders and regulators.

Whether you are just making a start or well advanced in your implementation project, use this publication to help you navigate the complexities of this standard.

Please speak to your usual KPMG contact if you are facing implementation challenges or would like to discuss any other accounting issues.

Brian K. Allen
Prabhakar Kalavacherla (PK)
Paul H. Munter
Brian O’Donovan
Anne Schurbohm

KPMG Global and US Revenue Recognition Leadership Teams
1 Key facts

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

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

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

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

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

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

The following table lists the mandatory effective date and early adoption provisions of the new standard for IFRS and US GAAP entities.
The impact of the new standard will vary by industry. Those steps of the model that are most likely to affect the current practice of certain industries are summarized below.

<table>
<thead>
<tr>
<th>Industry</th>
<th>Step</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Aerospace and defense</td>
<td>✓</td>
</tr>
<tr>
<td>Asset managers</td>
<td></td>
</tr>
<tr>
<td>Building and construction</td>
<td></td>
</tr>
<tr>
<td>Contract manufacturers</td>
<td></td>
</tr>
<tr>
<td>Health care (US)</td>
<td>✓</td>
</tr>
<tr>
<td>Licensors (media, life sciences,</td>
<td>✓ *</td>
</tr>
<tr>
<td>franchisors)</td>
<td></td>
</tr>
<tr>
<td>Real estate</td>
<td>✓</td>
</tr>
<tr>
<td>Software</td>
<td>✓</td>
</tr>
<tr>
<td>Telecommunications (mobile</td>
<td></td>
</tr>
<tr>
<td>networks, cable)</td>
<td></td>
</tr>
</tbody>
</table>

* In particular, life sciences.

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

Revenue may be recognized at a point in time or over time
Entities that currently use the stage-of-completion/percentage-of-completion or proportional performance method will need to reassess whether to recognize revenue over time or at a point in time. If they recognize it over time, then the manner in which progress toward completion is measured may change. Other entities that currently recognize revenue at a point in time may now need to recognize it over time. To apply the new criteria, an entity will need to evaluate the nature of its performance obligations and review its contract terms, considering what is legally enforceable in its jurisdiction.

Revenue recognition may be accelerated or deferred
Compared with current accounting, revenue recognition may be accelerated or deferred for transactions with multiple components, variable consideration, or licenses. Key financial measures and ratios may be impacted, affecting analyst expectations, earn-outs, compensation arrangements, and contractual covenants.

Revisions may be needed to tax planning, covenant compliance, and sales incentive plans
The timing of tax payments, the ability to pay dividends in some jurisdictions, and covenant compliance may all be affected. Tax changes caused by adjustments to the timing and amounts of revenue, expenses, and capitalized costs may require revised tax planning. Entities may need to revisit staff bonuses and incentive plans to ensure that they remain aligned with corporate goals.

Sales and contracting processes may be reconsidered
Some entities may wish to reconsider current contract terms and business practices – e.g. distribution channels – to achieve or maintain a particular revenue profile.

IT systems may need to be updated
Entities may need to capture additional data required under the new standard – e.g. data used to make revenue transaction estimates and to support disclosures. Applying the new standard retrospectively could mean the early introduction of new systems and processes, and potentially a need to maintain parallel records during the transition period.

New estimates and judgments will be required
The new standard introduces new estimates and judgmental thresholds that will affect the amount or timing of revenue recognized. Judgments and estimates will need updating, potentially leading to more financial statement adjustments for changes in estimates in subsequent periods.
Accounting processes and internal controls will need to be revised

Entities will need processes to capture new information at its source – for example, executive management, sales operations, marketing, and business development – and to document it appropriately, particularly as it relates to estimates and judgments. Entities will also need to consider the internal controls required to ensure the completeness and accuracy of this information – especially if it was not previously collected.

Extensive new disclosures will be required

Preparing new disclosures may be time-consuming, and capturing the required information may require incremental effort or system changes. There are no exemptions for commercially sensitive information. In addition, IFRS and SEC guidance require entities to disclose the potential effects that recently issued accounting standards will have on the financial statements when adopted.

Entities will need to communicate with stakeholders

Investors and other stakeholders will want to understand the impact of the new standard on the overall business – probably before it becomes effective. Areas of interest may include the effect on financial results, the costs of implementation, expected changes to business practices, the transition approach selected, and, whether they intend to early adopt.
Putting the new standard into context

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

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

Organization of the text

The following diagram highlights the layout of the new standard and provides the corresponding sections in this publication. Within each section we generally provide an overview, the requirements of the new standard, examples, our observations, comparisons with current IFRS and US GAAP guidance, and key differences between IFRS and US GAAP, if any.
Guidance referenced in this publication

This publication considers the requirements of IFRS 15 Revenue from Contracts with Customers and FASB ASU 2014-09, Revenue from Contracts with Customers (FASB ASC Topic 606), originally published jointly in May 2014, and subsequently amended for clarifications. This publication reflects the amendments to FASB ASC Topic 606 made by ASU 2016-08, Principal versus Agent Considerations (Reporting Revenue Gross versus Net), ASU 2016-10, Identifying Performance Obligations and Licensing, and ASU 2016-12, Narrow Scope Improvements and Practical Expedients. This publication also includes as Future developments, discussion of other FASB standard-setting projects and technical correction proposals that may further clarify certain requirements.

For specific provisions of the revenue recognition guidance, KPMG summarizes the requirements, identifies differences between IFRS and US GAAP, and identifies KPMG’s observations. Neither this publication nor any of KPMG’s publications should be used as a substitute for reading the standards and interpretations themselves.

References in the left hand margin of this publication relate to guidance issued as at May 6, 2016. Future developments are based on information as at May 6, 2016 and may be subject to changes. A list of the guidance referenced in this publication is available in the appendix ‘Guidance referenced in this publication’.

Authoritative portions of the new standard

The new standard includes:

– core requirements, including scope, recognition, measurement, disclosure, and presentation;

– additional guidance that is labeled ‘application guidance’ in the IFRS version of the new standard and ‘implementation guidance’ in the US GAAP version (referred to as application guidance in this publication);

– illustrative examples;

– consequential amendments to other guidance (other standards in IFRS and other Codification Topics in US GAAP); and

– a basis for conclusions.

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

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

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

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

<table>
<thead>
<tr>
<th>Portion of the new standard</th>
<th>IFRS</th>
<th>US GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Core requirements (e.g. 606-10-05-1 to 606-10-50-23 IFRS 15.1 – 15.129)</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Application/implementation guidance</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Illustrative examples</td>
<td>✗</td>
<td>✔️</td>
</tr>
<tr>
<td>Consequential amendments to other guidance</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Basis for conclusions</td>
<td>✗</td>
<td>✗</td>
</tr>
</tbody>
</table>

**Key:**
- ✔️ Authoritative
- ✗ Nonauthoritative
Summary of key differences between IFRS and US GAAP

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

<table>
<thead>
<tr>
<th></th>
<th>IFRS</th>
<th>US GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Collectibility threshold</strong>&lt;br&gt;(see 5.1.1)</td>
<td>‘Probable’ means ‘more likely than not’</td>
<td>‘Probable’ means ‘likely’</td>
</tr>
<tr>
<td><strong>Collectibility criterion</strong>&lt;br&gt;(see 5.1.1)</td>
<td>No equivalent guidance</td>
<td>Collectibility is assessed for the goods or services that will be transferred to the customer rather than for all promised goods or services</td>
</tr>
<tr>
<td><strong>Contracts that do not meet the Step 1 criteria</strong>&lt;br&gt;(see 5.1.3)</td>
<td>No equivalent guidance</td>
<td>A contract is considered terminated – and therefore revenue can be recognized for consideration received – when an entity has stopped delivering goods or services</td>
</tr>
<tr>
<td><strong>Immaterial goods or services</strong>&lt;br&gt;(see 5.2)</td>
<td>No equivalent guidance</td>
<td>Goods or services that are immaterial in the context of the contract need not be identified as performance obligations</td>
</tr>
<tr>
<td><strong>Shipping and handling activities</strong>&lt;br&gt;(see 5.2)</td>
<td>No equivalent policy election</td>
<td>An accounting policy election to treat shipping and handling activities undertaken by the entity after the customer has obtained control of the related goods as a fulfillment activity</td>
</tr>
<tr>
<td><strong>Noncash consideration</strong>&lt;br&gt;(see 5.3.3)</td>
<td>Judgment is required to determine the measurement date for noncash consideration</td>
<td>Noncash consideration is measured at contract inception</td>
</tr>
<tr>
<td><strong>Licenses</strong>&lt;br&gt;(see 8.3)</td>
<td>Different guidance on determining the nature of a distinct license</td>
<td></td>
</tr>
<tr>
<td>606-10-32-2A</td>
<td><strong>Sales taxes (see 10.3)</strong></td>
<td>IFRS</td>
</tr>
<tr>
<td>340-40-35-6</td>
<td>Reversal of previously impaired contract acquisition and contract fulfillment costs for a change in facts and circumstances (see 6.4)</td>
<td>IFRS</td>
</tr>
<tr>
<td>270-10-50-1A</td>
<td>Interim disclosures (see 12.2)</td>
<td>IFRS</td>
</tr>
<tr>
<td>606-10-50-7, 50-11, 50-16, 50-21, 340-40-50-4</td>
<td>Reduction of disclosure requirements for ‘all other entities’ (see 12.3)</td>
<td>IFRS</td>
</tr>
<tr>
<td>606-10-65-1</td>
<td>Effective date and transition (see 13.1)</td>
<td>IFRS</td>
</tr>
</tbody>
</table>
3 Putting the new standard into context

<table>
<thead>
<tr>
<th>Effective date and transition (see 13.1) (continued)</th>
<th>IFRS</th>
<th>US GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Early adoption permitted</td>
<td></td>
<td>Early adoption permitted but not before annual periods beginning after December 15, 2016</td>
</tr>
<tr>
<td>Date of application of the contract modification practical expedient is:</td>
<td></td>
<td>Date of application of the contract modification practical expedient is the date of initial application</td>
</tr>
<tr>
<td>– beginning of the earliest period presented; or</td>
<td></td>
<td></td>
</tr>
<tr>
<td>– date of the initial application</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Completed contract for the purposes of transition is a contract for which the entity has transferred all of the goods or services identified</td>
<td>Completed contract for the purposes of transition is a contract for which all (or substantially all) of the revenue was recognized under current GAAP</td>
<td></td>
</tr>
</tbody>
</table>

SEC guidance

This publication contains comparisons to current US GAAP, including the SEC’s guidance on revenue recognition. Although the new standard supersedes substantially all of the existing revenue recognition guidance issued by the FASB and included in the Codification, it does not supersede the SEC’s guidance for registrants. The SEC has rescinded certain observer comments and will continue to evaluate its guidance and determine which guidance may be relevant under the new standard, requires revision or will be rescinded.

Transition Resource Group for revenue recognition

The IASB and the FASB’s Joint Transition Resource Group for Revenue Recognition (TRG) was formed for the purpose of:

– soliciting, analyzing, and discussing stakeholder issues arising from the implementation of the new standard;

– informing the IASB and the FASB about implementation issues that will help the Boards determine what action, if any, will be needed to address them; and

– providing a forum for stakeholders to learn about the new guidance from others involved with implementation.

The TRG advises the Boards, but does not have standard-setting authority. The members of the TRG include auditors, financial statement preparers, and users from various industries and geographies (both United States and international), and both public and private companies and organizations. Others who attend and participate in the meeting as observers include the IASB and FASB Board members and staff, the PCAOB, the SEC, AICPA, and IOSCO. The TRG had its first meeting in July 2014 and held six joint meetings since that time. During these meetings more than 50 issues were addressed with some resulting in the amendments issued in early 2016 by both the IASB and FASB.

The IASB announced in January 2016 that it does not plan to schedule any further TRG meetings with IFRS constituents as they believe it is important for stakeholders to move forward with adoption of the standard without concern that the standard is subject to change. The FASB will continue to address implementation issues through TRG meetings with US GAAP constituents and scheduled three meetings for 2016, with the first having occurred on April 18, 2016.

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

The IASB will continue to collaborate with the FASB and monitor their TRG discussions but they noted that companies reporting under IFRS are not required to consider pronouncements or public discussions of the FASB. However, the SEC's Chief Accountant noted that SEC registrants, whether domestic or foreign, should monitor TRG discussions and meeting minutes to inform their selection and implementation of reasonable revenue recognition policies, whether established under US GAAP or IFRS.

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

---

4

Scope

Overview

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

In some cases, the new standard will be applied to part of a contract or, in certain circumstances, to a portfolio of contracts.

4.1 In scope

Requirements of the new standard

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

Contract

Entity

Goods and services

Consideration

Customer

Example 1 – Identifying in-scope contracts

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

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

Requirements of the new standard

The new standard does not apply to:

- lease contracts;
- insurance contracts (for US GAAP, insurance contracts in the scope of ASC Topic 944);
- financial instruments and other contractual rights or obligations in the scope of other specific guidance (because of the differences between IFRS and US GAAP, the standards that are not in the scope of the new revenue standard are not identical);
- guarantees (other than product or service warranties); and
- non-monetory exchanges between entities in the same line of business that facilitate sales to customers other than the parties to the exchange.

Differences between IFRS and US GAAP

Insurance contracts

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

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

The current insurance industry guidance under US GAAP also provides guidance to insurance entities on the accounting for investment contracts that do not subject the insurance entity to insurance risk.
4.2 Out of scope

Future developments in US GAAP

The FASB is expected to propose an amendment to the new standard to specify that contracts (not only insurance contracts) that are in the scope of the current insurance industry guidance be excluded from the scope of the new standard. As of the date of this publication, the FASB has not issued final guidance.

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

Guarantees

The new standard scopes out guarantees. The US GAAP version of the new standard specifies that guarantees (other than product or service warranties) are scoped out because they are covered in a stand-alone ASC Topic. However, the IFRS version of the new standard scopes out financial guarantees indirectly by scoping out rights and obligations that are in the scope of the financial instruments guidance in IFRS, which includes guidance on financial guarantees.

This difference in scoping may result in certain nonfinancial guarantees being outside the scope of the new standard for US GAAP but in scope for IFRS.

Gaming contracts

There is a difference between IFRS and US GAAP about whether certain gaming contracts are in the scope of the new revenue standard. The difference relates to fixed-odds wagering contracts in which the gaming entity takes a position against the customer – e.g. some sports betting contracts.

Under IFRS, unsettled positions generally meet the definition of a derivative, rather than the definition of a contract with a customer to provide goods or services. Therefore, these contracts are in the scope of the financial instruments guidance and out of the scope of the new revenue standard.

However, under current US GAAP, these contracts are not generally treated as financial instruments. Instead, industry-specific guidance defines gross gaming revenues as the net win from gaming activities. Although the new revenue standard supersedes that industry-specific guidance, the FASB did not intend to change current industry practice.

Future developments in US GAAP

The FASB is expected to propose creating a new Subtopic 924-815, "Entertainment – Casinos – Derivatives and Hedging," that would include a scope exception from derivatives guidance for fixed-odds wagering contracts of entities within Topic 924’s scope. As of the date of this publication, the FASB has not issued final guidance.
Credit card fees

US GAAP has specific guidance on the accounting for credit card fees (e.g. the annual up-front fee) that was not superseded by the new standard. IFRS does not contain any specific guidance therefore credit card fees are in the scope of the new standard under IFRS, but generally are not under US GAAP.

Observations

Guidance included for product and service warranties

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

Contributions

A contribution is a nonreciprocal transfer of cash or other assets, rather than an exchange transaction – i.e. it is not given in exchange for goods or services that are an output of the entity’s ordinary activities. Accordingly, contributions are not transactions with a customer, because a customer is defined in the new revenue standard as a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration. Therefore, contributions are not in the scope of the new revenue standard.

A not-for-profit entity may enter into some transactions that are contributions, and others that are not. A not-for-profit entity therefore needs to evaluate which, if any, of its transactions are either fully or partially in the scope of the new revenue standard.

Comparison with current IFRS

Similar scope despite some differences in explicit exemptions

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

Guidance on dividends moved to financial instruments standard

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

Requirements of the new standard

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

The following flow chart highlights the key considerations when determining the accounting for a contract that is partially in the scope of the new standard.
The new standard excludes from its scope contracts with a collaborator or a partner that are not customers, but rather share with the entity the risks and rewards of participating in an activity or process. However, a contract with a collaborator or a partner is in the scope of the new standard if the counterparty meets the definition of a customer for part or all of the arrangement. Accordingly, a contract with a customer may be part of an overall collaborative arrangement and the new standard is applied to that part.
Example 2 – Zero residual amount after applying other accounting requirements

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

This conclusion may change if Bank A also charges a monthly fee.

Example 3 – Collaborative agreement

Biotech X has an arrangement with Pharma Y to research, develop, and commercialize a drug candidate. Biotech X is responsible for the research and development (R&D) activities, while Pharma Y is responsible for the commercialization of the drug candidate. Both Biotech X and Pharma Y agree to participate equally in the results of the R&D and commercialization activities.

Because the parties are active participants and share in the risks and rewards of the end product – i.e. the drug – this is a collaborative arrangement. However, there may be a revenue contract within the overall collaborative arrangement (see ‘Observations’ and ‘Comparison with current US GAAP’, below).

Observations

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

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

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

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

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

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

Parts of the new standard apply to sales of nonfinancial assets

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

Comparison with current IFRS

Guidance on financial services fees that are retained

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

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

Comparison with current US GAAP

Separation and initial measurement

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

Gas-balancing agreements

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

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

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

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

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

This guidance is not superseded or amended by the new standard. However, the guidance on presentation refers entities to other authoritative literature or, if there is no appropriate analogy, suggests that they apply a reasonable, rational, and consistently applied accounting policy election. The guidance does not address the recognition and measurement of collaborative arrangements. Collaborative arrangements with parties that are not customers are excluded from the scope of the new standard. However, collaborative arrangements could be in the scope of the new standard if the counterparty meets the definition of a customer for some or all of the terms of the arrangement. If so, then the new standard applies to the aspect of the arrangement for which the other party is a customer.

**Alternative revenue programs**

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

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

Requirements of the new standard

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

Observations

Entities need to consider costs versus benefits of portfolio approach

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

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

No specific guidance on assessing whether portfolio approach can be used

The portfolio approach can be applied to both contract revenues and costs. The new standard includes illustrative examples in which the portfolio approach is applied, including for rights of return and breakage. However, it does not provide specific guidance on how an entity should assess whether the results of a portfolio approach would differ materially from applying the new standard on a contract-by-contract basis.
5

The model

5.1 Step 1: Identify the contract with a customer

Overview

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

5.1.1 Criteria to determine whether a contract exists

Requirements of the new standard

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

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

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

- ... collection of consideration is probable*
- ... it has commercial substance
- ... rights to goods or services and payment terms can be identified
- ... it is approved and the parties are committed to their obligations

* The threshold differs under IFRS and US GAAP due to different meanings of the term ‘probable’.
In making the collectibility assessment, an entity considers the customer’s ability and intention (which includes assessing its creditworthiness) to pay the amount of consideration when it is due. This assessment is made after taking into account any price concessions that the entity may offer to the customer (see 5.3.1).

If the criteria are not initially met, then an entity continually reassesses the contract against them and applies the requirements of the new standard to the contract from the date on which the criteria are met. Any consideration received for a contract that does not meet the criteria is accounted for under the requirements in 5.1.3.

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

Example 4 – Assessing the existence of a contract – Sale of real estate

In an agreement to sell real estate, Seller X assesses the existence of a contract. In making this assessment, Seller X considers factors such as:

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

If Seller X concludes that it is not probable that it will collect the amount to which it expects to be entitled, then a contract to transfer control of the real estate does not exist. Instead, Seller X applies the guidance on consideration received before concluding that a contract exists (see 5.1.3), and initially accounts for any cash collected as a deposit (liability).
Example 5 – Assessing the existence of a contract – No written sales agreement

Shoe Manufacturer A holds products available to ship to customers before the end of its current fiscal year. Shoe Store B places an order for the product, and Shoe Manufacturer A delivers the product before the end of its current fiscal year.

Shoe Manufacturer A generally enters into written sales agreements with this class of customer that require the signatures of the authorized representatives of both parties. Shoe Manufacturer A prepares a written sales agreement, and its authorized representative signs the agreement before the end of the year. Shoe Store B does not sign the agreement before the end of Shoe Manufacturer A’s fiscal year. However, Shoe Store B’s purchasing department has orally agreed to the purchase and stated that it is highly likely that the contract will be signed in the first week of Shoe Manufacturer A’s next fiscal year.

After consulting its legal counsel and obtaining a legal opinion, Shoe Manufacturer A determines that based on local laws and legal precedent in Shoe Store B’s jurisdiction, Shoe Store B is legally obliged to pay for the products shipped to it under the agreement, even though Shoe Store B has not yet signed the agreement.

Therefore, Shoe Manufacturer A concludes that a contract exists and applies the general requirements of the new standard to sales made under the agreement up to the year-end.

Example 6 – Collectibility threshold – Assessment based on goods or services to be transferred

Company C contracts with Customer D to sell 1,000 units for a fixed price of 1,000,000. Customer D has a poor payment history and often seeks price adjustments after receiving orders and so Company C assesses that it is probable it will only collect 70% of the amounts due under the contract.

Based on its assessment of the facts and circumstances, Company C expects to provide an implicit price concession and accept 70% of the fixed price from Customer D. When assessing whether collectibility is probable, Company C assesses whether it expects to receive 700,000, which is the amount after the expected implicit price concession.

On subsequent re-assessment, if Company C expects to collect more than 700,000, then it recognizes the excess as revenue. If Company C subsequently assesses it will collect less than 700,000, then the shortfall is recognized as a bad debt expense, which is measured using the guidance on impairment of receivables. If Company C determines it has granted an additional price concession, then the shortfall would be a reduction of transaction price and revenue.
5.1 Step 1: Identify the contract with a customer

Observations

**Assessment focuses on enforceability, not form of the contract**

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

However, although the contract has to create enforceable rights and obligations, some of the promises in the contract to deliver a good or service to the customer may be considered performance obligations even though they are not legally enforceable (see 5.2).

**Collectibility is only a gating question**

Under current requirements, an entity assesses collectibility when determining whether to recognize revenue. Under the new standard, the collectibility criterion is included as a gating question designed to prevent entities from applying the revenue model to problematic contracts and recognizing revenue and a large impairment loss at the same time.

This change is unlikely to have a significant effect for most industries. However, the criterion will replace specific US GAAP guidance for health care entities and real estate transactions (see “Comparison with current US GAAP”, below).

**Collectibility is assessed based on the amount the entity expects to receive in exchange for goods or services**

The collectibility threshold is applied to the amount to which the entity expects to be entitled in exchange for the goods and services that will be transferred to the customer, which may not be the stated contract price. The assessment considers:

– the entity’s legal rights;
– past practice;
– how the entity intends to manage its exposure to credit risk throughout the contract; and
– the customer’s ability and intention to pay.

The collectibility assessment is limited to the consideration attributable to the goods or services to be transferred to the customer for the noncancellable term of the contract. For example, if a contract has a two-year term but either party can terminate after one year without penalty, then an entity assesses the collectibility of the consideration promised in the first year of the contract (i.e. the noncancellable term of the contract).
Judgment required to differentiate between a collectibility issue and a price concession

Judgment will be required in evaluating whether the likelihood that an entity will not receive the full amount of stated consideration in a contract gives rise to a collectibility issue or a price concession.

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

Collectibility threshold may be assessed using information derived at the portfolio level

In some situations, an entity may use a portfolio of historical data to estimate the amounts that it expects to collect. This type of analysis may be appropriate when an entity has a high volume of homogeneous transactions. These estimates are then used as an input into the overall assessment of collectibility for a specific contract.

For example, if on average a vendor collects 60 percent of amounts billed for a homogeneous class of customer transactions and does not intend to offer a price concession, then this may be an indicator that collection of the full contract amount for a contract with a customer within that class is not probable. Therefore, the criterion requiring collection of the consideration under the contract to be probable may not be met.

Conversely, if on average a vendor collects 90 percent of amounts billed for a homogeneous class of contracts with customers, then this may indicate that collection of the full contract amount for a contract with a customer within that class is probable. Therefore, the criterion requiring collection of the consideration under the contract to be probable may be met. However, if the average collections were 90 percent because the vendor generally only collected 90 percent from each individual contract, then this may indicate that the vendor has granted a 10 percent price concession to its customer. For a discussion of the differentiation between collectibility issue and a price concession, see above.

Collectibility is only reassessed when there is a significant deterioration in the customer’s credit worthiness

An entity does not reassess the Step 1 collectibility criteria unless there is a significant change in facts and circumstances that results in a significant deterioration in the customer’s creditworthiness. For example, a significant deterioration in a customer’s ability to pay because it lost one of its customers that accounts for 75 percent of its annual sales would likely lead to a reassessment.
The determination of whether there is a significant deterioration in the customer’s creditworthiness will be situation-specific and will often be a matter of judgment. The evaluation is not intended to capture changes of a more minor nature – that is, those that do not call into question the validity of the contract. Nor does it capture changing circumstances that might reasonably fluctuate during the contract term (especially for a long-term contract) that do not have a significant effect.

If the entity determines that collectibility is no longer probable, then it discontinues revenue accounting and follows the guidance on accounting for consideration received when a contract does not exist – see 5.1.3.

Collectibility assessment required for contracts with a significant financing component

The assessment of collectibility in Step 1 of the model applies equally to contracts with or without a significant financing component. This is regardless of the fact that credit worthiness is factored into the discount rate and therefore the transaction price for a contract with a significant financing component.

Fiscal funding clauses may affect the assessment of whether a contract exists

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

Enforceable rights and obligations for an expired contract when the entity continues to provide services

In some cases, an entity may continue to deliver services to a customer under the terms of a contract after it has expired – e.g. when terms of the new contract to replace the existing one are not finalized before the expiration date of the existing contract. If the entity has legally enforceable rights and obligations related to these services, then the services delivered are accounted for using the general guidance of the new standard. Conversely, if the entity does not have legally enforceable rights and obligations for the services delivered after the contract expires, then it applies the guidance on accounting for consideration received before a contract exists – see 5.1.3.

Making the assessment of whether enforceable rights and obligations exist will often be complex and may require an entity to seek legal advice to determine whether it has enforceable rights and obligations after the expiration date of the contract.
Whether a Master Service Agreement represents a contract depends on facts and circumstances

Generally, a Master Service Agreement (MSA) under which a customer is required to place subsequent purchase orders to obtain goods or services does not itself constitute a contract with a customer. Unless the MSA requires that minimum quantities be purchased, the MSA only establishes the terms under which orders to purchase goods or services may be placed rather than creating enforceable rights and obligations for goods or services for the parties. However, enforceability is a matter of law in the relevant jurisdiction and each MSA will need to be evaluated based on its terms and conditions and local law.

When the MSA does not create enforceable rights and obligations, it will normally be the purchase order (PO) that creates enforceable rights and obligations between the entity and the customer. Therefore, the PO in combination with the MSA will be evaluated to determine whether the Step 1 criteria are met and a contract exists. However, if additional steps must be taken for the PO to create legally enforceable rights and obligations (e.g. executing a supplemental contract or addendum to the MSA subsequent to receipt of the PO), then a contract with a customer will not exist until those steps are completed.

Purchase orders under the same MSA may need to be combined

Even if the MSA is not legally enforceable, the pricing among the POs may be interrelated. POs that are issued separately should be evaluated and combined if the criteria for combining contracts are met. For further discussion of combination of contracts, see 5.1.4.

This may result in the transaction price for an individual PO being different from the stated contract price. For example, if unit prices are 100 in Month 1 and 80 in Month 2 for the same product, and the customer will order the same quantity in each month, then the entity assesses whether the POs were negotiated as a single commercial package (i.e. price adjustments were made for cash flow reasons) or independent of one another. If the entity concludes that the POs should be combined, then this results in revenue of 90 per unit in Months 1 and 2.

When POs are not combined, the MSA still needs to be considered to determine if there are implicit or explicit promises that need to be considered in Step 2 of the model. This includes considering whether the pricing on subsequent POs may include a material right in Step 2, or any variable consideration in Step 3 (e.g. a rebate or discount), that are not disclosed in the PO.

Contracting practices may need to be evaluated by customer class

Contracting practices with different classes of customers within the same jurisdiction may need to be evaluated. For example, an entity may have a business practice of using written contracts. However, the entity may enter into arrangements with certain customers whose business practices of providing evidence of an arrangement differ from the entity’s own practice.
If an entity establishes a different practice for evidencing an arrangement for specific customers, including implied contracts for various classes of customers (e.g., by customer type, geographic regions, product types, or sales price ranges), then it may need to consult legal counsel to determine whether these practices affect the determination of whether the arrangement is legally enforceable.

It may be advisable for an entity to document its conclusions about its evaluation of legal enforceability for each arrangement. Depending on the circumstances, it may also be appropriate for an entity to develop documentation for a particular customer or class of customer, or by jurisdiction.

**Comparison with current IFRS**

**Two definitions of a contract exist in IFRS**

The definition of a contract in the new standard focuses on legal enforceability. Although the term ‘contract’ is also defined in IAS 32, the IAS 32 definition is different and stops short of requiring the contract to be legally enforceable.

The IASB did not amend the definition of a contract in IAS 32 on the grounds that this may have unintended consequences on the accounting for financial instruments. As a result, there are two definitions of a contract in IFRS – one in IFRS 15 and another in IAS 32.

**Comparison with current US GAAP**

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

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

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

Under current SEC guidance, if an entity's customary business practice is to have, in addition to meeting the other criteria, a contract signed by both parties before it concludes that persuasive evidence of an arrangement exists, then the entity does not recognize revenue until a written sales agreement is finalized – including being signed by both the customer and the entity. Under the new standard, if the placement of the customer order and shipment of the goods constitute a legally enforceable contract, then the new revenue model is applied even if it differs from an entity's customary business practices. For application of this concept, see Example 5 in this publication. Similar arrangements in different jurisdictions may be treated differently if the determination of a legally enforceable contract varies.

Legally enforceable rights maybe less restrictive than persuasive evidence

Under the current guidance, an entity is required to have persuasive evidence that both parties in a transaction understand the specific nature and terms of an agreed-upon transaction. However, the form of persuasive evidence is required to be consistent with customary business practices, such as a signed contract.

Under the new standard, a contract must exist but it may be oral, written, or implied by customary business practices. However, it may not necessarily be consistent with the entity's customary business practices. An entity will need to consider the jurisdiction in which the transaction occurs to determine whether an agreement has created a legally enforceable right. Similar contracts may produce different results based on the jurisdiction. Therefore, it may be prudent to receive legal advice or an opinion in certain situations.

Consideration not required to be fixed or determinable

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

5.1.2 Term of the contract

Requirements of the new standard

The new standard is applied to the duration of the contract (i.e. the contractual period) in which the parties to the contract have presently enforceable rights and obligations.

A contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties).
A contract is wholly unperformed if both of the following criteria are met:

a. the entity has not yet transferred any promised goods or services to the customer; and

b. the entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

**Observations**

**Contract term affects many parts of the new standard**

The determination of the contract term is important because it may affect the measurement and allocation of the transaction price, the collectibility assessment, the timing of revenue recognition for up-front nonrefundable fees, contract modifications, and the identification of material rights.

**Consideration payable on termination can affect assessment of contract term**

If a contract can be terminated by compensating the other party and the right to compensation is considered substantive, then its duration is either the specified period or the period up to the point at which the contract can be terminated without compensating the other party.

However, if a contract can be terminated by either party without substantive compensation, then its term does not extend beyond the goods and services already provided.

In making the assessment of whether the right to compensation is substantive, an entity considers all relevant factors, including legal enforceability of the right to compensation on termination. If an entity has a past practice of not enforcing a termination penalty and that practice changes the legally enforceable rights and obligations, then that could affect the contractual term.

**Compensation is broader than only termination payments**

A payment to compensate the other party upon termination is any amount (or other transfer of value – e.g. equity instruments) other than a payment due as a result of goods or services transferred up to the termination date. It is not restricted only to payments explicitly characterized as termination penalties.

**Ability of either party to cancel the contract at discrete points in time may limit the term of the contract**

If an entity enters into a contract with a customer that can be renewed or cancelled by either party at discrete points in time without significant penalty, then it accounts for its rights and obligations as a separate contract for the period during which the contract cannot be cancelled by either party. Upon commencement of each service period (e.g. a month in a month-to-month arrangement), where the entity has begun to perform and the customer has not cancelled the contract, the entity normally obtains enforceable rights relative to fees owed for those services, and a contract exists.
### 5.1.3 Consideration received before concluding that a contract exists

#### Requirements of the new standard

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

- **Has the contract been terminated and is the consideration received nonrefundable?**
  - Yes
  - Recognize consideration received as revenue
  - No

- **Are there no remaining performance obligations and has all, or substantially all, of the consideration been received and is nonrefundable?**
  - Yes
  - Recognize consideration received as revenue
  - No

- **[US GAAP only] Has the entity stopped transferring goods or services and there is no obligation to transfer additional goods or services and all consideration received is nonrefundable?**
  - Yes
  - Recognize consideration received as a liability
  - No

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**Evergreen contracts**

For the purposes of assessing contract term, an evergreen contract (i.e. a contract that automatically renews) that is cancellable by either party each period (e.g. on a month-to-month basis) without penalty is no different from a similar contract structured to require the parties to actively elect to renew the contract each period (e.g. place a new order, sign a new contract). In these situations, an entity should not automatically assume a contract period that extends beyond the current period (e.g. the current month).

**Only the customer has a right to terminate the contract**

If only the customer has the right to terminate the contract without penalty and the entity is otherwise obligated to continue to perform until the end of a specified period, then the contract is evaluated to determine whether the option gives the customer a material right (see 10.4 for discussion of customer options for additional goods or services).
The entity is, however, required to reassess the arrangement and, if Step 1 of the model is subsequently met, begin applying the revenue model to the arrangement.

**Difference between IFRS and US GAAP**

The FASB included an additional step in the requirements to address concerns over potential diversity in the understanding of when a contract is considered terminated, which could have led in some cases to revenue not being recognized even though the entity had stopped delivering goods or services to the customer.

The IASB decided not to add the additional clarification to IFRS 15. It concluded that the existing guidance in IFRS 15 is sufficient for an entity to conclude that a contract is terminated when it stops providing goods or services to the customer without further clarification.

**Example 7 – Cumulative catch-up adjustment for consideration received before a contract exists**

Company A and Customer B enter into a 12-month service agreement that requires Customer B to pay service fees of 800 per month. The agreement expires on May 31, but Company A continues to deliver services and Company B continues to pay 800 a month. A new agreement requiring a fee of 1,000 per month is signed on July 31, which applies retrospectively from June 1.

Company A’s legal counsel advises that an enforceable obligation for Customer B to pay Company A for services provided in June and July did not exist before the new agreement was executed on July 31. Company A therefore concludes that a contract did not exist in June and July.

Because the existing contract was terminated on May 31, Company A would record the June and July payments of 1,600 received from Customer B as revenue only once performance in those months is complete and substantially all of the promised consideration of 1,600 is collected and nonrefundable.

Alternatively, if that was not the case, Company A would defer 1,600 of consideration received and recognize it as a liability until there was an enforceable contract (July 31). Company A would recognize 2,000 as of July 31 on a cumulative catch-up basis (1,000 for each month) once the agreement is enforceable because the pricing of 1,000 applies from June 1. For further discussion of timing of revenue recognition when an entity initially concludes that a contract does not exist and subsequently determines that a contract does exist, see 5.5.3.1.
However, if it had been determined that an enforceable contract existed as of June 1 even in the absence of a formally executed agreement on July 31, revenue would continue to have been recognized on a monthly basis based on a legal interpretation of the enforceable rights and obligations of the parties. Because the monthly fee amount may be uncertain, Company A would be required to estimate the total amount of variable consideration (subject to the constraint) to which it would be entitled in exchange for transferring the promised services (for further discussion of variable consideration and the constraint, see 5.3.1). In this case, the signing of the contract on July 31 would be accounted for, either as an adjustment to the variable consideration, or if the consideration was not deemed to be variable, as a contract modification. For further discussion of contract modifications, see 7.2.

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Observations

**Guidance also applies to the sale of nonfinancial assets**

Under US GAAP, the new standard’s guidance also applies to sales of nonfinancial assets to parties other than a customer. For further discussion on sales of nonfinancial assets, see Section 9.

**Revenue recognition may be deferred for a significant period**

If an entity cannot conclude that a legally enforceable contract exists, then it may be difficult to evaluate when all or substantially all of the promised consideration has been received and is nonrefundable. In some cases, an entity may have a deposit liability recognized for a significant period of time before it can conclude that a contract exists in the model or that the criteria for recognizing the consideration as revenue are met. However, under US GAAP it may be able to recognize revenue when it ceases to provide additional goods or services.

**A receivable is generally not recognized when the collectibility threshold is not met**

Generally, when an entity concludes that a contract does not exist because the collectibility threshold is not met, the entity does not record a receivable for consideration that it has not yet received, for the goods or services transferred to the customer.
5.1 Step 1: Identify the contract with a customer

**Comparison with current US GAAP**

**Consideration received before a contract is signed**

Current US GAAP requires persuasive evidence that an arrangement exists, services are being provided (or delivery has occurred), amounts to be received are fixed or determinable, and collection is reasonably assured in order to recognize revenue.

If an entity is able to determine that evidence of an arrangement does exist before signing a new agreement, then this overcomes the hurdle to recognize revenue. The entity then needs to determine the amount of the fee that is fixed or determinable. It is unlikely that the entity would be able to recognize revenue for an amount greater than the monthly nonrefundable amount collected from the customer (800 in Example 7 in this publication).

The new standard focuses on the enforceability of rights and obligations, rather than persuasive evidence of an arrangement. Also under the new standard, payment terms only need to be identifiable for an entity to estimate variable consideration in Step 3 of the model (see 5.3.1), rather than being fixed or determinable.

**Use of installment or cost recovery method**

Current US GAAP allows the use of the installment method or cost recovery method of accounting in rare cases if:

- receivables are collectible over an extended period of time; and
- there is no reasonable basis for estimating collectibility based on the terms or conditions of the transaction.

Under the installment method, collections are apportioned between cost recovered and profit. Under the cost recovery method, equal amounts of revenue and costs are recognized when collections occur until all costs have been recovered. These methods allow an entity to record revenue based on collections even though collectibility under the contract may not be reasonably assured.

Under the new standard, if collection is not considered probable, then an entity cannot record revenue based on its collections unless the consideration is non-refundable and it meets one of the three criteria:

- the contract is terminated;
- there are no remaining performance obligations and substantially all of the consideration is received; or
- the entity is under no obligation to provide the remaining goods or services and has stopped providing goods or services to the customer.

Further, an entity may not be able to defer any costs, including those incurred before collectibility is probable, if control of the underlying goods or services has been transferred to the customer.
5.1.4 Combination of contracts

Requirements of the new standard

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

**Example 8 – Combination of contracts for related services**

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

Software Company A determines that the two contracts are combined because they were entered into at nearly the same time with the same customer, and the goods or services in the contracts are a single performance obligation. For further discussion on identifying the performance obligations in a contract (Step 2 of the model), see 5.2.
5.1 Step 1: Identify the contract with a customer

Observations

Evaluating ‘at or near the same time’ when determining whether contracts should be combined

The accounting for a contract depends on an entity’s present rights and obligations, rather than on how the entity structures the contract. The new standard does not provide a bright line for evaluating what constitutes ‘at or near the same time’ to determine whether contracts should be combined for the purposes of applying the standard. Therefore, an entity should evaluate its specific facts and circumstances when analyzing the elapsed period of time.

Specifically, the entity should consider its business practices to determine what represents a minimum period of time that would provide evidence that the contracts were negotiated at or near the same time. Additionally, the entity should evaluate why the arrangements were written as separate contracts and how the contracts were negotiated (e.g., both contracts negotiated with the same parties versus different divisions within the entity negotiating separately with a customer).

An entity needs to establish procedures to identify multiple contracts initiated with the same customer on a timely basis to ensure that these arrangements are evaluated to determine whether they should be combined into a single contract for accounting purposes.

In addition, an entity should consider whether a separate agreement is a modification to the original agreement and whether it should be accounted for as a new contract or as part of the existing contract. For a discussion of contract modifications, see Section 7.

Definition of related parties acquires new significance

The new standard specifies that for two or more contracts to be combined, they should be with the same customer or related parties of the customer. The Boards state that the term ‘related parties’ as used in the new standard has the same meaning as the definition in current related party guidance. This means that the definition originally developed in US GAAP and IFRS for disclosure purposes acquires a new significance, because it can affect the recognition and measurement of revenue transactions.
Criteria for combining contracts are similar but not identical to current guidance for construction contracts

Both US GAAP and IFRS contain explicit guidance on combining construction contracts. The contracts must be: negotiated as a package; function as a single project; require closely interrelated activities, and performed concurrently or in a continuous sequence, which is sometimes applied by analogy to other contracts to identify different components of a transaction.

The new standard’s guidance on combining contracts applies to all contracts in its scope. The approach to combining contracts in the new standard is similar but not identical to that in current US GAAP and IFRS (e.g. the rebuttable presumption under current US GAAP is not present under the new standard), which may result in different outcomes under the new standard compared to current practice.

Additional complexities for sales through distribution channels

When applying the guidance on combining contracts, an entity needs to determine who the customer is under the contract. Contracts entered into by an entity with various parties in the distribution channel that are not customers of the entity are not combined.

For example, for automotive manufacturers the customer for the sale of a vehicle is typically a dealer, while the customer for a lease of a vehicle is typically the end consumer. Because the dealer and the end consumer are not related parties, these contracts (the initial sales contract for the vehicle to the dealer and the subsequent lease contract with the end consumer) are not evaluated for the purpose of combining them, and are treated as separate contracts. However, in other situations an entity’s customer may be acting as an agent for the end consumer. In these situations, the contracts will need to be evaluated for the purpose of combining them.

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

Comparison with current IFRS

Combination of contracts

IFRS 15 is broadly similar to the requirements of IAS 11 and IAS 18. However, IAS 11 requires an entity to consider combining a group of contracts as a single contract when the contracts are performed concurrently or in a continuous sequence. In contrast, IFRS 15 states that contracts are combined when the goods or services promised in the contract are a single performance obligation.

In addition, IFRS 15 provides more specific guidance on when to combine contracts than IAS 18, and combining of contracts is required when those conditions are met.
5.2 Step 2: Identify the performance obligations in the contract

### Overview

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

### Comparison with current US GAAP

#### Elimination of rebuttable presumption

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

#### Software-specific indicators versus specified criteria

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

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

Requirements of the new standard

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

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

Criterion 1: Capable of being distinct
Can the customer benefit from the good or service on its own or together with other readily available resources?

Criterion 2: Distinct within the context of the contract
Is the entity’s promise to transfer the good or service separately identifiable from other promises in the contract?

Yes
Distinct – performance obligation

No
Not distinct – combine with other goods and services
### Criterion 1

**Good or service is capable of being distinct**

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

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

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

### Criterion 2

**Distinct within the context of the contract**

The objective when assessing whether an entity’s promises to transfer goods or services are distinct within the context of the contract is to determine whether the nature of the promise is to transfer each of those goods or services individually, or whether the promise is to transfer a combined item or items to which the promised goods or services are inputs.

The new standard provides the following indicators to assist in evaluating whether two or more promises to transfer goods or services to a customer are not separately identifiable:

- The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. This occurs when the entity is using the goods or services as inputs to produce or deliver the output or outputs specified by the customer. A combined output (or outputs) might include more than one phase, element, or unit.
- One or more of the goods or services significantly modifies or customizes, or is significantly modified or customized by, one or more of the other goods or services promised in the contract.
- The goods or services are highly interdependent or highly interrelated, such that each of the goods or services is significantly affected by one or more of the other goods or services.

The list of indicators in the new standard is not exhaustive.
If a promised good or service is determined not to be distinct, then an entity continues to combine it with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, this results in the entity accounting for all of the goods or services promised in a contract as a single performance obligation.

For guidance and discussion on determining whether the promise to transfer a license along with other goods or services is distinct, see 8.2.

**Example 9 – Single performance obligation in a contract**

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

Construction Company C identifies goods and services that will be provided during the hospital construction that might otherwise benefit Customer D on its own. For example, if each construction material is sold separately by other entities, then it could be resold for more than scrap value by Customer D. It also could be sold together with other readily available resources such as additional materials or the services of another contractor.

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

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

**Example 10 – Multiple performance obligations in a contract**

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

The handset can be used by a customer to perform certain functions—e.g. calendar, contacts list, email, internet access, accessing apps via Wi-Fi and to play music or games.
Additionally, there is evidence of customers reselling the handset on an online auction site and recapturing a portion of the selling price of the phone. Telco T also regularly sells its voice and data services separately to customers, through renewals or sales to customers who acquire handsets from an alternative vendor – e.g. a retailer.

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

<table>
<thead>
<tr>
<th>Criterion 1</th>
<th>Handset is capable of being distinct</th>
</tr>
</thead>
<tbody>
<tr>
<td>– Customer R can benefit from the handset either on its own – i.e. because the handset has stand-alone functionalities and can be resold for more than scrap value and has substantive, although diminished, functionality that is separate from Telco T’s network – or together with its wireless services that are readily available to Customer R, because Telco T sells those services separately.</td>
<td></td>
</tr>
<tr>
<td>– Customer R can benefit from the wireless services in conjunction with readily available resources – i.e. either the handset is already delivered at the time of contract set-up, could be purchased from alternative retail vendors, or the wireless service could be used with a different handset.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Criterion 2</th>
<th>Distinct within the context of the contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>– The handset and the wireless services are separable in this contract because they are not inputs to a single asset – i.e. a combined output – which demonstrates that Telco T is not providing a significant integration service.</td>
<td></td>
</tr>
<tr>
<td>– Neither the handset nor the wireless service significantly modifies or customizes the other.</td>
<td></td>
</tr>
<tr>
<td>– Customer R could purchase the handset and the voice/data services from different parties – e.g. Customer R could purchase the handset from a retailer – therefore providing evidence that the handset and voice/data services are not highly dependent on, or highly interrelated with, each other.</td>
<td></td>
</tr>
</tbody>
</table>
Applying the indicators will require judgment

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

Certain indicators may provide more compelling evidence in the separability analysis than others in different scenarios or types of contracts. For example, factors such as the degree of customization, complexity, customer’s motivation for purchasing goods/services, contractual restrictions, and the functionality of individual goods/services may have differing effects on the distinct analysis for different types of contracts.

In addition, the relative strength of an indicator, in light of the specific facts and circumstances of a contract, may lead an entity to conclude that two or more promised goods or services are not separable from each other within the context of the contract. This may occur even if the other two indicators might suggest separation.

To assist an entity in applying the indicators, the new standard includes many examples illustrating their application. The following table summarizes them.

<table>
<thead>
<tr>
<th>Example #</th>
<th>Description of scenario</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>10A</td>
<td>Entity provides a significant integration service for a building construction and delivers a single output to the customer</td>
<td>Single performance obligation</td>
</tr>
<tr>
<td>10B</td>
<td>Entity provides a significant integration service and delivers multiple complex and specialized items as single outputs to the customer</td>
<td>Single performance obligation</td>
</tr>
<tr>
<td>10C (US GAAP only)</td>
<td>Entity provides a license to anti-virus software and future unspecified updates that are highly interrelated</td>
<td>Single performance obligation</td>
</tr>
<tr>
<td>11A</td>
<td>Entity provides the customer with software, installation, unspecified upgrades and telephone support from which it can benefit separately</td>
<td>Multiple performance obligations</td>
</tr>
</tbody>
</table>
### Example #

<table>
<thead>
<tr>
<th>Description of scenario</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity provides the customer with installation services that involve significant customization of the underlying software</td>
<td>Single performance obligation</td>
</tr>
<tr>
<td>Entity provides customer with equipment and a separately identifiable installation service; customer required to use entity’s installation service in 11D</td>
<td>Multiple performance obligations</td>
</tr>
<tr>
<td>Entity provides the customer with equipment and proprietary consumables that are separately identifiable</td>
<td>Multiple performance obligations</td>
</tr>
<tr>
<td>Entity provides the customer with a good and an explicit promise to provide a service to the customer’s customer who purchases the good</td>
<td>Multiple performance obligations</td>
</tr>
<tr>
<td>Entity provides the customer with a good and an implicit promise to provide a service to the customer’s customer who purchases the good</td>
<td>Multiple performance obligations</td>
</tr>
<tr>
<td>Entity provides a customer’s customer with a service that is not part of its promise to the customer</td>
<td>Single performance obligation (service is not a performance obligation of the contract)</td>
</tr>
</tbody>
</table>

**Applying Criterion 2 requires an entity to assess if there is a transformative relationship between the two items being analyzed**

The Boards noted that the evaluation of whether an entity’s promise to transfer a good or service is separately identifiable from other promises in the contract considers the relationship between the various goods or services within the contract in the context of the process of fulfilling the contract. An entity should consider the level of integration, interrelation, or interdependence among promises to transfer goods or services in evaluating whether the goods or services are distinct.

The Boards also observed that an entity should not merely evaluate whether one item, by its nature, depends on the other (i.e. whether the items have a functional relationship). Instead, an entity should evaluate whether there is a transformative relationship between the two items in the process of fulfilling the contract.
A potential change in practice for the software industry

In Example 11A of the new standard, post-contract customer support (PCS) that includes both technical support and unspecified software upgrades provided on a when-and-if available basis comprises two separate performance obligations.

Additionally, in that example the two performance obligations are distinct from the software license, which is also a separate performance obligation.

Current IFRS does not provide any specific guidance on revenue recognition for software-related transactions and the substance of each transaction needs to be considered to determine whether the various components are linked.

Under current US GAAP, PCS is treated as a single element when it is separable from the license – i.e. when the entity has vendor-specific objective evidence (VSOE) of the fair value of the PCS. Example 11A separates the PCS into two performance obligations. Therefore their treatment may differ because the allocation and recognition steps of the model are applied to each of these two performance obligations.

Goods or services promised to a customer’s customer may be a performance obligation

In some industries, a manufacturer may promise goods or services as sales incentives to the end customers of its customer to encourage the sale of its products through the distribution channel. The new standard requires an entity to evaluate the promise to the customer’s customer to determine whether it is a performance obligation in the contract with the customer.

Examples of these circumstance are an auto manufacturer that offers free maintenance services to customers who purchase cars from dealerships, a software provider that implicitly offers customer support or updates to end users of its software and a consumer goods company that provides mail-in offers for free goods to end customers.

These promises may be made explicitly in the contract with the customer or implied by an entity’s customary business practices, published policies, or specific statements. For more discussion on implied promises, see 5.2.2.

Contractual restrictions may not be determinative

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

In Example 11D of the new standard, the customer is contractually required to use the seller’s installation service to install the purchased good. The example notes that the contractual restriction does not affect the assessment of whether the installation services are considered distinct. Instead, the entity applies Criterion 1 and Criterion 2 to assess whether the installation services are distinct. By applying these criteria, Example 11D illustrates that substantive contractual provisions alone do not lead to a conclusion that the goods and services are not distinct.
### 5.2 Step 2: Identify the performance obligations in the contract

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(IFRS 15.BC100)

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

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

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

### Comparison with current IFRS

**Separately identifiable components**

Current IFRS includes limited guidance on identifying whether a transaction contains separately identifiable components. However, our view is that, based on analogy to the test in IFRIC 18, an entity should consider whether a component has a stand-alone value to the customer and whether that fair value can be reliably measured (see 4.2.50.60 in Insights into IFRS, 12th Edition).

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

### Comparison with current US GAAP

**Benefit to the customer versus stand-alone value**

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

- capable of being distinct (Criterion 1); and
- distinct within the context of the contract (Criterion 2).
Criterion 1 (capable of being distinct) is similar, but not identical, to the stand-alone value criterion required under current US GAAP. Specifically, under current US GAAP a delivered item has value on a stand-alone basis if it is sold separately by any entity or if the customer could resell the delivered item on a stand-alone basis (even in a hypothetical market).

Under the new standard, an entity evaluates whether the customer can benefit from the good or service on its own or together with other readily available resources. This evaluation no longer depends entirely on whether the entity or another entity sells an identical or largely interchangeable good or service separately, or whether the delivered item can be resold by the customer. Rather, in evaluating whether the customer can benefit from the good or service on its own, an entity determines whether the good or service is sold separately (by the entity or another entity) or could be resold for more than scrap value. An entity also considers factors such as a product’s stand-alone functional utility.

Therefore, potentially more goods may qualify as distinct under Criterion 1 than under current US GAAP. However, an entity also has to evaluate Criterion 2.

Promised goods or services versus deliverables

There may not be an exact correlation in all cases between what is considered a ‘deliverable’ under current US GAAP and what is considered a ‘promised good or service’ under the new standard.

The term ‘deliverable’ is not defined in current US GAAP. However, in a 2007 speech, the SEC staff noted that the following criteria are a helpful starting point in determining whether an item is a deliverable:

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

Under the new standard, promised goods or services are the promised obligations within the contract, which are considered as part of the analysis in Step 1 (see 5.1) and Step 2 (see 5.2).

Essential to functionality versus separately identifiable

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

5.2 Step 2: Identify the performance obligations in the contract

However, under the new standard an entity considers whether the software and the related services are separately identifiable, which includes evaluating whether:

- there is a significant integration service;
- one good or service significantly modifies or customizes the other; or
- the goods or services are highly dependent on, or highly interrelated with, each other.

Although significant judgment may be required, some entities may conclude that services and software should be combined under the new standard because they are highly dependent on or interrelated with each other, even though the services do not meet the currently required level of being essential to the software’s functionality.

**No change to how an entity evaluates specified and unspecified software upgrades**

The FASB staff indicated that it does not expect the new standard to change how an entity determines what constitutes a specified (as opposed to unspecified) upgrade right. It reached its conclusion because it believes that this determination is established in practice and that it did not intend the new standard to change this practice.

In current practice, distinguishing between a specified and an unspecified upgrade right requires an evaluation of: (1) all of the relevant facts and circumstances to determine whether the vendor has made a commitment to provide specific functionalities to the customer at some point in the future (regardless of whether the future date is specified); and (2) the significance of the additional functionalities and development effort in relation to the functionality and development effort related to the initial license. However, the accounting treatment for upgrades will be different from current accounting due to the elimination of the separation requirement to have vendor-specific objective evidence (VSOE) of the fair value of the upgrade rights (see 8.1).

**Potential change for life sciences**

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

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Potential change for tooling deliverables or engineering and design services

Suppliers will need to determine whether the development or procurement of the tooling required to produce parts in a supply arrangement with a customer is a distinct good or service, a good or service that should be combined with the related parts as one performance obligation, an administrative task or a fulfillment activity. Additionally, suppliers may need to determine whether separate contracts (e.g. one contract for the tooling and another for the production of parts) should be combined (see 5.1.4).

Fundamental to the determination of whether tooling and/or engineering and design services are performance obligations is whether control of that good or service is ever transferred to the customer. Therefore, it may be important to consider the guidance in Step 5 when making this Step 2 assessment.

Under existing US GAAP, some suppliers account for tooling as a revenue element because they have concluded that it is a deliverable in the arrangement. Those suppliers that currently account for tooling as a separate deliverable under existing US GAAP will likely conclude that tooling is a distinct service and is therefore a performance obligation under the new standard. However, there may be other situations in which tooling is not identified as a separate deliverable under existing US GAAP, but would be considered distinct and thus a performance obligation under the new standard.

Significant change for many entities that provide sales incentives

The new standard could result in a significant change in practice for entities that provide sales incentives, such as free maintenance services or other incentive-type goods or services, to their customers or to their customers’ customers in a distribution chain. It will generally result in those goods or services being identified as promised goods or services in the entity’s contract with its customer when the sales incentives are put in place before the sale to the customer. Existing practice when the sales incentive is a free product or service is mixed, with many entities accruing the cost of the free product or service and recognizing all of the revenue when the original good is sold to the customer.

Conversely, the new standard is generally consistent with current US GAAP software revenue recognition practice. This guidance requires software vendors that provide maintenance services to a reseller’s customer, or grant a reseller the right to provide upgrades and enhancements to the reseller’s customer, to account for those services as an implied deliverable in the arrangement between the software vendor and the reseller. However, separation of the implied deliverable is not subject to a VSOE threshold under the new standard.
5.2.2 Implied promises and administrative tasks

Requirements of the new standard

Promises to transfer a good or service can be explicitly stated in the contract, or be implicit based on established business practices or published policies that create a valid (‘reasonable’ under US GAAP) expectation that the entity will transfer the good or service to the customer.

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

Example 11 – Implied promise to reseller’s customers

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

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

- Reseller D and the end customers are not related parties – and, as such, these contracts will not be combined; and
- the promise to provide telephone support free of charge to end users is considered a service that meets the definition of a performance obligation when control of the software product transfers to Reseller D.

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

Example 12 – Implied performance obligation – Pre- and post-sale incentives

Car Manufacturer N has an historical practice of offering free maintenance services – e.g. oil changes and tire rotation – for two years to the end customers of dealers who purchase its vehicles. However, the two-years free maintenance is not explicitly stated in the contract with its dealers, but it is typically stated in Car Manufacturer N’s advertisements for the vehicles.

Therefore, the maintenance is treated as a separate performance obligation in the sale of the vehicle to the dealer. Revenue from the sale of the vehicle is recognized when control of the vehicle is transferred to the dealer. Revenue from the maintenance services is recognized as the maintenance services are provided to the retail customer.
However, if Car Manufacturer N does not have a customary business practice of offering free maintenance, and instead announces a maintenance program as a limited-period sales incentive after control of the vehicle has transferred to the dealer, then the free maintenance is not a separate performance obligation in the sale of the vehicle to the dealer.

In this case, Car Manufacturer N recognizes the full amount of revenue when control of the vehicle is transferred to the dealer. If Car Manufacturer N subsequently creates an obligation by announcing that it will provide incentives, then Car Manufacturer N will accrue as an expense its expected cost of providing maintenance services on the vehicles in the distribution channel – i.e. controlled by dealers – when the program is announced.

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

Example 13 – Administrative task – Registration of software keys

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

In this example, the operating system software is ready for use by Customer L, and delivery of the key is contingent only on Customer L’s actions. As such, it is an administrative task that does not transfer a promised good or service and therefore is not considered to be a promised service in the contract. Assuming that all other revenue recognition criteria have been met – including Customer L obtaining control of the operating system software – Software Company B recognizes revenue on delivery of the operating system software. For discussion on the timing and pattern of recognition of licenses, see 8.4.
5.2 Step 2: Identify the performance obligations in the contract

**Observations**

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

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

**Set-up activities as administrative task**

A software-as-a-service (SaaS) provider may perform tasks that are necessary for the customer to access its web-based software application. These tasks range from a simple activation service in some situations to more complex up-front activities needed to allow the customer to access the SaaS services from the customer’s IT platform.

Generally, these types of set-up activities provide no incremental benefit to the customer and therefore constitute an administrative task. However, the necessity of completing these activities before the customer can begin accessing the underlying service may affect the timing of when revenue recognition may begin.

**Comparison with current US GAAP**

**Administrative tasks**

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

In general, entities are unlikely to reach a substantially different conclusion under the new standard when they attempt to identify administrative tasks from the conclusion reached under current SEC guidance related to identifying activities that do not represent discrete earnings events.
5.2.3 Series of distinct goods or services

Requirements of the new standard

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

- The goods or services are substantially the same
- Each distinct good or service in the series is a performance obligation satisfied over time (see 5.5.2)
- The same method would be used to measure progress toward satisfaction of each distinct good or service in the series (see 5.5.3)

A single performance obligation
Example 14 – Series of distinct goods or services treated as a single performance obligation

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

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

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

Contract Manufacturer X concludes that each of the 1,000 widgets is distinct, because:

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

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

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

Consequently, the transaction price for all 1,000 widgets is recognized over time using an appropriate measure of progress. This outcome may be different from the outcome of allocating a fixed amount to each widget if each one were a performance obligation.
Example 15 – Distinct service periods within a long-term service contract

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

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

Observations

No exemption from applying the series guidance

If the series guidance requirements are met for a good or service, then that series is treated as a single performance obligation (i.e. the series guidance is not optional).

Accounting for a series is intended to provide a simplification of the model

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

The Boards also gave transaction processing and the delivery of electricity as examples of a series of goods or services.

However, in some cases applying the series guidance may complicate application of the model. For example, this may be the case for common transactions in certain industries (e.g. aerospace and defense) and other types of transactions that involve producing a relatively small number of products that meet the series guidance. For this reason, some stakeholders requested amendments to the new standard to make application of the series guidance optional. The Boards declined to do so and reiterated that this guidance is not optional.
5.2 Step 2: Identify the performance obligations in the contract

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

**Determining the nature of the entity’s promise to the customer is the first step in applying the series guidance**

Determining the nature of the entity’s promise is the first step in determining whether the series guidance applies. For example, if the nature of the promise is the delivery of a specified quantity of a good or service, then the evaluation should consider whether each good or service is distinct and substantially the same.

Conversely, if the nature of the entity’s promise is to stand ready or to provide a single service for a period of time (i.e. there is not a specified quantity to be delivered), then the evaluation would likely focus on whether each time increment, rather than the underlying activities, is distinct and substantially the same.

**Identifying distinct goods or services as a series may affect the allocation of variable consideration**

Even if per-unit pricing is fixed, if the quantity related to a series is not specified, then it results in variable consideration (see 5.3). However, an entity is not required to allocate variable consideration across the distinct goods or services included in a series on a stand-alone selling price basis. Instead, it follows the general guidance in the standard on allocating variable consideration entirely to a performance obligation or a distinct good or service that forms part of a performance obligation (see 5.4). For example, this may be relevant if the goods or services in the series and any other performance obligations in the contract are priced at market rates.

**Not necessary for goods or services to be provided consecutively**

To apply the series guidance, it is not necessary that the goods be delivered or services performed consecutively over the contract period. There may be a gap or an overlap in delivery or performance, and this would not affect the assessment of whether the series guidance applies.

Although the Boards specifically contemplated a consecutively delivered contract (e.g. repetitive service arrangement), they did not make this distinction a criterion for applying the series guidance.

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**Comparison with current US GAAP**

**Separate performance obligations**

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

Entities may incur out-of-pocket costs as they provide services to customers. In some cases, they will receive reimbursements from customers for these costs. Under current US GAAP, entities generally record the reimbursements as revenue when the out-of-pocket costs are incurred.

Under the new standard, payments for goods and services under contracts with customers that are described as reimbursements represent variable consideration that is included in the transaction price and allocated to the performance obligations in the contract. The individual out-of-pocket costs may not meet the distinct criteria and therefore would not represent the satisfaction of a performance obligation when they are incurred. This may cause the out-of-pocket cost and the reimbursement to be recognized at different times.

The treatment of out-of-pocket costs and reimbursements under the new standard will depend on the nature of the promise to the customer to which they relate. Some entities may be required to estimate reimbursements and include an amount that is not probable of significant reversal in the transaction price. Others may be able to allocate the variable consideration specifically to a distinct service (or day) when applying the series guidance. Entities will separately evaluate whether any of the out-of-pocket costs are required to be capitalized or expensed under the costs to fulfill a contract guidance.

5.2.4 Alternatives (US GAAP only)

Requirements of the new standard

Entities reporting under US GAAP:

- are not required to identify promised goods or services that are immaterial in the context of the contract as performance obligations; and

- can elect to treat as a fulfillment cost any shipping and handling activities that would otherwise be treated as a separate performance obligation because they are provided to a customer after the customer obtains control of the related goods.

Example 16 – Goods or services immaterial in the context of the contract – Evaluation (US GAAP only)

Company A produces consumer goods and reports under US GAAP. Company A enters into a supply arrangement with Customer B. The arrangement has a three-year term and includes minimum purchases of 5 million products per year. Company A will also provide:

- a toll-free customer service line for consumers purchasing the goods.

Company A spends 500,000 per year to maintain the customer service line for all of its customers and estimates the cost associated with providing this service to Customer B to be less than 10,000. Call volume is low because the goods are not highly specialized; and
5.2 Step 2: Identify the performance obligations in the contract

- an annual statement showing the purchase activity for each of Customer B’s stores. Customer B can obtain this information from its own stores but the annual statement provides the information in a format that allows Customer B to better analyze the stores’ purchases. Company A does not incur significant cost or effort but simply writes a report using its own sales system. Company A does not sell this service separately and estimates a selling price to be under 10,000.

Based upon the minimum volume commitments included in the contract, Company A estimates a transaction price of 15 million.

In evaluating the promises in the contract, Company A determines that the telephone support and the annual statement are immaterial in the context of the contract for the following reasons.

- Quantitatively, the services are <1% of the total value of the goods and services in the contract.
- Company A chooses not to identify the services as a performance obligation in the contract.

Importantly, Company A is permitted under US GAAP to make this election whether or not this conclusion would have a material effect on the financial statements taken as a whole.

Differences between IFRS and US GAAP

Shipping and handling activities

The IFRS version of the standard does not include an accounting policy election to treat shipping and handling activities undertaken by the entity after the customer has obtained control of the related good as a fulfillment activity. The IASB rejected this election because it considered that the election would result in an exception to the revenue model and would make it more difficult for users to compare entities’ financial statements.

A difference now exists between IFRS and US GAAP on this point. This will affect the comparability of the financial statements of entities reporting under IFRS and US GAAP that have a significant number of transactions in which shipping and handling activities are performed after control of the goods transfers to the customer, and the entity elects to treat the shipping and handling activity as a fulfillment cost under US GAAP.

Promised goods or services that are immaterial in the context of the contract

The FASB decided to permit an entity not to identify promised goods or services that are immaterial in the context of the contract as performance obligations. It reached this decision because it could be unduly burdensome in some circumstances to require an entity to aggregate and determine the effect on its financial statements of those items or activities determined to be immaterial at the contract level.
In contrast, the IASB decided not to include the exception in the IFRS version of the standard, but noted that it did not intend to require an entity to identify every possible promised good or service in the contract individually. The IASB therefore expects that this difference between the IFRS and US GAAP versions of the standard will not give rise to significant differences in practice. However, it remains to be seen whether this really is the case, because the US GAAP version of the standard permits the evaluation at the contract level while the IFRS version continues to rely on general materiality guidance, which is viewed from the financial statement level.

Comparison with current US GAAP

Approach to determining the accounting is different

Although some of the concepts are similar under the new standard and current US GAAP, an entity’s approach to the accounting may be slightly different. Generally, under current US GAAP, an entity determines its accounting by starting at the contract level. An entity determines if the contract can be separated into multiple units of accounting based on whether separation criteria are met or specific US GAAP provides accounting guidance for an item. Under the new standard, an entity determines its accounting by beginning at the promise level. An entity identifies all of its promises and then begins combining them if they are determined not to be distinct or are immaterial in the context of the contract.

Perfunctory or inconsequential

The FASB emphasized that ‘immaterial’ in the context of the contract is a qualitative and quantitative assessment based on what may be important to the customer. This concept is expected to be similar to the current US GAAP guidance on inconsequential or perfunctory deliverables.

The current US GAAP guidance states that a performance obligation is inconsequential or perfunctory if it is not essential to the functionality of the delivered products or services. Activities are not inconsequential or perfunctory if the failure to complete the activities would result in a full or partial refund or the customer’s right to reject the delivered goods or services.

The FASB also specifically noted that customer options to acquire additional goods or services that represent a material right to the customer will need to be identified as a performance obligation, even if they might have been considered immaterial in the context of the contract (see 10.4).

Shipping and handling activities

Under the new standard, shipping and handling activities can be accounted for as follows. If they are performed:

- before the customer obtains control of the goods, then they are fulfillment activities; and
5.2 Step 2: Identify the performance obligations in the contract

- after a customer obtains control of the goods, then:
  - an entity electing to account for shipping and handling as a fulfillment activity accrues the costs of these activities and recognizes all revenue at the point in time at which control of the goods transfers to the customer; or
  - an entity not choosing the policy election is likely to conclude that shipping and handling activities that occur after control of the goods transfers to the customer are a performance obligation, and therefore it allocates a portion of the transaction price to the shipping and handling and recognizes revenue as the shipping and handling performance obligation is satisfied.

The accounting policy choice included in the FASB’s version of the new standard will allow entities to accrue shipping and handling costs as an expense at the time when revenue is recognized for the delivery of a good, thereby achieving a ‘matching’ of the revenue and related fulfillment cost.

However, because this is a policy election, entities will not be required to do so, which could result in potential diversity in practice arising both from different:

- economic arrangements (e.g. shipping and handling occur before control of the goods transfers versus occurring after control transfers); and
- policy elections (when control of goods transfers before shipping and handling activities occur).

If the policy election is used under US GAAP, then this could create a difference with IFRS.

**Shipping and handling (synthetic ‘free on board’ (FOB) destination)**

Under current US GAAP, entities may have arrangements in which the goods are shipped to the customer with ‘free on board’ (FOB) shipping point terms. These terms may be accounted for as FOB destination arrangements because the entity has determined that the risks and rewards of the goods do not pass to the customer at the shipping point. This is often referred to as ‘synthetic FOB destination’.

Because transfer of the risks and rewards of the asset is only one of the indicators for determining when the customer obtains control of the goods, there may be cases under the new standard in which entities determine that control of the goods in these types of arrangements transfers when the goods are shipped. If so, then an entity could recognize revenue and accrue and expense shipping and handling costs at shipping by using the accounting policy choice available under the FASB’s new standard, rather than accounting for shipping and handling as a separate performance obligation.

Notwithstanding the FASB’s practical expedient, there may be circumstances in which, after considering the transfer of control indicators and despite the stated shipping terms, an entity concludes that control of a good does not transfer until the good is physically received by the customer.
Regardless of which policy the entity uses, when an entity concludes that control transfers to the customer before the risks and rewards of ownership have been transferred, the entity will experience a change in practice from its current synthetic FOB destination accounting. For further discussion on the assessment of transfer of control for these arrangements, see 5.5.4.

5.3 Step 3: Determine the transaction price

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

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

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

- **Variable consideration (and the constraint) (see 5.3.1)**
  - An entity estimates the amount of variable consideration to which it expects to be entitled, giving consideration to the risk of revenue reversal in making the estimate.

- **Significant financing component (see 5.3.2)**
  - For contracts with a significant financing component, an entity adjusts the promised amount of consideration to reflect the time value of money.

- **Noncash consideration (see 5.3.3)**
  - Noncash consideration is measured at fair value, if that can be reasonably estimated; if not, an entity uses the stand-alone selling price of the good or service that was promised in exchange for noncash consideration.

- **Consideration payable to a customer (see 5.3.4)**
  - An entity needs to determine whether consideration payable to a customer represents a reduction of the transaction price, a payment for a distinct good or service, or a combination of the two.
Customer credit risk is not considered when determining the amount to which an entity expects to be entitled – instead, credit risk is considered when assessing the existence of a contract (see 5.1). However, if the contract includes a significant financing component provided to the customer, then the entity considers credit risk in determining the appropriate discount rate to use (see 5.3.2).

An exception exists to the variable consideration guidance for sales- or usage-based royalties arising from licenses of intellectual property (see 8.6).

### 5.3.1 Variable consideration (and the constraint)

#### Requirements of the new standard

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

An entity assesses whether, and to what extent, it can include an amount of variable consideration in the transaction price at contract inception. The following flow chart sets out how an entity determines the amount of variable consideration in the transaction price, except for sales- or usage-based royalties from licenses of intellectual property (see 8.6).
An entity recognizes a refund liability for consideration received or receivable if it expects to refund some or all of the consideration to the customer.

The new standard applies the mechanics of estimating variable consideration in a variety of scenarios, some of which include fixed consideration – e.g. sales with a right of return (see 10.1) and customers’ unexercised rights (breakage) (see 10.5).

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

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

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

### A fixed rate per unit of output may be variable consideration

When an entity enters into a contract with a customer for an undefined quantity of output at a fixed contractual rate per unit of output, the consideration may be variable. In some cases there may be substantive contractual terms that indicate a portion of the consideration is fixed – e.g. contractual minimums.

For contracts with undefined quantities, it is important to appropriately evaluate the entity’s underlying promise to determine how the variability created by the unknown quantity should be treated under the new standard. For example, the entity’s underlying promise could be a series of distinct goods or services (see 5.2.3), a stand-ready obligation, or an obligation to provide the specified goods or services. Unknown quantities could also represent customer options for which the entity will need to consider whether a material right exists (see 10.4).

### Variable consideration or optional purchases

Different outcomes and disclosure requirements can arise depending on whether an entity concludes that purchases of additional goods or services by a customer are exercises of customer options or variable consideration. Future purchases that are options will be evaluated to determine whether they include a material right. Future purchases that are variable consideration are included in the initial identification of performance obligations, and determination of the transaction price, and may lead to additional estimation and disclosure requirements.
Distinguishing between options and variable consideration will require significant judgment and will require entities to assess the nature of their promise to the customer and evaluate the presently enforceable rights and obligations of the parties to the arrangement.

- **Options for additional goods or services:** The customer has a present contractual right to purchase additional distinct goods or services. Each exercise of an option is a separate purchase decision and transfer of control of additional goods and services by the entity if the customer is not currently obligated under the contract to do so. Before the customer’s exercise of the option, the vendor is not obligated to provide those goods or services and does not have a right to receive consideration. The customer options need to be evaluated to determine whether they provide the customer with a material right.

- **Variable consideration:** The contract with the customer obligates the vendor to stand ready to transfer the promised goods or services, and the customer does not make a separate purchase decision for the additional goods or services to be provided by the vendor. The future event that results in additional consideration occurs as the performance obligation is being satisfied (i.e. when control of the goods or services is transferred to the customer).

**Volume discounts or rebates may be variable consideration or may convey a material right**

Different structures of discounts and rebates may have a different effect on the transaction price. For example, some agreements provide a discount or rebate that applies to all purchases made under the agreement – i.e. the discount or rebate applies on a retrospective basis once a volume threshold is met. In other cases, the discounted purchase price may only apply to future purchases once a minimum volume threshold has been met.

If a discount applies retrospectively to all purchases under the contract once the threshold is achieved, then the discount represents variable consideration. In this case, the entity estimates the volumes to be purchased and the resulting discount in determining the transaction price and updates that estimate throughout the term of the contract.

However, if a tiered pricing structure provides discounts for future purchases only after volume thresholds are met, then the entity evaluates the arrangement to determine whether the arrangement conveys a material right to the customer (see 10.4). If a material right exists, then this is a separate performance obligation, to which the entity allocates a portion of the transaction price. If a material right does not exist, then there are no accounting implications for the transactions completed before the volume threshold is met, and purchases after the threshold has been met are accounted for at the discounted price.
**5.3.1.1 Estimate the amount of variable consideration**

**Requirements of the new standard**

When estimating the transaction price for a contract with variable consideration, an entity’s initial measurement objective is to determine which of the following methods best predicts the consideration to which the entity will be entitled.

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

The method selected is applied consistently throughout the contract and to similar types of contracts when estimating the effect of uncertainty on the amount of variable consideration to which the entity will be entitled.
Example 17 – Estimate of variable consideration – Expected value

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

<table>
<thead>
<tr>
<th>Price reduction in next six months</th>
<th>Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>70%</td>
</tr>
<tr>
<td>50</td>
<td>20%</td>
</tr>
<tr>
<td>100</td>
<td>10%</td>
</tr>
</tbody>
</table>

After considering all relevant facts and circumstances, Electronics Manufacturer M determines that the expected value method provides the best prediction of the amount of consideration to which it will be entitled. As a result, it estimates the transaction price to be 480 per television – i.e. (500 × 70%) + (450 × 20%) + (400 × 10%) – before considering the constraint (see 5.3.1.2).

Example 18 – Estimate of variable consideration – Most likely amount

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

<table>
<thead>
<tr>
<th>Outcome</th>
<th>Consideration</th>
<th>Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Project completes on time</td>
<td>130,000</td>
<td>90%</td>
</tr>
<tr>
<td>Project is delayed</td>
<td>110,000</td>
<td>10%</td>
</tr>
</tbody>
</table>

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

All facts and circumstances are considered when selecting estimation method

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

Expected value method – No need to quantify less probable outcomes

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

Expected value method – Estimated amount does not need to be a possible outcome for an individual contract

When an entity has a population of similar transactions, it may be appropriate to use this portfolio of data to estimate the transaction price for an individual contract using the expected value method. In this case, the transaction price may be an amount that is not a possible outcome for an individual contract but that is still representative of the expected transaction price.

It is important for an entity to have a sufficiently large number of similar transactions to conclude that the expected value method is the best estimate of the transaction price. Using a portfolio of data to assist in estimating the transaction price for a contract is not the same as applying the portfolio approach (see 4.4).

An entity uses judgment to determine whether:

– its contracts with customers are sufficiently similar;
– the contracts with customers from which the expected value is derived are expected to remain consistent with subsequent contracts; and
– the volume of similar contracts is sufficient to develop an expected value.

For example, if there are three possible outcomes for the transaction price, then the entity calculates an expected value as follows.

<table>
<thead>
<tr>
<th>Transaction price</th>
<th>Probability</th>
<th>Weighting</th>
</tr>
</thead>
<tbody>
<tr>
<td>100,000</td>
<td>30%</td>
<td>30,000</td>
</tr>
<tr>
<td>110,000</td>
<td>45%</td>
<td>49,500</td>
</tr>
<tr>
<td>130,000</td>
<td>25%</td>
<td>32,500</td>
</tr>
<tr>
<td>Expected value</td>
<td></td>
<td>112,000</td>
</tr>
</tbody>
</table>
5.3 Step 3: Determine the transaction price

Although 112,000 is not a possible outcome, when the conditions are met, the expected value is *appropriate* because the entity is really estimating that 30% of the transactions will result in 100,000, 45% of the transactions will result in 110,000 and 25% of the transactions will result in 130,000 which, in the aggregate, will be representative of the entity’s expectations of the price for each transaction.

**A combination of methods may be appropriate**

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

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

- *the price of a key material, such as steel* – this uncertainty will result in a range of possible consideration amounts, depending on the price of steel; and

- *a performance bonus if the contract is finished by a specified date* – this uncertainty will result in two possible outcomes, depending on whether the target completion date is achieved.

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

**Historical experience may be a source of evidence**

An entity may use a group of similar transactions as a source of evidence when estimating variable consideration, particularly under the expected value method. The estimates using the expected value method are generally made at the contract level, not at the portfolio level. Using a group as a source of evidence in this way is not itself an application of the portfolio approach (see 4.4).

For example, an entity may enter into a large number of similar contracts whose terms include a performance bonus. Depending on the outcome of each contract, the entity will either receive a bonus of 100 or will not receive any bonus. Based on its historical experience, the entity expects to receive a bonus of 100 in 60 percent of such contracts. To estimate the transaction price for future individual contracts of this nature, the entity considers its historical experience and estimates that the expected value of the bonus is 60. This example illustrates that when an entity uses the expected value method, the transaction price may be an amount that is not a possible outcome of an individual contract.

The entity needs to use judgment to determine whether the number of similar transactions is sufficient to develop an expected value that is the best estimate of the transaction price for the contract and whether ‘the constraint’ (see 5.3.1.2) should be applied.
5.3.1.2 Determine the amount for which it is probable (highly probable for IFRS) that a significant reversal will not occur (‘the constraint’)

Requirements of the new standard

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

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

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

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

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

This assessment needs to be updated at each reporting date.

An exception exists for sales- or usage-based royalties arising from licenses of intellectual property (see 8.6).
5.3 Step 3: Determine the transaction price

Difference between IFRS and US GAAP

**Level of confidence – A difference in wording only**

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

**Example 19 – Applying the constraint to an investment management contract**

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

<table>
<thead>
<tr>
<th>Quarterly management fee</th>
<th>2% per quarter, calculated on the basis of the fair value of the net assets at the end of the most recent quarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performance-based incentive fee</td>
<td>20% of the fund’s return in excess of an observable market index over the contract period</td>
</tr>
</tbody>
</table>

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

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

Investment Manager M determines that the cumulative amount of consideration from the management fee to which it is entitled is not constrained, because it is calculated based on asset values at the end of each quarter. Therefore, once the quarter finishes the consideration for the quarter is known. Investment Manager M determines that it can allocate the entire amount of the fee to the completed quarters, because the fee relates specifically to the service provided for those quarters.

Performance-based incentive fee

Investment Manager M determines that the full amount of the performance fee is constrained, and therefore excluded from the transaction price. This is because:
- the performance fee has a high variability of possible consideration amounts, and the magnitude of any downward adjustment could be significant;
- although Investment Manager M has experience with similar contracts, that experience is not predictive of the outcome of the current contract because the amount of consideration is highly susceptible to volatility in the market based on the nature of the assets under management; and
- there are a large number of possible outcomes.

As a result, Investment Manager M determines that the revenue recognized during the reporting period is limited to the quarterly management fees for completed quarters. This determination is made each reporting date and could change towards the end of the contract period.

Observations

Constraint assessment made against cumulative revenue

When constraining its estimate of variable consideration, an entity assesses the potential magnitude of a significant revenue reversal relative to the cumulative revenue recognized – i.e. for both variable and fixed consideration, rather than on a reversal of only the variable consideration. The assessment of magnitude is relative to the transaction price for the contract, rather than the amount allocated to the specific performance obligation.
5.3 Step 3: Determine the transaction price

Specified level of confidence included in constraint requirements

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

Constraint introduces an element of prudence

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

Comparison with current IFRS

Estimation uncertainty limits rather than precludes revenue recognition

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

Comparison with current US GAAP

Applying the constraint

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

An asset manager’s performance-based incentive fees are subject to the revenue constraint. The inclusion of these fees in the transaction price is limited to amounts for which it is probable that a significant revenue reversal will not occur, considering that the consideration is highly susceptible to external factors – e.g. market volatility (see Example 19 in this publication).

Under the new standard, an entity may recognize revenue earlier or later than under current US GAAP, depending on its current accounting policy election.

Under current US GAAP, an entity may elect to recognize incentive fee income at the end of the contract (Method 1) or recognize the amount that would be due under the formula at each reporting date (Method 2). Although Method 2 under current SEC guidance is seen by some as providing a reasonable depiction of an asset manager’s performance in each period, it is not consistent with the constraint’s objective, because a risk of significant revenue reversal due to market volatility is likely to exist, especially early in the performance period.

The new standard’s guidance on performance-based incentive fees is also different from Method 1 under current SEC guidance. This is because an asset manager would recognize a portion of the performance-based incentive fee before the contingency is resolved if it is probable that there will not be a significant revenue reversal when the uncertainty is resolved.

For example, an asset manager might lock in the performance fee before the end of the contract period by investing the managed funds in money market investments and intend to hold the managed funds in money market investments until the end of the contract period. In this case, the asset manager may be able to recognize a portion of the performance fees before the end of the contract period.

Incentive-based capital allocations

Performance-based incentive fees can be a capital allocation in the form of carried interest in a partnership or similar structure. Current US GAAP views fees in this form as compensation for investment management services. Feedback from recent industry outreach confirmed that asset managers generally agree with this view. However, if the SEC withdraws its current guidance, then there could be a question about whether an in-form equity fee is in the scope of the new revenue standard. The FASB confirmed that it intended these arrangements to be in the scope of the new standard, regardless of the form of consideration. The FASB may therefore consider whether a technical correction is needed to clarify this.

The SEC has indicated that it would not object to accounting for a carried interest that is in-form equity under the revenue standard. It also indicated that, in the absence of a technical correction, there was a basis for an alternative view that these arrangements are not in the scope of the revenue standard. However, the accounting for asset management arrangements in the form of a carried interest based on guidance in US GAAP would not necessarily result in revenue classification or a Method 2 measurement and recognition for a carried interest.
Many entities sell products through distributors or resellers. When a reseller is unable to sell the products, the entity is often compelled to grant a price concession, offer price protection, or accept product returns.

Under current US GAAP, some entities conclude that fees are not fixed or determinable, or that the significant risks and rewards of ownership have not been transferred to the customer if the entity has a history of offering price concessions. These entities recognize revenue when they have evidence that the reseller has sold the product to an end customer (sell-through), rather than when they sell products to a distributor or reseller (sell-in).

However, other entities conclude that the fees are fixed or determinable because they can reasonably predict the amount of price concessions or returns that will be given to customers based on the entity’s historical experience. These entities recognize revenue on sell-in.

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

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

Sell-through may not be appropriate unless:

- control of the goods has not transferred – e.g. inventory is consigned (see 5.5.6); or
- by applying the constraint, the amount recognized on selling to the distributor or reseller will be zero (which will not usually be the case) – i.e. the entire amount of consideration is at risk of a significant revenue reversal. The entity needs to update its assessment of whether an estimate of the amount is constrained at each reporting date. Even then, however, if the entity has transferred control of the products to the distributor or reseller, it will derecognize the inventory and recognize the related cost of goods sold.
Under current US GAAP on software revenue recognition, for transactions in which the risk of technological obsolescence is high, an arrangement fee is presumed not to be fixed or determinable if payment of a significant portion of the licensing fee is not due until after expiration of the license, or more than 12 months after delivery. Other entities with extended payment terms and technological obsolescence risk sometimes follow this guidance by analogy.

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

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

### 5.3.2 Significant financing component

#### Requirements of the new standard

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

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

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

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

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

<table>
<thead>
<tr>
<th>Factor</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>An entity receives an advance payment, and the timing of the transfer</td>
<td>A prepaid phone card or customer loyalty points</td>
</tr>
<tr>
<td>of goods or services to a customer is at the discretion of the</td>
<td></td>
</tr>
<tr>
<td>customer</td>
<td></td>
</tr>
<tr>
<td>A substantial portion of the consideration is variable, and the</td>
<td>A transaction whose consideration is a sales-based royalty</td>
</tr>
<tr>
<td>amount or timing of the consideration is outside the customer’s or</td>
<td></td>
</tr>
<tr>
<td>entity’s control</td>
<td></td>
</tr>
<tr>
<td>The difference between the amount of promised consideration and the</td>
<td>Protection against the counterparty not completing its obligations</td>
</tr>
<tr>
<td>cash selling price of the promised goods or services arises for non-finance</td>
<td>under the contract</td>
</tr>
<tr>
<td>reasons</td>
<td></td>
</tr>
</tbody>
</table>

The new standard indicates that:

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

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

For contracts with an overall duration greater than one year, the practical expedient applies if the period between performance and payment for that performance is one year or less.
The financing component is recognized as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears), and is presented separately from revenue from customers.

Example 20 – Time value of money in a multiple-element arrangement

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

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

Product Company B accounts for the contract as follows.

<table>
<thead>
<tr>
<th>Contract inception</th>
<th>Recognize a contract liability for the payment of 150,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years 1 and 2</td>
<td>During the two years from contract inception until the transfer of Product X, recognize interest expense of 9,000 and 9,540(^{(a)}) on 150,000 at 6% for Years 1 and 2, respectively, for a cumulative interest expense of 18,540</td>
</tr>
<tr>
<td></td>
<td>Recognize revenue of 42,135(^{(b)}) for the transfer of Product X</td>
</tr>
<tr>
<td>Years 3, 4 and 5</td>
<td>Recognize annual interest expense of 7,584, 8,039, 8,522(^{(c)}) for Years 3, 4, and 5, respectively, based on the contract liability at the beginning of Year 3 of 126,405(^{(d)})</td>
</tr>
<tr>
<td></td>
<td>Recognize revenue of 150,550(^{(e)}) for the transfer of Product Y</td>
</tr>
</tbody>
</table>

Notes

a. Calculated as 150,000 \(\times .06\) for Year 1 and 159,000 \(\times .06\) for Year 2.

b. Calculated as 37,500 + 4,635, being the initial allocation to Product X plus Product X’s portion of the interest for Years 1 and 2 of the contract (37,500 \(\div 150,000\) \(\times 18,540\)).

c. Calculated as 126,405 \(\times .06\) = 7,584; (126,405 + 7,584) \(\times .06\) = 8,039; and (126,405 + 7,584 + 8,039) \(\times .06\) = 8,522.

d. Calculated as 150,000 + 18,540 - 42,135, being the initial contract liability plus interest for two years less the amount derecognized from the transfer of Product X.

e. Calculated as 126,405 + 24,145, being the contract liability balance after two years plus interest for three years.
5.3 Step 3: Determine the transaction price

Example 21 – Determining whether an arrangement has a significant financing component – Payment in advance

Technology Company T signs a three-year, noncancellable agreement with Customer C to provide hosting services. Customer C may elect to either pay:

a. 140 per month (total payment is 5,040); or

b. 4,200 at the beginning of the contract term, with no additional monthly payments.

The contract includes a financing component.

The difference in pricing between option (a) and option (b) indicates that the contractual payment terms under option (b) have the primary purpose of providing Technology Company T with financing. The cash-selling price is the monthly fee of 140 because it reflects the amount due when the monthly hosting services are provided to Customer C. A comparison of the payment terms between options (a) and (b) indicates the total cumulative interest of 840 and an implied discount rate of 13%.

Technology Company T considers if factors indicating that a significant financing component does not exist apply in this case and concludes that they do not. Technology Company T determines that the financing component is significant because the difference between the cumulative cash-selling price of 5,040 and the financed amounts of 4,200 is 840, or approximately 20% of the financed amount. Therefore, an adjustment to reflect the time value of money will be needed if the customer elects option (b) to pay at the beginning of the contract.

Technology Company T evaluates whether the implied discount rate of 13% is consistent with the market rate of interest for companies with the same credit rating as its own. Assuming that it is, Technology Company T recognizes revenue of 5,040 ratably over the contract term as the performance obligation is satisfied and interest expense of 840 using the effective interest method. The amount of interest expense to recognize each period is based on the projected contract liability, which decreases as services are provided and increases for the accrual of interest.

Below is one example interest calculation under the effective interest method.

<table>
<thead>
<tr>
<th>Period</th>
<th>Contract liability – Beginning of month</th>
<th>Transaction price/ Delivery of service</th>
<th>Interest expense at 1.083% (Monthly rate – 13% ÷ 12)</th>
<th>Contract liability – End of month</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>4,200</td>
<td>140</td>
<td>44</td>
<td>4,104</td>
</tr>
<tr>
<td>2</td>
<td>4,104</td>
<td>140</td>
<td>43</td>
<td>4,007</td>
</tr>
<tr>
<td>3</td>
<td>4,007</td>
<td>140</td>
<td>42</td>
<td>3,909</td>
</tr>
<tr>
<td>4</td>
<td>3,909</td>
<td>140</td>
<td>41</td>
<td>3,810</td>
</tr>
<tr>
<td>5</td>
<td>3,810</td>
<td>140</td>
<td>40</td>
<td>3,710</td>
</tr>
<tr>
<td>36</td>
<td>140</td>
<td>140</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Continue for each period…
If, in the above example, the implied discount rate of 13% is determined to be an above-market rate, then the transaction price would be adjusted to reflect a market rate, based on Technology Company T’s creditworthiness. The difference between the implied discount rate and the market rate would represent a discount granted to the customer for purposes other than financing.

**Example 22 – Determining whether an arrangement has a significant financing component – Payment in arrears**

Manufacturer A enters into a contract to provide equipment to Customer C priced at 2,000,000. Customer C is a start-up entity with limited cash and Manufacturer A agrees that Customer C would pay for the equipment over two years by monthly installments of 92,000.

The contract includes a financing component. The difference in pricing between the selling price of 2,000,000 and the total of the monthly payments of 2,208,000 (24 x 92,000) indicates that the contractual payment terms have the primary purpose of providing Customer C with financing. The cash-selling price is 2,000,000 because it reflects the amount due at the point the equipment is transferred to Customer C. A comparison of the cash selling price and the total payments to be received indicates the total cumulative interest of 208,000 and an implied interest rate of 9.7%.

Technology Company T considers if factors indicating that a significant financing component does not exist apply in this case and concludes that they do not. Manufacturer A determines that the financing component is significant because the difference between the cash-selling price of 2,000,000 and the total promised consideration of 2,208,000 is 208,000, or approximately 10% of the financed amount. Therefore, an adjustment to reflect the time value of money is needed.

Manufacturer A evaluates whether the implied interest rate of 9.7% is consistent with the market rate of interest for companies with the same credit-standing as Customer C. Assuming that it is, Manufacturer A recognizes revenue of 2,000,000 upon delivery of the equipment – i.e. as the performance obligation is satisfied – and interest income on a monthly basis using the effective interest method. The amount of interest income for each month is based on the balance of the receivable for equipment sold, which decreases as payments are received.
Below is one example interest calculation under the effective interest method.

<table>
<thead>
<tr>
<th>Period</th>
<th>Receivable – Beginning of month</th>
<th>Monthly payment – End of month</th>
<th>Interest income at 0.81% (Monthly rate – 9.7% ÷ 12)</th>
<th>Receivable – End of month</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2,000,000</td>
<td>92,000</td>
<td>16,143</td>
<td>1,924,143</td>
</tr>
<tr>
<td>2</td>
<td>1,924,143</td>
<td>92,000</td>
<td>15,531</td>
<td>1,847,674</td>
</tr>
<tr>
<td>3</td>
<td>1,847,674</td>
<td>92,000</td>
<td>14,913</td>
<td>1,770,587</td>
</tr>
<tr>
<td>4</td>
<td>1,770,587</td>
<td>92,000</td>
<td>14,291</td>
<td>1,692,878</td>
</tr>
<tr>
<td>5</td>
<td>1,692,878</td>
<td>92,000</td>
<td>13,664</td>
<td>1,614,542</td>
</tr>
<tr>
<td>...</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>91,263</td>
<td>92,000</td>
<td>737</td>
<td>0</td>
</tr>
</tbody>
</table>

Continue for each period...

If, in the above example, the implied interest rate of 9.7% is determined to be a below-market rate, then the transaction price would be adjusted to reflect a market rate, based on Customer C’s creditworthiness. The difference between the implied interest rate and the market rate would represent a discount granted to the customer for purposes other than financing.

**Observations**

**Assessment is undertaken at the individual contract level**

An entity determines the significance of the financing component at an individual contract level, rather than at a portfolio level. The individual contract level for a particular customer could consist of more than one contract if the contract combination criteria in the new standard are met. However, the Boards believe that it would be unduly burdensome to require an entity to account for a financing component if the effects of the financing component are not material to the individual contract, but the combined effects for a portfolio of similar contracts would be material to the entity as a whole. An entity should apply judgment in evaluating whether a financing component is significant to the contract.
5 The model

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

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

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

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

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

Determining whether a difference between the amount of promised consideration and the cash selling price of the goods or services arises for reasons other than the provision of finance requires judgment. An entity considers all relevant facts and circumstances, including whether the difference is proportionate to any other reason provided. Also, it may be more common for the difference to be for a reason other than financing when payments are received in advance of the delivery of goods or services.

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

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

606-10-55-233 – 55-234 (Example 27) [IFRS 15.IE141–IE142]

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

Determining the effect of the time value of money for a contract with a significant financing component can be complex for long-term or multiple-element arrangements. In these contracts:
- goods or services are transferred at various points in time;
- cash payments are made throughout the contract; and
- there may be a change in the estimated timing of the transfer of goods or services to the customer.
5.3 Step 3: Determine the transaction price

If additional variable elements are present in the contract – e.g. contingent consideration – then these calculations can be even more sophisticated, involving significant cost and complexity for preparers.

In addition, an entity will need to have appropriate processes and internal controls to handle these potential complexities in assessing whether a significant financing component exists and, if so, developing the appropriate calculations and estimates.

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

It may not be appropriate to use an interest rate that is explicitly specified in the contract, because the entity might offer below-market financing as a marketing incentive. Consequently, an entity applies the rate that would be used in a separate financing transaction between the entity and its customer that does not involve the provision of goods or services.

This can lead to practical difficulties for entities with large volumes of customer contracts and/or multinational operations, because they will have to determine a specific discount rate for each customer, class of customer, or geographical region of customer.

**Presentation of interest income as revenue is not precluded**

The new standard does not preclude an entity from presenting interest income (when it has provided financing to the customer) as a type of revenue if the interest represents income arising from ordinary activities – e.g. entities that have significant lending operations.

**Advance payments will affect EBITDA**

When an entity receives an advance payment that includes a significant financing component, it increases the amount of revenue recognized, with a corresponding increase to interest expense. This change results in an increase to EBITDA, which may affect compensation and other contractual arrangements.

**Application of the practical expedient with multiple performance obligations**

In a contract with two or more performance obligations, identifying the period between customer payment and the transfer of goods or services may present challenges, especially when the performance obligations are satisfied at different points in time and consideration is paid over time or all at once.
In some contracts that include consideration paid over time, one performance obligation is completed in the early stages of a contract, while a second performance obligation continues for an extended period of time. In such cases, the entity generally allocates each payment received to both performance obligations in the contract on a pro rata basis to calculate the financing component and determine whether the practical expedient applies (rather than allocating payments to a single performance obligation until it has been fully paid, as would be the case with a FIFO allocation).

In other contracts, consideration includes an up-front payment and performance obligations are completed consecutively over time. An entity evaluates all relevant evidence, including termination clauses, to determine whether it is appropriate for an up-front cash payment to be allocated to the first performance obligation when determining whether the practical expedient can be applied at the contract level.

**A contract with an implied interest rate of zero may contain a financing component**

When the consideration to be received for a good or service with extended payment terms is the same as the cash selling price, the implied interest rate is zero. However, a significant financing component may still exist.

For example, retailers sometimes offer a promotional incentive that allows customers to buy items such as furniture and pay the cash selling price two years after delivery. Judgment is required to evaluate whether in these circumstances an entity is offering a discount or other promotional incentive for customers who pay the cash selling price at the end of the promotional period equal to the financing charge that would otherwise have been charged in exchange for financing the purchase.

If the entity concludes that financing has been provided to the customer, then the transaction price is reduced by the implicit financing amount and interest income is accreted. The implicit financing amount is calculated using the rate that would be used in a separate financing transaction between the entity and its customer.

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**Comparison with current IFRS**

**No specific guidance for advance payments**

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

### Requirements of the new standard

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

### Comparison with current US GAAP

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

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

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

### Accounting for financing for payments in arrears may be more frequent

Under current US GAAP, extended payment terms may result in a conclusion that revenue is not fixed or determinable which precludes revenue recognition. In those cases, entities default to a due-and-payable revenue model and do not account for a financing element. Under the new standard, the transaction price is estimated and a separate evaluation is performed to determine whether the payment terms provide financing to the customer. As a result, the accounting for financing in arrangements where the customer pays in arrears will likely arise more frequently. This accounting will result in a decrease in revenue and an increase in interest income as compared to similar arrangements under current US GAAP.
Estimates of the fair value of noncash consideration may vary. Although this may be due to the occurrence or non-occurrence of a future event, it can also vary due to the form of the consideration – e.g. variations due to changes in the price per share if the noncash consideration is an equity instrument.

When the fair value of noncash consideration varies for reasons other than the form of the consideration, those changes are reflected in the transaction price and are subject to the guidance on constraining variable consideration.

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

**US GAAP only**

Noncash consideration is measured at contract inception.

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**Difference between IFRS and US GAAP**

**Difference in guidance on measurement date for noncash consideration between US GAAP and IFRS**

The FASB amended its standard to require noncash consideration to be measured at contract inception. In contrast, the IASB did not believe that this specificity was necessary and did not make a corresponding amendment to its standard.

Example 31 in IFRS 15 illustrates how an entity measures equity instruments for a single performance obligation that is satisfied over time. On completion of each weekly service, the entity measures the fair value of the shares received as consideration for that week. Subsequent changes in the fair value of the shares received are not presented as revenue.

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

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

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

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

The determination of whether a change in fair value was caused by the form of the noncash consideration or other reasons, and the determination of how to allocate fair value changes between those affecting transaction price and those that do not, may be challenging in some situations.

Measurement date of share-based payments received by an entity is not specified (IFRS only)

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

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

When the terms of an equity-based compensation arrangement change after the measurement date, the incremental portion of the change in fair value is not considered revenue.
Comparison with current IFRS

Changes in the measurement threshold

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

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

Barter transactions involving advertising services

Currently, revenue from advertising barter transactions is measured at the fair value of the advertisement services given, if their fair value can be measured reliably. Furthermore, an exchange of similar advertisement services is not a transaction that generates revenue under current IFRS.

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

Transfer of assets from customers

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

Comparison with current US GAAP

Exchanges of non-monetary assets

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

One of the requirements for a contract to exist under the new standard is that it has commercial substance, which would result in non-monetary exchanges being accounted for at fair value. Under the new standard, if an entity cannot reasonably estimate the fair value of the noncash consideration received, then it looks to the estimated selling price of the promised goods or services.
However, under current US GAAP, rather than looking to the estimated selling price of the promised goods or services, the entity uses the fair value of either the assets received or the assets relinquished in the exchange – unless the fair value of the assets cannot be determined within reasonable limits, or the transaction lacks commercial substance.

**Goods or services in exchange for share-based payments**

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

The new standard eliminates current US GAAP on the accounting for share-based payments received by an entity in exchange for goods or services. Therefore, equity instruments received in a contract with a customer are accounted for consistently with other noncash consideration and measured at contract inception. When the fair value of equity-based consideration changes because of the form of consideration (i.e. changes in the value per share of stock) after the measurement date, the incremental portion of the change in fair value is not considered revenue. Changes for reasons other than form (e.g. changes in the number of shares to be received) give rise to variable consideration, which is included in revenue in accordance with the constraint guidance.

**Use of the estimated selling price**

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

In addition, the new standard eliminates the specific requirements on determining whether sufficient evidence exists – including prescriptive guidance requiring sufficient recent cash transactions to support the selling price – when recognizing revenue on exchanges of advertising space and exchanges involving barter credit transactions. Rather, under the new standard an entity recognizes revenue based on the fair value of the services received if that fair value can be reasonably estimated in a barter transaction involving advertising services. If not, the entity recognizes revenue based on the estimated stand-alone selling price of the services provided.

However, the entity will need to conclude that the contract has commercial substance – i.e. that it will change the amount, timing, or uncertainty of the contract’s future cash flows – in order to conclude that a contract exists. Otherwise, no revenue is recognized because the requirements for a contract under the new standard are not met.
5.3.4 Consideration payable to a customer

Requirements of the new standard

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

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

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

Does the consideration payable to a customer (or to the customer’s customer) represent a payment for a distinct good or service?

- **Yes**
  - Can the entity reasonably estimate the fair value of the good or service received?
    - **Yes**
      - Does the consideration payable exceed the fair value of the distinct good or service?
        - **Yes**
          - Excess of consideration payable is accounted for as a reduction of the transaction price
        - **No**
          - Consideration payable is accounted for as a purchase from suppliers
    - **No**
      - Consideration payable is accounted for as a reduction of the transaction price and recognized at the later of when:
        - the entity recognizes revenue for the transfer of the related goods or services
        - the entity pays or promises to pay the consideration (which might also be implied)

- **No**
  - Does the consideration payable to a customer exceed the fair value of the distinct good or service?
    - **Yes**
      - Consideration payable is accounted for as a purchase from suppliers
    - **No**
      - Consideration payable is accounted for as a reduction of the transaction price and recognized at the later of when:
        - the entity recognizes revenue for the transfer of the related goods or services
        - the entity pays or promises to pay the consideration (which might also be implied)
5.3 Step 3: Determine the transaction price

Example 23 – Payments to customers – Reduction in the transaction price

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

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

Example 24 – Payments to customers – Variable consideration

Company C contracts with Retailer X and delivers goods on December 15, Year 1. On January 20, Year 2, Company C offers coupons in a newspaper to encourage retail sales of the goods sold to Retailer X. Company C agrees to reimburse Retailer X for coupons redeemed.

Company C offered similar coupons in the prior years.

Company C would likely determine that the transaction price for the goods sold on December 15, Year 1 included variable consideration, given its history of offering coupons.

Conversely, if Company C had not offered coupons in prior years and did not expect to offer any coupons at contract inception, then it would recognize the amount payable to the retailer as an adjustment to revenue when it communicated to Retailer X its intention to reimburse Retailer X for any redeemed coupons.
Payments to distributors and retailers may be for distinct goods or services

Consumer goods companies often make payments to their distributors and retailers. In some cases, the payments are for identifiable goods or services – e.g. co-branded advertising. In these cases, the goods or services provided by the customer may be distinct from the customer’s purchase of the seller’s products.

If the entity cannot estimate the fair value of the good or service received from the customer, then it recognizes the payments as a reduction of the transaction price. If the payments to customers exceed the fair value of the good or service provided, then any excess is a reduction in the transaction price.

No specific guidance on slotting fees

Slotting fees are payments made to a retailer in exchange for product placement in the retailer’s store. Although IFRS is silent on how to account for slotting fees, in practice, an entity determines whether the payments are for an identifiable benefit that is separable from the supply contract, and therefore recognized as an expense; or whether they are a reduction in price, and therefore recognized as a reduction of revenue.

Under US GAAP, the payments are presumed to be a reduction in revenue.

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

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

The new standard does not contain an example, and is silent on its application to slotting fees. As a consequence, an entity will need to carefully consider the guidance above with respect to its particular circumstances to conclude whether these payments are for a distinct good or service or should be treated as a reduction of the transaction price.

For many of these arrangements, this will require significant judgment and an entity will need appropriate internal controls and documentation to support its judgment.
Scope of consideration payable to a customer is wider than payments made under the contract

Payments made to a customer that are not specified in the contract may still represent consideration payable to a customer. An entity will need to develop a process for evaluating whether any other payments made to a customer are consideration payable that requires further evaluation under the standard.

The determination of how broadly payments within a distribution chain should be evaluated requires judgment. However, an entity need not always identify and assess all amounts ever paid to a customer to determine if they represent consideration payable to a customer.

Consideration payable may include payments made outside a direct distribution chain

Consideration payable to a customer includes amounts paid to a customer’s customer – i.e. amounts paid to end customers in a direct distribution chain. However, in some cases an entity may conclude that it is appropriate to apply the guidance more broadly – i.e. to amounts paid outside the direct distribution chain.

For example, Marketing Company M may market and incentivize the purchase of Merchant P’s products by providing coupons to Merchant P’s Buyer B. When Buyer B purchases from Merchant P as a result of Marketing Company M’s actions, Marketing Company M earns revenue from Merchant P. Buyer B is not purchasing Marketing Company M’s services and is not within a direct distribution chain.

Service fee based on number of units sold by Merchant P

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606-10-32-25, ASU 2014-09.BC92, BC255
[IFRS 15.70, BC92, BC255]
Depending on the facts and circumstances, Marketing Company M may conclude that both Merchant P and Buyer B are its customers, or it may conclude that only Merchant P is its customer. As a consequence, judgment will be needed to evaluate a specific fact pattern to determine whether a payment to a party outside a direct distribution chain is treated as consideration payable to a customer and therefore as a reduction of revenue.

**Amounts payable to a customer may be either variable consideration or consideration payable to a customer**

The new standard states that consideration payable to a customer includes amounts that an entity pays, or expects to pay, to a customer or to other parties that purchase the entity’s goods or services from the customer. The guidance on consideration payable to a customer states that it is recognized at the later of when the entity recognizes revenue or when the entity pays or promises to pay the consideration. However, because consideration payable to a customer can be included in the transaction price, it can also be a form of variable consideration.

Variable consideration is estimated and included in the transaction price at contract inception, and remeasured at each subsequent financial reporting date. This is different from the guidance on when to recognize consideration payable to a customer.

This discrepancy puts pressure on the determination, at contract inception, of whether the entity intends to provide an incentive or the customer has a reasonable expectation that an incentive will be provided.

This evaluation includes an assessment of the entity’s past practice and other activities that could give rise to an expectation at contract inception that the transaction price includes a variable component. The consideration payable to a customer guidance is used only when an entity has not promised a payment to the customer at contract inception, either implicitly (including through its customary business practice) or explicitly.

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**Comparison with current IFRS**

**Customer incentives**

Accounting for customer incentives and similar items is a complex area for which there is limited guidance under current IFRS, other than specific guidance on customer loyalty programs (see 10.4). Customer incentives take many forms, including cash incentives, discounts and volume rebates, free or discounted goods or services, customer loyalty programs, loyalty cards, and vouchers.

Currently, there is some diversity in practice over whether incentives are accounted for as a reduction in revenue, an expense, or a separate deliverable (as in the case of customer loyalty programs), depending on the type of incentive. The requirements of the new standard may change the accounting for some entities.
5.3 Step 3: Determine the transaction price

### Comparison with current US GAAP

#### No rebuttable presumption

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

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

#### Other parties in the distribution chain

Similar to current US GAAP, the new standard requires an entity to consider other parties in the distribution chain that purchase the entity’s goods or services from the entity’s customer when applying the guidance on consideration payable to the customer. However, judgment needs to be applied to evaluate the nature of the transaction with a customer’s customer in order to conclude whether the transaction should be included in the determination of the transaction price.

#### Reduction of revenue may be recognized earlier in some cases

The new standard indicates that consideration payable to a customer might be implied by the entity’s customary business practices. Under current US GAAP, consideration payable to a customer is recognized at the later of when revenue is recognized and when an offer is made to a customer – which some have interpreted to be when an explicit offer is made to the customer. When an entity’s promise to pay the consideration is implied by its customary business practices, the consideration payable to a customer that is accounted for as a reduction of revenue could be recognized earlier under the new standard than under current US GAAP.
5.4  Step 4: Allocate the transaction price to the performance obligations in the contract

Overview

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

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

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

5.4.1  Determine stand-alone selling prices

Requirements of the new standard

The ‘stand-alone selling price’ is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of this is an observable price from stand-alone sales of the good or service to similarly situated customers.

A contractually stated price or list price may be the stand-alone selling price of that good or service, but this is not presumed to be the case.
If the stand-alone selling price is not directly observable, then the entity estimates the amount using a suitable method (see 5.4.1.1) as illustrated below. In limited circumstances, an entity may estimate the amount using the residual approach (see 5.4.1.2).

**Allocate based on relative stand-alone selling prices**

<table>
<thead>
<tr>
<th>Performance obligation 1</th>
<th>Performance obligation 2</th>
<th>Performance obligation 3</th>
</tr>
</thead>
</table>

**Determine stand-alone selling prices**

Is an observable price available?

- Yes
  - Use the observable price
  - Adjusted market assessment approach
  - Expected cost plus a margin approach

- No
  - Estimate price
  - Residual approach (only in limited circumstances)

**Observations**

**New standard does not contain a reliability threshold**

Under the new standard, the stand-alone selling price is determined at contract inception for each performance obligation. There are no circumstances in which revenue recognition is postponed because it is difficult to determine a stand-alone selling price.

If an observable price is available, then it is used to determine the stand-alone selling price; if not, then the entity is required to estimate the amount.

The new standard does not require that the amount can be ‘reliably’ estimated, nor does it prescribe another threshold. An entity is required to maximize the use of observable inputs, but in all circumstances will need to arrive at a stand-alone selling price and allocate the transaction price to each performance obligation in the contract.

An entity will need to apply judgment when there are observable prices but they are highly variable.
Introduction of specific guidance

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

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

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

More flexibility in establishing stand-alone selling prices

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

- vendor-specific objective evidence (VSOE) of the selling price, if it exists;
- third-party evidence of the selling price, if VSOE does not exist; or
- the best estimate of the selling price, if neither VSOE nor third-party evidence exists.

The effect of allocating the transaction price to performance obligations based on stand-alone selling prices will vary among contracts and industries. However, the approach and methods available for establishing stand-alone selling prices provide more flexibility than is currently available – e.g. using ‘observable selling prices’ under the new standard versus the current practice of establishing VSOE (e.g. 80 percent of sales within +/- 15 percent of the median selling price for the good or service).
5.4.1 Step 4: Allocate the transaction price to the performance obligations in the contract

5.4.1.1 Estimating stand-alone selling prices

Requirements of the new standard

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

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

- **Adjusted market assessment approach**: Evaluate the market in which goods or services are sold and estimate the price that customers in the market would be willing to pay.

- **Expected cost plus a margin approach**: Forecast the expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.

- **Residual approach (limited circumstances)**: Subtract the sum of the observable stand-alone selling prices of other goods or services promised in the contract from the total transaction price.

After contract inception, an entity does not reallocate the transaction price to reflect subsequent changes in stand-alone selling prices. For a discussion of changes in a transaction price as a result of a contract modification, see 7.2.

**Observations**

**Judgment will often be required**

Often, there will not be observable selling prices for all of the goods or services in a contract with a customer. As a result, significant judgment will often be involved in estimating a stand-alone selling price. While some entities may already have robust processes in place, others will need to develop new processes with appropriate internal controls for estimating stand-alone selling prices of goods or services that are not typically sold separately.
Reasonably available information that may be considered in developing these processes might include:

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

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

1. **Gather all reasonably available data points**
2. **Consider adjustments based on market conditions and entity-specific factors**
3. **Consider the need to stratify selling prices into meaningful groups**
4. **Weigh available information and make the best estimate**
5. **Establish processes for ongoing monitoring and evaluation**

Estimated stand-alone selling prices for a particular good or service may change over time due to changes in market conditions and entity-specific factors. Although the estimated stand-alone selling prices for previously allocated arrangements are not revised, new arrangements should reflect current reasonably available information, including shifts in pricing, customer base, or product offerings.

The extent of the monitoring process and the frequency of necessary changes to estimated stand-alone selling prices will vary based on the nature of the performance obligations, the markets in which they are being sold, and various entity-specific factors. For example, a new product offering or sales in a new geographical market may require more frequent updates to the estimated stand-alone selling price as market awareness and demand change.
5.4 Step 4: Allocate the transaction price to the performance obligations in the contract

If there is a range of observable prices, then a stated contract price within the range may be an acceptable stand-alone selling price

In some cases, an entity may sell a good or service separately for a range of observable prices. When this is the case and the stated contract price is within a sufficiently narrow range of observable selling prices, it may be appropriate to use a stated contract price as the estimated stand-alone selling price of a good or service.

To determine whether this is appropriate, an entity assesses whether an allocation of the transaction price based on such an estimate would meet the allocation objective (see 5.4.2). As part of this assessment, an entity considers all information that is reasonably available (including market conditions, entity-specific factors, information about the customer or class of customer, how wide the range of observable selling prices is, and where the stated price falls within the observable range).

For example, Company D sells a license plus post-contract customer support (PCS) for 450. The stated price for PCS in the contract is 206. The same PCS is regularly sold separately for observable prices ranging from 200 to 210. In this example, the stated price is within a reasonably narrow range of observable prices, and assuming that there are no other indicators that using the stated price would not meet the allocation objective, it may be appropriate to conclude that 206 is a reasonable estimate of the stand-alone selling price for the PCS that can be used in determining how to allocate the contract consideration of 450 between the license and PCS.

Using a range to estimate stand-alone selling prices

When estimating stand-alone selling prices, it may be acceptable to select from a range of prices, particularly when stand-alone selling prices would be expected to vary for similar types for customers. A range has to be narrow and based on an analysis that maximizes observable inputs and supports an assertion that any price within that range would be a valid pricing point if the performance obligation were sold on a stand-alone basis.

It would not be appropriate to establish a range by determining an estimated stand-alone selling price and then arbitrarily adding a range of a certain percentage on either side of the point estimate to create a reasonable range of estimated selling prices.
Comparison with current IFRS

Similar emphasis on use of observable inputs

Under current IFRS, our view is that a cost plus a margin approach should generally be applied only when it is difficult to measure the fair value of a component based on market inputs because there are few inputs (see 4.2.60.110 of *Insights into IFRS*, 12th Edition). This emphasis on the use of available market inputs – e.g. sales prices for homogeneous or similar products – is consistent with the new standard’s requirement to maximize the use of observable inputs.

Comparison with current US GAAP

No specified hierarchy for non-observable inputs

Multiple-element arrangement guidance currently contains a specified hierarchy for determining the selling price. Similar to the requirement to use VSOE first, the new standard requires an entity to use ‘observable prices’ (which might be a lower threshold than VSOE) when it sells a good or service separately.

However, the new standard does not prescribe a hierarchical order or a particular method for estimating the stand-alone selling price when observable prices are not available.

The new standard requires entities to maximize the use of observable inputs when estimating a selling price. For example, even when observable prices are not consistent enough to constitute VSOE, an entity will still consider those observable transactions in estimating the stand-alone selling price of the good or service.

Furthermore, an entity may be able to use an alternative estimation method, even if third party evidence of the selling price is available, as long as the approach taken maximizes the use of observable inputs. Similar to current multiple-element arrangement guidance, the new standard does not specifically require the stand-alone selling price to be a point estimate. As a result the practice of using narrow price ranges to estimate selling prices will continue to be appropriate (see discussion above).

The new standard applies the same approach regardless of the type of transaction or industry, and therefore differs from certain transaction- and industry-specific guidance in US GAAP – e.g. the use of the residual method if VSOE exists for undelivered items in a software arrangement or the requirement to assign the stated price in an extended-price warranty arrangement to the warranty component of the arrangement.
5.4 Step 4: Allocate the transaction price to the performance obligations in the contract

### No automatic conclusion for stated renewal percentages

Under current US GAAP guidance, a PCS renewal rate expressed as a consistent percentage of the stated license fee constitutes VSOE of fair value for PCS if the renewal percentage is substantive.

Under the new standard, PCS with a stated renewal percentage is not automatically considered to be an observable price. Rather, an entity should consider the stated renewal percentage rate as one data point in the overall evaluation and determination of the stand-alone selling price of PCS. Examples of other data points to consider are actual renewals or similar contracts with differing renewal rates.

### 5.4.1.2 Using the residual approach to estimate stand-alone selling prices

#### Requirements of the new standard

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

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

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

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

- the residual approach to estimate the aggregate stand-alone selling prices for all of the promised goods or services with highly variable or uncertain stand-alone selling prices; and then

- another technique to estimate the stand-alone selling prices of the individual goods or services relative to the estimated aggregate stand-alone selling price that was determined by the residual approach.

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

The PCS services comprise telephone technical support for each license. Software Vendor M has identified four performance obligations in the contract: License S; technical support for License S; License T; and technical support for License T.

The stand-alone observable price of $12,500 is available for the technical support for each of the licenses, based on renewals that are sold separately. However, the prices at which Software Vendor M has sold licenses similar to Licenses S and T have been in a broad range of amounts – i.e. selling prices of the licenses are highly variable and not directly observable. Also, the level of discounting in the bundled arrangements varies based on negotiations with individual customers.

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

<table>
<thead>
<tr>
<th>Product</th>
<th>Stand-alone selling price</th>
<th>Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Licenses S and T</td>
<td>75,000</td>
<td>Residual approach (100,000 - 12,500 - 12,500)</td>
</tr>
<tr>
<td>Technical support for License S</td>
<td>12,500</td>
<td>Directly observable price</td>
</tr>
<tr>
<td>Technical support for License T</td>
<td>12,500</td>
<td>Directly observable price</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100,000</strong></td>
<td></td>
</tr>
</tbody>
</table>
5.4 Step 4: Allocate the transaction price to the performance obligations in the contract

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

<table>
<thead>
<tr>
<th>Product</th>
<th>Average residual selling price</th>
<th>Ratio</th>
<th>Price allocation</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>License S</td>
<td>40,000</td>
<td>40%</td>
<td>30,000</td>
<td>(75,000 x 40%)</td>
</tr>
<tr>
<td>License T</td>
<td>60,000</td>
<td>60%</td>
<td>45,000</td>
<td>(75,000 x 60%)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100,000</strong></td>
<td></td>
<td><strong>75,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Observations**

The residual approach is an estimation technique, not an allocation method

The residual approach under the new standard is used for estimating the stand-alone selling price of a promised good or service. This contrasts with current revenue recognition guidance, in which the residual approach is generally used to allocate consideration between deliverables – e.g. the consideration allocated to a delivered item is often calculated as the total consideration less the fair value of the undelivered item.

In contracts for intellectual property or other intangible products, a residual approach may be appropriate for determining a stand-alone selling price

Determining stand-alone selling prices may be particularly challenging for contracts for intellectual property or intangible assets if they are infrequently sold separately but are often sold in a wide range of differently priced bundles. They often have little or no incremental cost to the entity providing those goods or services to a customer (so a cost plus a margin approach would be inappropriate) and may not have substantially similar market equivalents from which to derive a market assessment.

In these circumstances, the residual approach may be the most appropriate approach for estimating the stand-alone selling price.
The assessment of whether it is appropriate to use a residual approach should be made separately for each good or service

In some contracts, the price of one good or service may be calculated by reference to the price of another good or service. For example, in a contract containing intellectual property and PCS, the price of PCS may be established as a fixed percentage of the stated contract price of the license fee.

If this is the case and the stand-alone selling price of intellectual property is determined to be highly variable or uncertain, then an entity needs to consider all available data and evidence in determining the stand-alone selling price of the PCS rather than assuming that the fixed percentage of the contract price represents the stand-alone selling price of the PCS. The entity considers, among other evidence, the price charged for actual renewals of PCS and stated renewal rates in other contracts with similar customers.

Consideration allocated is unlikely to be zero or close to zero

If applying the residual approach under the new standard results in no or very little consideration being allocated to a good or service, or to a bundle of goods or services, then this outcome may not be reasonable unless the contract is only partially in the scope of the new standard and another standard also applies to the contract (see 4.3).

If an entity has determined in applying Step 2 of the model that a good or service is distinct, then by definition it has value to the customer on a stand-alone basis. In this case, an entity considers all reasonably available data and whether the stand-alone selling price of that good or service should be estimated using another method.

This contrasts with the use of the residual method to allocate consideration under current revenue recognition guidance, which may result in little or no consideration being allocated to the residual (delivered) item.

Comparison with current IFRS

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

Unlike current guidance, the new standard requires specific conditions to be met for an entity to use the residual approach. In addition, under the new standard the residual approach is used as a technique to estimate the stand-alone selling price of a good or service rather than as an allocation method. An entity in certain industries that use the residual approach may conclude that these conditions are not met, and therefore will need to estimate the stand-alone selling prices of goods or services using alternative methods. This will generally result in accelerated revenue recognition for the delivered good or service (e.g., a handset).
If it is appropriate to apply the residual approach under the new standard, then an entity is permitted to use it to estimate the stand-alone selling price of any promised goods or services in the contract, including undelivered items.

This is a change from our current view that the reverse residual method is not an appropriate basis for allocating revenue (see 4.2.60.50 of Insights into IFRS, 12th Edition).

Comparison with current US GAAP

Broader application of a residual approach and potential acceleration of software license revenue recognition

Using the residual approach to estimate stand-alone selling prices under the new standard may yield similar results to current guidance on multiple-element arrangements in some circumstances.

Although the residual approach is not permitted for estimating the selling price under current guidance, the amount that would be allocated may be one of several data points identified when developing an estimated selling price for the delivered element. In addition, the use of the residual method of allocation is currently permitted for:

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

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

- it can be used to develop an estimate of the selling price of a good or service, rather than to determine the allocation of consideration to a specific performance obligation – although in some circumstances it will result in the same outcome;
- its application is not limited to delivered items – i.e. a reverse residual approach is allowed; and
- it requires only observable stand-alone selling prices of other goods or services that are promised in the contract, which may allow greater application of the residual method than the requirement to establish VSOE.

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

Requirements of the new standard

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

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

Example 26 – Allocating the transaction price

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

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

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

<table>
<thead>
<tr>
<th>Performance obligation</th>
<th>Stand-alone selling prices</th>
<th>Selling price ratio</th>
<th>Price allocation</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Handset</td>
<td>200</td>
<td>40%</td>
<td>168</td>
<td>(420 x 40%)</td>
</tr>
<tr>
<td>Wireless plan</td>
<td>300</td>
<td>60%</td>
<td>252</td>
<td>(420 x 60%)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>500</strong></td>
<td><strong>100%</strong></td>
<td><strong>420</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Note**

a. In this example, the entity does not adjust the consideration to reflect the time value of money. This could happen if the entity concludes that the transaction price does not include a significant financing component, or if the entity elects to use the practical expedient (see 5.3.2).
5.4 Step 4: Allocate the transaction price to the performance obligations in the contract

Observations

Allocating the transaction price may be simple if the stated contract price is an acceptable estimate of the stand-alone selling price for all performance obligations in a contract

In some cases, an entity may determine that a stated contract price is an acceptable estimate of the stand-alone selling price for its performance obligations – e.g. if the stated contract price is within a narrow range of observable selling prices (see 5.4.1.1). If this is the case for all of the performance obligations in a contract, and there is no allocation of variable consideration or discounts, then this will simplify allocation of the transaction price.

For example, Medical Device Company (MDC) sells a medical imaging device bundled with one year of PCS and 10 days of training to a customer for a total fee of 564,900. MDC determines that the medical imaging device, PCS, and training are separate performance obligations. There is no variable consideration or discounts that are required to be allocated entirely to some but not all performance obligations.

The stated contract prices for the goods and services are as follows.

<table>
<thead>
<tr>
<th>Goods and services</th>
<th>Contract prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical imaging device</td>
<td>505,000</td>
</tr>
<tr>
<td>One year of PCS</td>
<td>50,000</td>
</tr>
<tr>
<td>Training</td>
<td>9,900</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>564,900</strong></td>
</tr>
</tbody>
</table>

MDC has established a narrow range of stand-alone selling prices for each of the goods and service identified as separate performance obligations.

<table>
<thead>
<tr>
<th>Performance obligation</th>
<th>Range of stand-alone selling prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical imaging device</td>
<td>500,000 to 525,000</td>
</tr>
<tr>
<td>One year of PCS</td>
<td>50,000 to 52,500</td>
</tr>
<tr>
<td>Training</td>
<td>960 to 990 per day</td>
</tr>
</tbody>
</table>

Because all of the stated contract prices fall within the narrow ranges, the stated contract price may be used to allocate the transaction price to the performance obligations. No further allocation is required.
Additional calculations are necessary if the stand-alone selling price of one or more performance obligations differs from its stated contract price

If the stated contract price for any of the performance obligations in the arrangement is not an appropriate estimate of stand-alone selling price, then it will be necessary for the entity to perform a relative selling price allocation of the transaction price.

This will be the case if, for example, the stated contract price falls outside the narrow range of stand-alone selling prices established for that performance obligation. When this is the case, an entity should apply a consistent policy to determine which price in the range of stand-alone selling prices should be used as the stand-alone selling price.

For example, an entity may consider a policy of using either (1) the midpoint of the range or (2) the outer limit of the range nearest to the stated contract price for that performance obligation. The appropriateness of the policy will be determined by whether the resulting allocation of the transaction price would meet the allocation objective.

This can be illustrated by varying the facts in the previous example. For example, assume that the total fee for the arrangement is 551,000, with stated contract prices of 520,000 for the medical imaging device, 26,000 for the PCS, and 5,000 for the training. The company’s policy is to estimate stand-alone selling prices using the midpoint of its narrow range of observable selling prices for performance obligations whose stated contract prices fall outside the established ranges when performing the relative selling price allocation.

Because the stated prices for PCS and training fall outside their respective estimated selling price ranges, consistent with its policy, the company allocates the transaction price using the midpoint of the ranges, as follows.

<table>
<thead>
<tr>
<th>Performance obligation</th>
<th>Stated price</th>
<th>Stand-alone selling price</th>
<th>Selling price ratio</th>
<th>Price allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical imaging device (stated price within range)</td>
<td>520,000</td>
<td>520,000(^{[a]})</td>
<td>89.5%</td>
<td>493,145</td>
</tr>
<tr>
<td>One year of PCS (midpoint of range)</td>
<td>26,000</td>
<td>51,250(^{[b]})</td>
<td>8.8%</td>
<td>48,488</td>
</tr>
<tr>
<td>Ten days of training (midpoint of range)</td>
<td>5,000</td>
<td>9,750(^{[c]})</td>
<td>1.7%</td>
<td>9,367</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>551,000</strong></td>
<td><strong>581,000</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>551,000</strong></td>
</tr>
</tbody>
</table>

**Notes**

a. Stated contract price is used because it falls within the narrow range.

b. Mid-point of range 50,000 – 52,500 is used because stated contract price is outside the narrow range.

c. Mid-point of range 960 – 990 per day x 10 days is used because stated price is outside the narrow range.
5.4.2.1 Allocating a discount

Requirements of the new standard

If the sum of the stand-alone selling prices of a bundle of goods or services exceeds the promised consideration in a contract, then the discount is generally allocated proportionately to all of the performance obligations in the contract. However, this does not apply if there is observable evidence that the entire discount relates to only one or more but not all of the performance obligations.

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

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

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

Example 27 – Allocating a discount – Transaction involving a customer loyalty program

Retailer R has a customer loyalty program that rewards a customer with 1 customer loyalty point for every 10 of purchases. Each point is redeemable for a 1 discount on any future purchases of the Retailer R’s products. During a reporting period, Customer C purchases products and gift cards for 1,200 and earns 100 points that are redeemable on future purchases. The consideration is fixed, and the stand-alone selling price of the purchased products is 1,200 (1,000 for products and 200 for gift cards). Retailer R expects 95 points to be redeemed. Retailer R estimates a stand-alone selling price of 0.95 per point (totaling 95) on the basis of the likelihood of redemption.

The loyalty points provide a material right to Customer C that it would not receive without entering into the contract. Therefore, Retailer R concludes that the promise to provide the loyalty points is a performance obligation.

The sum of the stand-alone prices of 1,295 (1,000 in products, 200 in gift cards, and 95 in loyalty points) exceeds the promised consideration of 1,200. Retailer R needs to determine whether to allocate the discount to all or only some of the performance obligations.
Retailer R regularly sells both the gift cards and the products with loyalty points on a stand-alone basis. The amounts paid for the gift cards are equal to the stand-alone selling price. Retailer R also regularly sells, on a stand-alone basis, the products and loyalty points in a bundle at substantially the same discount as under the contract being evaluated. As a result, Retailer R has evidence that the entire discount should be allocated to the promise to transfer the products and loyalty points, and not the gift card.

As a result, Retailer R determines that the discount relates entirely to the products and loyalty points. Retailer R allocates the transaction price to the products, gift cards, and loyalty points as follows.

<table>
<thead>
<tr>
<th>Performance obligation</th>
<th>Stand-alone selling price</th>
<th>Price allocation Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gift cards</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Products</td>
<td>1,000</td>
<td>913 1,000 x (1,000 ÷ 1,095)</td>
</tr>
<tr>
<td>Loyalty points</td>
<td>95</td>
<td>87 1,000 x (95 ÷ 1,095)</td>
</tr>
<tr>
<td>Total</td>
<td>1,295</td>
<td>1,200</td>
</tr>
</tbody>
</table>

Observations

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

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

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

Determination of ‘regularly sells’ will be a key judgment

Under the guidance on allocating a discount entirely to one or more performance obligations, a bundle of goods or services has to be regularly sold on a stand-alone basis. An entity may need to establish a policy to define ‘regularly sells’.

The entity will need processes and related controls to monitor sales transactions and determine which bundles are regularly sold.
5.4 Step 4: Allocate the transaction price to the performance obligations in the contract

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

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

Comparison with current IFRS

New prescriptive guidance

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

Comparison with current US GAAP

Discount may be allocated to undelivered items

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

Requirements of the new standard

Variable consideration (see 5.3.1) may be attributable to:

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

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

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

Example 28 – Variable consideration allocated entirely to one performance obligation in the contract

Company M

Contract

Equipment X
Price: 800

Equipment Y
Price: 800 or 1,000
Company M enters into a contract with Customer N for two pieces of equipment, Equipment X and Equipment Y. Company M determines that Equipment X and Equipment Y represent two performance obligations, each satisfied at a point in time. The stand-alone selling prices of Equipment X and Equipment Y are 800 and 1,000, respectively.

The price stated in the contract for Equipment X is a fixed amount of 800. For Equipment Y, the price is 800 if the equipment is used by Customer N to produce 1,000 products or less in Year 1 and 1,000 if it's used to produce more than 1,000 products in Year 1. Company M estimates that it will be entitled to variable consideration of 1,000 and that it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur.

Company M allocates the estimated 1,000 in variable consideration entirely to Equipment Y because:

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

Company M recognizes revenue for Equipment X and Equipment Y of 800 and 1,000, respectively, when control of the good is transferred to the customer.

**Comparison with current IFRS**

A new area of practice

[IAS 18.9]

There is no specific guidance in current IFRS on allocating variable consideration. Arguably, the general requirement in current IFRS to measure revenue at the fair value of the consideration received or receivable means that such guidance is less relevant than it is under the new standard.

However, the new standard’s guidance on variable consideration and the constraint, including the exception for some sales- or usage-based royalties (see 8.6), could produce counterintuitive results if variable consideration were always allocated to all performance obligations in a contract. The new standard therefore requires alternative approaches in specific circumstances.
Comparison with current US GAAP

Similarities to the milestone method

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

If a milestone is substantive, an entity currently recognizes a milestone payment as revenue when the milestone is achieved—effectively allocating the payment entirely to the efforts to satisfy the milestone.

A milestone is ‘substantive’ only if the payment is:

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

Under the new standard, similar results are likely when variable consideration in the contract remains constrained until an entity achieves a milestone that relates specifically to a distinct good or service that has been transferred. However, revenue may be recognized:

– before a milestone is achieved if it is probable that a subsequent change in the estimate of the amount of variable consideration will not result in a significant revenue reversal; or
– if the variable consideration is a sales- or usage-based royalty for a license of intellectual property, then at the later of when the customer’s sales or usage occur and when the performance obligation is satisfied or partially satisfied.
5.4 Step 4: Allocate the transaction price to the performance obligations in the contract

### Observations

**Variable consideration allocation guidance is applied before the guidance on allocating discounts**

In some cases, a contract may contain both variable consideration and a discount. For example, an entity may sell products in a bundle at a discount to the aggregate stand-alone selling prices of the products in the bundle. In addition, the transaction price may include a variable element.

In these cases, an entity applies the guidance on allocating variable consideration before it applies the guidance on allocating discounts. That is, the standard includes an allocation hierarchy. When a contract contains both variable consideration and a discount, applying the respective allocation guidance in the reverse order may result in an incorrect allocation of the transaction price.

Some contracts contain features that may be variable consideration and/or a discount – e.g. a rebate. In these cases, an entity evaluates the nature of the feature. If the rebate causes the transaction price to be variable – e.g. the amount of the rebate depends on the number of purchases that a customer makes – then the entity follows the hierarchy and applies the guidance on allocating variable consideration first. Conversely, if a rebate is fixed and not contingent – e.g. the rebate is simply a fixed discount against the aggregate stand-alone selling prices of the items in a bundle – then an entity applies the guidance on allocating discounts and does not consider the guidance on allocating variable consideration.

### 5.4.3 Changes in the transaction price

**Requirements of the new standard**

After contract inception, the transaction price may change for various reasons – including the resolution of uncertain events or other changes in circumstances that affect the amount of consideration to which an entity expects to be entitled.

In most cases, these changes are allocated to performance obligations on the same basis as at contract inception; however, changes in the transaction price resulting from a contract modification are accounted for under the new standard’s contract modifications guidance (see Section 7). If a change in the transaction price occurs after a contract modification, then it is allocated to the performance obligations in the modified contract – i.e. those that were unsatisfied or partially unsatisfied immediately after the modification – unless the:

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

A change in the transaction price is allocated to one or more distinct goods or services only if specified criteria are met (see 5.4.2.2).
Any portion of a change in transaction price that is allocated to a satisfied performance obligation is recognized as revenue – or as a reduction in revenue – in the period of the transaction price change.

**Comparison with current IFRS**

**Introduction of guidance on reallocation**

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

**Comparison with current US GAAP**

**Removal of the contingent cap**

The allocation of arrangement consideration to delivered items is currently limited to amounts of revenue that are not contingent on an entity’s future performance. The new standard does not have such a limitation: the full estimated transaction price – which includes all amounts, including contingent amounts, to which the entity expects to be entitled – is allocated on a relative stand-alone selling price basis to each separate performance obligation.

However, the recognition of variable consideration may be constrained (see 5.3.1.2). Nevertheless, the new standard’s removal of the contingent cap may accelerate the recognition of contingent or variable consideration.

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

**Overview**

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

A good or service is ‘transferred’ when or as the customer obtains control of it.
Requirements of the new standard

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

<table>
<thead>
<tr>
<th>Is the performance obligation satisfied over time – i.e., is one of the criteria met? (see 5.5.2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
</tr>
<tr>
<td>Apply that method to recognize revenue over time</td>
</tr>
</tbody>
</table>

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

Comparison with current IFRS

Over-time recognition retained, but with new criteria

Construction contracts, and contracts for rendering services, are currently accounted for under the stage-of-completion method. The new standard may result in a broadly similar profile of revenue to that under current stage-of-completion accounting, but introduces new criteria to determine when revenue should be recognized over time.

Some contracts that are currently accounted for under the stage-of-completion method may now require revenue to be recognized on contract completion. However, for other contracts over-time recognition may be required for the first time under the new model.
Over-time recognition retained, but with criteria rather than guidance based on type of activity

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

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

5.5.1 Transfer of control

Requirements of the new standard

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

<table>
<thead>
<tr>
<th>Control is …</th>
<th>… an asset.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>the ability</strong></td>
<td>– the customer has a present right</td>
</tr>
<tr>
<td><strong>to direct the use of</strong></td>
<td>– the right enables it to:</td>
</tr>
<tr>
<td></td>
<td>- deploy the asset in its activities</td>
</tr>
<tr>
<td></td>
<td>- allow another entity to deploy the asset in its activities</td>
</tr>
<tr>
<td></td>
<td>- prevent another entity from deploying the asset</td>
</tr>
<tr>
<td><strong>and obtain the remaining benefits from</strong></td>
<td>– the right also enables it to obtain potential cash flows directly or indirectly – for example, through:</td>
</tr>
<tr>
<td></td>
<td>- use of the asset</td>
</tr>
<tr>
<td></td>
<td>- consumption of the asset</td>
</tr>
<tr>
<td></td>
<td>- sale or exchange of the asset</td>
</tr>
<tr>
<td></td>
<td>- pledging the asset</td>
</tr>
<tr>
<td></td>
<td>- holding the asset</td>
</tr>
</tbody>
</table>
5.5 Step 5: Recognize revenue when or as the entity satisfies a performance obligation

Observations

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

The new standard is a control-based model. First, an entity determines whether control of the good or service transfers to the customer over time based on the criteria in the new standard and, if it does, the pattern of that transfer. If it does not, then control of the good or service transfers to the customer at a point in time, with the notion of risks and rewards being retained only as an indicator of the transfer of control (see 5.5.4).

Assessing the transfer of goods or services by considering when the customer obtains control may result in different outcomes – and therefore significant differences in the timing of revenue recognition. The Boards believe that it can be difficult to judge whether the risks and rewards of ownership have been transferred to a customer, so applying a control-based model may result in more consistent decisions about the timing of revenue recognition.

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

New conceptual basis for revenue recognition

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

Comparison with current IFRS

Move away from a risk-and-reward approach

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

IFRIC 15 introduced the notion that the criteria for recognizing a sale of goods could also be met progressively over time, resulting in the recognition of revenue over time. However, this approach is not generally applied, except in the specific circumstances envisaged in IFRIC 15.
For construction contracts that are in the scope of IAS 11, and for contracts for the rendering of services that meet the over-time criteria in the new standard, revenue is recognized by reference to the stage of completion of the transaction at the reporting date – i.e. measuring the entity’s performance in satisfying its performance obligation.

The new standard applies a control-based approach (control can be transferred either over time or at a point in time) to all arrangements, regardless of transaction type or industry.

**Comparison with current US GAAP**

**Move away from a risk-and-reward approach**

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

- persuasive evidence of an arrangement;
- the occurrence of delivery or performance;
- a fixed or determinable sales price; and
- reasonable assurance of collectibility.

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

**5.5.2 Performance obligations satisfied over time**

**Requirements of the new standard**

For each performance obligation in a contract, an entity first determines whether the performance obligation is satisfied over time – i.e. control of the good or service transfers to the customer over time. It does this using the following criteria (a different approach applies if the performance obligation is a license of intellectual property – see Section 8).
### 5.5 Step 5: Recognize revenue when or as the entity satisfies a performance obligation

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

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

**Criterion 1**

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

When determining whether another party would not need to substantially reperform, the entity also presumes that another party would not have the benefit of any asset that the entity presently controls and would continue to control if that other party took over the performance obligation.

**Criterion 2**

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

**Criterion 3**

In assessing whether an asset has an alternative use, at contract inception an entity considers its ability to readily direct that asset in its completed state for another use, such as selling it to a different customer.
Applying Criteria 1 and 3

Potential contractual restrictions or practical restrictions may prevent the entity from transferring the remaining performance obligation to another entity (Criterion 1) or directing the asset for another use (Criterion 3). The new standard provides guidance on whether these facts or possible termination affect the assessment of those criteria. It provides the following guidance on the assumptions that an entity should make when applying Criteria 1 and 3:

<table>
<thead>
<tr>
<th>Determining whether …</th>
<th>Consider contractual restrictions?</th>
<th>Consider practical limitations?</th>
<th>Consider possible termination?</th>
</tr>
</thead>
<tbody>
<tr>
<td>… another entity would not need to substantially re-perform (Criterion 1)</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>… the entity’s performance does not create an asset with an alternative use (Criterion 3)</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

Example 29 – Assessing if another entity would need to reperform the work completed

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

Observations

Differences in assumptions used when applying Criteria 1 and 3

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

Criterion 1 involves a hypothetical assessment of what another entity would need to do if it took over the remaining performance obligation. Contractual restrictions or practical limitations, which would otherwise prevent the entity from transferring the performance obligation to another entity, are not relevant when assessing whether the entity has transferred control of the goods or services provided to date.
By contrast, Criterion 3 focuses on the entity’s ability to direct the completed asset for an alternative use, assuming that the contract is fulfilled. This ability is directly affected by the existence of contractual restrictions and practical limitations.

However, the entity’s rights upon contract termination are considered when evaluating whether the entity has a right to payment under Criterion 3.

**Determining whether a commodity transfers over time may depend on Criterion 1**

An entity that agrees to deliver a commodity considers the nature of its promise to determine whether to recognize revenue over time or at a point in time. In many contracts to deliver commodities, an entity has promised to transfer a good and will consider the point-in-time guidance to determine when control transfers. However, there may be scenarios in which an entity has promised to provide a service of delivering a commodity that the customer immediately consumes and therefore immediately receives the benefits.

For example, a contract to deliver natural gas to temporary storage may represent a promise to deliver a good, while a contract to provide natural gas to the customer for on-demand consumption may represent a service that meets Criterion 1 for over-time recognition.

To determine whether the customer immediately consumes the assets and receives the benefits as the performance obligation is satisfied, the entity evaluates the:

- inherent characteristics of the commodity;
- contract terms;
- information about the infrastructure and other delivery mechanisms; and
- other relevant facts and circumstances.

**Comparison with current IFRS**

Applying the new criteria may alter the timing of revenue recognition

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

- the contract is a construction contract in the scope of IAS 11: this is the case when, and only when, the contract has been specifically negotiated for the construction of an asset or assets;
- the contract is for the sale of goods under IAS 18, and the conditions for the recognition of a sale of goods are met progressively over time; and
- the contract is for the rendering of services.
By contrast, the new standard introduces new concepts and uses new wording that entities need to apply to the specific facts and circumstances of individual performance obligations. Subtle differences in contract terms could result in different assessment outcomes – and therefore significant differences in the timing of revenue recognition compared with current practice.

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

**Application to service concession arrangements**

The currently effective version of IFRIC 12 specifies that an operator in a service concession arrangement accounts for construction and upgrade services using the guidance in IAS 11. The new standard amends IFRIC 12 to state that the operator accounts for these services using the new standard. Therefore, the operator applies the criteria in the new standard to determine whether construction and upgrade services are separate performance obligations and recognizes revenue as it satisfies the performance obligations over time or at a point in time.

In many situations, revenue from construction and upgrade services under service concession arrangements will be recognized over time because Criterion 2 and/or Criterion 3 will be met.

**Comparison with current US GAAP**

Some similarities, but new concepts to be applied

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

However, Criteria 1 and 3 of the new standard will require an entity to think differently about the satisfaction of performance obligations. In general, the effect of applying the new criteria will vary depending on the relevant facts and circumstances, and subtle differences in contract terms could result in different assessment outcomes. These different assessments could create significant differences in the timing or pattern of revenue recognition.
5.5 Step 5: Recognize revenue when or as the entity satisfies a performance obligation

For example, sales of goods produced in a standard manufacturing process or sales to provide goods from inventory are currently excluded from the scope of ASC Subtopic 605-35. Thus, contract manufacturing arrangements to produce goods to a customer’s specifications are currently generally treated as product sales, and revenue is recognized at the point in time at which the manufactured goods are shipped or delivered to the customer. Under the new standard, these types of performance obligations may meet Criterion 3 and, if so, revenue will be recognized over time.

5.5.2.1 Performance does not create an asset with an alternative use

Requirements of the new standard

606-10-55-9
[IFRS 15.B7]
For an asset to have no alternative use to an entity, a contractual restriction on the ability to direct its use has to be substantive – i.e. an enforceable right. If an asset is largely interchangeable with other assets and could be transferred to another customer without breaching the contract or incurring significant incremental costs, then the restriction is not substantive.

606-10-55-10
[IFRS 15.B8]
A practical limitation on an entity’s ability to direct an asset for another use – e.g. design specifications that are unique to a customer – exists if the entity would:
– incur significant costs to rework the asset; or
– be able to sell the asset only at a significant loss.

606-10-25-28
[IFRS 15.36]
The assessment of whether an asset has an alternative use is made at contract inception and is not subsequently updated, unless a contract modification substantially changes the performance obligation (see Section 7).

Example 30 – Applying the guidance on alternative use

606-10-55-165 – 55-168 (Example 15)
[IFRS 15.IE73–IE76]
Manufacturer Y enters into a contract with a customer to build a specialized satellite. Manufacturer Y builds satellites for various customers; however, the design and construction of each satellite differs substantially on the basis of each customer’s needs and the type of technology that is incorporated into the satellite.

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

Many factors to consider when evaluating alternative use

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

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

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

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

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

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

Requirements of the new standard

An entity that is constructing an asset with no alternative use is effectively constructing the asset at the direction of the customer. The contract will often contain provisions providing some economic protection against the risk of the customer terminating the contract and leaving the entity with an asset of little or no value. Therefore, to demonstrate that a customer controls an asset that has no alternative use as it is being created, an entity evaluates whether it has an enforceable right to payment for the performance completed to date.

In performing this evaluation, the entity considers whether, throughout the contract, it is entitled to compensation for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity’s failure to perform as promised.
To meet this part of Criterion 3, the entity’s right to payment has to be for an amount that approximates the selling price of the goods or services transferred – e.g. a right to recover costs incurred plus a reasonable profit margin. The amount to which the entity is entitled does not need to equal the contract margin, but has to be based on either a reasonable proportion of the entity’s expected profit margin or a reasonable return on the entity’s cost of capital. However, if an entity would only recover its costs, then it would not have the right to payment for performance completed to date and this part of Criterion 3 would not be met.

Other factors to consider include the following.

| Payment terms | An unconditional right to payment is not required, but rather an enforceable right to demand or retain payment for the performance completed to date if the contract is terminated by the customer for convenience |
| Payment schedule | A payment schedule does not necessarily indicate whether an entity has an enforceable right to payment for performance to date |
| Contractual terms | If a customer acts to terminate a contract without having a contractual right at that time to do so, then the contract terms may entitle the entity to continue to transfer the promised goods or services and require the customer to pay the corresponding consideration promised |
| Legislation or legal precedent | Even if a right is not specified in the contract, jurisdictional matters such as legislation, administrative practice, or legal precedent may confer a right to payment to the entity |
|  | By contrast, legal precedent may indicate that rights to payment in similar contracts have no binding legal effect, or that an entity’s customary business practice not to enforce a right to payment may result in that right being unenforceable in that jurisdiction |

**Example 31 – Applying the over-time criteria to a consulting contract**

Consulting Firm B enters into a contract to provide a professional opinion to Customer C based on Customer C’s specific facts and circumstances. If Customer C terminates the consulting contract for reasons other than Consulting Firm B’s failure to perform as promised, then the contract requires Customer C to compensate Consulting Firm B for its costs incurred plus a 15% margin. The 15% margin is approximately the profit margin that Consulting Firm B earns from similar contracts.
Consulting Firm B assesses the contract against the over-time criteria, and reaches the following conclusions.

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

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

Conversely, if Consulting Firm B determined that it did not have a legally enforceable right to payment if Customer C terminated the consulting contract for reasons other than Consulting Firm B’s failure to perform as promised, then none of the three criteria would be met. In that situation, the revenue from the consulting service would be recognized at a point in time – probably on completion of the engagement and delivery of the professional opinion.
Example 32 – Applying the over-time criteria to sales of real estate

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

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

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

Observations

A right to payment may be established by relevant laws and regulations

When a right to payment on termination is not specified in the contract with the customer, an entity may still have a right to payment under relevant laws or regulations.

The fact that the entity may sue a customer who defaults or cancels a contract for convenience does not in itself demonstrate that the entity has an enforceable right to payment. Generally, a right to payment exists only if taking legal actions entitles the entity to a payment for the cost incurred plus a reasonable profit margin for the performance completed to date.
Factors to consider when determining if an entity has a right to payment include:

- relevant laws and regulations;
- customary business practices;
- the legal environment;
- relevant legal precedents; and
- legal opinions on the enforceability of rights (see below).

Each individual factor may not be determinative on its own. An entity needs to determine which factors are relevant for its specific set of circumstances. In cases of uncertainty – e.g. when the above factors are inconclusive or provide contradictory evidence about the existence of a right to payment – an entity considers all relevant factors and applies judgment in reaching its conclusion.

**Use of legal opinion when assessing enforceability of right to payment**

In some cases, an entity may have an apparent right to payment described in its contract with the customer, or under a relevant law or regulation, but there may be uncertainty over whether the right is enforceable. This may be the case when there is no legal precedent for the enforceability of the entity’s right.

For example, in a rising property market an entity may choose not to enforce its right to payment in the event of customer default, because it prefers to recover the property and resell it at a higher price. A practice of not enforcing an apparent right to payment may result in uncertainty over whether the contractual right remains enforceable.

In such cases, an entity may need a legal opinion to help it assess whether it has an enforceable right to payment. However, all facts and circumstances need to be considered in assessing how much weight (if any) to place on the legal opinion. This may include an assessment of:

- the quality of the opinion – i.e. how strong are the legal arguments that support it;
- whether there are conflicting opinions provided by different legal experts; and
- whether there are conflicting legal precedents for similar cases.

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

Applying the criteria to real estate contracts may result in different conclusions on the pattern of transfer of control, depending on the relevant facts and circumstances of each contract. For example, the terms of some real estate contracts may prohibit an entity from transferring an asset to another customer and require the customer to pay for performance completed to date (therefore meeting Criterion 3). However, other real estate contracts that create an asset with no alternative use may only require a customer to make an up-front deposit, and therefore would not provide the entity with an enforceable right to payment for its performance completed to date (therefore failing to meet Criterion 3).
In practice, a detailed understanding of the terms of the contract and local laws may be required to assess whether an entity has a right to payment for performance to date. For example, in some jurisdictions customer default may be infrequent and contracts may not include extensive detail on the rights and obligations that arise in the event of termination. In such cases, expert opinion may be required to establish the legal position.

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

**Enforceable right to payment for standard materials used as inputs**

Contracts with customers to manufacture or construct goods with no alternative use to the entity may require the use of standard raw materials or components as inputs to the product being manufactured or constructed. In many cases, these inputs (including work-in-progress) remain interchangeable with other products until they are integrated into the customer’s product – i.e. they have an alternate use. The entity will often not have an enforceable right to payment for those standard inputs until they are integrated into the customer’s product.

In these circumstances, the entity treats the raw materials or work in progress as inventory until they are incorporated into the customer’s product. The fact that the entity does not have an enforceable right to payment for standard materials until they are integrated into the product being manufactured does not result in the arrangement failing to meet Criterion 3. An entity’s right to payment is assessed for performance completed. Standard materials are not considered completed performance until they are integrated into the production process. The assessment of an entity’s right to payment is for the standard materials once they are integrated.

**Comparison with current IFRS**

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

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

Revenue from real estate sales may be recognized earlier or later

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

For comparison with current US GAAP, see KPMG’s US publication Building a Bridge from Statement 66: Real Estate Sales Under the New Revenue Standard.

5.5.3 Measuring progress toward complete satisfaction of a performance obligation

5.5.3.1 Selecting a method to measure progress

Requirements of the new standard

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

<table>
<thead>
<tr>
<th>Method</th>
<th>Description</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Output</td>
<td>Based on direct measurements of the value to the customer of goods or services transferred to date, relative to the remaining goods or services promised under the contract</td>
<td>– Surveys of performance to date&lt;br&gt;– Appraisals of results achieved&lt;br&gt;– Milestones reached&lt;br&gt;– Time elapsed</td>
</tr>
<tr>
<td>Input</td>
<td>Based on an entity’s efforts or inputs toward satisfying a performance obligation, relative to the total expected inputs to the satisfaction of that performance obligation</td>
<td>– Resources consumed&lt;br&gt;– Costs incurred&lt;br&gt;– Time elapsed&lt;br&gt;– Labor hours expended&lt;br&gt;– Machine hours used</td>
</tr>
</tbody>
</table>
5.5 Step 5: Recognize revenue when or as the entity satisfies a performance obligation

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

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

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

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

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

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

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

The new standard also provides examples of circumstances in which a particular method does not faithfully depict performance – e.g. it states that units-of-production may not be an appropriate method when there is a material amount of work in progress. Judgment is required when identifying an appropriate method of measuring progress.
When evaluating which method depicts the transfer of control of a good or service, the entity’s ability to apply that method reliably may also be relevant. For example, the information required to use an output method may not be directly observable or may require undue cost to obtain – in these circumstances, an input method may be appropriate.

**Single method of measuring progress is used for a performance obligation**

Under the new standard an entity applies a single method of measuring progress for each performance obligation. This may be difficult when a single performance obligation contains multiple promised goods or services that will be transferred over different periods of time. For example, this might occur when a performance obligation combines a license and a service arrangement, or a sale of goods and design or installation services.

Significant judgment may be required in some circumstances, and understanding the nature of its overall promise to the customer is key for the entity to select a reasonable measure of progress.

If the determination of a single method of progress is challenging, then an entity may need to re-consider the assessment of performance obligations and whether there are multiple distinct performance obligations. However, just because the identification of a single measure of progress is challenging does not necessarily mean that the promised goods or services are not a single performance obligation.

**Consideration does not need to be a fixed amount per unit to recognize revenue at the amount that the entity has a right to invoice**

As a practical expedient, an entity may recognize revenue using the amount that it has the right to invoice, if this amount directly corresponds with the value that is transferred to the customer. The amount that the entity has the right to invoice does not need to be based on a fixed amount per unit for this practical expedient to be applied.

The determination of whether the invoice amount represents the value to the customer may be more difficult in scenarios with multiple performance obligations or where the fixed amount per unit changes over time. This might occur with contracts that have declining unit prices, rates with forward market curves, rates with contractual minimums, or contracts with volume rebates. In these cases, judgment is required to determine whether the changes in pricing are in response to a change in the underlying value to the customer. If a contract includes fixed fees in addition to per-unit invoicing, substantive contractual minimums or payments to the customer such as rebates, discounts or signing bonuses, then the use of the practical expedient may be precluded because they cause the invoiced amounts not to correspond to the value that the customer receives. Further, to apply the practical expedient to a contract, all goods and services in the contract need to qualify.
5.5 Step 5: Recognize revenue when or as the entity satisfies a performance obligation

**Certain sales agent arrangements may be over time**

Generally, when the entity is acting as a sales agent for a customer the entity satisfies its promise at a point in time. This is because the activities performed by the agent before sale typically do not transfer a good or service to a customer. If the customer receives any benefit from the entity’s activities, then that benefit is limited unless the sale is completed.

However, there may be sales agent arrangements that provide benefits to the customer over time before a sale is completed. For example, assume that an entity receives a significant nonrefundable fee at the time of listing and a relatively smaller commission fee when a sale is completed. The large non-refundable up-front fee indicates that the entity is providing the customer with a listing service and the customer is benefiting from that service over time. In this example, the entity estimates the commission fee following the guidance on variable consideration.

Judgment and evaluation of the facts will be necessary to determine whether a good or service is being transferred before the sale is completed.

**Measure of progress for stand-ready obligations is not always straight-line**

Judgment is required to determine an appropriate measure of progress for a stand-ready obligation. When making the judgment, an entity considers the substance of the stand-ready obligation to ensure that the measure of progress aligns with the nature of the underlying promise. In assessing the nature of the obligation, the entity considers all relevant facts and circumstances, including the timing of transfer of goods or services, and whether the entity’s efforts (i.e. costs) are expended evenly throughout the period covered by the stand-ready obligation.

In many cases, a straight-line measure of progress will be appropriate for recognizing revenue on a stand-ready obligation. However, a straight-line measure of progress is not always appropriate.

For example, in a contract for unspecified software upgrades (a stand-ready obligation) or a health club contract, revenue is generally recognized on a straight-line basis because the pattern of benefit to the customer as well as the entity’s efforts to fulfill the contract are generally even throughout the period. In contrast, a straight-line basis of recognition would not generally be appropriate in an annual contract to provide snow removal services in an area where snowfall is highly seasonal. The pattern of benefit of these services, as well as the entity’s effort to fulfill the contract, would not generally be even throughout the year, because snow is only expected in the winter.
Milestone method may not depict pattern of performance

If control transfers to the customer over time, then the measure of progress should reflect this. Although the new standard lists milestones as an example of a possible measure of progress when using an output method, it remains necessary to consider whether milestones faithfully depict performance, particularly if the milestones are widely spaced. This is because control generally transfers continuously as the entity performs rather than at discrete points in time. Normally, a milestone method would need to incorporate a measure of progress between milestone achievements to faithfully depict an entity’s performance.

Work in progress for an over-time performance obligation is generally expensed as a fulfillment cost when it is incurred because control of the work in progress transfers to the customer as it is produced and not at discrete intervals. However, inventory to support multiple contracts that has an alternative use is recognized as an asset until it is dedicated to a specific contract.

A performance obligation may be partially satisfied before the contract is identified

Entities sometimes start to perform before:

- entering into a contract with a customer; or
- the contract with the customer meets the Step 1 criteria (e.g. collectibility is not probable).

In these cases, if the work completed to date has no alternative use and the performance obligation meets the criteria for revenue to be recognized over time, then the entity recognizes a cumulative catch-up adjustment at the date on which the Step 1 criteria are met. This is because under the new standard an entity recognizes revenue based on progress toward complete satisfaction of the performance obligation. Therefore, because the entity has already partially satisfied the performance obligation, it recognizes revenue to reflect that performance.

For example, if a developer sells an apartment to a customer when the apartment is 20 percent complete and the contract meets the criteria to recognize revenue over time, then the developer would recognize 20 percent of its revenue under the contract on the date on which the contract is signed.

Additionally, fulfillment costs incurred before the existence of the contract that are not in the scope of another standard (e.g. inventory) would be capitalized as costs to fulfill an anticipated contract when the capitalization criteria are met (see Section 6). These costs are expensed immediately at the date on which the Step 1 criteria are met if they relate to progress made to date on goods or services already deemed to have transferred to the customer at that date.
Comparison with current IFRS

Similar measures of progress

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

The new standard does not prescribe when certain methods should be used, but the Boards believe that, conceptually, an output measure is the most faithful depiction of an entity’s performance because it directly measures the value of the goods or services transferred to the customer. The Boards also believe that an input method would be appropriate if it would be less costly and would provide a reasonable basis for measuring progress. Our view under current IFRS is that output measures are the more appropriate measure of the stage of completion as long as they can be established reliably (see 4.2.290.30 of Insights into IFRS, 12th Edition).

However, the new standard includes additional guidance that notes that if an entity’s performance has produced a material amount of work in progress or finished goods that are controlled by the customer, then output methods such as units-of-delivery or units-of-production may not be appropriate. Therefore, entities that have historically applied these methods will be required to consider whether the method continues to faithfully depict its progress (see 5.5.3.2). Similarly, an entity that uses a milestone method under IAS 11 will need to consider if it appropriately depicts its progress toward satisfaction of the performance obligations.

Comparison with current US GAAP

Similar measures of progress

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

Current guidance indicates that if a reliable measure of output can be established, then it is generally the best measure of progress toward completion; however, it acknowledges that output measures often cannot be established, in which case input measures are used. Similarly, the Boards believe that, conceptually, an output measure is the most faithful depiction of an entity’s performance because it directly measures the value of the goods or services transferred to the customer. However, if an entity’s performance has produced a material amount of work in progress or finished goods that are controlled by the customer, then output methods such as units-of-delivery or units-of-production as they have been applied historically may not faithfully depict progress (see 5.5.3.2). The Boards also believe that an input method would be appropriate if it would be less costly and would provide a reasonable basis for measuring progress.
Currently, the percentage-of-completion method is used to determine the amount of revenue and costs to recognize, but there are two methods for this determination.

- Alternative A provides a basis for recognizing costs in the financial statements earlier or later than when they are incurred.
- Alternative B allows an entity to apply a margin to the costs incurred.

The new standard supersedes both of these methods. However, if an entity uses cost-to-cost as its measure of progress, then the amount of revenue and costs recognized will be similar to the amounts under Alternative B in current construction- and production-type-specific guidance. Additionally, the margin expressed as a percentage of revenue will remain constant throughout the contract.

**Specified and unspecified upgrades**

Current software revenue guidance is superseded by the new standard, including the guidance on recognizing revenue from specified and unspecified upgrades. However, this is not expected to result in a significant change in practice with respect to:

- measuring progress for performance obligations to provide when-and-if-available unspecified software upgrades (i.e. a stand-ready performance obligation – see also the observation above on measuring progress for stand-ready obligations); and
- identifying specified upgrades as performance obligations.

However, unlike current US GAAP, an entity does not defer the entire estimated selling price of the specified upgrade (or defer the entire arrangement consideration when the selling price is not sufficiently determinable). Instead, the entity applies Step 4 of the model and allocates a portion of the arrangement consideration to the specified upgrade. The portion of the arrangement consideration that is allocated to the initial software to be delivered is recognized when control of that software transfers to the customer (see Section 8).

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

**Requirements of the new standard**

An output method may not provide a faithful depiction of performance if the output method selected fails to measure some of the goods or services for which control has transferred to the customer.

For example, if at the reporting date an entity's performance has produced work in progress or finished goods that are controlled by the customer, then using an output method based on units produced or units delivered as it has been applied historically would distort the entity's performance. This is because it would not recognize revenue for the assets that are created before delivery or before production is complete but that are controlled by the customer.
5.5 Step 5: Recognize revenue when or as the entity satisfies a performance obligation

**Observations**

**Design and production services – A units-of-delivery method or a units-of-production method may not be appropriate**

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

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

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

**5.5.3.3 Adjusting the measure of progress**

**Requirements of the new standard**

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

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

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

- the good is not distinct;
- the customer is expected to obtain control of the good significantly earlier than it receives services related to the good;
- the cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation; and
- the entity is acting as the principal, but procure the good from a third party and is not significantly involved in designing and manufacturing the good.
In November 2015, Contractor P enters into a lump-sum contract with Customer Q to refurbish a three-story building and install new elevators for total consideration of 5,000. The following facts are relevant.

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

The transaction price and expected costs are as follows.

<table>
<thead>
<tr>
<th>Transaction price</th>
<th>5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs</td>
<td></td>
</tr>
<tr>
<td>Elevators</td>
<td>1,500</td>
</tr>
<tr>
<td>Other costs</td>
<td>2,500</td>
</tr>
<tr>
<td>Total expected costs</td>
<td>4,000</td>
</tr>
</tbody>
</table>

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

By December 31, 2015, other costs of 500 have been incurred (excluding the elevators) and Contractor P therefore determines that its performance is 20% complete (500 ÷ 2,500). Consequently, it recognizes revenue of 2,200 (20% x 3,500(a) + 1,500) and costs of 2,000 (500 + 1,500).

**Note**

a. Calculated as the transaction price of 5,000 less the cost of the elevators of 1,500.
5.5 Step 5: Recognize revenue when or as the entity satisfies a performance obligation

Observations

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

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

The Boards believe that recognizing a contract-wide profit margin before the goods are installed could overstate the measure of the entity’s performance and, therefore, revenue. However, requiring an entity to estimate a profit margin that is different from the contract-wide profit margin could be complex and could effectively create a performance obligation for goods that are not distinct (therefore bypassing the requirements on identifying performance obligations).

The adjustment to the cost-to-cost measure of progress for uninstalled materials is generally intended to apply to a subset of goods in a construction-type contract – i.e. only to those goods that have a significant cost relative to the contract and only if the entity is essentially providing a simple procurement service to the customer.

Judgment will be required in determining whether a customer is obtaining control of a good ‘significantly’ before receiving services related to the good. In Example 33 in this publication, it is unclear whether the same guidance would apply if the elevators were expected to be installed in January 2016 instead of June 2016.

No detailed guidance on identifying inefficiencies and wasted materials

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

Comparison with current IFRS

Revenue recognized to the extent of costs

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

Requirements of the new standard

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

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

Comparison with current IFRS

Similar to current practice

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

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

However, the new standard does not include guidance on the accounting for losses. Instead, an entity applies IAS 37 to assess whether the contract is onerous and, if it is, to measure the provision (see 10.7).
5.5 Step 5: Recognize revenue when or as the entity satisfies a performance obligation

**Comparison with current US GAAP**

**Similar to current practice**

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

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

**Completed contract method not permitted**

Currently, an entity uses the completed contract method when it cannot make reasonably dependable estimates for construction- and production-type contracts in the scope of ASC 605-35. As a result, the entity defers revenue and costs until the contract is complete or substantially complete, unless it is required to accrue an expected loss.

Under the new standard, an entity determines if it can reasonably measure its progress towards complete satisfaction of the performance obligation. If the entity cannot reasonably measure its progress but expects to recover its costs, then it generally recognizes revenue to the extent of costs incurred until it can reasonably measure its progress. It would be unusual that an entity would be unable to determine an appropriate measure of progress when the over-time criteria are met. Once an entity is able to measure its progress, it is required to estimate the transaction price and recognize revenue based on that measure of progress using a cumulative catch adjustment. Further, an entity is required to expense its costs when they are incurred because the work in progress is transferring continuously to the customer when the over-time criteria are met.
5.5.4 Performance obligations satisfied at a point in time

Requirements of the new standard

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

Indicators that control has passed include a customer having ...

- ... a present obligation to pay
- ... physical possession
- ... legal title
- ... risks and rewards of ownership
- ... accepted the asset

Relevant considerations include the following.

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

Observations

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

The indicators of transfer of control are factors that are often present if a customer has control of an asset; however, they are not individually determinative, nor are they a list of conditions that have to be met. The new standard does not suggest that certain indicators should be weighted more heavily than others, nor does it establish a hierarchy that applies if only some of the indicators are present. However, it remains possible that in some facts and circumstances certain indicators will be more relevant than others and so carry greater weight in the analysis.
5.5 Step 5: Recognize revenue when or as the entity satisfies a performance obligation

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

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

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

An example of a delivery arrangement that may result in a change in accounting is when an entity ships a product FOB shipping point, but the seller has a historical business practice of providing free replacements of that product or waiving its invoice if the products are damaged in transit (commonly referred to as a 'synthetic FOB destination arrangement').

Under current guidance, revenue recognition is generally precluded until the product is delivered to the customer’s destination, because the risks and rewards of ownership have not transferred to the customer, despite having satisfied the FOB shipping point delivery terms. However, under the new standard, whether the significant risks and rewards have been transferred is an indicator of transfer of control but an entity evaluates and could reach a different conclusion about the timing of transfer. The transfer of legal title is also only an indicator of control, and different entities may reach different conclusions about when control transfers depending on the facts and circumstances of their arrangements.

If the entity concludes that transfer of control has occurred when the product is shipped, then under the new standard, an entity also considers whether its business practices give rise to a separate performance obligation in addition to the performance obligation to transfer the product itself – i.e. a stand-ready obligation to cover the risk of loss if goods are damaged in transit. If a separate performance obligation is identified, then only the revenue allocated to the sale of the goods is recognized at the shipping date.

An entity will need to evaluate the facts and circumstances and apply judgment to determine whether the lack of transfer of the significant risks and rewards of ownership of an asset results in a conclusion that either:

- control of the asset has not transferred to a customer; or
- the entity is providing a separate performance obligation.
If an entity under US GAAP concludes that control of the asset has transferred at shipping, then it may elect as an accounting policy to account for the shipping and handling as fulfillment activities and accrue the cost of shipping and handling when revenue is recognized at shipping rather than identifying it as a performance obligation (see 5.2).

**Indirect channels and sell-in versus sell-through**

Many entities sell through distributors and resellers. These transactions will require judgment to determine if the transfer of control occurs upon delivery to the intermediary (sell-in model) or when the good is resold to the end customer (sell-through model). Entities need to consider the guidance on consignment sales (see 5.5.6) and variable consideration (see 5.3.1) to determine which model is appropriate.

### 5.5.5 Repurchase agreements

**Overview**

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

**Requirements of the new standard**

#### A forward or a call option

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

In a financing arrangement, the entity continues to recognize the asset and recognizes a financial liability for any consideration received. The difference between the consideration received from the customer and the amount of consideration to be paid to the customer is recognized as interest, and processing or holding costs if applicable. If the option expires unexercised, then the entity derecognizes the liability and the related asset, and recognizes revenue.
5.5 Step 5: Recognize revenue when or as the entity satisfies a performance obligation

The customer does not obtain control of the asset

Asset repurchased for less than original selling price?

Yes

Lease arrangement*

No

Financing arrangement

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

A put option

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

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

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

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

When comparing the repurchase price with the selling price, the entity considers the time value of money.
Under US GAAP, if the contract is part of a sale-leaseback transaction it is accounted for as a financing arrangement. A revised approach that focuses on the repurchase price

The new standard includes guidance on the nature of the repurchase right or obligation and the repurchase price relative to the original selling price. In contrast, the current accounting focuses on whether the risks and rewards of ownership have been transferred. As a result, determining the accounting treatment for repurchase agreements may, in some cases, be more straightforward under the new standard, but differ from current practice. However, judgment will be required to determine whether a customer with a put option has a significant economic incentive to exercise its right. This determination is made at contract inception and is not updated for subsequent changes in asset prices. Historical customer behavior in similar arrangements will be relevant to this determination.

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

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

In some cases, a forward contract or a call option may be conditional on a future event. Although all of the facts and circumstances need to be evaluated for each arrangement, treating certain conditional forwards or call options as rights of return (see 10.1) may be more consistent with the economics of these transactions. In these cases, it is appropriate to apply the principles for recognizing and measuring variable consideration from a right-of-return provision, rather than accounting for the arrangement as a lease or a financing transaction.

For example, some perishable goods manufacturers include provisions in their agreements with customers where they have the right to remove and replace out-of-date products to ensure the end consumers receive the product quality and freshness they expect. Under these circumstances, the manufacturer does not have the unconditional right to repurchase the products at any time. The product must be past its sell-by date for the manufacturer to apply this right.

In this example, the existence of a conditional call option does not restrict the customer’s ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset unless and until the conditional event occurs, because the customer has no right to return the product if the sell-by date has not passed. Consequently, the customer has control over the asset until the contingent event occurs. Therefore, in this example the manufacturer accounts for the arrangement as a sale with a right of return.

Right of first refusal

A seller may retain the right of a first refusal for a future sale of the purchased asset by the customer. This allows the seller to repurchase the asset at the same price as a third-party agrees to pay to the customer for the sale of the asset.

This right is not a call or a put option because it does not prevent the customer from controlling the asset. Accordingly, it does not generally constitute a repurchase agreement and therefore does not affect revenue recognition by the seller. Additionally, the customer has no right to return the asset to the seller so the returns are not estimated.

Difference between IFRS and US GAAP

Sale-leaseback transactions

The accounting for sale-leaseback transactions currently differs between US GAAP and IFRS. As a result, the specific guidance on the accounting for repurchase agreements that are part of sale-leaseback transactions included in the US GAAP version of the new standard is not included in the IFRS version. Under IFRS, the existing authoritative guidance on sale-leaseback transactions continues to apply.
IFRS 16 *Leases* amends the guidance on sale and repurchase agreements included in IFRS 15, to state that if the contract is part of a sale-leaseback transaction, then the entity treats the arrangement as a financing and accounts for the financial liability in accordance with IFRS 9.

ASC Topic 842 *Leases* does not amend the guidance in ASC Topic 606 related to the effect of repurchase agreements in the context of sale-leaseback transactions. ASC Topic 606 guidance focuses on the repurchase price relative to the original selling price. However, ASC Topic 842 does specify that if the asset subject to a sale-leaseback transaction is not real estate, then a repurchase option does not preclude sale accounting if the exercise price of the option is the fair value of the asset at the time the option is exercised and there are alternative assets that are substantially the same as the transferred asset and are readily available in the marketplace.

### Comparison with current IFRS

**Introduction of more prescriptive guidance**

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

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

### Comparison with current US GAAP

**New guidance for certain sale-leaseback transactions**

The guidance on the accounting for sale-leaseback transactions has not changed except when the seller-lessee holds a forward or call option to repurchase an asset for an amount that is less than its original selling price, or the buyer-lessee has a significant economic incentive to exercise a put option. In these cases, the contract is accounted for as a financing arrangement under the new standard; therefore, no profit or loss can be recognized. Under current US GAAP, a profit or loss can be recognized when certain conditions are met.
Consistent treatment of processing costs for product financing arrangements

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

Commodity repurchase agreements

In commodity repurchase agreements a seller (e.g. a bank) sells a commodity (e.g. gold) to a customer and agrees to repurchase the same type of commodity at a future date for a fixed price. Under current US GAAP, the seller typically accounts for these arrangements as a product financing arrangement.

Consistent with current guidance, these agreements would not be accounted for as a lease under the new standard even if the repurchase price is less than the original selling price. This is because the repurchase agreement does not relate to a specific asset (e.g. the gold repurchased may not be the same gold that has been sold) and therefore the customer has control over the purchased asset.

Change in practice for guarantees of resale value

Under current US GAAP if an entity guarantees the resale value of an asset, then the arrangement is accounted for as a lease. Under the new standard, the guarantee is evaluated to determine if it is in scope of the revenue standard (see Section 4) and if so, revenue is recognized at the point in time at which the customer obtains control of the asset, which may result in a significant change in practice for some entities.

5.5.6 Consignment arrangements

Requirements of the new standard

An entity may deliver goods to another party but retain control of the goods – e.g. it may deliver a product to a dealer or distributor for sale to an end customer. These types of arrangements are called ‘consignment arrangements’, and do not allow the entity to recognize revenue on delivery of the products to the intermediary.
The new standard provides indicators that an arrangement is a consignment arrangement as follows.

<table>
<thead>
<tr>
<th>Indicators of a consignment arrangement</th>
</tr>
</thead>
<tbody>
<tr>
<td>The entity controls the product until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period expires.</td>
</tr>
<tr>
<td>The entity is able to require the return of the product or transfer the product to a third party, such as another dealer.</td>
</tr>
<tr>
<td>The dealer does not have an unconditional obligation to pay for the products, although it might be required to pay a deposit.</td>
</tr>
</tbody>
</table>

When is revenue recognized?

- While the entity retains control of the product ... ✗ Performance obligation is not satisfied and revenue is not recognized
- When control transfers to the intermediary or end customer ... ✓ Performance obligation is satisfied and revenue is recognized

Example 34 – Consignment arrangement

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

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

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

Manufacturer M determines that control of the dresses transfers when they are sold to an end customer – i.e. when Retailer A has an unconditional obligation to pay Manufacturer M and can no longer return or otherwise transfer the dresses. Manufacturer M recognizes revenue as the dresses are sold to the end customer.
5.5 Step 5: Recognize revenue when or as the entity satisfies a performance obligation

Observations

Move away from a risk-and-reward approach

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

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

Although the conclusions about the point in time of transfer may be similar to current GAAP, some entities may still experience a change in the timing of revenue recognition because the new standard requires that revenue recognition for estimated contingent consideration occur when control has passed (see 5.3.1).

5.5.7 Bill-and-hold arrangements

Requirements of the new standard

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

To determine when to recognize revenue, an entity needs to determine when the customer obtains control of the product. Generally, this occurs at shipment or delivery to the customer, depending on the contract terms (for discussion of the indicators for transfer of control at a point in time, see 5.5.4). The new standard provides criteria that have to be met for a customer to obtain control of a product in a bill-and-hold arrangement. These are illustrated below.
If an entity concludes that it is appropriate to recognize revenue for a bill-and-hold arrangement, then it is also providing a custodial service to the customer, which may constitute a separate performance obligation to which a portion of the transaction price is allocated.
5.5 Step 5: Recognize revenue when or as the entity satisfies a performance obligation

Example 35 – Bill-and-hold arrangement

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

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

Company C concludes that Customer A’s request for the bill-and-hold basis is substantive. It also concludes that control of the equipment has transferred to Customer A and that it will recognize revenue on a bill-and-hold basis even though Customer A has not specified a delivery date.

The obligation to warehouse the goods on behalf of Customer A represents a separate performance obligation. Company C needs to estimate the stand-alone selling price of the warehousing performance obligation based on its estimate of how long the warehousing service will be provided. The amount of the transaction price allocated to the warehousing obligation is deferred and then recognized over time as the warehousing services are provided.

Comparison with current IFRS

Broadly similar requirements, but with some differences

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

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

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

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

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

First, the bill-and-hold arrangement is not required to be at the customer’s explicit request. The new standard requires the reason for the bill-and-hold arrangement to be substantive. An understanding of the business reasons is important, and in some cases this may require an explicit request from the customer as evidence to support a conclusion that it is substantive.

Second, the entity does not need a specified delivery schedule to meet the bill-and-hold criteria. However, the lack of a planned or estimated delivery date could indicate that the contract does not exist for the purpose of applying the bill and hold requirements. If a delivery schedule does not exist, then it may be important that the entity receives appropriate consideration to hold the asset indefinitely to conclude the parties are committed to their obligations and a contract exists (see 5.1).

Under the new standard, an obligation to warehouse the goods after control has transferred to the customer is a separate performance obligation unless the entity concludes that it is immaterial in the context of the contract. The entity will need a process and relevant internal controls to estimate the stand-alone selling price of the warehousing performance obligation based on its estimate of how long it will provide the warehousing service.

5.5.8 Customer acceptance

Requirements of the new standard

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

Customer acceptance clauses included in some contracts are intended to ensure the customer’s satisfaction with the goods or services promised in the contract. The table below illustrates examples of customer acceptance clauses.
### 5.5 Step 5: Recognize revenue when or as the entity satisfies a performance obligation

<table>
<thead>
<tr>
<th>If the entity ...</th>
<th>Then ...</th>
<th>For example ...</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>606-10-55-86</strong></td>
<td>can objectively verify that the goods or services comply with the specifications underlying acceptance</td>
<td>customer acceptance would be a formality, and revenue could be recognized before explicit acceptance</td>
</tr>
<tr>
<td><strong>606-10-55-87</strong></td>
<td>cannot objectively determine whether the specifications have been met</td>
<td>it is unlikely that the entity would be able to conclude that the customer has obtained control before formal customer acceptance</td>
</tr>
<tr>
<td><strong>606-10-55-88</strong></td>
<td>delivers products for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses</td>
<td>control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses</td>
</tr>
</tbody>
</table>

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

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

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**Comparison with current IFRS**

**Revenue may be recognized if certain formalities remain outstanding**

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

Unlikely to significantly change current practice

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

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

Overview

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

6.1 Costs of obtaining a contract

Requirements of the new standard

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

However, as a practical expedient, an entity is not required to capitalize the incremental costs to obtain a contract if the amortization period for the asset is one year or less. The costs of fulfilling a contract that meet the capitalization criteria are not eligible for the practical expedient, which can only be applied to the costs of obtaining a contract.
Costs that will be incurred regardless of whether the contract is obtained – including costs that are incremental to *trying* to obtain a contract, are expensed as they are incurred, unless they meet the criteria to be capitalized as fulfillment costs (see 6.2). An example of such costs are costs to prepare a bid, which are incurred even if the entity does not obtain the contract.

**Example 36 – Costs incurred to obtain a contract**

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

<table>
<thead>
<tr>
<th>Cost Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>External legal fees for due diligence</td>
<td>15</td>
</tr>
<tr>
<td>Travel costs to deliver proposal</td>
<td>25</td>
</tr>
<tr>
<td>Commissions to sales employees and related payroll taxes</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total costs incurred</strong></td>
<td><strong>50</strong></td>
</tr>
</tbody>
</table>

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

By contrast, although the external legal fees and travel costs are incremental costs, they are costs associated with *trying* to obtain the contract. Therefore, they are incurred even if the contract is not obtained. Consequently, Consulting Company E expenses the legal fees and travel costs as they are incurred.
6.1 Costs of obtaining a contract

Observations

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

The requirement to capitalize the costs of obtaining a contract will be a change for entities that currently expense those costs. It may also be complex to apply, especially for entities with many contracts and a variety of contract terms and commission and incentive structures.

Also, those entities that have not previously tracked the costs of acquiring a contract, and have expensed them as they were incurred, may find it difficult to determine which costs to capitalize, both for the transition amounts on adoption (regardless of the transition method used) and in the ongoing application of the new standard.

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

**Practical expedient applies if the amortization period is less than one year**

The practical expedient allowing entities not to capitalize the incremental costs to obtain a contract offers potential relief for an entity that enters into contracts of relatively short duration without a significant expectation of renewals. However, it will reduce comparability between entities.

The question of whether to use the practical expedient will be a key implementation decision.

Whether to use the practical expedient is an accounting policy choice, which can be made when the amortization period associated with the asset that would otherwise have been recognized is one year or less. For discussion of the amortization period, which may not be limited to the term of the contract because of future anticipated renewals, see 6.3.

Consistent with other accounting policy choices for which the relevant standard does not specify the level that the accounting policy choice is applied, the practical expedient related to contract costs is applied on an entity-wide basis across all of its business units or segments.

The assessment of whether the practical expedient applies is made at the contract level. Generally, if a contract includes multiple performance obligations, and one or more of them will be satisfied beyond one year, then the practical expedient usually will not apply. This will be the case when the asset relates to all of the goods and services in the contract and more than one performance obligation is present, which means that the amortization period of the capitalized costs will be longer than a year.
For discussion of the amortization period, see 6.3.

**Capitalizing commission when associated liability is accrued**

In some cases, an additional commission may be payable, or the original commission amount adjusted, at a future date. Examples include commissions:

- paid for renewal of the contract;
- earned on contract modifications;
- contingent on future events;
- subject to clawback; and
- that are tiered, subject to a threshold.

In these cases, an entity considers the enforceable rights and obligations created by the arrangement to determine when the liability is accrued and whether to capitalize a commission, and in what amount. Consider these examples:

- If an entity pays commission of 100 on commencement of a contract with a noncancellable two-year term, and agrees to pay further commission of 100 if the customer renews the contract at the end of two years, then the entity generally capitalizes only the initial commission of 100 on contract commencement. The entity capitalizes the second commission of 100 only when the customer renews the contract. This is because the contract creates enforceable rights and obligations for both parties only for the initial contract period of two years, and the entity does not accrue the second commission payment until it has a present obligation.

- If an entity pays commission of 100 on commencement of a contract with a noncancellable two-year term and agrees to pay additional commission of 100 on the first anniversary of the contract, then the entity generally capitalizes 200 on contract commencement. This is because the contract creates enforceable rights and obligations for both parties for the contract period of two years. Also, the entity accrues the second payment because it has a present obligation, and its payment depends only on the passage of time.

In more complex scenarios, an entity focuses on whether its obligation to pay a commission meets the definition of a liability. This will be particularly important when considering commission structures that include thresholds – e.g. a commission amount is payable only if cumulative sales within a given period exceed a specified amount, or the commission rate varies with cumulative sales. In general, if an entity recognizes a liability to pay commission that qualifies for recognition as the cost of obtaining a contract, then the entity recognizes an asset at the same time.
This focus on whether the obligation to pay commission meets the definition of a liability may result in differences between IFRS and US GAAP due to underlying differences in liability accounting in the two frameworks. Differences may also occur in interim financial statements because IFRS generally takes a discrete approach to interim reporting (with some exceptions). However, US GAAP views the interim period as a portion of the annual period. This can potentially result in different liability recognition and measurement at interim reporting dates.

For example, commission payable on reaching a specified threshold for which the threshold is expected to be met only in the third quarter is not recognized at the end of the first quarter under IFRS, because the entity does not have a present obligation at that date. Conversely, under US GAAP a portion of the expected commission is recognized as an expense in the first quarter to reflect the portion of the expense that relates to that period.

**Judgment required for multiple-tier commissions**

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

Many sales commission models are based on multiple criteria, not just the acquisition of an individual contract – e.g. overall contract performance. It will require careful analysis to determine what portion of the supervisor’s commission is an acquisition cost that is directly related to a specific contract or contracts.

**Comparison with current IFRS**

**Capitalizing costs to obtain a contract**

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

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

The new standard therefore brings clarity to this topic. It also introduces a new cost category – an asset arising from the capitalization of the incremental costs to obtain a contract – which is in the scope of the new revenue standard and not in the scope of IAS 38.
Comparison with current US GAAP

**Policy election**

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

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

**Direct-response advertising costs**

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

Although the current US GAAP guidance that allows the capitalization of direct-response advertising if certain conditions are met was superseded, this guidance was added to ASC 944 and therefore applies to insurance entities in the scope of that guidance.

**Costs for investment companies**

The new standard generally will not change current US GAAP accounting for mutual fund distribution fees associated with contingent deferred sales charges.

The current US GAAP guidance requiring the deferral of related incremental costs and expense recognition of indirect costs is superseded but replaced by substantially the same guidance in ASC 946-720-25-4. This industry-specific guidance does not address the assessment of the appropriate amortization period or asset impairment test. As a result, investment companies may consider the new standard’s guidance in ASC 340 when making these assessments.
6.2 Costs of fulfilling a contract

Requirements of the new standard

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

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

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

The following are examples of costs that are capitalized when the specified criteria are met and of costs that cannot be capitalized.

<table>
<thead>
<tr>
<th>Direct costs that are eligible for capitalization if other criteria are met</th>
<th>Costs required to be expensed when they are incurred</th>
</tr>
</thead>
<tbody>
<tr>
<td>✔ Direct labor – e.g. employee wages</td>
<td>✗ General and administrative costs – unless explicitly chargeable under the contract</td>
</tr>
<tr>
<td>✔ Direct materials – e.g. supplies</td>
<td>✔ Costs that relate to satisfied performance obligations</td>
</tr>
<tr>
<td>✔ Allocation of costs that relate directly to the contract – e.g. depreciation and amortization</td>
<td>✔ Costs of wasted materials, labor or other contract costs&lt;br&gt;a)</td>
</tr>
<tr>
<td>✔ Costs that are explicitly chargeable to the customer under the contract</td>
<td>✔ Costs that do not clearly relate to unsatisfied or partially satisfied performance obligations</td>
</tr>
<tr>
<td>✔ Other costs that were incurred only because the entity entered into the contract – e.g. subcontractor costs</td>
<td></td>
</tr>
</tbody>
</table>

a. For the effects these costs have on the measure of progress, see 5.5.3.3.
Example 37 – Set-up costs incurred to fulfill a contract

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

<table>
<thead>
<tr>
<th>Type of cost</th>
<th>Accounting treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Design services</td>
<td>40</td>
</tr>
<tr>
<td>Hardware and software</td>
<td>210</td>
</tr>
<tr>
<td>Migration and testing</td>
<td>100</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>350</strong></td>
</tr>
</tbody>
</table>

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

- **Type of cost**
  - Design, migration, and testing of the data center
- **Accounting treatment**
  - Capitalized under the new standard because they:
    - relate directly to the contract
    - generate or enhance resources of the entity that will be used to satisfy performance obligations in the future
    - are expected to be recovered over the five-year contract period

The capitalized hardware and software costs are subsequently measured using other applicable guidance. The costs capitalized under the new standard are subject to its amortization and impairment requirements (see 6.3 and 6.4).
Judgment needed in determining whether to capitalize learning curve costs

The new standard may affect the accounting for contracts that have significant learning curve costs that decrease over time as process and knowledge efficiencies are gained. The Boards noted that the new standard addresses the accounting for the effect of learning curve costs when two conditions exist:

- an entity has a single performance obligation to deliver a specified number of units; and
- the performance obligation is satisfied over time.

The Boards noted that in such cases an entity is likely to select a method for measuring progress (e.g. cost-to-cost method) that would result in more revenue and expense recognized earlier in the contract when the first units are produced, because this is when more of the costs are incurred. The Boards believed that this effect is appropriate because of the greater value of the entity’s performance in the earlier part of the contract, and if only one unit was sold then the entity would sell it for a higher price. Further, when control passes to the customer as costs are incurred, it would be inappropriate to capitalize those costs because they relate to past performance. Therefore, if these conditions exist and the cost-to-cost method is used, then generally learning curve costs will not be capitalized.

In other cases, if the contract is for multiple performance obligations (e.g. selling multiple goods or products, such as multiple pieces of equipment or machinery) that are each satisfied at a point in time (e.g. on transfer of control of the good), then an entity will principally account for the costs of these performance obligations under other standards, such as inventory guidance. This is because an entity incurring costs to fulfill a contract without also satisfying a performance obligation over time is likely creating an asset in the scope of other guidance (e.g. inventory).

Costs in excess of constrained transaction price

In certain circumstances, an up-front loss may arise because the revenue from a transaction is constrained or the allocation of transaction price to a performance obligation is limited to an amount that is lower than the cost of the goods transferred to the customer. In these cases, it is not appropriate for an entity to defer the up-front loss unless other specific guidance requires deferral.

For example, an entity sells goods with a cost basis of 100,000 for stated consideration of 120,000. However, the total consideration is subject to a risk of price concession in the future. The entity determines that the contract is not onerous and a loss accrual is not required under other applicable guidance. The entity constrains the transaction price and concludes that 90,000 is (highly) probable of not resulting in a significant revenue reversal. When control transfers, the entity recognizes revenue of 90,000 and costs of 100,000. This accounting entry results in an up-front loss until the uncertainty associated with the variable consideration is resolved. For discussion of variable consideration and the constraint, see 5.3.1.
Comparison with current IFRS

**Capitalizing costs to fulfill a contract**

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

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

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

Comparison with current US GAAP

**Policy election**

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

**Costs in excess of transaction price**

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

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

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Under the new standard, an entity may similarly deliver a good or provide a service, and all or a portion of the transaction price relating to that good or service may be constrained from revenue recognition. Otherwise the amount of transaction price allocated to the performance obligation may not exceed the cost. There is no provision in the new standard that is similar to the current SEC guidance for situations in which applying the variable consideration constraint or the new standard’s allocation guidance results in an up-front loss on the delivered good or service. As a result, in certain circumstances an entity may be required to recognize costs before recognizing expected revenue on satisfied performance obligations.

**Sell-through versus sell-in**

An entity that applies sell-through accounting (i.e. recognizes revenue when goods are sold by its customer, a distributor, to the distributor’s customers) under existing US GAAP, will generally apply sell-in accounting (i.e. recognize revenue when control of goods transfers to the distributor) under the new standard. As a result, in certain circumstances an entity who is the principal in the transaction with the distributor may be required to recognize expenses before recognizing much of the expected revenue on satisfied performance obligations because the revenue may be constrained by the risks that cause the amount not to be fixed or determinable under current US GAAP.

**Pre-production costs relating to long-term arrangements**

The new standard does not amend the current US GAAP guidance for pre-production costs related to long-term supply arrangements. However, the FASB is expected to propose that this guidance be superseded. As a result, an entity applying this guidance would be required instead to follow the revenue recognition and cost guidance in the new standard. As of the date of this publication, the FASB’s proposal has not been finalized.

Under current US GAAP, design and development costs for products to be sold under these arrangements are expensed as they are incurred. However, the costs are recognized as an asset if there is a contractual guarantee for reimbursement. Design and development costs for molds, dies, and other tools that an entity owns and that are used in producing the products under a long-term supply arrangement are capitalized as part of the molds, dies, and other tools – unless the design and development involves new technology. If so, they are expensed as incurred under the accounting for R&D costs.

Under the new standard, an entity needs to perform an analysis of whether those pre-production activities transfer a distinct good or service to the customer. If they transfer a distinct good or service, then revenue is allocated and recognized when that performance obligation is satisfied. If the FASB’s anticipated proposal is finalized and the activities transfer a distinct good or service, then the timing of recognition for these costs would also coincide with the satisfaction of the related performance obligation and not the period of ongoing delivery of goods or services under the contract. For discussion of engineering and design services and tooling deliverables, see 5.2.1.
If the FASB’s proposal is finalized, then the new standard would require the costs related to these pre-production activities to be capitalized if they meet the specific criteria, regardless of whether there is a contractual guarantee for reimbursement. Design and development costs that are currently in the scope of ASC 340-10 would generally meet the first two capitalization criteria. The criteria are met because they generally relate directly to an existing contract or specific anticipated contract, and they generate or enhance resources of the entity that will be used to satisfy performance obligations in the future. The new standard requires capitalization if these costs are expected to be recovered but, unlike current guidance, it does not limit capitalization to costs that would be recovered under a contractual guarantee for reimbursement.

**Pre-contract costs relating to construction-type and production-type contracts**

The new revenue standard supersedes current US GAAP guidance for pre-contract costs on construction-type and production-type contracts. Therefore, an entity that has historically followed that pre-contract cost guidance will now follow the fulfillment cost guidance in the new revenue standard if the costs are not in the scope of another Codification topic.

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

**Future developments in US GAAP**

**Pre-production cost guidance may be superseded**

Some stakeholders indicated that existing guidance for pre-production costs conflicted with the requirements in the new revenue standard. In response, the FASB is expected to issue a proposal in its forthcoming technical corrections exposure draft that would supersede the guidance in ASC 340-10-25. However, other stakeholders have raised questions about this potential proposal.

### 6.3 Amortization

**Requirements of the new standard**

An entity amortizes the asset recognized for the costs to obtain and/or fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates. This can include the goods or services in an existing contract, as well as those to be transferred under a specific anticipated contract – e.g., goods or services to be provided following the renewal of an existing contract.
Example 38 – Amortization of costs over specifically anticipated contracts

Company X enters into a contract with Customer Z to manage its payroll processing for five years. Company X incurs initial setup costs of $500. These set-up activities do not transfer goods or services to Customer Z. Based on historical experience and customer analysis, Company X expects Customer Z to renew the contract for an additional five years for a total of ten years.

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

Observations

Amortization period may need to include anticipated contracts

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

Anticipated contracts included when determining whether practical expedient applies

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

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

The capitalized asset is generally recognized over the period covered by the commission. If the renewal commission is commensurate with the initial commission, then the initial commission is amortized over the original contract term and the renewal commission is amortized over the renewal period. Commissions are generally considered commensurate with each other when they are reasonably proportional to the respective contract value.

Systematic amortization for contract assets related to multiple performance obligations

The new standard requires the asset to be amortized on a systematic basis (which might not be on a straight-line basis) that is consistent with the transfer to the customer of the goods or services to which the asset relates. When the contract contains multiple performance obligations satisfied at different points in time, the entity takes this into account when determining the appropriate amortization period and pattern.

No correlation with the accounting for nonrefundable up-front fees

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

Presentation of amortization costs

If an entity chooses to present its expenses by nature, then judgment will be required to determine the nature of the expenses arising from the amortization of capitalized contract costs. The appropriate classification may often depend on the nature of the entity and the industry in which it operates. In all cases, an entity is subject to the general requirement to ensure that its presentation is not misleading and is relevant to an understanding of its financial statements.
Comparison with current US GAAP

No correlation with the accounting for nonrefundable up-front fees

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

If the amount of deferred up-front fees exceeds the deferred costs, then these two amounts are recognized over the same period and in the same manner. However, if the amount of deferred costs exceeds the deferred revenue from any up-front fees, then current practice is somewhat mixed and some entities may amortize the net deferred costs over the shorter of the estimated customer life and the stated contract period.

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

Presentation of costs similar to current SEC guidance

SEC guidance on income statement classification requires costs and expenses applicable to sales and revenues to be separately stated from selling, general and administrative expenses. The new standard does not change this guidance. An entity may have costs that are required to be capitalized under the new standard that are expensed as they are incurred under current US GAAP. The classification of the amortization cost will be treated the same as the current classification of the expense. Amortization of costs to obtain a contract will generally be classified as selling, general and administrative expenses. An entity will determine the appropriate costs of sales category in which to classify amortization of its costs to fulfill a contract.
6.4 Impairment

Requirements of the new standard

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

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

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

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

Observations

New impairment model for capitalized contract costs

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

The entity applies, in the following order:

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

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

The new standard specifies that an asset is impaired if its carrying amount exceeds the remaining amount of consideration that an entity expects to receive, less the costs that relate directly to providing those goods or services that have not been recognized as expenses.

Under the new standard, an entity considers specific anticipated contracts when capitalizing contract costs. Consequently, the entity includes cash flows from both existing contracts and specific anticipated contracts when determining the consideration expected to be received in the contract costs impairment analysis. However, the entity excludes from the amount of consideration the portion that it does not expect to collect, based on an assessment of the customer’s credit risk.

Discounting may be relevant for long-term contracts

For certain long-term contracts that have a significant financing component, the estimated transaction price may be discounted. In this case, the new standard does not prescribe whether to discount the estimated remaining contract costs when performing the impairment test, even though the contract cost asset is not presented on a discounted basis in the entity’s statement of financial position. Under IFRS, an entity discounts the contract costs for impairment test purposes consistent with IAS 36, which requires it to take into account the time value of money when determining value in use. There is diversity in the discount requirements in impairment tests under US GAAP. However, an entity’s decision about whether to discount estimated remaining contract costs should be consistent with the measurement of the remaining transaction price.

Future developments in US GAAP

Consideration received but not recognized as revenue

When assessing a contract asset for impairment, an entity determines the consideration it expects to receive. This amount includes both the amount of consideration that it has already received, but has not recognized as revenue, and the amount that it expects to receive in exchange for the goods or services to which the contract asset relates. The FASB is expected to propose a clarification to its standard to clarify this point. As of the date of this publication, the FASB has not finalized this proposal.
**Difference between IFRS and US GAAP**

**Reversal of an impairment loss**

The requirements on a reversal of an impairment loss are different under the US GAAP and IFRS versions of the new standard, to maintain consistency with their existing models. Under US GAAP, an entity does not recognize a reversal of an impairment loss that has previously been recognized.

By contrast, under IFRS an entity recognizes a reversal of an impairment loss that has previously been recognized when the impairment conditions cease to exist. Any reversal of the impairment loss is limited to the carrying amount, net of amortization, that would have been determined if no impairment loss had been recognized.
7 Contract modifications

Overview

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

7.1 Identifying a contract modification

Requirements of the new standard

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

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

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

Example 39 – Assessing whether a contract modification is approved

Shipbuilder S is an experienced shipbuilder. One of its largest customers is CruiseLines C, for whom Shipbuilder S has previously built 11 cruise ships. Shipbuilder S agrees to build a 12th cruise ship for CruiseLines C and begins work on January 1, Year 1.

On January 1, Year 3, CruiseLines C informs Shipbuilder S that it wishes to amend the specifications of the new cruise ship to accommodate 50 additional staterooms. Shipbuilder S determines that in order to meet the request it would need to redesign three of the decks and procure additional materials. Shipbuilder S and CruiseLines C discuss these changes and start preparing an amendment to the contract.
To determine whether to account for the contract modification, Shipbuilder S assesses whether it has created new, or changed existing, enforceable rights and obligations under the contract.

In making this determination, Shipbuilder S notes the following.

– Although Shipbuilder S and CruiseLines C have not executed a contract amendment or formal change order for the additional materials, design services, or the construction labor necessary to complete the requested redesign and construction, changes of this nature are common.

– When changes resulting from redesign have occurred in previous projects, CruiseLines C has compensated Shipbuilder S for the incremental costs along with a margin, as long as Shipbuilder S has been able to demonstrate that the additional costs are reasonable.

– Despite the fact that there has been no formal written agreement on the change in scope or price, after consultation with its legal counsel Shipbuilder S determines that there is legal precedent for enforceability of similar types of arrangements in the jurisdiction.

– Shipbuilder S has significant, relevant history with CruiseLines C through 11 previous shipbuilding contracts, which supports a conclusion that CruiseLines C will agree to pay Shipbuilder S for additional costs along with a reasonable margin.

– Shipbuilder S fully expects that CruiseLines C will agree to, and be able to pay, the incremental fees in this specific case.

– Considering all relevant facts and circumstances, Shipbuilder S has the necessary documentation to support its conclusion that enforceable rights and obligations have been established.

Shipbuilder S therefore concludes that the contract modification has been approved.

Conversely, if the facts and circumstances had been different, then the following factors may have indicated that the contract modification had not been approved.

– There is an absence of legal precedent in the jurisdiction related to oral agreements of this nature, or Shipbuilder S’s counsel cannot determine whether the unpriced change order would be enforceable.

– This is Shipbuilder S’s first project with CruiseLines C, so Shipbuilder S does not have relevant history or an established business practice with CruiseLines C to support a conclusion that there is an agreement between the parties that CruiseLines C will pay Shipbuilder S for additional costs along with a reasonable margin to create enforceable rights and obligations in the contract.

– Previous experience with CruiseLines C has shown them to be reluctant or even unwilling to pay for incremental costs and related margin on any scope changes before their formal approval, which has usually been given only after extensive negotiations.

– At the time of the contract modification, it was not probable that CruiseLines C would be able to pay any incremental fees resulting from the scope changes.
7.1 Identifying a contract modification

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

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

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

Assessment focuses on enforceability

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

Additional criteria to evaluate, including probability of collection

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

Also, in many cases a modification of the contract will be a ‘significant change in facts and circumstances’ and therefore will require the entity to reassess whether the Step 1 criteria for a contract are met. Under that guidance, the following criteria are used to determine whether a contract exists and to help assess whether a modification exists.
Relevant considerations when assessing whether the parties are committed to perform their respective obligations, and whether they intend to enforce their respective contract rights, may include whether:

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

No specific guidance on accounting for contract claims

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

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

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

**Partial contract terminations are accounted for as a contract modification**

Termination clauses are evaluated in Step 1 of the model to determine the contract term for which enforceable rights and obligations exist. A substantive termination penalty is evidence that rights and obligations exist throughout the term to which the penalty applies. Once the contract term is established, the entity accounts for the contract on that basis – i.e. if the contract term is established on the basis that the customer will not terminate it, then the termination penalty is not included. Upon termination, any penalties whether included in the original contract or negotiated at the time the parties agree to the partial termination, are accounted for as a contract modification.

For example, Company B enters into a contract with Customer C to provide a monthly service for a three-year period. Customer C has the right to cancel the service in Year 3 by paying a substantive termination penalty. Therefore, Company B determines that it has a three-year contract to provide a series of distinct services (i.e. a single performance obligation satisfied over time).

At the end of Year 1, Customer C decides to cancel Year 3 of the contract and pay the termination penalty. Company B accounts for this partial termination as a contract modification because the existing enforceable rights and obligations under the contract have been changed – i.e. there is now only a two-year contract (one remaining year). Customer C’s termination payment is accounted for as consideration under the modified contract and recognized prospectively (see 7.2).
A new framework

IAS 11 includes specific guidance on the accounting for claims and variations in a construction contract as follows.

| Claims | A ‘claim’ is an amount that the entity seeks to collect from the customer (or another party) as reimbursement for costs not included in the contract price. A claim is included in contract revenue only when:
| - negotiations have reached an advanced stage;
| - it is probable that the customer will accept the claim; and
| - the amount can be measured reliably. |

| Variations | A ‘variation’ is an instruction from a customer to change the scope of work to be performed. A variation is included in contract revenue when:
| - it is probable that the customer will approve the variation; and
| - the amount of revenue can be measured reliably. |

This specific guidance is not carried forward into the new standard. Instead, claims and variations in construction contracts are accounted for under the new standard’s general guidance on contract modifications.

The criteria in the new standard for recognizing a contract modification, and for applying the general requirements about variable consideration to some contract modifications, may change the timing of revenue recognition from claims and variations. Whether the new guidance will accelerate or defer revenue recognition will depend on the specific facts and circumstances of the contract.

Comparison with current US GAAP

New general framework replaces specific guidance

Current US GAAP on long-term construction- and production-type contracts includes guidance for unpriced change orders, contract options and additions, and claims. The new standard replaces this guidance with general guidance on contract modifications that applies to all entities, including those whose contracts were previously outside the scope of the guidance on construction- and production-type contracts. The new guidance also applies to contracts under which performance obligations are satisfied at a point in time, over time, or a combination of both.
Unpriced change orders arise when the work to be performed is defined, but the adjustment to the contract price is to be negotiated later. Under current US GAAP, unpriced change orders are reflected in the accounting for a contract if recovery is probable. Some of the factors considered under current US GAAP when evaluating whether recovery is ‘probable’ include:

- the customer’s written approval of the scope of the change order;
- separate documentation for change order costs that are identifiable and reasonable; and
- the entity’s experience in negotiating change orders, especially as they relate to the specific type of contract and change orders being evaluated.

Under current US GAAP, a claim is included in contract revenue if it is probable that the claim will result in additional contract revenue that can be reliably estimated. This requirement is satisfied if all of the following conditions exist:

- the contract or other evidence provides a legal basis for the claim, or a legal opinion has been obtained;
- additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor’s performance;
- costs associated with the claim are identifiable or otherwise determinable; and
- the evidence supporting the claim is objective and verifiable.

The contract modification guidance in the new standard requires an entity to assess whether the modification creates new, or changes, enforceable rights and obligations. Similar to current US GAAP, this assessment includes an evaluation of the collectibility of the consideration for an unpriced change order or claim. However, a number of additional criteria included in the new standard also need to be considered when evaluating whether a contract modification exists. These criteria may or may not have been incorporated into an entity’s evaluation of the probability of recovery under current US GAAP, and may therefore change the timing of revenue associated with contract modifications. For example, when determining whether and when to recognize revenue from contract claims, an entity should consider whether there are differences between a legal basis for a claim and the modification being legally enforceable.
7.2 Accounting for a contract modification

Requirements of the new standard

To faithfully depict the rights and obligations arising from a modified contract, the new standard requires an entity to account for modifications either on a prospective basis (when the additional goods or services are distinct) or on a cumulative catch-up basis (when the additional goods or services are not distinct).

A contract modification is treated as a separate contract (prospective treatment) if the modification results in:

- a promise to deliver additional goods or services that are distinct (see 5.2.1); and
- an increase in the price of the contract by an amount of consideration that reflects the entity’s stand-alone selling price of those goods or services adjusted to reflect the circumstances of the contract.

If these criteria are not met, then the entity’s accounting for the modification is based on whether the remaining goods or services under the modified contract are distinct from those goods or services transferred to the customer before the modification.

If they are distinct, then the entity accounts for the modification as if it were a termination of the existing contract and the creation of a new contract. In this case, the entity does not reallocate the change in the transaction price to performance obligations that are completely or partially satisfied on or before the date of the contract modification. Instead, the modification is accounted for prospectively and the amount of consideration allocated to the remaining performance obligations is equal to the:

- consideration included in the estimate of the transaction price of the original contract that has not been recognized as revenue; plus or minus

- increase or decrease in the consideration promised by the contract modification.

If the modification to the contract does not add distinct goods or services, then the entity accounts for it on a combined basis with the original contract, as if the additional goods or services were part of the initial contract – i.e. a cumulative catch-up adjustment. The modification is recognized as either an increase in or reduction to revenue at the date of modification.

The key decision points to consider when determining whether a contract modification should be accounted for as part of the original contract or a separate contract are illustrated in the following flow chart.
If the transaction price changes after a contract modification, then an entity applies the guidance on changes in the transaction price (see 5.4.3).

The following table provides examples of contract modifications, as well as how to account for these modifications.

<table>
<thead>
<tr>
<th>Example 1</th>
<th>... a separate contract</th>
<th>... a termination of an existing contract and creation of a new contract</th>
<th>... part of the original contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Addition of a distinct good or service at an undiscounted price (e.g. a customer adds a text messaging package to an existing cellular phone service package and pays the standard price offered to customers for that additional package)</td>
<td>Addition of a distinct good or service at a price that is discounted from its stand-alone selling price (e.g. a customer receives free premium channel cable service); all remaining services provided under the original contract are distinct</td>
<td>Addition of a good or service to a contract that consists of a single, integrated performance obligation where that additional good or service is highly interrelated with the single performance obligation (e.g. changing the floor plan of a partially constructed house)</td>
<td></td>
</tr>
</tbody>
</table>
### Account for the contract modification as ...

<table>
<thead>
<tr>
<th>... a separate contract</th>
<th>... a termination of an existing contract and creation of a new contract</th>
<th>... part of the original contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Modification of the contract price, with no change in the contracted goods or services and the remaining goods and services are distinct from those already delivered (e.g. a change in the unit price for the remaining quantity of homogeneous item)</td>
<td>Modification of the contract price, with no change in the contracted goods or services and the remaining goods and services are not distinct from those already delivered (e.g. a change in the contract price of a highly customized piece of software)</td>
<td></td>
</tr>
</tbody>
</table>

### Example 2

Modification of the contract price, with no change in the contracted goods or services and the remaining goods and services are distinct from those already delivered (e.g. a change in the unit price for the remaining quantity of homogeneous item).

### Example 40 – Contract modification – Additional goods or services

Construction Company G enters into a contract with Customer M to build a road for a contract price of 1,000. During the construction of the road, Customer M requests that a section of the road be widened to include two additional lanes. Construction Company G and Customer M agree that the price will increase by 200.

In evaluating how to account for the contract modification, Construction Company G first needs to determine whether the modification adds distinct goods or services.

- If the road widening is not distinct from the construction of the road, then it becomes part of a single performance obligation that is partially satisfied at the date of the contract modification, and the measure of progress is updated using a cumulative catch-up method.

- If the road widening is distinct, then Construction Company G needs to determine whether the additional 200 is commensurate with the stand-alone selling price of the distinct good.

  - If the 200 reflects its stand-alone selling price, then construction of the additional two lanes is accounted for separately from the original contract for construction of the road. This will result in prospective accounting for the modification as if it were a separate contract for the additional two lanes.

  - If the 200 does not reflect its stand-alone selling price, then the agreement to construct the additional two lanes is combined with the original agreement to build the road and the unrecognized consideration is allocated to the remaining performance obligations. Revenue is recognized when or as the remaining performance obligations are satisfied – i.e. prospectively.
Example 41 – Contract modification – An unpriced change order

Company A enters into a contract with Customer B to build a specialized asset (Product S) for 1,000,000. Company A determines that revenue for the contract should be recognized over time using the cost-to-cost method. Company A estimates that the total cost of Product S will be 800,000 and incurs 600,000 in the first two years of the contract.

At the end of Year 2, Customer B asks Company A to make a complex change to Product S. Company A agrees and begins the work immediately. However, the corresponding change in transaction price will be determined subsequently. Company A estimates that the costs of Product S will increase by 200,000 and the consideration will increase by 300,000.

Company A assesses that the modification has created enforceable rights and obligations and that Company B will pay for the incremental efforts. Company A therefore concludes that the contract has been modified.

Because the contract includes only one performance obligation, which is being satisfied over time, the modification will be accounted for as part of the original contract. However, before including the estimated consideration in the transaction price, Company A considers whether the amount should be constrained.

Company A assesses all relevant factors and determines that it has sufficient experience in fulfilling similar change orders on similar contracts and past experience with this customer such that it is probable (highly probable under IFRS) that a reversal of revenue will not occur upon resolution of the uncertainty (i.e. agreement with Customer B on a price for the change order). Therefore, Company A updates its measure of progress and adjusts revenue for the modification as follows.

<table>
<thead>
<tr>
<th>At end of Year 2</th>
<th>Before modification</th>
<th>After modification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cumulative revenue</td>
<td>750,000(a)</td>
<td>780,000(b)</td>
</tr>
<tr>
<td>Adjustment to revenue</td>
<td></td>
<td>30,000(c)</td>
</tr>
</tbody>
</table>

Notes
a. Calculated as 1,000,000 x 600,000 ÷ 800,000.
b. Calculated as (1,000,000 + 300,000) x 600,000 ÷ (800,000 + 200,000).
c. Calculated as 780,000 - 750,000.

Company A therefore increases the cumulative amount of revenue recognized at the end of Year 2 by 30,000 to 780,000.
Example 42 – Contract modification – Partially satisfied performance obligation and additional distinct goods or services

Company A enters into a contract with Customer B for a specialized asset for consideration of 1,000,000. Company A has determined that the revenue should be recognized over time using the cost-to-cost method.

At the end of Year 1, Company A has satisfied 30% of its performance obligation. Therefore, Company A has recognized 300,000 of revenue up to the end of Year 1.

At the beginning of Year 2, the parties agree to change the specification of the customized asset and increase the consideration by 100,000. Additionally, Company A agrees with Customer B to deliver Product X for 120,000 along with the specialized asset.

Products S and X are distinct goods. The price of Product X is significantly discounted from its stand-alone selling price of 150,000.

Because the price of Product X is not commensurate with its stand-alone selling price, Product X cannot be accounted for as a separate contract. Therefore, both Product S and Product X are considered part of the same contract when accounting for the modification.

Company A accounts for the modification as follows.

**Step (i) – Calculate the remaining consideration**

| Remaining consideration on original contract not yet recognized as revenue | 700,000 |
| Change order | 100,000 |
| Product X | 120,000 |
| **Total remaining consideration** | **920,000** |

**Step (ii) – Allocate the remaining consideration between Products S and X**

The remaining consideration of 920,000 is allocated to Products S and X under the general guidance in Step 4 of the model as follows.

<table>
<thead>
<tr>
<th>Stand-alone selling prices</th>
<th>Percent allocated</th>
<th>Allocated amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remaining for Product S</td>
<td>900,000</td>
<td>85.7%</td>
</tr>
<tr>
<td>Product X</td>
<td>150,000</td>
<td>14.3%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,050,000</strong></td>
<td></td>
</tr>
</tbody>
</table>
Step (iii) – Record a cumulative catch-up adjustment for the partially satisfied performance obligation

For the partially satisfied performance obligation (Product S), Company A accounts for the contract modification as part of the original contract. Therefore, Company A updates its measure of progress and estimates that it has satisfied 27.4% of its performance obligation after revising its cost-to-cost measure of progress for the revised expected costs. As a consequence, Company A calculates the following adjustment to reduce revenue previously recognized:

\[ 1,732 = 27.4\% \text{ complete} \times 1,088,571 (a) \text{ modified transaction price allocable to Product S} - 300,000 \text{ revenue recognized to date.} \]

When Company A transfers control of Product X it recognizes revenue in the amount of 131,429.

Note

a. Calculated as 300,000 + 788,571.

Observations

Different approaches for common types of contract modifications

To determine the appropriate accounting under the new standard, an entity will need to evaluate whether the modification adds distinct goods or services, and, if so, whether the prices of those distinct goods or services are commensurate with their stand-alone selling prices. This determination will depend on the specific facts and circumstances of the contract and the modification, and may require significant judgment.

Companies entering into construction-type contracts or project-based service contracts (e.g. a service contract with a defined deliverable such as a valuation report) may often account for contract modifications on a combined basis with the original contract. However, modifications to other types of contracts for goods (e.g. a sale of a number of distinct products), or services (e.g. residential television or internet services, or hardware/software maintenance services) may often result in prospective accounting. For discussion on modifications of licenses of intellectual property, including renewals and extensions of licenses, see 8.4.

Distinct goods or services in a series that are treated as a single performance obligation are considered separately

Sometimes an entity needs to apply the contract modification guidance in the new standard to a series of distinct goods or services that is accounted for as a single performance obligation. In this case, the entity considers the distinct goods or services in the contract, rather than the single performance obligation.
Interaction of new contracts with pre-existing contracts needs to be considered

Any agreement with a customer involving a pre-existing contract with an unfulfilled performance obligation may need to be evaluated to determine whether it is a modification of the pre-existing contract.

Comparison with current IFRS

Similarities to current practice

Although current IFRS does not include general guidance on the accounting for contract modifications, IAS 11 includes specific guidance on the accounting for contract claims and variations. When a claim or variation is recognized, the entity revises its measure of contract progress or contract price. Because the basic approach in IAS 11 is that the entity reassesses the cumulative contract position at each reporting date, this effectively results in a cumulative catch-up adjustment, although IAS 11 does not use this term.

Conversely, if an entity enters into a new construction contract with a customer that does not meet the contract combination criteria in IAS 11, then the entity accounts for the new construction contract as a separate contract. This outcome also arises under the new standard when a contract modification adds a distinct good or service at its stand-alone selling price.

Comparison with current US GAAP

Potential changes in practice for some entities

Current US GAAP contains very limited guidance on the accounting for contract modifications, other than for contracts that are in the scope of the guidance for construction- and production-type contracts. Entities with long-term construction- and production-type contracts generally account for contract modifications on a cumulative catch-up basis — i.e. updating their measure of progress under the contract for the effects of the modification. For contracts that are in the scope of other ASC Subtopics, practice may be mixed. Because the new standard provides guidance that applies to all contracts with customers, current practice under US GAAP is likely to change for some entities.
8 Licensing

**Overview**

The new standard provides application guidance for the recognition of revenue attributable to a distinct license of intellectual property (IP).

If the license is distinct from the other goods or services, then an entity assesses its nature to determine whether to recognize revenue allocated to the license at a point in time or over time.

An entity applying US GAAP also considers the nature of its promise in granting a license when evaluating the timing and pattern of revenue recognition for a combined performance obligation that includes a license. Otherwise, the entity applies the general model to determine the recognition of revenue for the combined performance obligation.

The new standard also contains guidance, separate from the general model for estimating variable consideration, for the recognition of sales- or usage-based royalties on licenses of IP when the license is the sole or predominant item to which the royalty relates.

The following decision tree summarizes how the new standard applies to licenses of IP.
8.1 Licenses of intellectual property

Requirements of the new standard

A license establishes a customer’s rights to the IP of another entity. Examples of IP licenses include:

– software and technology;
– franchises;

7. Under US GAAP, the guidance on licenses of IP does not apply to software that is provided as part of a hosting arrangement that does not meet the criteria in ASC paragraph 985-20-15-5. IFRS does not include the same specific scoping. However, the assessment of whether a license is distinct from other promised goods or services will likely yield similar accounting results under IFRS. See 8.2.
- patents, trademarks, and copyrights;
- movies, music, and video games; and
- scientific compounds.

### Observations

#### Different accounting for a license and sale of IP

A license establishes a customer’s rights to a licensor’s IP and the licensor’s obligations to provide those rights. The FASB version of the new standard also states that what might be considered an ‘in-substance sale’ – e.g., a license that transfers control to all of the worldwide rights on an exclusive basis in perpetuity for all possible IP applications – is a license of IP, rather than a sale. Specific application guidance is provided for measuring and recognizing revenue from licensing transactions, including guidance for recognizing revenue from sales- or usage-based royalties (see 8.6).

The accounting depends on the legal distinction of a sale or a license of IP. If a transaction is a legal sale of IP, then it is subject to the general model in the same way as the sale of any good or other nonfinancial asset. Sales- or usage-based royalties on a sale of IP are subject to the guidance on measuring variable consideration, including the constraint, and not the specific recognition guidance applicable to sales- or usage-based royalties from a license of IP.

#### No definition of intellectual property

The term ‘intellectual property’ is not defined in the new standard, nor elsewhere in either US GAAP or IFRS. In some cases, it will be clear that an arrangement includes a license of IP – e.g., a trademark. In other cases, such as when content is being made available to a customer over the internet, it may be less clear and the accounting may be different depending on that determination. Therefore, an entity may need to apply judgment to determine whether the guidance on licenses applies to an arrangement.

#### First-sale doctrine

IP may be included in tangible products such as DVDs, hard-copy books, or CDs. The first-sale doctrine, which exists in US copyright law, provides that an individual who purchases a copyrighted work from the copyright holder is the owner of that individual copy and receives the right to sell or lease that particular copy.

Generally, when IP is embedded in the tangible product, the licensing guidance does not apply to the sale of goods subject to the first-sale doctrine. Instead, an entity applies the general guidance in the new revenue standard to determine the transaction price and when control of the goods transfers to the customer. Non-US entities would consider similar laws and concepts as the first-sale doctrine.
8.2 Determining whether a license is distinct

Requirements of the new standard

A contract to transfer a license to a customer may include promises to deliver other goods or services in addition to the promised license. These promises may be specified in the contract or implied by an entity’s customary business practices.

Consistent with other types of contracts, an entity applies Step 2 of the model (see 5.2) to identify each of the performance obligations in a contract that includes a promise to grant a license in addition to other promised goods or services. This includes an assessment of whether the:

- customer can benefit from the license on its own or together with other resources that are readily available; and
- license is separately identifiable from other goods or services in the contract.

The US GAAP version of the new revenue standard further states that when a performance obligation includes a license and other goods or services, an entity considers the nature of the license when evaluating the timing and pattern of revenue recognition. This includes determining whether the performance obligation that includes the license is satisfied over time or at a point in time and, if it is satisfied over time, selecting an appropriate method for measuring progress toward satisfaction of that performance obligation.

Although the IFRS version of the new revenue standard does not include this specific guidance, the IASB’s Basis for Conclusions states that:

- in some cases it may be necessary to consider the nature of the entity’s promise in granting a license that is not distinct; and
- an entity considers the nature of its promise in granting a license that is the primary or dominant component of a combined performance obligation.

Otherwise, if a license is not distinct, then an entity recognizes revenue for the single performance obligation when or as the combined goods or services are transferred to the customer. An entity generally applies Step 5 of the revenue model (see 5.5) to determine whether the performance obligation containing the license is satisfied over time or at a point in time.
The following are examples of licenses that are not distinct.

<table>
<thead>
<tr>
<th>Type of license</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>License that forms a component of a tangible good and is integral to the</td>
<td>– Software embedded in the operating system of a car</td>
</tr>
<tr>
<td>functionality of the good</td>
<td></td>
</tr>
<tr>
<td>License from which the customer can benefit only in conjunction with a</td>
<td>– Media content that the customer can access only via an online service</td>
</tr>
<tr>
<td>related service</td>
<td>– Drug compound that requires proprietary research and development (R&amp;D) services from the entity</td>
</tr>
</tbody>
</table>

**Example 43 – An IP license in a combined performance obligation**

Company X enters into a five-year patent license with Customer Z for a fixed fee. Company X also provides essential consulting services for two years.

Company X determines that there are two promises in the contract – the patent license and the consulting service component. However, the license is not distinct from the service component in the contract because the services are essential and highly interrelated.

Assume that the combined performance obligation is satisfied over time – e.g. because the patent is being created for the customer and will have no alternative use to Company X, and Company X has an enforceable right to payment for performance completed to date. Company X considers the nature of the license to determine the period of time over which the combined performance obligation will be satisfied and the appropriate measure of progress to apply.

If the license provides a *right to use* the IP, then the combined performance obligation is satisfied over the two-year consulting service period. In contrast, if the license provides a *right to access* Company X’s IP, then the performance obligation will not be completely satisfied until the end of the license term (and revenue is recognized over the five-year license period). In both cases, Company X has to determine an appropriate measure of progress to apply over the two- or five-year performance period (e.g. time-elapsed, costs incurred). For discussion of measuring progress, see 5.5.3.
Example 44 – Customer’s option to purchase additional licenses

Software Vendor S enters into a five-year software arrangement with Customer C. As part of that arrangement, Software Vendor S provides access to download copies of the software from its website. Customer C pays a fixed fee of 300,000 for up to 200 software downloads. Each downloaded copy can have only a single user. Customer C pays an additional 1,000 per copy downloaded in addition to the 200, prorated based on the remaining license period at the time of download (e.g. 1,000 for copies downloaded in Year 1, 800 for copies downloaded in Year 2). Customer C has been given access codes for 200 downloads. Customer C has to request access codes for each additional download, which Software Vendor S will provide. The number of downloads is measured by Software Vendor S and any additional downloads are paid for each quarter.

The initial arrangement is generally a multiple license scenario (i.e. Customer C has been granted 200 software licenses) that can be accounted for as a single performance obligation because the licenses are transferred to Customer C at the same point in time. Therefore, the option for additional downloads represents an option to acquire additional user licenses to the software for 1,000 per license.

Because the 1,000 per copy option price is less than the initial per user license fee of 1,500 per license (300,000 ÷ 200 users), Software Vendor S needs to evaluate whether the option provides Customer C with a material right (see 10.4).
Assessing whether a license is distinct may require significant judgment

Licenses of IP are frequently included in arrangements that include promises for other goods or services. The evaluation of whether a license is distinct is often complex and requires assessment of the specific facts and circumstances of the contract. The new standard provides the following illustrative examples that may be helpful in evaluating different fact patterns.

<table>
<thead>
<tr>
<th>Type of contract</th>
<th>Description</th>
<th>Observations</th>
</tr>
</thead>
</table>
| Example 10C – Technology (US GAAP-only example) | Contract to transfer a three-year license for antivirus software and critical unspecified updates | The example illustrates the identification of a combined performance obligation when the promise to provide updates is an input to a combined item. It is an input because the software license would be of little value without the updates, and the updates significantly modify the functionality of the initial software. The example concludes that the license and the updates are not distinct and should be accounted as a single performance obligation. | Determining the degree to which updates are critical to the utility of a software license may require significant judgment for arrangements other than antivirus software arrangements. Some considerations may include:  
- the value that the customer would ascribe to the up-front deliverable versus the upgrades;  
- whether customers choose to delay or never install upgrades; and  
- the nature of the promise (e.g. a digital protection service versus a business application). |
### Example 11A and 11B – Technology

<table>
<thead>
<tr>
<th>Type of contract</th>
<th>Description</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Two cases are provided to illustrate differences in identifying performance obligations depending on whether the software will be significantly customized or modified as part of professional services also promised to the customer in the contract.</td>
<td>Two cases are provided to illustrate differences in identifying performance obligations depending on whether the software will be significantly customized or modified as part of professional services also promised to the customer in the contract.</td>
<td>Installation services involving the customization or modification of a software license may result in a conclusion that the license is not distinct from the services. Determining whether professional services involve significant customization or modification of the software may require significant judgment. Some entities may conclude that services and software will be combined under the new standard, even though the services do not meet the currently required level of being essential to the software's functionality.</td>
</tr>
</tbody>
</table>

### Example 55 – Technology

<table>
<thead>
<tr>
<th>Type of contract</th>
<th>Description</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>The customer is entitled to all updates for new designs or production processes. The updates are essential to the customer’s ability to derive benefit from the license. The example concludes that the license and the updates are inputs into a combined item for which the customer contracted and that the promises to grant the license and the updates are not distinct. The entity's overall promise to the customer is to provide ongoing access to the entity's IP.</td>
<td>The customer is entitled to all updates for new designs or production processes. The updates are essential to the customer’s ability to derive benefit from the license. The example concludes that the license and the updates are inputs into a combined item for which the customer contracted and that the promises to grant the license and the updates are not distinct. The entity's overall promise to the customer is to provide ongoing access to the entity's IP.</td>
<td>There may be diversity in views about the kinds of technology to which the fact pattern, analysis, and outcome may apply in practice. Similar to the discussion on Example 10 in the new standard related to the antivirus software, an entity considers the nature of the promise in these fact patterns. For example, this promise is a service rather than a license of IP with upgrades.</td>
</tr>
</tbody>
</table>
8.2 Determining whether a license is distinct

<table>
<thead>
<tr>
<th>Type of contract</th>
<th>Description</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Example 56A and 56B – Life sciences</strong></td>
<td>Contract to license patent rights to an approved drug, which is a mature product, and to manufacture the drug for the customer</td>
<td>Manufacturing services that can be provided by another entity are an indication that the customer can benefit from a license on its own.</td>
</tr>
<tr>
<td></td>
<td>Two cases are provided to illustrate differences in identifying performance obligations depending on whether the manufacturing process is unique or specialized; whether the license can be purchased separately; or whether other entities can also manufacture the drug.</td>
<td></td>
</tr>
</tbody>
</table>

These examples highlight the potential difficulty of determining whether services and IP are, in effect, inputs into a combined item and, therefore, not separately identifiable from each other. For example, an entity may license a video game and provide additional online hosting services that are not sold on a stand-alone basis. The entity will need to determine the degree to which the service is integral to the customer’s ability to derive benefit from its rights to the video game. The entire arrangement may be a single performance obligation or, alternatively, if the customer can derive substantial functionality from using the video game on a stand-alone basis without the additional online hosting services, then they may be separate performance obligations.

**Customer’s option to purchase additional licenses**

In some contracts, an entity charges fees for additional copies or usage of software. The entity determines whether the contract is for a single license or multiple licenses. Depending on the facts of the arrangement, the contract might contain options to purchase additional software licenses that will need to be evaluated to determine whether they convey a material right to the customer, or a single license with a usage-based fee. Judgment will be needed to determine whether an entity should apply the guidance on customer options or usage-based fees to these types of arrangements (see Example 44 in this publication).

Although this type of arrangement is common for software, the same considerations apply to similar arrangements for licenses of other types of IP.
Comparison with current IFRS

More specific guidance

Current IFRS does not contain specific guidance on separating a license of IP from other components of an arrangement. Instead, a transaction involving a transfer of rights to IP is subject to the general guidance on combining and segmenting contracts, and identifying separate components within a contract that applies to other revenue-generating transactions.

As discussed in Section 5.2, the new standard’s guidance on identifying distinct goods or services is more detailed and more prescriptive than the guidance on identifying separate components under current IFRS. This is likely to increase the consistency with which a license component is separated from other goods or services in the arrangement, but could result in different conclusions from current practice.

Comparison with current US GAAP

Software licenses

Under current US GAAP, software licenses are potentially separate units of account unless they are sold with services (e.g. consulting, installation, training, implementation support, customization services) and those services constitute significant modification, customization, or production of the software or are essential to the software’s functionality. However, even when the separation criteria are met, the license is not separated from the other services unless the entity has vendor-specific objective evidence (VSOE) of the stand-alone selling price of the undelivered elements.

Although the VSOE requirement in current US GAAP does not exist in the new standard, the analysis of whether software and related elements are distinct is similar in many respects to the current evaluation of whether services are essential to the functionality of the software. However, some of the examples in the new standard suggest that the distinct evaluation may, in limited cases, result in the combination of software and related elements (e.g. the right to unspecified upgrades in the antivirus software example) even when they are not services that are essential to the functionality of the software.
8.2 Determining whether a license is distinct

Post-contract customer support (PCS)

Software entities will need to apply judgment to determine whether the services that they now account for as a single post-contract customer support service (PCS) element (e.g. technical support and the right to unspecified software upgrades/enhancements) are separate performance obligations.

In addition, software entities will need to evaluate the nature of the promise to deliver unspecified upgrades or enhancements (or unspecified additional software products) to determine whether it is a stand-ready obligation to provide those items on a when-and-if-available basis. If the nature of the promise is a stand-ready obligation, then the entity determines the appropriate measure of progress that may result in the amount allocated to the unspecified additional products being recognized ratably over the term of the arrangement. If the promise is not determined to be a stand-ready obligation, then the allocated amount is recognized using the pattern of delivering upgrades (or additional products) under the arrangement.

Unspecified additional software products

Software entities sometimes enter into arrangements to license software and also promise to deliver unspecified additional software products (rather than unspecified upgrades or enhancements). Under current US GAAP, such an arrangement is a single unit of account. Under the new standard, the software entity will need to determine whether the promise to deliver unspecified additional software products is a performance obligation separate from the license in the arrangement (which will usually be the case). When the promise to provide unspecified additional software products is distinct from the software delivered at inception of the arrangement, the transaction price will be allocated between (or among) the performance obligations. The amount allocated to the specified software will generally be recognized once the software is delivered and the customer is able to begin to use and benefit from it, assuming that the software is a distinct right-to-use license (see 8.6).

Specified upgrades

Software entities may provide customers with a right to specified upgrades or enhancements as part of the software arrangement. Under current US GAAP the software entity may be unable to separate the delivered elements from the specified upgrades because the VSOE of fair value is generally unavailable for yet-to-be-provided upgrades. Consequently, the specified upgrade is combined with the delivered elements as a single element, and revenue for the entire arrangement is deferred until the specified upgrade is provided.

Under the new standard, the specified upgrade is evaluated to determine whether it is distinct from the delivered software and, if it is, a portion of the transaction price is allocated to the upgrade. In that case, only the revenue allocated to the upgrade is deferred until the specified upgrade is provided.
Cloud-computing arrangements

Under current US GAAP, a hosting arrangement includes a software license and a hosting service only if the following criteria are met:

- the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty; and
- it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

If these criteria are not met, then the entire arrangement is a service arrangement.

The US GAAP version of the new standard applies the same test to determine if a contract with a customer includes a software license. Hybrid and cloud-computing arrangements will be evaluated to determine the distinct goods or services (i.e. determine whether there are separate software and service performance obligations). The service performance obligation in these arrangements will continue to be accounted for as service contracts satisfied over time.

Pharmaceutical arrangements

Under current US GAAP, a biotech entity evaluates whether a drug license has stand-alone value apart from R&D services. The analysis often requires an evaluation of any contractual limitations on the license – e.g. limitations on sub-licensing – and whether the services are highly specialized or proprietary. If a customer is contractually restricted from reselling the technology, then the fact that the R&D services are not proprietary and can be performed by other entities is an indication that the license has stand-alone value.

Under the new standard, in arrangements to transfer a biotech license and provide R&D services, both the license and R&D services are evaluated to determine whether they are distinct. An entity will need to apply judgment to specific facts to determine whether the new standard’s guidance on a license being distinct within the context of the contract will result in a conclusion similar to current practice. The entity will need to determine to what extent substantive contractual prohibitions on the ability to sub-license, and the requirement for the entity to provide R&D services, will impact the assessment.

Multiple licenses

In general, under current US GAAP an arrangement in which the license fee varies based on the provision of each copy (i.e. for each seat or user) is considered to be multiple licenses, which might include an option to purchase additional licenses. An entity may evaluate the question of whether an arrangement is for a single or multiple licenses in a manner similar to current practice.
8.3 Determining the nature of a distinct license

Requirements of the new standard

A license of IP that is distinct from other goods or services in the contract is a separate performance obligation. To determine whether the performance obligation is satisfied at a point in time or over time, the entity considers whether the nature of its promise is to provide the customer with a right to:

- access the entity’s IP throughout the license period; or
- use the entity’s IP as it exists at the point in time at which the license is granted.

Requirements of IFRS

The nature of an entity’s promise in granting a license is a promise to provide a right to access the entity’s IP if all of the following criteria are met.

- Entity expects to undertake activities that significantly affect the IP
- Rights directly expose the customer to positive or negative effects of the entity’s activities
- Activities do not result in the transfer of a good or service to the customer

To determine whether a customer could reasonably expect the entity to undertake activities that do not result in the transfer of a good or service to the customer that significantly affect the IP, the entity considers its customary business practices, published policies, and specific statements, and whether there is a shared economic interest between the entity and the customer.
Under Criterion 1, an entity significantly affects the IP when either the:

- activities are expected to change the form (e.g. the design or content) or functionality (e.g. the ability to perform a function or task) of the IP; or

- ability to obtain benefit from the IP is substantially derived from, or dependent upon, those activities (e.g. the ability to benefit from a brand is often dependent upon the entity’s ongoing activities to support or maintain the value of that brand).

An entity’s ongoing activities do not significantly affect the IP when that IP has significant stand-alone functionality, unless they change that functionality. Intellectual property that often has significant stand-alone functionality includes software, biological compounds or drug formulas, and completed media content (e.g. films, television shows, and music recordings).

Contractual provisions such as time, geographical region, or use could represent:

- additional licenses if they create a right to use or access IP that the customer does not already control; or

- only attributes of a promised license to IP that the customer controls.

If these provisions do not represent multiple licenses, then they are not considered when determining the nature of the entity’s promise in granting a license (i.e. whether a right-to-use or right-to-access license).

A guarantee provided by the licensor that it has a valid patent to the underlying IP and that it will maintain and defend that patent is also not considered when determining whether the license provides a right to access or a right to use the entity’s IP.

**Requirements of US GAAP**

The licensed IP is first classified into one of two categories – functional or symbolic. The category generally determines whether the entity’s promise is to provide a right to access or right to use the IP.

a. **Functional IP** – IP that has significant stand-alone functionality (e.g. the ability to process a transaction, perform a function or task, or be played or aired). Functional IP derives a substantial portion of its utility (i.e. its ability to provide benefit or value) from its significant stand-alone functionality.

b. **Symbolic IP** – IP that is not functional IP (i.e. that does not have significant stand-alone functionality). Because symbolic IP does not have significant stand-alone functionality, substantially all of its utility is derived from its association with the entity’s past or ongoing activities, including its ordinary business activities.
The following decision tree summarizes the evaluation to determine whether a license provides a right to access or a right to use the entity’s IP.

**Does the IP to which the customer has rights have significant stand-alone functionality?**

- No
  - The underlying IP is **symbolic** in nature. The nature of the license is a right to access the entity’s IP
- Yes
  - The underlying IP is **functional** in nature
    - **(A)** Is the functionality of the IP to which the customer has rights expected to change during the license period as a result of activities or other actions of the licensor that do not transfer a promised good or service to the customer and **(B)** is the customer contractually or practically required to use the updated version of the IP?
      - Yes to both (A) and (B)
        - The nature of the license is a right to access the entity’s IP
      - No to either (A) or (B)
        - The nature of the license is a right to use the entity’s IP

Because symbolic IP has limited or no stand-alone functionality, a customer’s ability to derive benefit from a license to symbolic IP depends on the entity continuing to support or maintain the IP. Therefore, a license to symbolic IP grants the customer a right to access the entity’s IP, which is satisfied over time as the entity fulfills its promise to both:

- grant the customer rights to use and benefit from the entity’s IP; and
- support or maintain the IP. An entity generally supports or maintains symbolic IP by continuing to undertake those activities from which the utility of the IP is derived and/or refraining from activities or other actions that would significantly degrade its utility.
An entity’s promise in granting a license to functional IP generally does not include supporting or maintaining the IP because the functional IP has significant stand-alone functionality.

A license to functional IP provides a right to use the entity’s IP unless both the:

- functionality of the IP to which the customer has rights is expected to change substantively during the license period as a result of activities of the entity that do not transfer a good or service to the customer (e.g. rights to an upgrade or additional IP); and
- customer is contractually or practically required to use the updated IP.

### Example 45 – Assessing the nature of a software license with unspecified upgrades

Software Company X licenses its software application to Customer Y. Under the agreement, Software Company X will provide updates or upgrades on a when-and-if-available basis; Customer Y can choose whether to install them.

**IFRS**

There is no expectation that Software Company X will undertake activities that change the functionality of the software but do not result in a transfer of a good or service to Customer Y. Although the updates and upgrades will change the functionality of the software, they are not activities considered in determining the nature of the entity’s promise in granting the license. The activities of Software Company X to provide updates or upgrades are not considered because they transfer a promised good or service to Customer Y. Therefore, the software license provides a right to use the IP that is satisfied at a point in time.

**US GAAP**

The software has significant stand-alone functionality and, therefore, is functional IP. Because there is no expectation that Software Company X will undertake activities that will change the functionality of the software but not result in the transfer of a good or service to Customer Y, the license provides a right to use IP and is satisfied at a point in time.

**Comparison of IFRS and US GAAP**

Although the analysis might be different under IFRS and US GAAP, significant differences in practice are not expected to arise.
8.3 Determining the nature of a distinct license

**Example 46 – Assessing the nature of a film license and the effect of marketing activities**

Film Studio C grants a license to Customer D to show a completed film. Film Studio C plans to undertake significant marketing activities that it expects will affect box-office receipts for the film. The marketing activities will not change the functionality of the film, but they could affect its value.

**IFRS**

Film Studio C would probably conclude that the license provides a right to use its IP and, therefore, is transferred at a point in time. There is no expectation that Film Studio C will undertake activities to change the form or functionality of the movie. Because the IP has significant stand-alone functionality, the Film Studio C’s marketing activities do not significantly affect Customer D’s ability to obtain benefit from the film, nor do they affect the IP available to Customer D.

**US GAAP**

The licensed film is functional IP because it has substantial stand-alone functionality (i.e. the ability to be aired in its current, completed form). There is no expectation that Film Studio C will undertake activities to change the film. Therefore, the license provides a right to use the film and is satisfied at a point in time.

**Comparison of IFRS and US GAAP**

Although the analysis might be different under IFRS and US GAAP, significant differences in practice are not expected to arise for such arrangements.

**Example 47 – Assessing the nature of a team name and logo license – Active sports team**

Sports Team D enters into a three-year agreement to license its team name and logo to Apparel Maker M. The license permits Apparel Maker M to use the team name and logo on its products, including display products, and in its advertising or marketing materials.

**IFRS**

The nature of Sports Team D’s promise in this contract is to provide Apparel Maker M with the right to access the sports team’s IP and, accordingly, revenue from the license will be recognized over time. In reaching this conclusion, Sports Team D considers all of the following facts.

- Apparel Maker M reasonably expects Sports Team D to continue to undertake activities that support and maintain the value of the team name and logo by continuing to play games and field a competitive team throughout the license period. These activities significantly affect the IP’s ability to provide benefit to Apparel Maker M because the value of the team name and logo is substantially derived from, or dependent upon, those ongoing activities.
The activities directly expose Apparel Maker M to positive or negative effects (i.e. whether Sports Team D plays games and fields a competitive team will have a direct effect on how successful Apparel Maker M is in selling clothing featuring the team’s name and logo).

Sports Team D’s ongoing activities do not result in the transfer of a good or a service to Apparel Maker M as they occur (i.e. the team playing games does not transfer a good or service to Apparel Maker M).

**US GAAP**

The team name and the logo do not have significant stand-alone functionality and, therefore, are symbolic IP. Because the license conveys rights to symbolic IP, the nature of the Sports Team D’s promise is to provide a right to access its IP throughout the license period. That promise includes continuing to support and maintain the IP (i.e. by continuing to undertake those activities from which the utility of the IP is derived, such as playing games and fielding a competitive team). Therefore, revenue from the license will be recognized over time.

**Comparison of IFRS and US GAAP**

Although the analysis might be different under IFRS and US GAAP, significant differences in practice are not expected to arise.

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**Example 48 – Assessing the nature of a team name and logo license**

- **Sports team that is no longer active**

Modifying Example 47, Sports Team D has not played games in many years and the licensor is Brand Collector B, an entity that acquires IP such as old team or brand names and logos from defunct entities or those in financial distress. Brand Collector B’s business model is to license the IP, or obtain settlements from entities that use the IP without permission, without undertaking any ongoing activities to promote or support the IP.

In this example, Brand Collector B would generally reach a different conclusion about the nature of the license under IFRS and US GAAP.

**IFRS**

Based on Brand Collector B’s customary business practices, Apparel Maker M likely does not reasonably expect Brand Collector B to undertake any activities to change the form of the IP or to support or maintain the IP. Therefore, Brand Collector B would probably conclude that the nature of its promise is to provide Apparel Maker M with a right to use its IP as it exists at the point in time at which the license is granted.
8.3 Determining the nature of a distinct license

**US GAAP**

The team name and the logo do not have significant stand-alone functionality and, therefore, are symbolic IP. Because the license conveys rights to symbolic IP, the nature of Brand Collector B’s promise is to provide a right to access its IP throughout the license period. Because Brand Collector B still owns the symbolic IP, the promise to grant the license includes continuing to support and maintain the IP by refraining from activities that would significantly degrade the IP. Accordingly, revenue from the license will be recognized over time.

**Observations (IFRS and US GAAP)**

The FASB and IASB standards are now worded differently

The new revenue standards issued by the IASB and FASB in 2014 contained identical application guidance on licensing. They stated that a license was a right to access if, among other criteria, the entity was expected to undertake activities that ‘significantly affect’ the IP. However, stakeholders questioned which activities should be evaluated, and whether the focus should be on the effect of those activities on the functionality of the IP, the value of the IP, or both.

In response to those concerns, the FASB introduced the symbolic/functional IP concept as a way for entities to more consistently determine whether an entity’s activities that do not transfer a good or service to the customer significantly affect the underlying IP. In contrast, the IASB decided to provide additional guidance on how to determine when an entity’s expected activities significantly affect the IP to which the customer has rights.

The Boards have stated that they expect the outcomes to be similar in most circumstances. The examples included in observations below demonstrate how the application of the two standards can result in the same outcome in common scenarios. However, because the new standards differ in their specific requirements, it remains possible that differences in practice between IFRS and US GAAP may develop.

Franchise licenses generally provide a right to access IP

Under the new standard, franchise rights generally provide a right to access the underlying IP. This is because the franchise right is typically affected to some degree by the licensor’s activities of maintaining and building its brand. For example, the licensor generally undertakes activities to analyze changing customer preferences and enact product improvements, and the customer has the right to exploit and benefit from those product improvements.

Example 57 in the new standard illustrates a 10-year franchise arrangement in which the entity concludes that the license provides access to its IP throughout the license period. This is the same conclusion under both standards, but under US GAAP, a franchise right is identified as symbolic IP which by definition makes it a right-to-access license.
Only consider licensor’s activities that do not transfer a good or service to the customer

When evaluating the nature of its promise to provide a license of IP, a licensor considers only activities that do not transfer a good or service to the customer. This applies under both IFRS and US GAAP, though the requirement is articulated differently.

Under IFRS, the third criterion for a license to be a right to access the entity’s IP is that the licensor’s activities do not transfer a good or service to the customer. If all of the activities that may significantly affect the IP transfer goods or services to the customer, then this criterion will not generally be met, resulting in point-in-time recognition.

For example, a contract that includes a software license and a promise to provide updates to the customer’s software, does not result in a conclusion that the licensor is undertaking activities that significantly affect the IP to which the customer has rights. This is because the provision of updates constitutes the transfer of an additional good or service to the customer.

The US GAAP standard similarly stipulates that ‘activities’ in the context of the licensing guidance refers only to those activities that do not transfer a good or service to the customer. It identifies the activities related to a promise to provide updates to a customer’s software on a when-and-if-available basis as activities that transfer a good or service to the customer.

Effect of different attributes of a license on determining the nature of the entity’s promise

A license is, by its nature, a bundle of rights conveyed to a customer. The various attributes of a license (e.g. restrictions on time, geography, or use) do not affect whether the license provides a right to use or a right to access the entity’s IP.

For example, Example 59 in the new standard discusses a license to a symphony recording that includes restrictions on time, geography, and use (i.e. the license is limited to two years in duration, permits use within only Country A, and limits the customer to use of the recorded symphony only in commercials). These restrictions are attributes of the single license in the contract and do not affect the conclusion that the license provides a right to use the entity’s IP. However, in certain fact patterns contractual provisions characterized as restrictions on time, geography, or use may result in a conclusion that the entity has promised to grant multiple licenses to the customer (see 8.5).
### Observations (IFRS only)

#### Entity’s activities that significantly affect the IP

An entity’s activities that do not transfer a good or service to the customer can significantly affect the IP to which the customer has rights when the customer’s ability to obtain benefits from the IP is substantially derived from, or dependent upon, those activities. This is one of the three criteria that has to be met under IFRS to recognize revenue for a license of IP over time.

When classifying a license as a right to use or a right to access IP, an entity focuses on whether its ongoing activities are expected to change the license's form or functionality, or whether the customer’s ability to obtain benefit from the license substantially depends on other activities of the entity that are not expected to change the form or functionality of the IP (e.g. advertising or other activities to support or maintain the value of the IP).

<table>
<thead>
<tr>
<th>Recognition timing</th>
<th>Rationale</th>
<th>Examples</th>
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| **Point in time**  | Revenue is recognized at a point in time because there is no explicit or implied obligation for the entity to undertake activities during the license period to: (a) change the form or functionality of the IP, or (b) support or maintain the value of the IP during the license period. | − Software  
− Biological compounds  
− Drug formulas  
− Copies of media content – e.g. films, television shows, music |
| **Over time**      | Revenue is recognized over time because the IP's design or functionality changes over time, or because the customer’s ability to obtain benefits from the IP is substantially derived from, or dependent on, the company’s ongoing activities that will be performed over the license period. | − Brand names  
− Franchise rights  
− Logos and team names |
Does the licensor consider its cost and effort to undertake activities?

A license is not satisfied over time solely because the entity is expected to undertake activities that significantly affect the licensed IP (the first criterion). Those activities also have to directly expose the customer to their effects (the second criterion). When the activities do not affect the customer, the entity is merely changing its own asset – and although this may affect the entity’s ability to grant future licenses, it does not affect the determination of what the current license provides to the customer or what the customer controls.

Example 58 in the new standard illustrates that, when determining the nature of its promise, an entity focuses on whether its activities directly affect the IP already licensed to the customer – e.g. updated character images in a licensed comic strip – rather than the significance of the cost and effort of the entity’s ongoing activities. An entity also focuses on whether the customer’s ability to obtain benefit from the IP is substantially derived from, or dependent upon, the entity’s activities (i.e. the publishing of the comic strip).

Similarly, a media company licensing completed seasons of TV programs and simultaneously working on subsequent seasons would generally conclude that the subsequent seasons do not significantly affect the IP associated with the licensed seasons, and would not focus merely on the significance of the cost or efforts involved in developing the subsequent seasons.

Observations (US GAAP only)

Nature of functional IP

The FASB’s guidance states that IP is functional if it has significant stand-alone functionality (e.g. the ability to process a transaction, perform a function or task, or be played or aired). Activities that do not change that functionality do not significantly affect the utility of the license to the customer because the customer derives a substantial portion of the overall benefit of the license from the IP’s stand-alone functionality. Therefore, the entity’s promise to the customer in granting the license does not include an ongoing obligation during the license period to support or maintain the IP and the entity’s promise to transfer the license is satisfied at a point in time.
8.3 Determining the nature of a distinct license

### Typical timing of revenue recognition

<table>
<thead>
<tr>
<th>Point in time</th>
<th>Features</th>
<th>Examples</th>
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<tbody>
<tr>
<td></td>
<td>– The IP derives a substantial portion of its utility from its stand-alone functionality</td>
<td>– Software</td>
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<tr>
<td></td>
<td>– Ongoing activities are not part of an integrated promise to the customer in granting a license</td>
<td>– Biological compounds</td>
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<tr>
<td></td>
<td>– The license is transferred at a point in time</td>
<td>– Drug formulas</td>
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<tr>
<td></td>
<td></td>
<td>– Copies of media content – e.g. films, television shows, music</td>
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</table>

### Licenses to symbolic IP

Symbolic IP includes IP such as brand, team, or trade names; logos; and franchise rights. The utility of symbolic IP to a customer largely depends on the entity continuing to support or maintain that IP (e.g. a license to a sports team’s name and logo will typically have limited ongoing value if the team stops playing games).

Therefore, the entity’s promise to a customer is both to (a) grant the customer rights to use and benefit from the entity’s IP, which includes making a copy of the underlying IP available for the customer’s use, and (b) support or maintain the IP. Consequently, a license to symbolic IP is satisfied over time.

### Perpetual licenses to symbolic IP

In determining the period over which a performance obligation for a license of symbolic IP is satisfied, the entity’s support or maintenance of the IP generally exists for the duration of the license period. However, in the case of perpetual licenses or licenses with terms that extend beyond the remaining economic life of the IP, the FASB concluded that it is reasonable to assume that an entity will not support or maintain symbolic IP past the end of its economic life. Therefore, a license to symbolic IP is satisfied over the shorter of the license period and the remaining economic life of the IP.

There is no guidance on how an entity should determine the revenue recognition period for a perpetual license of symbolic IP with an indefinite economic life (e.g. some brand or trade names); instead, judgment is required. A discounted cash flow analysis could be helpful in providing a point in time at which a substantial portion of the present value of the future cash flows has been captured. This might provide support for an appropriate recognition period.
Comparison with current IFRS

The pattern of revenue recognition from licenses may change

Under current IFRS, license fees and royalties are recognized based on the substance of the agreement.

In some cases, license fees and royalties are recognized over the life of the agreement, similar to over-time recognition under the new standard. For example, fees charged for the continuing use of franchise rights may be recognized as the rights are used. IAS 18 gives the right to use technology for a specified period of time as an example of when, as a practical matter, license fees and royalties may be recognized on a straight-line basis over the life of the agreement.

In other cases, if the transfer of rights to use IP is in-substance a sale, the entity recognizes revenue when the conditions for a sale of goods are met, similar to point-in-time recognition under the new standard. This is the case when the entity assigns rights for fixed consideration and has no remaining obligations to perform, and the licensee is able to exploit the rights freely. IAS 18 includes two examples:

- a licensing agreement for the use of software when the entity has no obligations after delivery; and
- the granting of rights to distribute a motion picture in markets where the entity has no control over the distributor and does not share in future box office receipts.

Although these outcomes are similar to over-time and point-in-time recognition under the new standard, an entity is required to review each distinct license to assess its nature under the new standard. It is possible that revenue recognition will be accelerated or deferred compared with current practice, depending on the outcome of this assessment.
8.3 Determining the nature of a distinct license

Comparison with current US GAAP

The pattern of revenue recognition for licenses may change

Current US GAAP contains specific guidance for licenses in certain industries – e.g., films, music, software, and franchise rights. For other licenses – e.g., patents, trademarks, copyrights, and pharmaceutical and biotechnology applications – and for other intangible assets, there is no specific US GAAP guidance about whether license revenue is recognized over the license term or at inception of the license period. Current SEC guidance indicates that revenue for licenses of IP is recognized “in a manner consistent with the nature of the transaction and the earnings process.” As a consequence, for licenses for which there is no specific current US GAAP guidance, there is diversity in practice because entities evaluate their particular facts and circumstances to conclude which manner of revenue recognition is consistent with the nature of the transaction and the earnings process.

Therefore, the new standard could change current practice for entities following specialized industry guidance, as well as others with an accounting policy for recognizing license revenue that differs from the classification of licenses of IP as functional or symbolic in the new standard. Revenue recognition for licenses under the new standard may also change from current practice because the criteria for concluding that a license is distinct in Step 2 of the model differ from some current industry-specific guidance.

<table>
<thead>
<tr>
<th>Industry</th>
<th>Guidance</th>
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<tr>
<td>Franchisors</td>
<td>Under current US GAAP, the up-front franchise fee is recognized as revenue when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor (which is often when the store opens). The new standard lists franchise rights as an example of symbolic IP. Therefore, franchise rights will be accounted for as rights to access the franchisor’s IP and any fixed fee allocated to those rights generally will be recognized over the term of the franchise agreement.</td>
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<tr>
<td>Industry</td>
<td>Guidance</td>
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| **Technology and software** | If the license is a separate performance obligation, then applying the guidance in the new standard may often accelerate revenue because the entity no longer needs to have VSOE of the undelivered elements to separately recognize revenue for the delivered software license.  
If payment of a significant portion of the licensing fee is not due until after the expiration of the license or more than 12 months after delivery, then the arrangement fee under current US GAAP is presumed not to be fixed or determinable. Revenue then would be generally recognized when the amounts are due and payable. Under the new standard, extended payment terms will not preclude up-front revenue recognition; however, entities will need to determine whether all of the conditions for contract existence are met (see 5.1.1) and whether the arrangement contains a significant financing component (see 5.3.2). |
| **Pharmaceutical arrangements** | Under current US GAAP, when an entity licenses a compound that has stand-alone value, revenue is recognized either at the point of delivery or over the license period, depending on the entity’s assessment of the nature of the transaction and the earnings process.  
Under the new standard, a pharmaceutical license that is a separate performance obligation will frequently be recognized at a point in time because the drug formula or the biological compound will be considered functional IP.  
However, certain distinct distribution licenses may result in over-time revenue recognition if:  
– they require the distributor to sell and/or produce only the most recent version of the licensed drug product; and  
– the license is for a drug product that is not mature and will continue to be changed. |
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<tr>
<th>Industry</th>
<th>Guidance</th>
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<td></td>
<td>In some pharmaceutical arrangements, other services – e.g. R&amp;D or manufacturing services – may not be distinct from the license. Therefore, an entity may have to evaluate the nature of the combined performance obligation, which may still require determining the nature of the license to determine the appropriate revenue recognition for the combined performance obligation that includes the license.</td>
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<tr>
<td><strong>Entertainment and media companies</strong></td>
<td>Under current US GAAP, film licensors recognize revenue on the:</td>
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<td></td>
<td>– existence of persuasive evidence of an arrangement;</td>
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<tr>
<td></td>
<td>– film being complete and delivered or available for delivery;</td>
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<td></td>
<td>– license period having commenced;</td>
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<td></td>
<td>– arrangement fee being fixed or determinable; and</td>
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<td></td>
<td>– collection being reasonably assured.</td>
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<td></td>
<td>Under the new standard, because completed media content (e.g. films, television shows, and music) will generally be considered functional IP, licenses to completed media content that are separate performance obligations will generally be transferred at the point in time at which the customer is able to begin to use and benefit from licensed IP. However, judgment will be required to determine whether a media licensing contract includes one or multiple licenses. This determination may significantly affect revenue recognition for the contract. Also, broadcasting affiliate agreements (e.g. Cable Channel sales to Cable Company) may include a license of IP that is not distinct from the service of transmitting the content. This determination will also affect how revenue is recognized under the new standard and may mean that the licensing guidance does not apply in these cases.</td>
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</table>
The above examples illustrate potential changes in the timing of revenue recognition as a result of the determination of the nature of the license. However, it is important to note that if the customer’s payment stream is in the form of a sales- and usage-based royalty for a license of IP, then the recognition of that royalty will generally be when the subsequent sale or usage occurs. This is similar to today’s accounting (see 8.6).

### 8.4 Timing and pattern of revenue recognition

#### Requirements of the new standard

The nature of an entity’s promise in granting a license to a customer is to provide the customer with either a right to:

- access the entity’s IP; or
- use the entity’s IP.

A promise to provide the customer with a right to access the entity’s IP is satisfied over time because the customer simultaneously consumes and receives benefit from the entity’s performance of providing access to its IP as that performance occurs. The entity applies the general guidance for measuring progress toward the complete satisfaction of a performance obligation satisfied over time in selecting an appropriate measure of progress.

A promise to provide the customer with a right to use the entity’s IP is satisfied at a point in time. The entity applies the general guidance on performance obligations satisfied at a point in time to determine the point in time at which the license transfers to the customer. However, revenue cannot be recognized before the beginning of the period during which the customer can use and benefit from the license (i.e. before the start of the license period).

US GAAP further states that revenue cannot be recognized from a license of IP before the entity provides or otherwise makes available a copy of the IP to the customer. Furthermore, the requirement that revenue cannot be recognized before the beginning of the period during which the customer can use and benefit from the license applies to license renewals as well as initial licenses.

#### Example 49 – Right-to-access license

Company S enters into a contract with Customer C on November 15, Year 0 to grant Customer C a five-year license to its IP, with the license period beginning on January 1, Year 1 and ending December 31, Year 5. Company S provides Customer C with a copy of the IP on December 1, Year 0. Company S determines that the license provides a right to access.
Because the license provides Customer C with a right to access Company S’s IP, Company S will recognize the revenue from the license over the five-year term (from January 1, Year 1 until December 31, Year 5) as it satisfies its performance obligation to provide Customer C with access to the IP. Company S cannot begin to recognize revenue until January 1, Year 1 when Customer C can begin to use and benefit from the license.

**Example 50 – Right-to-use license**

Modifying Example 49 it is assumed that the license provides Customer C with a right to use Company S’s IP.

Because the license provides a right to use its IP, Company S recognizes the revenue from the license at a point in time on January 1, Year 1. This date is the first point in time at which Customer C:

- has obtained control of the license based on an evaluation of the general guidance on performance obligations satisfied at a point in time; and
- is able to use and benefit from the license.

**Observations**

**Application of the general guidance on performance obligations satisfied at a point in time**

The new standard states that a right-of-use license is satisfied at a point in time and that the indicators for determining when control transfers generally apply (see 5.5.4). However, for licenses of IP that are a right of use, the new standard adds an additional requirement that revenue cannot be recognized before the beginning of the period in which the customer can begin to use and benefit from the license.

Although the point at which the customer can begin to use and benefit from the license will typically be readily determinable, the point in time transfer of control indicators may not be applied to licenses as easily as they might be to physical goods. For example, there may not be ‘legal title’ to a license and it may be difficult to assess whether the customer has the significant risks and rewards of a license. However, the contract can be viewed as analogous to title to a license and availability of a copy of the IP (when applicable) as the equivalent to ‘physical possession’. Assessing the entity’s right to payment in a license contract should not be significantly different from that assessment in other scenarios.
Consequently, control of a license will generally transfer to the customer when:

- there is a valid contract between the parties;
- the customer has a copy or the ability to obtain a copy of the IP; and
- the customer can begin to use and benefit from the license.

Less prescriptive guidance under IFRS could result in GAAP differences, particularly for license renewals

The US version of the standard states explicitly that revenue cannot be recognized before the entity provides or makes available a copy of the license, and that the use and benefit test also applies to renewals.

The IFRS version is silent on these points. However, in the case of an initial license, application of the general requirements of the new standard will often result in a similar accounting outcome to US GAAP.

- For a right-of-access license, the licensor determines an appropriate measure of progress – in many cases, it will be difficult to support an argument that a measure of progress that involves revenue recognition before the customer obtains a copy of the IP depicts performance.

- For a right-to-use license, the licensor recognizes revenue only when the customer can use and benefit from the license – usually, the customer will not be able to use and benefit from the license before a copy of the IP is made available to them and the license period has begun.

However, the less prescriptive guidance in IFRS in this area and on contractual restrictions and attributes (see 8.5) may result in differences in some cases, particularly for renewals.

Comparison with current IFRS

More prescriptive guidance than under current IFRS

Under current IFRS, license fees and royalties are recognized based on the substance of the agreement. Beyond that, there is no specific guidance on the point in time at or from which an entity recognizes revenue.

In some cases, an entity may analogize to aspects of the leases guidance to determine an appropriate accounting policy for licenses. The leases guidance states that an entity recognizes a lease on commencement – i.e. the date from which the lessee (customer) has the right to use the underlying item. Often this date would be identified under the new revenue standard on or from which revenue is recognized for an initial license. However, there is no similar guidance for renewals.
8.4 Timing and pattern of revenue recognition

Comparison with current US GAAP

### Recognition of right-of-use license renewals

Under current US GAAP, renewals of licenses (other than those accounted for under the ‘lease method’) are generally recognized when the renewal (or extension) is agreed to by the parties. Under the new standard, entities will not be able to recognize revenue from license renewals until the renewal term commences.

<table>
<thead>
<tr>
<th>Example</th>
<th>Current US GAAP</th>
<th>New standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>Three-year term license that commences on January 1, Year 1; on June 30, Year 3, both parties agree to extend the license for two years effective January 1, Year 4.</td>
<td>In general, assuming the other applicable revenue recognition criteria have been met, the license fee is recognized as revenue on June 30, Year 3.</td>
<td>The renewal license fee is recognized on January 1, Year 4, when the two-year extension period begins.</td>
</tr>
</tbody>
</table>

### Electronic delivery of software

Software companies may deliver software to customers electronically by placing the software on their websites for download or by providing customers with an authorization code to access copies of the licensed software.

Under current US GAAP, the delivery criterion is met for software delivered electronically when the customer has:

- taken possession of the software via a download (that is, when the customer takes possession of the electronic data on its hardware); or
- been provided access codes that allow immediate possession of the software on the customer’s hardware pursuant to an agreement or purchase order for the software.

If the arrangement includes a hosting service in which the software company hosts the software but the customer has the option to take possession of the software, then the delivery of the software occurs when the customer has the ability to take immediate possession of the software.

Current US GAAP further specifies that, for an initial license of software, revenue cannot be recognized before the commencement of the license term.
Under the new standard, an entity assesses whether the license provides a right to access or a right to use IP to determine whether it is transferring the software license over time or at a point in time, which is based principally on whether the licensed IP is symbolic or functional. If the license provides a right to use the entity’s IP (which will generally be the case with software), then the timing of revenue recognition may be consistent with current practice if the license qualifies for separation from other deliverables (e.g. PCS).

Delivery of the access code is not determinative that control of the license has transferred under the new standard, and entities will need to consider other indicators of point-in-time control transfer. Further, delivery of the access code might not be substantive if the customer is already obtaining benefits from the software through a distinct hosting service. In this case, although the hosting services are transferred over time, control of the software license transfers at a point in time, which may be when the hosting service commences.

### 8.5 Contractual restrictions and attributes of licenses

#### Requirements of the new standard

The following factors are not considered when determining the nature of the entity’s promise in granting a license:

- restrictions of time, geography, or use of the license; and
- guarantees provided by the licensor that it has a valid patent to the underlying IP and that it will maintain and defend that patent.

US GAAP version of the new standard states that explicit or implicit provisions that require the entity to transfer additional licenses to the customer (because they are deemed to convey additional rights to the customer) are distinguished from contractual provisions that define the attributes of a promised license. Attributes of a promised license' define the scope of the customer’s right to use or right to access the entity’s IP, but do not affect whether the entity satisfies its performance obligation at a point in time or over time. They also do not create an obligation for the entity to transfer any additional rights to use or access its IP.
Example 51 – Subsequently accruing rights to IP

On January 1, Year 1, Film Studio F enters into a three-year contract with Broadcaster B granting Broadcaster B the exclusive right to air ABC Movie in the United States and Canada during the term of the contract. However, because of an overlapping contract with a Canadian competitor, the rights to air ABC Movie in Canada do not begin until July 1, Year 1 – i.e. there is a six-month hold-back period. Film Studio F provides a copy of ABC Movie to Broadcaster B immediately, and Broadcaster B has the right to air the movie in the United States immediately.

Film Studio F considers whether the contract grants Broadcaster B a single license, subject to a use restriction, or two licenses. It concludes that the provision in the contract preventing Broadcaster B from airing ABC Movie in Canada for the first six months of the contract term requires Film Studio F to transfer additional rights on July 1, Year 1 that Broadcaster B does not control because it cannot use and benefit from those rights in Canada before that date.

Film Studio F concludes that the contract includes two promised licenses.

Example 52 – Attributes of a promised license

Modifying Example 51, the rights to air ABC Movie in the United States and Canada both commence on January 1, Year 1. However, the terms of Broadcaster B’s rights to air ABC Movie extend only to eight broadcasts of ABC Movie in each territory during the three-year period and, as part of the contract, Broadcaster B agrees not to air certain types of advertisements during the movie.

The term of the license (three years), the geographical scope of the license (Broadcaster B’s US and Canadian networks only), and the usage limitations (limited to eight showings per territory and restrictions on advertisements during the airings of ABC Movie) define the scope of Broadcaster B’s rights. None of these provisions requires Film Studio F to transfer additional rights to use or access IP after January 1, Year 1, which is when Broadcaster B can begin to use and benefit from the rights conveyed by the contract. Therefore, Film Studio F concludes that the contract is for a single license.
### Observations

**IFRS does not include explicit guidance on distinguishing attributes of a license from additional licenses**

IFRS does not include the additional guidance contained in the US GAAP standard. Consequently, it is possible that some entities applying IFRS might evaluate whether a contract includes one or multiple licenses differently from an entity applying US GAAP. Although IFRS does not include this specific guidance, the IASB did make other amendments that are broadly consistent with changes made by the FASB.

- The IASB clarified that the restrictions of time, geography, and use in Example 59 of the new standard are attributes of a single license in that contract.
- The IASB expressed in the Basis for Conclusions that the guidance on restrictions does not alter or subvert the entity’s obligation to identify the promises to the customer and the performance obligations in the contract under Step 2 of the revenue model.
- The IASB expressed in the Basis for Conclusions that an entity considers all of the terms in a contract when considering whether promised rights result in the transfer of one or more licenses to the customer. That judgment is necessary to distinguish between contractual provisions that create promises to transfer rights to use the entity’s IP from contractual provisions that establish when, where, and how those rights may be used.

Judgment will be required to determine when a restriction creates multiple licenses and when it is an attribute of the license.

**Distinguishing attributes of a single license from additional promises to transfer licenses**

A provision in a contract that requires the entity to transfer additional rights to use or access IP that the customer does not already control generally describes an additional promise for the entity to fulfill. In Example 51 of this publication, the provision restricting the customer’s ability to use the IP in Canada initially means that, until those rights commence, the entity has a remaining obligation to transfer those rights that the customer does not already control. Because of that provision, the contract in Example 51 could easily have been written as a contract to grant two distinct licenses (one to air ABC Movie in the United States and a second license to air ABC Movie in Canada). The accounting outcome in a scenario like Example 51 does not depend on how the contract is written.

In contrast, Example 52 in this publication illustrates that licenses are, by nature, a bundle of rights to IP that are often limited on duration and scope (geographical and usage). The provisions describing the duration and scope of customer’s rights in Example 52 are distinguished from the requirement in Example 51 that the entity transfer additional rights after some other rights have been transferred (i.e. to fulfill a remaining promise to transfer those additional rights).
8.6 Sales- or usage-based royalties

Requirements of the new standard

For sales- or usage-based royalties that are attributable to a license of IP, the amount is recognized at the later of:

– when the subsequent sale or usage occurs; and
– the satisfaction or partial satisfaction of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.

This is an exception to the general requirements and it applies when the:

– royalty relates only to a license of IP; or
– license is the predominant item to which the royalty relates (e.g. when the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).

An entity does not split a royalty into a portion that is subject to the exception and a portion that is subject to the guidance on variable consideration, including the constraint (see 5.3.1).
Example 53 – Royalty – License of IP is the predominant item

Movie Distributor D licenses the right to show a movie in cinemas for six weeks to Movie Company T. Movie Distributor D has agreed to provide memorabilia to Movie Company T for display at the cinemas and to sponsor radio advertisements. In exchange, Movie Distributor D will receive a royalty equal to 30% of the ticket sales.

Movie Distributor D has a reasonable expectation that Movie Company T would ascribe significantly more value to the license than to the related promotional activities, and therefore Movie Distributor D concludes that the license to show the movie is the predominant item to which the sales-based royalty relates.

Movie Distributor D applies the royalties exception to the entire sales-based royalty and therefore cannot recognize revenue when the promotional activities are provided based on an estimate of the expected royalty amount.

If the license, the memorabilia, and the advertising activities were separate performance obligations, then Movie Distributor D would allocate the sales-based royalties to each performance obligation when or as the subsequent sales occur. Then it would recognize the royalties allocated to each performance obligation based on whether that performance obligation has been satisfied (e.g. whether the license, which is a right to use IP in this example, has been transferred to the customer or whether the advertising services are complete).

Observations

Exception for sales- or usage-based royalties aligns the accounting for different license types

A key practical effect of the exception for sales- or usage-based royalties is that it may reduce the significance of the distinction between the two types of licenses in certain circumstances. In particular, if the consideration for a license consists solely of a flat sales- or usage-based royalty for a distinct license, then an entity is likely to recognize it in the same, or a substantially similar, pattern, irrespective of whether the license provides the customer with a right to access IP or a right to use IP.
8.6 Sales- or usage-based royalties

Judgment is required to assess when a license of IP is ‘predominant’

An entity may be entitled to a sales-based or usage-based royalty in exchange for a license and other goods or services in the contract, which may or may not be distinct from the license. Licenses of IP are often bundled with other goods or services, with the consideration taking the form of a sales- or usage-based royalty for all goods or services in the contract. For example:

- software licenses are commonly sold with PCS and other services – e.g. implementation services – or hardware where there is a single consideration in the form of a sales- or usage-based royalty;
- franchise licenses are frequently sold with consulting or training services or equipment, with ongoing consideration in the form of a sales-based royalty;
- biotechnology and pharmaceutical licenses are often sold with R&D services and/or a promise to manufacture the drug for the customer, with a single consideration in the form of a sales-based royalty; or
- licenses to digital media and a promise for promotional activities may be sold with a single consideration in the form of a sales-based royalty.

The guidance specifies that the royalties exception applies when the license is the predominant item to which the royalty relates. ‘Predominant’ is not defined. However, the new standard says “this may be the case when the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates.”

Significant judgment may be required to determine whether a license is the predominant item in an arrangement. For example, an entity may determine that a license of IP is the predominant item when it represents the major part or substantially all of the value or utility of the bundle. Another entity may conclude that the exception would apply when a license of IP is the largest single item in a bundle of goods or services. These different interpretations could result in differences in practice and may give rise to differences in the transaction price and timing of revenue recognition, because they could affect the conclusion on whether the royalties exception applies to an arrangement.

Application of royalties exception to milestone payments

Entity X enters into a contract to license IP to Entity Y. In exchange for the license, Entity X is entitled to a 5 million milestone payment after Entity Y has reached 50 million in sales.

The royalties exception generally applies to the milestone payment because the payment is based on the customer’s subsequent sales. Consequently, Entity X should not recognize any revenue for the variable amount until the subsequent sales occur. However, this view does not extend to milestone payments that are determined by reference to other events or indicators such as regulatory approval or enrollment in clinical trials.

For example, arrangements in the life sciences industry often include a license of IP of a drug and an obligation to perform R&D services, with a substantial portion of the fee being contingent on achieving milestones such as regulatory approval of the drug.
Under current IFRS, if receipt of a license fee or royalty is contingent on a future event, then an entity recognizes revenue only when it is probable that the fee or royalty will be received. This is normally when the future event triggering the payment of the fee or royalty occurs.

In many cases, the accounting outcome under the new standard’s exception for a sales- or usage-based royalty will be the same as under current IFRS. However, the new standard prohibits the recognition of a sales- or usage-based royalty until the sale or usage occurs, even if the sale or usage is probable. Therefore, an entity that currently recognizes a sales- or usage-based royalty before the sale or usage occurs, on the grounds that receipt is probable, will recognize revenue later under the new standard.

As noted in the observation above, it is not always clear when the new standard’s exception for a sales- or usage-based royalty will apply. This is not generally an issue under current IFRS, which applies more widely to any license fee or royalty that is contingent on a future event. Therefore, for arrangements to which the exception does not apply, an entity may recognize revenue earlier than under current IFRS when applying the guidance on variable consideration, including the constraint.

Under current US GAAP, a sales- or usage-based royalty – irrespective of whether it relates to the licensing of IP or other goods or services – is recognized only when the amount is fixed or determinable, which is typically when the subsequent sale or usage occurs. In addition, current US GAAP specifies that substantive milestone fees may be recognized once the milestone is achieved.

Under the new standard, a sales- or usage-based royalty that relates entirely to a non-license element or to a license and non-license element, but whose license element is not the predominant item to which the royalty relates, may be included in the arrangement consideration and recognized sooner than under current US GAAP when applying the guidance on variable consideration, including the constraint.
9 Sales outside ordinary activities

Overview

Certain aspects of the new standard apply to the sale or transfer of nonfinancial assets (such as intangible assets and property, plant, and equipment) that are not an output of the entity’s ordinary activities. Although the guidance under the new standard is converged, differences remain in the accounting for some sales and transfers of nonfinancial assets under IFRS and US GAAP, including assessing when to apply the derecognition guidance.

9.1 General requirements

Requirements of the new standard

When an entity sells or transfers a nonfinancial asset (including in-substance nonfinancial assets for US GAAP) that is not an output of its ordinary activities, it derecognizes the asset when control transfers to the recipient, using the guidance on transfer of control in the new standard (see 5.5.1).

The resulting gain or loss is the difference between the transaction price measured under the new standard (using the guidance in Step 3 of the model) and the asset’s carrying amount. In determining the transaction price (and any subsequent changes to the transaction price), an entity considers the guidance on measuring variable consideration – including the constraint, the existence of a significant financing component, noncash consideration, and consideration payable to a customer (see 5.3).

The resulting gain or loss is not presented as revenue. Likewise, any subsequent adjustments to the gain or loss – e.g. as a result of changes in the measurement of variable consideration – are not presented as revenue.
Observations

Judgment required to identify ordinary activities

Under the new standard, a ‘customer’ is defined as a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration. Because ‘ordinary activities’ is not defined, evaluating whether the asset transferred is an output of the entity’s ordinary activities may require judgment. An entity may consider how ‘ordinary activities’ is currently interpreted in the FASB’s Statements of Financial Accounting Concepts and the IASB’s Conceptual Framework for Financial Reporting.

In many cases, this judgment will be informed by the classification of a nonfinancial asset – e.g. an entity that purchases a tangible asset may assess on initial recognition whether to classify the asset as property, plant, and equipment or as inventory. Typically, the sale or transfer of an item that is classified as property, plant, and equipment will result in a gain or loss that is presented outside revenue, while the sale or transfer of inventory will result in the recognition of revenue.

Accounting for a non-current or long-lived nonfinancial asset held for sale may result in a gain or loss on transfer of control because consideration may differ from fair value

When the carrying amount of a non-current nonfinancial asset is expected to be recovered principally through a sale (rather than from continuing use), the asset is classified as held for sale if certain criteria are met.

The new standard does not amend the current measurement and presentation guidance for non-current assets that are held for sale. Under this guidance, assets that are held for sale are measured at the lower of fair value less costs to sell and the carrying amount, which may differ from the expected transaction price as determined under the new standard. If the sale or transfer includes variable consideration that is constrained under the new standard, then the resulting transaction price that can be recognized could be less than the fair value. This could result in the recognition of a loss when control of the asset transfers to the counterparty, even though the carrying amount may be recoverable through subsequent adjustments to the transaction price. In these situations, an entity may consider providing an early warning disclosure about the potential consequences of these accounting requirements.

Little difference in accounting for sales of real estate to customers and noncustomers

Because an entity applies the guidance on measuring the transaction price for both customer and noncustomer transactions, the difference in accounting for an ordinary (customer) versus a non-ordinary (noncustomer) sale of real estate is generally limited to the presentation in the statement of comprehensive income (revenue and cost of sales, or gain or loss).
9.2 Application under IFRS

Requirements of the new standard

Under the IFRS version of the new standard, the guidance on measurement and derecognition applies to the transfer of a nonfinancial asset that is not an output of the entity’s ordinary activities, including:

- property, plant, and equipment in the scope of IAS 16;
- intangible assets in the scope of IAS 38; and
- investment property in the scope of IAS 40.

When calculating the gain or loss on the sale or transfer of a subsidiary or associate, an entity will continue to refer to the guidance in IFRS 10 and IAS 28, respectively.

Example 54 – Sale of a single-property real estate entity – IFRS

Consulting Company X decides to sell an apartment building to Buyer Y. Consulting Company X owns the building through a wholly owned subsidiary whose only asset is the building. The transaction is outside its ordinary consulting activities.

Title transfers to Buyer Y at closing, and Consulting Company X has no continuing involvement in the operations of the property including through a leaseback, property management services, or seller-provided financing.

The arrangement consideration includes a fixed amount paid in cash at closing, plus an additional 5% contingent on obtaining a permit to re-zone the property as a commercial property. Consulting Company X believes there is a 50% chance that the re-zoning effort will be successful.

Under IFRS, Consulting Company X applies the deconsolidation guidance in IFRS 10 because the apartment building is housed in a subsidiary.

In this example, the accounting under US GAAP and IFRS may differ if the transaction is deemed to be a sale of an in-substance nonfinancial asset under US GAAP. Under IFRS the seller follows the deconsolidation guidance and measures the contract consideration at fair value. Under US GAAP, however, if the transaction is the sale of an in-substance nonfinancial asset, then the seller applies the new standard and the variable consideration is subject to the constraint (see 9.3).
Observations

Applying the new standard to the transfer of a group of nonfinancial assets that represents a business may result in different accounting

[IFRS 10.25]

IFRS does not explicitly address how to calculate the gain or loss on the sale of a group of nonfinancial assets that represents a business and is not housed in a subsidiary. Whether an entity currently applies the deconsolidation guidance or IAS 18 is not decisive, because the consideration is measured at fair value under both approaches. However, the approach may differ under the new standard, because an entity applies the guidance on the transaction price. This guidance specifies that variable consideration is subject to the constraint, and may be measured at a lower amount than fair value.

No concept of in-substance nonfinancial assets, unlike US GAAP

The consequential amendments to IFRS do not refer to in-substance nonfinancial assets. Therefore, unlike US GAAP, the guidance on deconsolidation applies to a subsidiary and the entity does not assess whether it is an in-substance nonfinancial asset. This may result in different accounting for similar transactions under IFRS and US GAAP.

Transfers to inventory are still possible if specific criteria are met

[IAS 16.68A, IAS 40.58]

If an entity sells or transfers an item of property, plant, and equipment or an investment property, then it recognizes a gain or loss on disposal outside revenue. However, in limited circumstances it remains possible that an item may be transferred to inventory before sale, in which case an entity recognizes revenue on disposal – for example:

- an entity that, in the course of its ordinary activities, routinely sells items of property, plant, and equipment that it has held for rental to others transfers these assets to inventory when they cease to be rented and become held for sale; and

- an entity transfers investment property to inventory when there is a change of use evidenced by the start of development with a view to sale.
9.3 Application under US GAAP

Requirements of the new standard

The US GAAP version of the new standard amends the derecognition guidance for intangibles and property, plant and equipment by creating ASC Topic 610. The scope of this guidance includes sales or transfers of nonfinancial assets to entities that are not customers. Derecognition of an asset in a transaction with a customer is in the scope of the new revenue standard and follows this guidance in its entirety.

A ‘customer’ is a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration.
For sales or transfers of nonfinancial assets to entities that are not customers, an entity applies the following guidance within the revenue standard:

- the determination about whether a contract exists (and, if not, the guidance on the accounting for consideration received in advance of having a contract – see 5.1.3) – Step 1;
- the transaction price: Step 3; and
- the point in time that transfer of control occurs: Step 5.

The guidance for derecognizing nonfinancial assets under US GAAP also extends to derecognizing an ownership interest in a subsidiary (or a group of assets) that is an in-substance nonfinancial asset – e.g. the sale of a subsidiary with just one nonfinancial asset, such as a building or a machine. If the transferred subsidiary (or group of assets) is not an in-substance nonfinancial asset, then the entity assesses whether it constitutes a business or nonprofit activity. If it does, then the transaction is in the scope of the deconsolidation guidance.

If the transferred subsidiary (or group of assets) does not constitute an in-substance nonfinancial asset, business, or nonprofit activity, then other US GAAP generally applies. For example, it may constitute an in-substance financial asset for which the guidance on the derecognition of financial assets applies. If no other guidance specifically applies, then the deconsolidation guidance is generally applied.
Example 55 – Sale of a single-property real estate entity – US GAAP

Consider the same fact pattern as presented in Example 54 of this publication.

Under US GAAP, Company X first assesses whether the entity is an in-substance nonfinancial asset. If it is, then Company X applies the contract existence, measurement, and transfer of control guidance in the new standard.

Because the building is the entity’s only asset, Company X concludes that it is an in-substance nonfinancial asset.

Company X concludes that a contract exists and that control transfers at closing, and therefore recognizes the sale (and derecognizes the building) at that time.

The 5% fee that is contingent on re-zoning is variable consideration that is subject to the constraint guidance. Company X cannot demonstrate that it is probable that a significant reversal of the transaction price will not occur if the contingent amount is recognized as profit at the date of the sale. Therefore, Company X limits the transaction price to the fixed amount received at closing. Company X will continue to evaluate the variable consideration until final resolution, and will adjust the transaction price (and ultimately true it up) when the contingency is resolved.

Observations

Distinguishing between sales of real estate to customers and noncustomers

Determining whether the buyer of a nonfinancial asset (or in-substance nonfinancial asset) is a customer is important because it affects whether the seller reports revenue and any cost of sales or gain/loss on sale and may, in some circumstances, affect the amount and timing of revenue/profit recognition.

An entity exercises judgment to determine whether the nonfinancial asset is being sold or transferred to a customer (in which case the new revenue standard is applied) or to a noncustomer (in which case ASC Topic 610 is applied).

The definition of a customer focuses on whether the goods or services they obtain are an output of the entity’s ordinary activities. For example, if an entity is a developer whose predominant business is selling retail land or residential units, then real estate is likely to be an output of its ordinary activities. Conversely, if a real estate investment trust (REIT) is involved primarily in leasing real estate, then sales of real estate may not necessarily be an output of its ordinary activities.

Although some REITs often sell properties as part of their overall investment strategy, the output of their normal activities is typically identified as the service that they provide to their tenants as lessors. This conclusion is consistent with the treatment of such entities for US federal income tax purposes. Under US tax law, although a REIT’s income is generally tax-exempt (assuming that all of the REIT qualification criteria are met), sales of property held primarily for sale to customers in the ordinary course of business are prohibited transactions and are taxable. Accordingly, to preserve the maximum tax advantage to themselves and their investors, REITs generally do not sell property to customers in the ordinary course of business.
Sales and transfers to a noncustomer

Noncustomer sales are accounted for under ASC Subtopic 610-20, which uses many of the revenue recognition principles of the new revenue standard. Specifically, it requires a seller of a nonfinancial asset or an in-substance nonfinancial asset to a noncustomer to apply the new revenue standard’s guidance on:

- the existence of a contract;
- the determination of the transaction price, including estimating variable consideration, constraining that consideration, evaluating whether there is a significant financing component, noncash consideration and consideration payable to the customer; and
- the timing of satisfaction of a performance obligation by transferring control of an asset.

Although ASC Subtopic 610-20 does not specifically refer to the new standard’s guidance on identifying performance obligations and allocating the transaction price (Steps 2 and 4), it is generally appropriate to apply this guidance by analogy.

Contract existence may be difficult to establish when the seller provides significant financing to the buyer

Contract existence (and the counterparty’s commitment to perform under a contract) may be difficult to establish when the seller provides significant financing to the buyer. This is because one of the criteria for a contract to exist is the probability of collection by the seller of the consideration to which it will be entitled.

In evaluating whether collectibility is probable, the seller may need to consider the following factors.

- **Payment terms**: Do the payment terms reflect inherent uncertainty about the buyer’s intent to fulfill its obligations? Payment terms that may suggest a significant uncertainty about the buyer’s intent and ability to fulfill its obligations may include:
  - small down payment relative to the overall contracted price;
  - nonrecourse, seller-provided financing;
  - recourse financing with a buyer who has no other assets;
  - buyer-provided collateral or guarantees that are not highly liquid or have a highly variable or unobservable fair value;
  - continuing periodic payments that extend beyond a customary financing period for similar transactions (or beyond the estimated useful life of the property) or no periodic payments until maturity; and
  - guarantees provided by non-highly rated counterparties.
9.3 Application under US GAAP

- **Importance of the property to the buyer’s operations**: Do the buyer’s business model and reasons for entering into the transaction raise doubt about the buyer’s intent to follow through with its obligations? For example, a buyer may be more committed to perform if it is purchasing property that is essential to operating a particular line of business than if it is making a speculative investment that is not part of its ordinary business activities.

- **Prior experience**: Does the seller have prior experience with the buyer (or a similar class of buyer) for the same or similar transactions that call into question the intent and ability of the buyer to perform? Or, similarly, has the seller previously chosen not to enforce its contractual rights in similar contracts with the buyer (or buyer class) under similar circumstances?

- **Future subordination**: Is the seller’s receivable subject to future subordination?

None of these factors should be viewed in isolation; instead, they should be evaluated collectively based on all relevant facts and circumstances. No single factor is determinative of whether the buyer is committed to perform or collectibility is probable.

**Determining when a subsidiary (or a group of assets) is an in-substance nonfinancial asset requires judgment**

The new standard’s guidance on transfers of nonfinancial assets also applies to transfers of in-substance nonfinancial assets. However, it does not define ‘in-substance nonfinancial asset’ or provide guidance on how an entity should determine whether a subsidiary (or a group of assets) is one.

For example, it is unclear whether the evaluation should:

- be based on the relative fair values of the various assets in the subsidiary (or group of assets); or
- include unrecognized nonfinancial assets (e.g. internally developed intangible assets).

Therefore, this evaluation will often require significant judgment based on an analysis of all of the facts and circumstances. However, the FASB has a project to clarify the scope of ASC 610-20 and the Board is planning to provide more guidance about what constitutes an in-substance nonfinancial asset (see *Future developments in US GAAP* section below).

Additionally, in some cases a subsidiary (or a group of assets) may be both an in-substance nonfinancial asset and a business – e.g. an operating real estate property (including an ownership interest in an entity that holds a single real estate property) or technology business.

The guidance on the deconsolidation of a subsidiary or derecognition of a group of assets specifically excludes the transfer of an in-substance nonfinancial asset. However, the FASB’s project to clarify the scope of ASC 610-20 is expected to provide amendments to this guidance to clarify when the guidance on the deconsolidation or derecognition of a business applies (see *Future developments in US GAAP* section below).
Lack of current derecognition guidance

Other than the guidance on the accounting for real estate sales, there is little guidance in current US GAAP on the derecognition of nonfinancial assets that:

- are not an output of an entity’s ordinary activities; and
- do not constitute a business or nonprofit activity accounted for under the deconsolidation guidance.

Transfer of in-substance nonfinancial assets

A sale or transfer of a subsidiary (or a group of assets) that constitutes a business or nonprofit activity continues to be accounted for using the deconsolidation guidance only when it does not also constitute a transfer of an in-substance nonfinancial asset.

In these cases, portions of the new standard apply and may result in differences in the derecognition date and/or the measurement of the gain or loss. In addition, an entity does not apply the new standard to conveyances of oil and gas mineral rights.

Sale-leaseback transactions

The current real estate sale guidance in US GAAP continues to apply to sale-leaseback transactions involving real estate. The current leasing guidance applies to disposals through sale-leaseback transactions involving non-real-estate transactions until the new leasing standard is effective.

Sales of real estate

The new standard differs significantly from current US GAAP for sales of real estate. Current US GAAP requires a number of criteria to be met to recognize the full amount of profit on a sale of real estate.

Buyer’s initial and continuing investment

Current US GAAP requires, among other things, a buyer’s initial and continuing investments to be adequate to demonstrate a commitment to pay for the property in order to recognize profit by the full accrual method. The adequacy of the buyer’s initial investment is measured both by its composition and by its size compared with the sales value of the property. To qualify, the buyer’s continuing investment requires a payment on the total debt for the purchase price:

- an amount at least equal to the level annual payment that would be needed to pay the debt and interest on the unpaid balance over no more than 20 years for the land; or
- the customary amortization term of a first mortgage loan by an independent established lending institution for other real estate.
If the buyer’s initial or continuing investment is not adequate, then the seller applies the installment, cost recovery, or deposit method to account for the sale, depending on the likelihood of recovering the cost of the property if the buyer defaults.

Under the new standard, if an entity determines that a contract exists based on the qualitative considerations discussed above, although it would not otherwise meet the initial and continuing investment requirements under current US GAAP, it recognizes revenue (or a gain in a noncustomer transaction) when or as control transfers to the buyer.

Although there is no prescribed level of initial or continuing investment, the amount of initial or continuing investment may impact the assessment of whether a contract exists – i.e. as it increases there is a greater likelihood that the entity may conclude that a contract exists. If a contract does not exist, then the new standard does not permit the application of the installment or cost recovery method, but rather requires accounting similar to the deposit method.

**Future subordination**

Current US GAAP precludes a seller from recognizing profit on a real estate sale if the seller’s receivable from the buyer is subject to future subordination. There is an exception if it is subordinate only to a first mortgage on the property existing at the time of sale or to a future loan (including an existing permanent loan commitment) provided that the terms of the sale require the proceeds of the loan to be applied first to the payment of the seller’s receivable. If the seller’s receivable is subject to future subordination, then current US GAAP requires profit recognition using the cost recovery method.

The new standard changes the accounting for transactions in which a contract exists (based on the qualitative considerations discussed above) and the seller’s receivable from the buyer is subject to future subordination. Under the new standard, these contracts result in revenue recognition (or gain recognition in a noncustomer transaction) when or as control transfers to the buyer, while under current US GAAP the cost recovery method is applied.

The results of applying the new standard may also differ from the current accounting under current US GAAP when a contract does not exist. The new standard does not permit the application of the cost recovery method; it requires accounting similar to the deposit method.

**Continuing involvement**

The new standard changes the effect of continuing involvement by the seller on profit recognition. Continuing involvement under current US GAAP can prevent or delay derecognition of the property and/or affect the pattern of profit recognition on the overall arrangement. Under the new standard, continuing involvement with the transferred property will often be accounted for on its own as either a separate:

- unit of account that is subject to other guidance (e.g. seller guarantees); or
- performance obligation from the transfer of the property (e.g. providing ongoing property management services or development services).
**Seller support of operations and seller guarantees**

Under current US GAAP, an agreement to initiate or support the operations of a property in connection with a sale of that property requires the seller to account for the sale as a financing, leasing, or profit sharing arrangement if it is required to initiate or support operations or continue to operate the property at its own risk (or may be presumed to have such risk) for an extended period of time. Additionally, if it provides conditions that, presume support for an extended period of time, then it also applies the same accounting.

If support is required (or presumed to be required) for a limited time, then the seller recognizes profit on a proportional performance basis as it provides services. Performance is measured by the costs incurred and expected to be incurred over the period during which the services are performed (i.e. on a cost-to-cost basis). The seller begins to recognize profit when there is reasonable assurance that the future rent receipts will cover operating expenses and debt service, including payments due to the seller under the terms of the transaction. Other forms of guarantees – e.g. a guarantee of a buyer’s return on investment in connection with a real estate sale – may also prevent recognition of a sale of the real estate. The new standard changes the accounting for these arrangements because the existence of a guarantee does not preclude the seller from recognizing a sale of the real estate. If the guarantee is accounted for separately, then the seller records the sale. However, there is a reduction of profit on the sale of the real estate under the new standard because the fair value of the guarantee reduces the contract consideration allocated to the sale of the real estate (which serves as the basis for determining the transaction price).

If the support obligation is not in the scope of specific US GAAP guidance, then the transaction price is variable and the guidance on variable consideration, including the constraint, applies for determining the amount of revenue or gain/loss (see 5.3.1).

**Seller is general partner in acquiring limited partnership**

Under current US GAAP, if a seller retains a general partnership interest in the entity that purchases its property, and holds a receivable from the limited partnership for a significant part of the sales price, then it accounts for the transaction as a financing, leasing, or profit-sharing arrangement. The accounting under the new standard may result in a change because revenue/profit recognition may be appropriate if a contract exists and control has transferred – i.e. the mere existence of the general partnership interest and significant receivable does not preclude revenue/profit recognition.

**Partial sales**

Current US GAAP defines a real estate sale as a partial sale if the seller retains an equity interest in the property or has an equity interest in the buyer. An entity recognizes profit on the sale equal to the difference between the sales value and the proportionate cost of the partial interest sold if:
- the buyer is independent of the seller;
- collection of the sales price is reasonably assured; and
- the seller will not be required to support the operations of the property or its related obligations to a greater extent than its proportionate interest.
If these conditions are not met, then the seller may be unable to derecognize the property or may need to delay profit recognition – e.g. by applying either the installment or cost recovery method.

Partial sales of real estate typically occur in the following circumstances.

a. A seller contributes a wholly owned property (or an interest in a real estate entity considered an in-substance real estate/in-substance nonfinancial asset) to a newly formed venture and simultaneously receives cash from a third party to buy a partial ownership interest in that newly formed venture. The cash may come directly from the third party to the seller or may be contributed by the third party to the venture and distributed from the venture to the seller. The seller retains a controlling interest in the venture after the sale and does not have interest in the third party.

b. The same facts as (a), except that the seller retains only a noncontrolling interest in the venture after the sale.

c. A seller contributes a wholly owned property (or an interest in a real estate entity considered an in-substance real estate/in-substance nonfinancial asset) to a newly formed, wholly owned venture. Later on it sells a partial ownership interest in the venture to a third party for cash. The cash may come directly from the third party to the seller or may be contributed by the third party to the venture and distributed from the venture to the seller. The seller retains a controlling interest in the venture after the sale and does not have an interest in the third party.

d. The same facts as (c), except that the seller retains only a noncontrolling interest in the venture after the sale.

The new standard does not amend current US GAAP guidance on partial sales of real estate. For ongoing FASB deliberations of partial sales, see Future developments in US GAAP below.

Example 56 – Partial sales – Control retained

Company M owns 100% of the equity interests in a real estate venture and enters into a contract to sell 40% of its interest to Company P. The transaction price is equal to the fair value of the 40% interest of 120, and the carrying amount of Company M’s 100% interest at the time of sale is 100. Company M continues to consolidate the venture after the transaction. In this situation, there is no immediate profit recognition because Company M retains a controlling financial interest in the property; the gain of 80 (120 – (100 × 40%)) is deferred until it is realized through third-party sale of the property or operations.
Example 57 – Partial sales – Noncontrolling interest retained

Modifying Example 56, Company M sells a 60% interest. The transaction price (equal to the fair value of the 60% interest) is 180 and Company M holds only a noncontrolling interest in the property after the transaction. In this situation, Company M immediately recognizes profit of 120 (180 - (100 × 60%)) on the partial interest sold because it no longer holds a controlling financial interest. Company M’s retained interest is accounted for under the equity method.

Generally, an ownership interest in a venture owning operating real estate is an in-substance nonfinancial asset even if it meets the definition of a business. Therefore, sales of these assets are accounted for under the new standard.

If the interest in the venture is not considered an in-substance nonfinancial asset and the venture is a business, then partial sales are accounted for under the consolidation guidance. Under this guidance, if an entity deconsolidates the venture, then it recognizes 100% of profit on the transaction, and if it continues to consolidate the venture, then it does not recognize any profit.

For a detailed discussion of sales of real estate under US GAAP, see KPMG’s US publication Building a Bridge from Statement 66: Real Estate Sales Under the New Revenue Standard.

Future developments in US GAAP

The FASB has commenced deliberations on its project Clarifying the Scope of Subtopic 610-20 and Accounting for Partial Sales of Nonfinancial Assets (formerly part of its definition of a business project).

Scope of ASC Subtopic 610-20 and in-substance nonfinancial assets

The FASB has tentatively decided that all businesses should be excluded from the scope of ASC Subtopic 610-20, which would result in deconsolidation guidance taking precedence when a business is also an in-substance nonfinancial asset. The FASB also tentatively decided that in-substance nonfinancial assets include groups of assets or subsidiaries that are not a business where substantially all of the fair value of the assets (recognized and unrecognized) is concentrated in nonfinancial assets, excluding cash and cash equivalents.

Transition to ASC Subtopic 610-20

ASC Subtopic 610-20 was issued as part of the new revenue standard and will be effective at the same time. The FASB has tentatively decided that an entity does not need to apply the same transition method for the new revenue standard and ASC Subtopic 610-20.
Partial sales

The FASB has indicated its tentative view to maintain consistency with the new revenue standard and require the assessment of control to be made from the perspective of the counterparty. The FASB tentatively decided to clarify how to evaluate the transfer of control when the entity transfers ownership interests in a subsidiary that consists of nonfinancial assets.

- If an entity promises to transfer a 100 percent ownership interest in a wholly owned subsidiary to a single party, then control would be transferred when the counterparty in the contract obtains control of the asset.
- If an entity promises to transfer an ownership interest in a subsidiary to multiple parties, and does not retain an ownership interest in the former subsidiary, then control would be transferred when the other parties are deemed to collectively control the asset.
- If an entity promises to transfer an ownership interest in a subsidiary and retains a noncontrolling ownership interest in that former subsidiary, then control would be transferred if (or when) the former subsidiary controls the asset.

Any noncontrolling interest retained by the seller in the entity holding the real estate would be recognized and measured at fair value and included in the consideration used to calculate the gain or loss on derecognition.

As of the date of this publication, the FASB is continuing its deliberations on this project and anticipates issuing a proposed ASU for public comment in the second quarter of 2016.
10 Other issues

10.1 Sale with a right of return

**Overview**

Under the new standard, when an entity makes a sale with a right of return it recognizes revenue at the amount to which it expects to be entitled by applying the variable consideration and constraint guidance set out in Step 3 of the model (see 5.3). The entity also recognizes a refund liability and an asset for any goods or services that it expects to be returned.

**Requirements of the new standard**

An entity applies the accounting guidance for a sale with a right of return when a customer has a right to:

- a full or partial refund of any consideration paid;
- a credit that can be applied against amounts owed, or that will be owed, to the entity; or
- another product in exchange (unless it is another product of the same type, quality, condition, and price such as exchanging a red sweater for a white sweater).

An entity does not account for its stand-ready obligation to accept returns as a performance obligation.

In addition to product returns, the guidance also applies to services that are provided subject to a refund.

The guidance does not apply to:

- exchanges by customers of one product for another of the same type, quality, condition, and price; and
- returns of faulty goods or replacements, which are instead evaluated under the guidance on warranties (see 10.2).
When an entity makes a sale with a right of return, it initially recognizes the following.

<table>
<thead>
<tr>
<th>Item</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>Measured at the gross transaction price, less the expected level of returns calculated using the guidance on estimating variable consideration and the constraint (see 5.3)</td>
</tr>
<tr>
<td><strong>Refund liability</strong></td>
<td>Measured at the expected level of returns – i.e. the difference between the cash or receivable amount and the revenue as measured above</td>
</tr>
<tr>
<td><strong>Asset</strong></td>
<td>Measured by reference to the carrying amount of the products expected to be returned, less the expected recovery costs</td>
</tr>
<tr>
<td><strong>Cost of goods sold</strong></td>
<td>Measured as the carrying amount of the products sold less the asset as measured above</td>
</tr>
<tr>
<td><strong>Reduction of inventory</strong></td>
<td>Measured as the carrying amount of the products transferred to the customer</td>
</tr>
</tbody>
</table>

The entity updates its measurement of the refund liability and asset at each reporting date for changes in expectations about the amount of the refunds. It recognizes adjustments to the:

- refund liability as revenue; and
- asset as an expense.

---

**Example 58 – Sale with a right of return**

Retailer B sells 100 products at a price of 100 each and receives a payment of 10,000. The sales contract allows the customer to return any undamaged products within 30 days and receive a full refund in cash. The cost of each product is 60. Retailer B estimates that three products will be returned and a subsequent change in the estimate will not result in a significant revenue reversal.

Retailer B estimates that the costs of recovering the products will not be significant and expects that the products can be resold at a profit.

Within 30 days, two products are returned.

Retailer B records the following entries on:

- transfer of the products to the customer to reflect its expectation that three products will be returned;
- return of the two products; and
- expiration of the right to return products.
### Revenue – Issues In-Depth

#### 10 Other issues

<table>
<thead>
<tr>
<th>Sale</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Refund liability</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

To recognize sale excluding revenue on products expected to be returned

<table>
<thead>
<tr>
<th>Asset</th>
<th>Cost of sales</th>
<th>Inventory</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>180</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>5,820</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>6,000</td>
<td></td>
</tr>
</tbody>
</table>

To recognize cost of sales and right to recover products from customers

<table>
<thead>
<tr>
<th>Two products returned</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refund liability</td>
<td></td>
<td>200</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>200</td>
</tr>
</tbody>
</table>

To recognize the refund for product returned

<table>
<thead>
<tr>
<th>Inventory</th>
<th>Asset</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>120</td>
<td>120</td>
</tr>
</tbody>
</table>

To recognize product returned as inventory

<table>
<thead>
<tr>
<th>Right of return expires</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refund liability</td>
<td></td>
<td>100</td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td>100</td>
</tr>
</tbody>
</table>

To recognize revenue on the expiration of the right of return

<table>
<thead>
<tr>
<th>Cost of sales</th>
<th>Asset</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>60</td>
<td>60</td>
</tr>
</tbody>
</table>

To recognize cost of sales on the expiration of the right to recover products from customers

#### Notes

- a. 100 x 3 (the price of the products expected to be returned).
- b. 60 x 3 (the cost of the products expected to be returned).
- c. 100 x 2 (the price of the products returned).
- d. 60 x 2 (the cost of the products returned).
Observations

Change in estimation method, but end result broadly similar in many situations

Under current IFRS and US GAAP, an entity records a provision for products that it expects to be returned if a reasonable estimate can be made. If a reasonable estimate cannot be made, then revenue recognition is deferred until the return period lapses or a reasonable estimate can be made.

The new standard’s approach of adjusting revenue for the expected level of returns and recognizing a refund liability is broadly similar to current guidance when the entity can make a reasonable estimate of the returns. However, the detailed methodology for estimating revenue may be different. The new standard’s methodology requires the use of either the expected value or most likely outcome method to determine the expected returns, depending on which better predicts the consideration to which the entity will be entitled. After an estimate of expected returns is made, the new standard requires the entity to assess whether using that estimate would make it probable (highly probable for IFRS) that a significant reversal in revenue would occur and, if so, the amount of revenue should be constrained. For discussion of variable consideration and the constraint, see 5.3.1.

Although revenue could conceivably be constrained to zero under the new standard, it is likely that most entities will have sufficient information to recognize consideration for an amount greater than zero. This is because revenue is recognized to the extent that it is probable (highly probable for IFRS) that a significant reversal in the amount of cumulative revenue recognized will not occur and recognition does not necessarily default to zero (as happens under current IFRS and US GAAP when a reasonable estimate cannot be made regardless of probability). As a consequence, entities that are unable to make a reasonable estimate of returns may recognize some revenue sooner under the new standard.

Net presentation no longer permitted

Under the new standard, the refund liability is presented gross as a refund liability and an asset for recovery. This will be a change in practice for entities that currently present reserves or allowances for returns net.

Partial refunds

The measurement of a refund liability reflects the amount expected to be refunded to the customer. Therefore, when a right of return allows the customer to return a product for a partial refund (e.g. 95 percent of the sales price), the refund liability (and the corresponding change in the transaction price) is measured based on the portion of the transaction price expected to be refunded. For example, this would be the number of products expected to be returned multiplied by 95 percent of the selling price.
Restocking fees and costs

An entity sometimes charges a customer a restocking fee when a product is returned. The restocking fee is generally intended to compensate the entity for costs associated with the product return (e.g. shipping costs and repacking costs) or the reduction in the selling price that an entity may achieve when reselling the product to another customer.

A right of return with a restocking fee is similar to a right of return for a partial refund. Therefore, a restocking fee is included as part of the estimated transaction price when control transfers – i.e. the refund liability is based on the transaction price less the restocking fee.

Similarly, the entity’s expected costs related to restocking are reflected in the measurement of the return asset when control of the product transfers. This is consistent with the guidance in the new standard that any expected costs to recover returned products should be included by reducing the carrying amount of the asset recorded for the right to recover those products.

For example, assume that an entity sells 20 widgets to a customer for 30 each and the cost of each widget is 15. The customer has the right to return a widget but is charged a 10% restocking fee. The entity expects to incur restocking costs of 2 per widget returned. The entity estimates returns to be 5%.

When control of the widgets transfers to the customer, the entity recognizes the following.

<table>
<thead>
<tr>
<th>Item</th>
<th>What to include</th>
<th>Amount</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>Widgets not to be returned plus restocking fee</td>
<td>573</td>
<td>(19&lt;sup&gt;a&lt;/sup&gt; x 30) + (1 x 3&lt;sup&gt;b&lt;/sup&gt;)</td>
</tr>
<tr>
<td>Refund liability</td>
<td>Widget expected to be returned less restocking fee</td>
<td>27</td>
<td>(1 x 30) - 3&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>Return asset</td>
<td>Cost of widget expected to be returned less restocking cost</td>
<td>13</td>
<td>(1 x 15) - 2</td>
</tr>
</tbody>
</table>

Notes

a. Widgets not expected to be returned calculated as 20 widgets sold less one (20 x 5%) expected to be returned.

b. Restocking fee calculated as 30 x 10%.
Conditional right of return

The new standard does not distinguish between conditional and unconditional rights of return, and both are accounted for similarly. However, for a conditional right of return, the probability that the return condition would be met is considered in determining the expected level of returns. For example, a food production company only accepts returns of its products that are past a sell-by date. Based on historical experience, the food production company assesses the probability that the products will become past their sell-by date and estimates their return rate.

Historical experience may be a source of evidence for estimating returns

When estimating the amount of consideration expected to be received from a sales contract with a right of return, an entity may consider historical experience with similar contracts to make estimates and judgments. Using a group of similar transactions as a source of evidence is not itself an application of the portfolio approach (see 4.4 and 5.3.1.1).

When the entity elects to estimate the transaction price using the expected value method and uses a portfolio of data to determine the expected value of an individual contract, the estimated amount might not be a possible outcome for an individual contract (see 5.3.1.1). Because a sale with a right of return represents variable consideration, an entity is also required to apply the constraint to its estimate.

The new standard includes Example 22 illustrating how to determine the transaction price for a portfolio of 100 individual sales with a right of return. In the example, the entity concludes that the contracts meet the conditions to be accounted for at a portfolio level, and determines the transaction price for the portfolio using an expected value approach to estimate returns. However, as explained above, the entity could achieve the same accounting outcome by using the portfolio as a source of data, rather than assessing whether the contracts meet the conditions to be accounted for at a portfolio level.

Comparison with current US GAAP

Return rights provided to customers

Current US GAAP allows entities to recognize the sale of products subject to a right of return when the amount of future returns can be reasonably estimated, among other criteria. Sales revenue (and cost of sales) that is not recognized at the time of sale is recognized either when the return privilege expires or when the criteria are met, whichever occurs first. Current US GAAP right of return guidance applies to products only, not services. However, SEC guidance allows entities to analogize in limited circumstances to the product right of return guidance with respect to services.
Although the new standard treats rights of return or refund as variable consideration, the results of applying the guidance on variable consideration may not be substantially different from applying the current US GAAP right of return guidance in circumstances where a reasonable estimate can be made. If an entity cannot make a reasonable estimate, then it applies the constraint on variable consideration; this may not necessarily prohibit all of the related revenue from being recognized before a reasonable estimate can be made or the return period lapses.

The constraint guidance is intended to ensure that adjustments to previously constrained product or services revenue generally only occur upward (i.e. increases to revenue). Because current US GAAP only requires future returns to be reasonably estimable, entities often record upward and downward adjustments to revenue as a result of the right of return guidance. Downward adjustments could be the result of new facts or changes in circumstances and will not necessarily be considered an error under the new standard. Adjustments will be evaluated under current guidance for changes in estimates versus errors.

Current US GAAP does not link customer put options that require the seller to repurchase a product at a specified price to the right of return guidance. A provision that enables the buyer of a product to require the sponsor (i.e. seller) to repurchase the product (i.e. a put option) at a specified price will cause an arrangement to be considered a product financing arrangement (rather than a sale).

For further discussion of repurchase arrangements, see 5.5.5. For further discussion of right of return provided to customers, see 10.1.

### 10.2 Warranties

#### Overview

Under the new standard, an entity accounts for a warranty (or part of a warranty) as a performance obligation if the warranty is distinct including:

- the customer has an option to purchase the warranty separately; or
- additional services are provided as part of the warranty.

Otherwise, warranties will generally continue to be accounted for under existing guidance.
10.2 Warranties

10.2.1 Applying guidance on warranties

Requirements of the new standard

Under the new standard, a warranty is considered a performance obligation if it is distinct under the Step 2 criteria (see 5.2.1). If the customer has an option to purchase the good or service with or without the warranty, then the warranty is a distinct service. If the warranty includes a service beyond assuring that the good complies with agreed-upon specifications, then it is distinct.

When a warranty is not sold separately, the warranty or a portion of it may still be a performance obligation if it provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. A warranty that only covers a product’s compliance with agreed-upon specifications (an ‘assurance warranty’) is accounted for under other guidance. For further discussion of how to distinguish between an assurance- and service-type warranty, see 10.2.2.

If the warranty – or part of it – is considered to be a performance obligation, then the entity allocates a portion of the transaction price to the service performance obligation by applying the requirements in Step 4 of the model (see 5.4).

If an entity provides a warranty that includes both an assurance element and a service element and the entity cannot reasonably account for them separately, then it accounts for both of the warranties together as a single performance obligation.

A legal requirement to pay compensation or other damages if products cause damage is not a performance obligation, and is accounted for under other relevant guidance.

Example 59 – Sale of a product with a warranty

Manufacturer M grants its customers a standard warranty with the purchase of its product. Under the warranty, Manufacturer M:

- provides assurance that the product complies with agreed-upon specifications and will operate as promised for three years from the date of purchase; and
- agrees to provide up to 20 hours of training services to the customer.

The customer also chooses to purchase an extended warranty for two additional years.

In this example, Manufacturer M concludes that there are three performance obligations in the contract.
The training services are a performance obligation because they provide a distinct service in addition to ensuring that the product complies with specifications.

The extended warranty is a performance obligation because it can be purchased separately and is distinct based on the Step 2 criteria (see 5.2).

The component of the standard warranty that provides assurance that the product complies with stated specifications is an assurance-type warranty, and therefore is not a performance obligation. As a consequence, Manufacturer M accounts for it as a cost accrual under other relevant guidance when control of the product transfers to the customer.

**Observations**

**A refund for defective services may be variable consideration rather than a warranty**

The guidance in the new standard on warranties is intended to apply to services as well as goods. However, it does not further explain how the concept should be applied to services.

In a contract for the delivery of services, an entity may offer to ‘make good’ or offer a refund. If an entity offers to ‘make good’ – e.g. to repaint an area that a customer was not pleased about – then it considers this in determining the timing of the transfer of control and revenue recognition.

If an entity offers a refund to customers who are dissatisfied with the service provided, then it applies the guidance on a sale with a right of return (see 10.1) and follows the guidance on estimating variable consideration in determining the transaction price for the service being provided (see 5.3).
Defective product returns in exchange for compensation

An entity may offer compensation in the form of cash or credit to a customer, rather than repairing or replacing the defective product. Unlike returns of faulty goods or replacements, this refund is generally accounted for using the right of return guidance (see 10.1), and not the guidance on warranties.

Liquidated damages and similar types of contractual terms

Many contracts contain terms providing for liquidated damages and similar compensation to the customer upon the occurrence or nonoccurrence of certain events. These terms may be considered variable consideration, given that the standard identifies penalties as variable consideration.

However, in some circumstances the terms may be similar to a warranty provision. For example, if a third party fixes a defective product sold by an entity and the entity reimburses the customer for costs incurred, then that term may be similar to a warranty provision.

Amounts considered similar to a warranty provision are accounted for as either consideration payable to a customer or a warranty (assurance- or service-type).

Judgment is required to distinguish those terms that are accounted for as warranties from the more common scenarios in which the terms give rise to variable consideration.

Comparison with current IFRS

Presence of warranty clause does not preclude recognition of revenue

Under IAS 18, a standard warranty clause in a sales contract that does not result in the seller retaining significant risks does not preclude revenue recognition at the date of sale of the product. In this case, the entity recognizes a warranty provision under IAS 37 at the date of sale, for the best estimate of the costs to be incurred for repairing or replacing the defective products.

However, an abnormal warranty obligation could indicate that the significant risks and rewards of ownership have not been passed to the buyer, and that revenue should therefore be deferred.

Unlike current IFRS, the new standard does not envisage that the presence of a warranty would ever preclude the recognition of all of the revenue associated with the sale of the product. This could accelerate revenue recognition in some cases compared to current IFRS.
Comparison with current US GAAP

Entities will be required to consider factors in addition to considering whether a warranty is separately priced

Under current US GAAP, warranties that are not separately priced are accounted for when the goods are delivered, by recognizing the full revenue on the product and accruing the estimated costs of the warranty obligation. The warranty is only treated as a separate unit of account under current US GAAP if it is separately priced.

Under the new standard, an entity evaluates whether the warranty provides a service regardless of whether it is separately priced – and, if it does, assesses whether it (or part of it) is a separate performance obligation.

Amount of revenue allocated to a separately priced warranty may change

The amount of revenue recognized for some separately priced extended warranties and product maintenance contracts may change when the transaction price is allocated on a relative stand-alone selling-price basis, rather than by deferring the contractually stated amount of the warranty, as required under current US GAAP.

Product recalls

Product recalls occur when a concern is raised about the safety of a product and may be either voluntary or involuntary. These product recalls and liability claims will likely continue to be subject to the US GAAP guidance for contingencies.

Service level agreement

Contracts may guarantee an entity’s performance through a service level agreement (SLA) under which an entity is required to pay compensation to a customer if it fails to provide the required level of service. Because these guarantees relate to an entity’s own performance, they are not accounted for under the guidance on guarantees but under the new revenue standard.

There is diversity in practice in the accounting for an SLA under current US GAAP, including whether compensation payments are recorded as an expense or a reduction of revenue.

However, under the new standard an SLA that provides the customer with consideration if performance conditions are not met is accounted for as variable consideration (see 5.3). This may require an entity to estimate the anticipated pay-outs under its SLAs for the contractual period and include those estimated payments as a reduction of the transaction price and revenue.
10.2.2 Distinguishing between an assurance- and a service-type warranty

Requirements of the new standard

An entity distinguishes between the types of distinct product warranties as follows.

---

To assess whether a warranty provides a customer with an additional service, an entity considers factors such as:

- **whether the warranty is required by law:** because such requirements typically exist to protect customers from the risk of purchasing defective products;

- **the length of the warranty coverage period:** because the longer the coverage period, the more likely it is that the entity is providing a service, rather than just guaranteeing compliance with agreed-upon specification; and

- **the nature of the tasks** that the entity promises to perform.

---

**Example 60 – Lifetime warranty**

Luggage Company A is a leading manufacturer in the specialty luggage industry. Luggage Company A provides a lifetime warranty on all bags. If a bag is broken or damaged, Luggage Company A will repair or replace the bag free of charge.

There are currently no regulations in the specialty luggage industry on warranties.
Luggage Company A assesses whether the lifetime warranty is a service-type warranty as follows.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>No legal requirement</td>
<td>In this example, there is no law that requires Luggage Company A to make a promise for the lifetime of the product. Therefore, this factor suggests that the warranty is a separate performance obligation.</td>
</tr>
<tr>
<td>Longer coverage period</td>
<td>In this example, the length of the warranty is for the life of the baggage, as compared with other manufacturers that offer warranty for a specific period. Therefore, this factor suggests that the warranty is a separate performance obligation.</td>
</tr>
<tr>
<td>Promises beyond agreed-upon specifications</td>
<td>In this example, the nature of the tasks not only includes repairing or replacing baggage that does not meet the promised specifications, but also includes repairing damage that occurs after the customer obtains control of the luggage. Therefore, the baggage warranty goes beyond the promise that the baggage complies with agreed-upon specifications, which suggests that the warranty is a separate performance obligation.</td>
</tr>
</tbody>
</table>

Based on its analysis, Luggage Company A concludes that the lifetime warranty is a service in addition to the assurance that the product complies with agreed-upon specifications. It therefore accounts for the service as a separate performance obligation.

**Observations**

*‘Reasonably account’ threshold is undefined*

The new standard requires an entity that cannot reasonably account for a service-type warranty and an assurance-type warranty separately to account for them together as a single performance obligation. Because the ‘reasonably account’ threshold is not defined in the standard, entities will need to exercise judgment in applying this guidance.
**Length of the warranty period is an indicator of the type of warranty, but is not always determinative**

The new standard lists the length of the warranty period as a factor to consider when assessing whether the warranty provides a customer with a service. However, it is only one of the factors. An entity usually considers the length of the warranty in the context of the specific market, including geography and product line. In addition to the length of the warranty period, the nature of costs incurred in performing the warranty work may provide evidence of the nature of the warranty promise.

**Repairs outside the warranty period as a customary practice**

An entity may have a customary business practice to provide repairs outside the warranty period – i.e. an ‘implied warranty’. In some cases, it may not be clear if the repairs provided during the implied warranty period are an assurance- or service-type warranty.

For example, if an entity determines that the repairs made during the implied warranty period generally involve correcting defects that existed at the time of sale, then the repairs could be an assurance-type warranty. Conversely, if the entity determines that the repairs made during the implied warranty period provide a service to the customer beyond fixing defects that existed at the time of sale, then the repairs could be a service-type warranty.

An entity considers all facts and circumstances in making an assessment of whether an implied warranty is an assurance- or service-type warranty.

**An ‘extended warranty’ may be a service-type warranty or an assurance-type warranty**

A warranty that is marketed as being an ‘extended warranty’ may be a service-type warranty, but the facts will need to be evaluated to determine whether the warranty provides service beyond the assurance that the product meets the agreed-upon specifications. The mere labeling of a warranty as ‘extended’ or ‘enhanced’ is not determinative.

An entity considers all facts and circumstances and the factors included in the new standard in making that determination. This will include, but not be limited to, consideration of the length of the coverage period.
10.3 Principal versus agent considerations

Overview

When another party is involved in providing goods or services to a customer, an entity evaluates the nature of its promise to the customer. If an entity obtains control of another party’s goods or services before transferring control to the customer, then the entity’s promise is to provide the goods or services itself. Therefore, the entity is acting as a principal.

However, if an entity does not control the good or service before it is transferred to the customer, then the entity is acting as an agent and arranges for that good or service to be provided by another party.

An entity identifies each specified good or service to be transferred to the customer and determines whether it is a principal or agent for each one. An entity may be a principal for some goods and services and an agent for others in a contract to transfer multiple goods or services.

Requirements of the new standard

When other parties are involved in providing goods or services to an entity’s customer, the entity determines whether the nature of its promise is a performance obligation to provide the specified goods or services itself, or to arrange for them to be provided by another party – i.e. whether it is a principal or an agent. This determination is made by identifying each specified good or service promised to the customer in the contract and evaluating whether the entity obtains control of the specified good or service before it is transferred to the customer.

Because an entity evaluates whether it is a principal or an agent for each good or service to be transferred to the customer, it is possible for the entity to be a principal for one or more goods or services and an agent for others in the same contract.

An entity is a principal if it controls the specified good or service that is promised to the customer before it is transferred to the customer.

When another party is involved, an entity that is a principal obtains control of any one of the following:

- a good from another party that it then transfers to the customer;
- a right to a service that will be performed by another party, which gives the entity the ability to direct that party to provide the service on the entity’s behalf; or
- a good or a service from another party that it combines with other goods or services to produce the specified good or service promised to the customer.
If the entity is a principal, then revenue is recognized on a gross basis – corresponding to the consideration to which the entity expects to be entitled. If the entity is an agent, then revenue is recognized on a net basis – corresponding to any fee or commission to which the entity expects to be entitled. An entity’s fee or commission might be the net amount of consideration that the entity retains after paying other parties.

‘Control’ is the ability to direct the use of, and obtain substantially all of the remaining benefits from, the goods or services (or prevent others from doing so).

The new standard includes the indicators listed below to assist an entity in evaluating whether it controls a specified good or service before it is transferred to the customer.

These indicators may be more or less relevant to the assessment of control, depending on the nature of the specified goods or services and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.

If an entity does not obtain control of the goods or the right to the services in advance of transferring them to the customer, then it is an agent for that good or service.

An entity that is a principal in a contract may satisfy a performance obligation by itself or it may engage another party – e.g. a subcontractor – to satisfy some or all of a performance obligation on its behalf. However, if another party assumes an entity’s performance obligation so that the entity is no longer obliged to satisfy the performance obligation, then the entity is no longer acting as the principal and therefore does not recognize revenue for that performance obligation. Instead, the entity evaluates whether to recognize revenue for satisfying a performance obligation to obtain a contract for the other party – i.e. whether the entity is acting as an agent.
**Practical expedient for sales taxes (US GAAP only)**

An entity applying US GAAP may elect to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with the specific revenue-producing transaction and collected by the entity from a customer – e.g. sales, use, value-added and some excise taxes. Taxes assessed on an entity’s total gross receipts or imposed during the inventory procurement process are not included in the scope of this election.

An entity that applies the election is required to exclude from the transaction price all taxes in the scope of the election and comply with accounting policy disclosure requirements. Entities not adopting this policy need to evaluate whether they are principal or agent for each transaction/jurisdiction.

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**Difference between IFRS and US GAAP**

The policy election available under US GAAP for the treatment of sales taxes is similar to the one that is currently available under US GAAP. The IASB decided not to provide a similar exception because it would reduce comparability, and an analysis similar to that required under the new standard already is required under current IFRS revenue requirements.

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**Example 61 – Entity arranges for the provision of goods or services**

Internet Retailer B operates a website that enables Customer E to buy goods from a range of suppliers that deliver the goods directly to Customer E. The website facilitates payment between the supplier and Customer E at prices set by the supplier, and Internet Retailer B is entitled to commission of 10% of the sales price. Customer E pays in advance and all orders are nonrefundable.

Internet Retailer B observes that each supplier delivers its goods directly to Customer E, and that Internet Retailer B itself does not control the goods. In reaching the conclusion that it does not control the goods before they are transferred to Customer E, Internet Retailer B makes these observations.

- The supplier is primarily responsible for fulfilling the promise to provide the goods to Customer E (i.e. by shipping the goods to Customer E). Internet Retailer B is not obliged to provide the goods to Customer E if the supplier fails to deliver, and is also not responsible for the acceptability of the goods delivered by the supplier.

- Internet Retailer B does not take inventory risk at any time before or after the goods are transferred to Customer E (because the goods are shipped directly by the supplier to Customer E), Internet Retailer B does not commit to obtain the goods from the supplier before they are purchased by Customer E, and Internet Retailer B is not responsible for any damaged or returned goods.

- Internet Retailer B does not have discretion in establishing prices for the goods because the sales price is set by the supplier.
Consequently, Internet Retailer B concludes that it is an agent, and that its performance obligation is to arrange for the supplier to provide the goods. When Internet Retailer B satisfies its promise to arrange for the supplier to provide the goods to Customer E – which, in this example, is when the goods are purchased by Customer E – Internet Retailer B recognizes revenue at the amount of the commission to which it is entitled.

**Example 62 – Entity is agent and principal for sales of virtual or intangible goods**

Company H contracts to provide recruiting services. As part of the contract, Customer J agrees to obtain a license to access a third party’s database of information on potential recruits. Company H arranges for this license and collects payment on behalf of the third-party database provider. However, the database provider sets the price to Customer J for the license, and is responsible for providing technical support.

Company H concludes that the recruitment services and the database access are distinct. Company H considers the control principle and indicators to determine whether it controls the specified goods and services before they are transferred to Customer J.

Company H concludes that it is the principal in relation to the recruitment services because it performs those services itself. In contrast, Company H concludes that it is an agent in relation to the promise to provide access to the third party’s database because Company H does not control access to the database before it is transferred to Customer J for the following reasons.

- Company H is not responsible for fulfilling the promise to provide access to the database access.
- Company H does not have inventory risk because it does not purchase, or commit to purchase, the database access from the database provider.
- Company H does not have discretion in setting the price for the database access.

**Observations**

**Unit of account is the specific good or service**

The evaluation focuses on the promise to the customer, and the unit of account is the specified good or service. A ‘specified good or service’ is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer. If individual goods and services are not distinct from one another, then they represent inputs into a combined promise that is the specified good or service that the entity assesses.
The specified good or service may be a right

The specified good or service to be transferred to the customer may in some cases be a right to an underlying good or service that will be provided by another party. For example, a travel website may sell an airline ticket that gives the customer the right to fly on a particular airline, or an entity may provide a voucher that gives the holder the right to a meal at a specified restaurant.

In these cases, the principal versus agent assessment is analyzed based on who controls the right to the underlying good or service. That is, an entity may be a principal in a transaction relating to a right (e.g. sale of a voucher that gives the customer the right to a meal) even if another party controls and transfers the underlying good or service (e.g. the flight or the meal) to the end customer.

An entity may be a principal in a transaction relating to a right if it has the ability to direct the use of the right to the underlying service because it has committed itself to purchase the right and has inventory risk. The entity’s ability to establish the price that the customer would pay for the right also may be a relevant indicator to consider.

No specified hierarchy for the indicators

There is no specific hierarchy for the indicators, and all of the indicators are considered in making the assessment. However, depending on the facts and circumstances one or more indicators may be more relevant to the specific contract. Assessing the relevance of the indicators may be challenging when it is unclear whether the entity or other party bears the responsibility, or when there are shared responsibilities between the entity and other party.

For example, an entity that does not have primary responsibility for providing the specified good or service or inventory risk may have discretion to set prices. In this case, the entity makes an overall assessment of all of the facts and circumstances. This may include assessing whether the discretion to set prices was merely a way for the entity to generate additional revenue while arranging for another entity to provide the specified goods or services, or evidence that the entity was acting as a principal.

Providing a significant integration service is determinative

When a customer contracts for a combined output of significantly integrated goods or services and the entity is the party that provides the significant integration service, the entity is the principal for the combined output. In these cases, the entity controls the specified good or service (the combined output) before it transfers control to the customer because it controls the inputs necessary to perform the significant integration service.
10.3 Principal versus agent considerations

No specific guidance on allocation of a discount when an entity is a principal for part of the arrangement and an agent for the other part

The new standard does not include specific guidance on how an entity allocates a discount in an arrangement in which it is a principal for some goods or services and an agent for others. To achieve the allocation principle in these situations, judgment will be needed in determining the discount to allocate to the performance obligation related to acting as an agent in arranging for goods or services on a customer’s behalf.

For further discussion on allocating the transaction price including discounts, see 5.4.2.

Estimating gross revenue as a principal

In some arrangements, the entity may be the principal even though it does not know the price paid by the end customer to the intermediary because it receives a fixed amount per unit regardless of the price paid.

The new standard does not address these fact patterns, but both the IASB and FASB provided their views in their Basis for Conclusions. The IASB noted that an entity that is a principal would generally be expected to be able to apply judgment and determine the consideration to which it is entitled using all relevant facts and circumstances that are available to it. The FASB’s basis indicates that if the price charged to the end customer is not expected to be known to the principal, then the net amount received from the intermediary is the transaction price. This may result in a difference between IFRS and US GAAP for these types of arrangements.

Evaluation under IFRS

Although a principal may be unaware of the specific amount charged by the intermediary, it may have information that could be used to estimate the transaction price. An entity that is a principal should carefully consider the facts and circumstances and available information when estimating the transaction price.

Example 63 – Estimating gross revenue as a principal

Company A is a principal that is entitled to receive 3 from the intermediary for each good sold to end customers. The intermediary may sell the good to the end customer for a range of prices from 2 to 5, but the amount remitted by the intermediary to Company A will be 3 for each good sold to end customers on Company A’s behalf.

Company A does not know and will not know the specific price charged by the intermediary to the end customer. However, it should consider what information is available in assessing whether it could estimate the transaction price (e.g. estimated transaction price of 4 resulting in revenue of 4 and commission expense of 1).
Example 64 – Revenue is gross transaction price

Company B is a principal that is entitled to receive 80 percent of the 10 list price for each good sold by the intermediary to end customers. Regardless of whether the intermediary sells the good for 7, 10, or another amount, the amount remitted by the intermediary will be 8 for each good sold to end customers on Company B’s behalf.

Company B knows the list price which is the product’s stand-alone selling price. Therefore, any incremental discount offered to the end customer by the intermediary is attributed to the intermediary. Company B’s transaction price for each good is 10.

Evaluation under US GAAP

The FASB’s basis likely will result in a conclusion that the entity will record the net amount received from the intermediary in both Examples 63 and 64 in this publication.

Comparison with current IFRS

From risk and reward to transfer of control

There is a similar principle in current IFRS that amounts collected on behalf of a third party are not accounted for as revenue. However, determining whether the entity is acting as an agent or a principal under the new standard differs from current IFRS, as a result of the shift from the risk-and-reward approach to the transfer-of-control approach. Under current IFRS, the entity is a principal in the transaction when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. The Boards noted that the indicators serve a different purpose from those in current IFRS, reflecting the overall change in approach.

Comparison with current US GAAP

Less guidance under new standard

Many of the indicators in current US GAAP for assessing whether a party is a principal or an agent are not included in the new standard – e.g. discretion in supplier selection, involvement in determining the product or service specifications, or customer credit risk. Based on the changes to the principal versus agent guidance introduced by the new standard, entities will need to reconsider their conclusions. Also, the new standard does not identify any of the indicators as being more important than others, while current US GAAP specifies that the primary obligor and general inventory risk are strong indicators.
The new standard does not contain explicit principal versus agent guidance for shipping costs and cost reimbursement as current US GAAP does. Under the new standard, an entity can make a policy election to account for shipping and handling that is provided after control of the related goods transfers to the customer either as a fulfillment cost or as a promised service.

For further discussion on shipping and handling, see 5.2.

Under existing US GAAP, an entity may elect an accounting policy to present sales taxes (and other similar taxes) on a gross or net basis. Under the new standard, an entity is permitted to elect a practical expedient to present those taxes on a net basis, but there is no option to elect to present them on a gross basis. When the practical expedient is not elected, an entity evaluates whether the taxes are collected on behalf of a third party (e.g. government) on a case-by-case basis in each jurisdiction in which it has sales. This may result in some taxes being presented on a net basis and others on a gross basis for entities not electing the practical expedient.

### 10.4 Customer options for additional goods or services

#### Overview

An entity accounts for a customer option to acquire additional goods or services as a performance obligation if the option provides the customer with a material right. The new standard provides guidance on calculating the stand-alone selling price of a customer option when it is a material right.

#### 10.4.1 General requirements

**Requirements of the new standard**

When an entity grants the customer an option to acquire additional goods or services, that option is a performance obligation under the contract if it provides a material right that the customer would not receive without entering into that contract.
The following flow chart helps analyze whether a customer option is a performance obligation.

The entity grants the customer an option to acquire additional goods or services

Could the customer obtain the right to acquire the additional goods or services without entering into the sale agreement?

No → Yes

Does the option give the customer the right to acquire additional goods or services at a price that reflects the stand-alone selling price for those goods or services?

No → Yes

The option may be a material right, and if so, it gives rise to a performance obligation

The option does not give rise to a performance obligation

If the stand-alone selling price for a customer’s option to acquire additional goods or services that is a material right is not directly observable, then an entity will need to estimate it. This estimate reflects the discount that the customer would obtain when exercising the option, adjusted for:

- any discount that the customer would receive without exercising the option; and
- the likelihood that the option will be exercised.

If the goods or services that the customer has a material right to acquire are similar to the original goods in the contract – e.g. when the customer has an option to renew the contract – then an entity may allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding consideration expected to be received.
Example 65 – Product sold with a discount voucher

Retailer R sells a computer to Customer C for 2,000. As part of this arrangement, Retailer R gives Customer C a voucher. The voucher entitles Customer C to a 25% discount on any purchase up to 1,000 in Retailer R’s store during the next 60 days. Retailer R intends to offer a 10% discount on all sales to other customers during the next 60 days as its seasonal promotion. Retailer R regularly sells this model of computer for 2,000 without the voucher.

Retailer R notes that the discount voucher provides a material right that Customer C would not receive without entering into the original sales transaction. This is because Customer C receives a 15% incremental discount compared with the discount expected to be offered to other customers (25% discount voucher - 10% discount for all customers). Therefore, the discount voucher is a separate performance obligation.

Retailer R estimates that there is an 80% likelihood that Customer C will redeem the voucher and will purchase additional products with an undiscounted price of 500.

Retailer R allocates the transaction price between the computer and the voucher on a relative selling price basis as follows.

<table>
<thead>
<tr>
<th>Performance obligation</th>
<th>Stand-alone selling prices</th>
<th>Selling price ratio</th>
<th>Price allocation</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer</td>
<td>2,000</td>
<td>97.1%</td>
<td>1,942</td>
<td>(2,000 x 97.1%)</td>
</tr>
<tr>
<td>Voucher</td>
<td>60(^{a})</td>
<td>2.9%</td>
<td>58</td>
<td>(2,000 x 2.9%)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,060</strong></td>
<td><strong>100%</strong></td>
<td><strong>2,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

Note

a. Stand-alone selling price for the voucher calculated as 500 estimated purchase of products x 15% incremental discount x 80% likelihood of exercise.

Customer C purchases 200 of additional products (pre-discount) within 30 days of the original purchase for 150 cash payment.

Customer C makes no additional purchases before the expiration of the voucher. Therefore, at the expiration date Retailer R recognizes the remaining amount allocated to the voucher as revenue.

Retailer R records the following journal entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>2,000</td>
</tr>
<tr>
<td>Revenue</td>
<td>1,942</td>
</tr>
<tr>
<td>Contract liability</td>
<td>58</td>
</tr>
<tr>
<td><em>To recognize initial sale of computer and voucher</em></td>
<td></td>
</tr>
</tbody>
</table>
### Observations

**Customers’ options that provide accumulating rights are assessed in aggregate**

In many cases, the rights that an entity grants to its customers accumulate as the customer makes additional purchases. For example, in a customer loyalty program, the points granted in an initial transaction are typically used in conjunction with points granted in subsequent transactions. Further, the value of the points granted in a single transaction may be low, but the combined value of points granted over an accumulation of transactions may be much higher. In such cases, the accumulating nature of the right is an essential part of the arrangement.

When assessing whether these customer options represent a material right, an entity considers the cumulative value of the rights received in the transaction, the rights that have accumulated from past transactions, and additional rights expected from future transactions.

An entity considers all relevant quantitative and qualitative factors.

---

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>150(a)</td>
</tr>
<tr>
<td>Contract liability</td>
<td>23(b)</td>
</tr>
<tr>
<td>Revenue</td>
<td>173</td>
</tr>
<tr>
<td><strong>To recognize subsequent purchase</strong></td>
<td></td>
</tr>
<tr>
<td>Contract liability</td>
<td>35(c)</td>
</tr>
<tr>
<td>Revenue</td>
<td>35</td>
</tr>
<tr>
<td><strong>To recognize expiration of voucher</strong></td>
<td></td>
</tr>
</tbody>
</table>
10.4 Customer options for additional goods or services

Exercise of a material right

When a customer exercises a material right for additional goods or services, an entity may account for it using one of the following approaches.

- **Continuation of the original contract:** Under this approach, an entity treats the consideration allocated to the material right as an addition to the consideration for the goods or services under the contract option – i.e. as a change in the transaction price.

- **Contract modification:** Under this approach, an entity applies the contract modification guidance to evaluate whether the goods or services transferred upon exercise of the option are distinct from the other goods or services in the contract. The outcome of this evaluation will determine whether the modification is accounted for prospectively or with a cumulative catch-up adjustment.

The following example illustrates the two approaches and demonstrates that when the optional goods or services are distinct from those promised in the original contract, the outcome under either approach will be similar.

**Example 66 – Exercise of a material right**

**Scenario 1**

Service Provider S enters into a contract with Customer M to provide Service A for two years for 100. It also offers Customer M an option to purchase two-year Service B, which is typically priced at 400, for 300. Service Provider S determines that the option gives rise to a material right and therefore is a separate performance obligation. Assume that Service Provider S allocates 75 to Service A and 25 to the option to purchase Service B, based on their stand-alone selling prices. Six months into the contract, Customer M exercises the option to purchase Service B.
Scenario 2

Modifying Scenario 1, Service A and Service B are not distinct. It is assumed that the measure of progress on the date of the exercise of the option changes from 25% to 10%. The other assumptions are the same.

The table below explains how Service Provider S would account for the exercise of the option under each approach in Scenario 1 and Scenario 2.

<table>
<thead>
<tr>
<th>Continuation of the original contract</th>
<th>Contract modification</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Prospective</strong></td>
<td><strong>Distinct – Prospective</strong></td>
</tr>
<tr>
<td>Scenarios 1 and 2</td>
<td>Scenario 1</td>
</tr>
<tr>
<td>Recognize revenue of 325 (25 + 300) for Service B over two years.</td>
<td>Recognize revenue of 325 (25 + 300) for Service B over two years.</td>
</tr>
<tr>
<td>No changes to the amount or timing of revenue recognition for Service A.</td>
<td>No changes to the amount or timing of revenue recognition for Service A.</td>
</tr>
<tr>
<td>Update the transaction price to 400 (100 + 300).</td>
<td>Update the measure of progress from 25% to 10%.</td>
</tr>
<tr>
<td>Recognize revenue of 378.75 (400 - 21.25) over the remaining 18 months.</td>
<td>Recognize revenue of 378.75 (400 - 21.25) over the remaining 18 months.</td>
</tr>
</tbody>
</table>

Estimate of the likelihood of exercise of an option is not revised

When determining the stand-alone selling price of a customer option for additional goods or services, an entity estimates the likelihood that the customer will exercise the option. This initial estimate is not subsequently revised because it is an input into the estimate of the stand-alone selling price of the option. Under the new standard, an entity does not reallocate the transaction price to reflect changes in stand-alone selling prices after contract inception.

The customer’s decision to exercise the option or allow the option to expire affects the timing of recognition of the amount allocated to the option, but it does not result in reallocation of the transaction price.
Estimating the stand-alone selling price of ‘free’ gift cards and coupons

In some cases, an entity may sell gift cards or coupons in stand-alone transactions with customers. In addition, the entity may grant gift cards or coupons in the same denomination in transactions in which customers purchase other goods and services. In the latter case, the gift cards or coupons may be identified as conveying a material right to the customer – e.g. an entity offers a free gift card or coupon with a value of 15 with every 100 of goods purchased.

In these cases, the stand-alone selling price of the gift card or coupon identified as a material right may differ from the stand-alone selling price of a separately sold gift card or coupon. This is because customers who receive the gift card or coupon as a material right may be significantly less likely to redeem them than customers who purchase a gift card or coupon in a separate transaction.

Therefore, an entity may conclude that there is no directly observable stand-alone selling price for a free gift card or coupon provided to a customer in connection with the purchase of another good or service. In this case, the entity estimates the stand-alone selling price using the guidance in Step 4 of the model (see 5.4).

Options that do not expire

Revenue for material rights is recognized when the future goods or services are transferred or when the option expires. When an option does not expire, an entity may apply the guidance on unexercised rights – i.e. breakage (see 10.5).

Coupons issued at the point of sale

Retail stores often print coupons at the register after a purchase is completed (sometimes referred to as ‘Catalina coupons’ or ‘bounce-back coupons’ that can be redeemed for a short period of time). The coupons are handed to the customers at the point of sale, or packaged with the good that the customers have contracted to purchase. Often, the customers are not aware that they will receive this coupon.

These coupons are often a form of marketing offer, and customers can often access similar discounts without making a purchase – e.g. if coupons are printed in a newspaper or freely available in-store or online.

Typically, these coupons have little or no effect on the revenue accounting when they are granted. If there is no general marketing offer, then the entity assesses whether the coupon conveys a material right. This assessment includes consideration of the likelihood of redemption which will often be low, and therefore reduces the likelihood that the coupon will be identified as a material right.

As a result, the coupons are often recognized as a reduction in revenue on redemption.
‘Immaterial in the context of the contract’ does not apply to customer options

Under the US GAAP version of the new revenue standard, an entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer. However, entities evaluate whether options provide a material right to the customer by following the guidance on customer options. The ‘immaterial in the context of the contract’ concept does not apply.

If an entity concludes the customer’s behavior is materially influenced by the right, then a portion of the transaction price is allocated to the material right, even if that allocation is quantitatively immaterial.

The IFRS version of the new revenue standard does not include the immaterial in the context of the contract guidance.

Comparison with current US GAAP

Credit card fees are generally accounted for under the receivables guidance

The new revenue standard does not provide any specific guidance on its application to credit card loyalty programs. However, the standard excludes from its scope other contractual rights and obligations that are in the scope of other ASC Topics, including receivables. Current US GAAP includes guidance on accounting for credit card fees, and states that credit card fees can cover many cardholder services. To the extent that a fee compensates the entity for a service provided during the loan commitment period, the separate components of a commitment fee are not identifiable and reliably measurable to allow for separate accounting recognition for each component part.

Under current US GAAP, most credit card fees are accounted for using the explicit guidance. The new revenue standard does not change this guidance. Therefore, credit card fees are generally outside the new revenue standard’s scope. However, a card-issuing bank cannot assume that all of its arrangements are outside the scope of the new revenue standard. In particular, arrangements labelled as credit card lending arrangements that are clearly the sale of other goods or services are accounted for under the new revenue standard.

Loyalty programs included in credit card arrangements also are accounted for under the guidance applicable to credit card fees if the credit card arrangement that gives the right to participate in the loyalty program falls within scope of the credit card fees guidance. If it does not, then the loyalty program is accounted for under the new revenue standard. Therefore, the card-issuing bank needs to evaluate the specific facts and circumstances of its arrangement. However, most of the credit card arrangements commonly available will be scoped out of the new standard for entities applying US GAAP.
10.4 Customer options for additional goods or services

Options in software arrangements

The evaluation under the new standard of whether a discount offered on future purchases provides a customer with a material right is similar to, but not the same as, current US GAAP and could lead to different units of accounting. The US GAAP currently used applies to software arrangements but is sometimes analogized to in the accounting for non-software arrangements. Under current US GAAP, an offer of a discount on future purchases of goods or services in a software arrangement is accounted for separately if it is significant and incremental to both:

- the range of discounts reflected in the pricing of other elements in that contract; and
- the range of discounts typically given to other similarly situated customers in comparable transactions.

This guidance is not followed for customer options to purchase additional copies of the same software that has been delivered. The additional copies are not considered to be undelivered under current guidance. Under the new standard, judgment is needed to determine when it is appropriate to apply the guidance on customer options or usage-based fees to a customer’s option to purchase additional copies of software. For further discussion, see 8.2.

To assess whether an option gives the customer a material right under the new standard, an entity needs only to determine whether the discount on future purchases of goods or services is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographic area or market, and not whether the discount is also incremental to the discount in the current arrangement.

Stand-alone selling price of a customer option

The new revenue standard requires an entity to establish either an observable or estimated stand-alone selling price for a customer option that provides the customer with a material right. This is not a requirement under current US GAAP.

There are two approaches to accounting for a significant incremental discount under current US GAAP:

- **Apply general multiple element accounting guidance**: An entity may account for the option as a separate deliverable under general multiple element accounting guidance. This practice is similar to the accounting required under the new standard.

- **Apply software revenue recognition guidance**: Although this guidance applies to software arrangements, it is sometimes analogized to in the accounting for significant incremental discounts in non-software arrangements. This approach generally results in accounting that is different from the new standard and typically results in a greater amount allocated to the future discount than under the new standard.
Under the software guidance, if an arrangement includes a right to a significant incremental discount on a customer’s future purchase of products or services, then a proportionate amount of that significant incremental discount is applied to each element based on its fair value (selling price) without regard to the significant incremental discount. For example, a 35% discount on future purchases would result in each element in the arrangement being recognized at a 35% discount to its fair value (selling price). This approach does not require an estimate of the selling price for that customer option. This is different from the new revenue standard’s requirement to establish either an observable or estimated stand-alone selling price for a customer option that is a material right.

In addition, if the products to which the discount applies are not specified or the fair value of the future purchases cannot be determined but the maximum discount is quantifiable, then under current guidance it is allocated to the elements assuming that the customer will purchase the minimum amount necessary to receive the maximum discount. This approach is inconsistent with the new standard’s guidance on estimating the selling price of an option, which inherently includes an estimate of breakage.

Also, if the discount is unlimited in a software arrangement (i.e. a customer could hypothetically buy an infinite amount of additional software products at a significant incremental discount), then revenue would be recognized under the subscription accounting model. This model does not allocate revenue, which instead is recognized ratably over the term or estimated term. This approach is inconsistent with the new standard’s allocation requirements.

These changes may increase the need to establish estimates, and related internal processes and controls, when customer options for the future purchase of goods or services are included in contracts.

10.4.2 Customer loyalty programs

Requirements of the new standard

Customer loyalty programs are often in the scope of the customer option guidance and the requirements discussed in 10.4.1 apply. A customer loyalty program that provides a customer with a material right is accounted for as a separate performance obligation.
Example 67 – Customer loyalty points program

Retailer C offers a customer loyalty program at its store. Under the program, for every 10 that customers spend on goods, they are rewarded with one point. Each point is redeemable for a cash discount of 1 on future purchases. Retailer C expects 97% of customers’ points to be redeemed. This estimate is based on Retailer C’s historical experience, which is assessed as being predictive of the amount of consideration to which it will be entitled. During Year 1, customers purchase products for 100,000 and earn 10,000 points. The stand-alone selling price of the products to customers without points is 100,000.

The customer loyalty program provides the customers with a material right, because the customers would not receive the discount on future purchases without making the original purchase. Additionally, the price that they will pay on exercise of the points on future purchases is not the stand-alone selling price of those items.

Because the points provide a material right to the customers, Retailer C concludes that the points are a performance obligation in each sales contract – i.e. the customers paid for the points when purchasing products. Retailer C determines the stand-alone selling price of the loyalty points based on the likelihood of redemption.

Retailer C allocates the transaction price between the products and the points on a relative selling price basis as follows.

<table>
<thead>
<tr>
<th>Performance obligation</th>
<th>Stand-alone selling prices</th>
<th>Selling price ratio</th>
<th>Price allocation</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Products</td>
<td>100,000&lt;sup&gt;(a)&lt;/sup&gt;</td>
<td>91%</td>
<td>91,000</td>
<td>(100,000 x 91%)</td>
</tr>
<tr>
<td>Points</td>
<td>9,700&lt;sup&gt;(b)&lt;/sup&gt;</td>
<td>9%</td>
<td>9,000</td>
<td>(100,000 x 9%)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>109,700</strong></td>
<td><strong>100%</strong></td>
<td><strong>100,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Notes**

a. Stand-alone selling price for the products.

b. Stand-alone selling price for the points (10,000 x 1 x 97%).

During Year 2, 4,500 of the points are redeemed, and Retailer C continues to expect that 9,700 points will be redeemed in total. Retailer C calculates the revenue to be recognized and the corresponding reduction in the contract liability as follows.

\[ 4,175 = 9,000 \times 4,500 \div 9,700 \] – i.e. price allocated to points multiplied by points redeemed in Year 2 divided by total points expected to be redeemed.
During Year 3, a further 4,000 points are redeemed. Retailer C updates its estimate, because it now expects 9,900 rather than 9,700 points to be redeemed. Retailer C calculates the revenue to be recognized and the corresponding reduction in the contract liability as follows.

\[3,552 = \left(9,000 \times \frac{4,500 + 4,000}{9,900}\right) - 4,175\] – i.e. price allocated to points multiplied by points redeemed in Year 2 and Year 3 divided by total points expected to be redeemed minus revenue recognized in Year 2.

**Observations**

No significant financing component in most customer loyalty programs

Customer loyalty programs generally do not include a significant financing component even though the time period between when the customer loyalty points are earned and redeemed may be greater than one year. This is because the transfer of the related goods or services to the customer – i.e. use of the loyalty points – occurs at the discretion of the customer.

Cancelable customer loyalty programs may be implicit performance obligations

Many customer loyalty programs can be cancelled or changed by the issuer at any time. However, if the entity has a past practice that creates a valid expectation for its customers that it will fulfill its promises under the loyalty program, then it accounts for the customer loyalty program as a separate performance obligation. That is, the entity has made an implicit promise to operate the customer loyalty program.

**Comparison with current IFRS**

Treatment of customer loyalty programs broadly similar to current practice

The current IFRS guidance on customer loyalty programs is broadly similar to the guidance in the new standard.

However, an entity needs to consider whether the allocation method that it currently applies remains acceptable under the new standard. Under current IFRS, an entity can choose which method it wants to use to allocate the consideration between the sales transaction and the award credits, and many use the residual method to estimate the stand-alone selling price of award credits. By contrast, under the new standard the residual approach can only be applied if certain criteria are met (see 5.4.1.2).
10.5 Customers’ unexercised rights (breakage)

Overview

An entity may receive a nonrefundable prepayment from a customer that gives the customer the right to receive goods or services in the future. Common examples include gift cards, vouchers, and nonrefundable tickets. Typically, some customers do not exercise their right – this is referred to as ‘breakage’.

Requirements of the new standard

An entity recognizes a prepayment received from a customer as a contract liability, and recognizes revenue when the promised goods or services are transferred in the future. However, a portion of the contract liability recognized may relate to contractual rights that the entity does not expect to be exercised – i.e. a breakage amount.

The timing of revenue recognition related to breakage depends on whether the entity expects to be entitled to a breakage amount – i.e. if it is probable (highly probable for IFRS) that recognizing breakage will not result in a significant reversal of the cumulative revenue recognized.

Comparison with current US GAAP

Currently no authoritative guidance on accounting for customer loyalty programs

There is currently no authoritative broadly applicable US GAAP guidance on the accounting for customer loyalty programs, and practice is mixed. Some companies accrue the direct and incremental costs of providing the goods or services underlying the loyalty program while recognizing the full amount of revenue at the point of the initial sale; others, however, defer a portion of the revenue from the transaction that generates the points.

The new standard requires entities to follow the deferral approach if a customer loyalty program provides a customer with a material right and therefore constitutes a performance obligation. The new standard may significantly affect entities in industries that offer customer loyalty programs – e.g. retail, airline, and hospitality. There is no accounting policy election to treat these arrangements as marketing expenses.

An entity will need to consider whether its customer loyalty programs provide customers with a material right – if they do, then it will be required to allocate a portion of the consideration in a contract to that material right. This will result in a revenue deferral until the customer exercises the right or the right expires.
An entity considers the variable consideration guidance to determine whether – and to what extent – the constraint applies (see 5.3.1.2). It determines the amount of breakage to which it is entitled as the amount for which it is considered probable (highly probable for IFRS) that a significant reversal will not occur in the future. This amount is recognized as revenue in proportion to the pattern of rights exercised by the customer (proportional method) when the entity expects to be entitled to breakage. Otherwise, the entity recognizes breakage when the likelihood of the customer exercising its remaining rights becomes remote (remote method).

If an entity is required to remit to a government entity the amount that is attributable to customers’ unexercised rights – e.g. under applicable unclaimed property or escheatment laws – then it recognizes a financial liability until the rights are extinguished, rather than revenue.

**Example 68 – Sale of a prepaid phone card – Entity expects to be entitled to breakage**

Retailer R sells a prepaid phone card to Customer C for 100. On the basis of historical experience with similar prepaid phone cards, Retailer R estimates that 10% of the prepaid phone card balance will remain unredeemed and that the unredeemed amount will not be subject to escheatment. Because Retailer R can reasonably estimate the amount of breakage expected, and it is probable (highly probable for IFRS) that including the amount in the transaction price will not result in a significant revenue reversal, Retailer R recognizes the breakage revenue of 10 in proportion to the pattern of exercise of the customer’s rights.

Specifically, when it sells the prepaid phone card, Retailer R recognizes a contract liability of 100, because Customer C prepaid for a nonrefundable card. No breakage revenue is recognized at this time.

If Customer C redeems an amount of 45 in 30 days, then half of the expected redemption has occurred \((45 \div (100 - 10) = 50\%)\). Therefore, half of the breakage – i.e. \((10 \times 50\% = 5)\) – is also recognized.

On this initial prepaid phone card redemption, Retailer R recognizes revenue of 50 – i.e. revenue from transferring goods or services of 45 plus breakage of 5.
Example 69 – Sale of a prepaid phone card – Entity does not expect to be entitled to breakage

Retailer C implements a new prepaid phone card program. Retailer C sells Customer D a prepaid phone card for $50. Retailer C does not have an obligation to remit the value of unredeemed cards to any government authority or other entity. The prepaid phone card expires two years from the date of issue.

Because this is a new program, Retailer C has very little historical information. Specifically, Retailer C does not have sufficient entity-specific information, nor does it have knowledge of the experience of other service providers. Therefore, Retailer C concludes that it does not have the ability to estimate the amount of breakage that, if it were included in the transaction price, would be probable (highly probable for IFRS) of not resulting in a significant revenue reversal.

Retailer C therefore recognizes the breakage when the likelihood of Customer D exercising its remaining rights becomes remote. This may occur at the expiration of the prepaid phone card, or earlier if there is evidence to indicate that the probability has become remote that Customer D will redeem any remaining amount on the prepaid phone card.

Observations

Constraint applies even though consideration amount is known

If an entity does not have a basis for estimating breakage – i.e. the estimate is fully constrained – then it recognizes the breakage as revenue only when the likelihood becomes remote that the customer will exercise its rights.

When the entity concludes that it is able to determine the amount of breakage to which it expects to be entitled, it estimates the breakage. To determine the breakage amount, the entity assesses whether it is probable (highly probable for IFRS) that including revenue for the unexercised rights in the transaction price will not result in a significant revenue reversal. Applying the guidance on the constraint in this context is unique – the amount of consideration is known and has already been received, but there is uncertainty over how much of the consideration the customer will redeem for the transfer of goods or services in the future. Conversely, in other situations to which the constraint applies, the total amount of consideration is unknown.

Breakage does not constitute variable consideration

Although an entity considers the variable consideration guidance to determine the amount of breakage, breakage itself is not a form of variable consideration because it does not affect the transaction price. It is a recognition, rather than a measurement concept in the new standard. For example, the transaction price for a sale of a $50 gift card is fixed at $50; the possibility of breakage does not make the transaction price variable. However, the expected breakage affects the timing of revenue recognition.
Prepaid stored-value products may be financial liabilities

A prepaid stored-value product is a card with a monetary value stored on the card itself – e.g. a gift card. The guidance under the new standard on the recognition of breakage excludes prepaid stored-value products that meet the definition of financial liabilities.

These are instead accounted for using the applicable financial instruments guidance under IFRS.

Under US GAAP, a narrow-scope amendment to the relevant liability recognition guidance requires breakage on certain types of prepaid stored-value products to be recognized in a manner consistent with the breakage guidance under the new standard.

Portfolio of data

An entity can use a portfolio of similar transactions as a source of data to estimate expected breakage for an individual contract if the entity has a sufficiently large number of similar transactions or other history. Doing so is not using the portfolio approach (see 4.4).

Comparison with current IFRS

The timing of revenue recognition may change

Current IFRS does not contain specific guidance on the accounting for breakage. However, the new standard may result in changes in the timing of revenue recognition compared with our current view that an unredeemed amount should be recognized as revenue if:

– the amount is nonrefundable; and
– an entity concludes, based on available evidence, that the likelihood of the customer requiring it to fulfill its performance obligation is remote.

For further discussion of this issue, see 4.2.440.20 of Insights into IFRS, 12th Edition.
10.6 Nonrefundable up-front fees

Overview

Some contracts include nonrefundable up-front fees that are paid at or near contract inception—e.g., joining fees for health club membership, activation fees for telecommunication contracts, and set-up fees for outsourcing contracts. The new standard provides guidance on determining the timing of recognition for these fees.

Comparison with current US GAAP

Removal of policy election

There is currently no authoritative guidance on the accounting for breakage in US GAAP. Practice has developed based on an SEC speech from December 2005, which stated that it is not acceptable for an entity to recognize breakage immediately on the sale of a gift card. The speech described three acceptable methods to recognize breakage revenue:

- as the entity is legally released from its obligation—e.g., at redemption or expiration;
- at the point at which redemption becomes remote; or
- in proportion to actual gift card redemptions.

The new standard requires an entity to determine whether it expects to be entitled to a breakage amount and, if so, recognize the breakage amount in proportion to customer redemptions of the gift cards. Because the methods listed above are accounting policies, rather than an analysis of the entity’s specific facts and circumstances, some entities using either of the first two methods may be required to recognize revenue sooner than under their current accounting policy election.

Requirements of the new standard

An entity assesses whether the nonrefundable up-front fee relates to the transfer of a promised good or service to the customer.

In many cases, even though a nonrefundable up-front fee relates to an activity that the entity is required to undertake to fulfill the contract, that activity does not result in the transfer of a promised good or service to the customer. Instead, it is an administrative task. For further discussion on identifying performance obligations, see 5.2.

If the activity does not result in the transfer of a promised good or service to the customer, then the up-front fee is an advance payment for performance obligations to be satisfied in the future and is recognized as revenue when those future goods or services are provided.

If the up-front fee gives rise to a material right for future goods or services, then the entity attributes all of it to the goods and services to be transferred, including the material right associated with the up-front payment.

Does the fee relate to specific goods or services transferred to customer?

Yes

Account for as a promised good or service

Recognize allocated consideration as revenue on transfer of promised good or service

No

Account for as an advanced payment for future goods or services

Recognize as revenue when control of future goods or services is transferred, which may include future contract periods
Example 70 – Nonrefundable up-front fees – Annual contract

Cable Company C enters into a one-year contract to provide cable television to Customer A. In addition to a monthly service fee of 100, Cable Company C charges a one-time up-front fee of 50. Cable Company C has determined that its set-up activity does not transfer a promised good or service to Customer A, but is instead an administrative task.

At the end of the year, Customer A can renew the contract on a month-to-month basis at the then-current monthly rate, or can commit to another one-year contract at the then-current annual rate. In either case, Customer A will not be charged another fee upon renewal. The average customer life for customers entering into similar contracts is three years.

Cable Company C considers both quantitative and qualitative factors to determine whether the up-front fee provides an incentive for Customer A to renew the contract beyond the stated contract term to avoid the up-front fee. If the incentive is important to Customer A’s decision to enter into the contract, then there is a material right.

First, Cable Company C compares the up-front fee of 50 with the total transaction price of 1,250 (the up-front fee of 50 plus the service fee of 1,200 (12 x 100)). It concludes that the nonrefundable up-front fee is not quantitatively material.

Second, Cable Company C considers the qualitative reasons Customer A might renew. These include, but are not limited to, the overall quality of the service provided, the services and related pricing provided by competitors, and the inconvenience to Customer A of changing service providers (e.g. returning equipment to Cable Company C, scheduling installation by the new provider).

Cable Company C concludes that although the avoidance of the up-front fee on renewal is a consideration to Customer A, this factor alone does not influence Customer A’s decision whether to renew the service. Cable Company C concludes based on its customer satisfaction research data that the quality of service provided and its competitive pricing are the key factors underpinning the average customer life of three years.

Overall, Cable Company C concludes that the up-front fee of 50 does not convey a material right to Customer A.

As a result, the up-front fee is treated as an advance payment on the contracted one-year cable services and is recognized as revenue over the one-year contract term. This results in monthly revenue of 104 (1,250 ÷ 12) for the one-year contract.

Conversely, if Cable Company C determined that the up-front fee results in a contract that includes a customer option that is a material right, then it would allocate the total transaction price including the up-front fee between the one-year cable service and the material right to renew the contract. The consideration allocated to the material right would be recognized as revenue when that right is exercised or expires (see 10.4).
Example 71 – Allocation of nonrefundable up-front fees

Customer C enters into a 12-month service contract with Telco T. Customer C agrees to pay $50 per month plus a nonrefundable up-front activation fee of $40. Telco T has determined that its activation activity does not transfer a promised good or service to the customer, but is instead an administrative task.

The contract gives Customer C the right to renew the contract for an additional one year at a monthly fee of $50.

Telco T estimates that the prices charged to customers in the same class will increase to $56 per month in the next year and that 75% of customers will renew.

Telco T concludes that the up-front fee by itself does not convey a material right to Customer C for reasons consistent with Example 70. However, it concludes that the renewal option is a material right because the expected discount on renewal is sufficient to incentivize Customer C to renew and likely was a factor in Customer C’s decision to enter into the contract. Therefore, there are two performance obligations in the contract: the first year of service and the material right to renew the contract at a discount.

Telco T allocates the transaction price of $640 (12 x $50 + $40) to the performance obligations based on their relative stand-alone selling prices (see 5.4).

Telco T determines that the stand-alone selling price of the current-year service is $640, because a customer purchasing that service would be required to pay the activation fee.

Telco T estimates the stand-alone selling price of the material right by multiplying the estimated monthly discount by the expected likelihood of exercise. This results in an estimated stand-alone selling price of $54 (($56 - $50) x 12) x 75%).

Telco T allocates the transaction price as follows.

<table>
<thead>
<tr>
<th></th>
<th>Stand-alone selling price</th>
<th>Relative %</th>
<th>Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service</td>
<td>$640</td>
<td>92%</td>
<td>589</td>
</tr>
<tr>
<td>Material right</td>
<td>$54</td>
<td>8%</td>
<td>51</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$694</strong></td>
<td><strong>100%</strong></td>
<td><strong>$640</strong></td>
</tr>
</tbody>
</table>

In Year 1, Telco T recognizes revenue of $49 per month ($589 ÷ 12). In Year 2, assuming exercise of the option to renew, Telco T recognizes revenue of $54 per month (($51 + $50 x 12) ÷ 12). If the customer does not renew the contract, then Telco T recognizes the $51 allocated to the material right as revenue when the right expires – i.e. at the end of Year 1.

Telco T also considers whether a significant financing component exists within the contract (see 5.3.2).

This example assumes that Telco T determined that the contract did not contain a significant financing component.
Quantitative and qualitative indicators are considered when assessing up-front fees

An entity considers both quantitative and qualitative factors when assessing whether a nonrefundable up-front fee provides the customer with a material right, because it would likely impact the customer’s decision on whether to exercise the option to continue buying the entity’s product or service. This is consistent with the notion that an entity considers valid expectations of the customer when identifying promised goods or services. Therefore, a customer’s perspective on what constitutes a ‘material right’ includes consideration of qualitative factors as well as quantitative factors.

Determining whether a nonrefundable up-front fee relates to the transfer of a promised good or service

In many cases, even though a nonrefundable up-front fee relates to an activity that the entity is required to undertake at or near contract inception to fulfill the contract, that activity does not result in the transfer of a promised good or service to the customer.

When assessing whether the up-front fee relates to the transfer of a promised good or service, an entity considers all relevant facts and circumstances, including whether:

– a good or service is transferred to the customer in exchange for the up-front fee and the customer is able to realize a benefit from the good or service received. If no good or service is received by the customer or if the good or service is of little or no value to the customer without obtaining other goods or services from the entity, then the up-front fee is likely to represent an advance payment for future goods or services; and

– if the entity does not separately price and sell the initiation right or activities covered by the up-front payment, then the payment may not relate to the transfer of a promised good or service.

Up-front fee may need to be allocated

Even when a nonrefundable up-front fee relates to a promised good or service, the amount of the fee may not equal the relative stand-alone selling price of that promised good or service; therefore, some of the nonrefundable up-front fee needs to be allocated to other performance obligations. For further discussion on allocation, see 5.4.2.
Deferral period for nonrefundable up-front fee depends on whether the fee provides a material right

A nonrefundable up-front fee may provide the customer with a material right if that fee is significant enough that it is likely to impact the customer’s decision on whether to reorder a product or service – e.g. to renew a membership or service contract, or order an additional product.

If the payment of an up-front fee provides a material right to the customer, then the fee is recognized over the period for which the payment provides the customer with a material right. Determining that period will require significant judgment, because it may not align with the stated contractual term or other information historically maintained by the entity – e.g. the average customer relationship period.

When the up-front fee is not deemed to provide a material right and the cost amortization period is determined to be longer than the stated contract period, the period over which a nonrefundable up-front fee is recognized as revenue differs from the amortization period for contract costs.

Consideration of whether a nonrefundable up-front fee gives rise to a significant financing component

An entity will need to consider whether the receipt of an up-front payment gives rise to a significant financing component within the contract. All relevant facts and circumstances will need to be evaluated, and an entity may need to apply significant judgment in determining whether a significant financing component exists (see 5.3.2).

Principle of a material right builds on previous US GAAP guidance

A key question when accounting for an up-front fee in a contract that includes a renewal option is whether the customer receives a material right. The Boards noted that the principle of a ‘material right’ builds on previous US GAAP guidance. In that guidance, the significance of the up-front fee and incremental discount received relative to other customers for a comparable transaction helps to differentiate between an option and a marketing or promotional offer.

The nonrefundable up-front fee provides the customer a material right if it would likely impact the customer’s decision on whether to exercise the option to continue buying the entity’s product or service (e.g. to renew a membership or service contract or order an additional product).
10.6 Nonrefundable up-front fees

**Comparison with current IFRS**

**Accounting for nonrefundable up-front fees**

Under current IFRS, any initial or entrance fee is recognized as revenue when there is no significant uncertainty over its collection and the entity has no further obligation to perform any continuing services. It is recognized on a basis that reflects the timing, nature, and value of the benefits provided. In our experience, these fees may be recognized totally or partially up-front or over the contractual or customer relationship period, depending on the facts and circumstances.

Under the new standard, an entity needs to assess whether a nonrefundable, up-front fee relates to a specific good or service transferred to the customer – and, if not, whether it gives rise to a material right to determine the timing of revenue recognition.

**Comparison with current US GAAP**

**Accounting for nonrefundable up-front fees as a separate performance obligation**

Concluding whether a nonrefundable up-front fee represents a payment for a promised good or service under the new standard may involve an analysis similar to current US GAAP to determine whether the up-front fee is payment for delivery of a good or a service that represents the culmination of a separate earnings process. When performing the analysis under the new standard, an entity considers the integration guidance in Step 2 of the model, which is not necessarily the same as current US GAAP.

**Deferral period when nonrefundable up-front fee is recognized as advance payment**

Under current SEC guidance, the up-front fee is deferred and recognized over the expected period of performance, which can extend beyond the initial contract period. In our experience, this has often resulted in an entity recognizing nonrefundable up-front fees over the average customer relationship period.

Under the new standard, an entity assesses the up-front fee to determine whether it provides the customer with a material right – and, if so, for how long. This means that an entity no longer defaults to an average customer relationship period, which may be driven by factors other than the payment of an initial up-front fee. These factors may include the availability of viable alternatives, the entity’s customer service, the inconvenience of changing service providers, or the quality of the product or service offering.
10.7 Onerous contracts

Requirements of the new standard

The new standard does not include specific guidance on the accounting for onerous revenue contracts or on other contract losses. Instead, an entity applies other applicable guidance in US GAAP or IFRS.

Observations

No convergence for onerous contracts

Although the new standard contains substantially converged guidance on the recognition and measurement of revenue, it does not include specific guidance on the accounting for onerous contracts. This is because the Boards concluded that the current guidance in both US GAAP and IFRS could adequately identify onerous contracts, and they were not aware of any pressing practice issues resulting from its application.

As a result, entities reporting under US GAAP and IFRS may identify different contracts as onerous, and may measure required provisions for onerous contracts in different ways. Although the new standard will facilitate comparisons between the revenue reported under US GAAP and IFRS, differences in the accounting for costs and contract losses remain. For further discussion on contract costs, see Section 6.
A single approach to onerous revenue contracts

Current IFRS deals with onerous revenue contracts in two standards.

- IAS 37 includes general guidance on the recognition and measurement of provisions for onerous contracts. An entity recognizes a provision when the unavoidable costs of meeting the obligations under a contract exceed the economic benefits to be received. However, IAS 37 also prohibits the recognition of a provision for future operating losses.

- IAS 11 requires an expected loss on a construction contract to be recognized immediately.

The new standard withdraws IAS 11 so that accounting for onerous contracts will now fall under a single standard – IAS 37.

For contracts other than construction ones, there is no change in the overall approach to accounting for onerous contracts. However, the new standard is silent on the consequences of withdrawing the specific guidance in IAS 11 on contract losses. It is unclear whether the IASB expects to see a change in measurement for loss-making construction contracts.

Interpretative issues could arise in the following areas.

| Unit of account | IAS 37 includes a specific prohibition on recognizing provisions for future operating losses. A common issue in applying it is distinguishing between:
- onerous obligations, for which the recognition of a provision is required; and
- future operating losses, for which the recognition of a provision is prohibited.
It is not clear how the prohibition on recognizing provisions will affect the current practice under IAS 11 of recognizing an expected contract loss immediately. |
| Costs | Under IAS 11, expected contract losses are identified by reference to expected contract costs, which are generally taken to be the full costs of fulfilling the contract – e.g. including attributable overheads. Under IAS 37, an entity considers the ‘unavoidable costs’ of fulfilling an obligation when identifying onerous contracts and measuring any required provision. IAS 37 does not explain what is meant by ‘unavoidable costs’, except for noting that they reflect ‘the least net cost of exiting from the contract’ – i.e. the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it. It is unclear whether the IASB believes that the unavoidable costs of fulfilling an obligation are equivalent to the contract costs under IAS 11. |
Comparison with current US GAAP

Different onerous contract guidance for different contracts

The current guidance on onerous revenue contracts remains applicable under the new standard. Current US GAAP does not contain general guidance for recognizing a provision for onerous contracts, but instead focuses either on types of contracts or on industry-specific arrangements. Because US GAAP does not provide general guidance on the accrual of losses on onerous contracts, an entity will only accrue such losses when a contract is in the scope of current US GAAP that contain requirements for the accrual of a loss on a contract. The new standard applies to all contracts with customers, so some entities will need to apply its requirements on the recognition of revenue and certain costs, and then also consider the scope of current US GAAP for loss recognition on certain contracts.

Current US GAAP addresses the recognition of losses on the following arrangements.

<table>
<thead>
<tr>
<th>ASC reference</th>
<th>Losses on …</th>
</tr>
</thead>
<tbody>
<tr>
<td>605-20</td>
<td>Separately priced extended warranty and product maintenance</td>
</tr>
<tr>
<td>605-35</td>
<td>Construction- and production-type contracts</td>
</tr>
<tr>
<td>985-605</td>
<td>Certain software arrangements</td>
</tr>
<tr>
<td>954-440-35-1 to 35-3</td>
<td>Continuing care retirement community contracts</td>
</tr>
<tr>
<td>954-450-30-3 to 30-4</td>
<td>Prepaid health care services</td>
</tr>
<tr>
<td>980-350-35-3</td>
<td>Certain long-term power sales contracts</td>
</tr>
<tr>
<td>912-20-45-5</td>
<td>Certain federal government contracts</td>
</tr>
</tbody>
</table>

An entity with contracts that are subject to existing industry- or transaction-specific guidance that contains requirements for loss recognition will continue to apply that specific guidance to determine whether a loss should be recognized. Although the specific provisions for loss recognition have not changed, the amount and timing may change if there are differences in the accounting or timing of revenue and costs recognized or the performance obligations identified. For example, a loss on a separately priced extended warranty contract may differ from the loss that would be recognized under current practice, because under the new standard revenue may be allocated to it based on its relative selling price rather than the stated contractual amount (which is required by current US GAAP).

In addition, an entity needs to evaluate whether a contract is in the scope of the current US GAAP Codification Topics that are brought forward, even though these may no longer apply for determining revenue recognition. An entity with contracts that are not in the scope of these industry- or transaction-specific requirements is not permitted to recognize an onerous contract loss provision.
Separately priced extended warranties and product maintenance

The current guidance applies to:

– separately priced contracts for an extended warranty; and

– product maintenance contracts that provide warranty protection or product services, and whose contract price is not included in the original price of the product covered by the warranty or service.

These warranties are service-type warranties, and therefore a performance obligation, under the new standard (see 10.2). However, not all service-type warranties under the new standard are in the scope of the current onerous contracts guidance, because warranties can constitute a separate performance obligation under the new standard without being separately priced.

The current onerous contract guidance specifies that: “a loss shall be recognized on extended warranty or product maintenance contracts if the sum of the expected costs of providing services under the contracts and any asset recognized for the incremental cost of obtaining a contract exceeds the related unearned revenue (contract liability).” Unearned revenue could include both fixed and variable consideration. Losses are first charged directly to operating expense by writing off any assets relating to the incremental costs of obtaining a contract. Any additional loss is accrued as a liability.

Current US GAAP requires the costs of services performed for separately priced extended warranty and product maintenance contracts to be expensed as they are incurred. Although the consequential amendments remove the cost guidance for separately priced extended warranties, the new standard will likely result in similar accounting for contracts in the scope of this onerous contract guidance, because the costs will likely not meet the criteria for capitalization of fulfillment costs.

When an entity has a separate performance obligation for a service-type warranty that is not separately priced, the onerous contracts guidance does not apply. For example, an entity would not apply the onerous contracts guidance if it promises to provide a customer with a service-type warranty but does not provide the customer with the option to purchase that service for an expressly stated amount separate from the product.

Construction- and production-type contracts

The onerous contracts guidance for construction- and production-type contracts applies to contracts for which the customer provides specifications for the construction of facilities, the production of goods, or the provision of related services.
A loss is recognized when the current estimate of the consideration that an entity expects to receive is less than the current estimate of total costs. The unit of account for the provision is the performance obligation. An entity applies the guidance in the new standard on combining contracts (see 5.1.4) and identifying the performance obligations in a contract (see 5.2).

**Future developments in US GAAP**

Under current US GAAP, the unit of account for determining the loss provision for construction- and production-type contracts depends on whether the contract has been segmented (i.e. loss provision is applied at the contract level for some contracts and at the segment level for other contracts). The guidance in the new revenue standard specifying that loss provisions should be evaluated at the performance obligation level is inconsistent with the FASB’s stated intent not to change current practice in this area. The FASB is expected to propose an amendment to the onerous contract test in the scope of ASC 605-35 so that the contract is the level at which testing is required, without precluding an entity from evaluating onerous contracts at the performance obligation level. As of the date of this publication, the FASB’s proposal has not been finalized.
The consideration to be received is based on the guidance in the new standard for determining the transaction price (see 5.3); however, the guidance on constraining estimates of variable consideration is not applied. Instead, current loss guidance has been amended to include variable consideration as a factor to be considered in arriving at the projected loss on a contract. In addition, an entity applies the contract modifications guidance in the new standard to change orders and claims (see Section 7).

The loss on a contract is reported as an operating expense (contract cost), and not as a reduction of revenue or a non-operating expense. For a contract on which a loss is anticipated, recognition of the entire anticipated loss is required as soon as the loss becomes evident.

The loss guidance on construction- and production-type contracts mainly applies to the contracts specified above, while the new standard applies broadly to contracts with customers. An entity is required to assess the scope of the guidance on construction- and production-type contracts when determining the need for a loss provision on a contract with a customer. Because the guidance on combining contracts and segmenting contracts – i.e. identifying performance obligations – differs from current US GAAP, the evaluation may differ under the new standard. In addition, because the scope is limited to construction- and production-type contracts, not all over-time performance obligations are in the scope of the current guidance.

Software

For software requiring significant production, modification, or customization, a loss is determined by applying the guidance on loss provisions for construction- and production-type contracts described above.

To determine whether the guidance on loss provisions for construction- and production-type contracts applies, an entity is still required to determine whether a good or service is software that requires significant production, modification, or customization. Under the new standard, generally, if the installation services result in significant production, modification, or customization of the software, then the services are combined with the license into a single performance obligation – i.e. the services and license are not distinct in the context of the contract. The entity applies the construction- and production-type contracts guidance on loss provisions to this performance obligation. This outcome is consistent with current US GAAP.

In addition to the loss provisions for construction- and production-type contracts, the FASB’s consequential amendments to the software requirements retain the general loss provision guidance. Under that guidance, a loss is recognized when it is probable that the amount of the transaction price allocated to an unsatisfied or partially unsatisfied performance obligation will result in a loss on that performance obligation. An entity that accrues losses under current GAAP will likely accrue losses under the new standard, but changes could occur based on the changes in separation guidance.

For additional observations on the separation guidance related to software arrangements, see 5.2 and Section 8.
Continuing care retirement community (CCRC) contracts

There is specific loss guidance for contracts with CCRC residents. It requires the obligation to provide future services and the use of facilities to current residents to be calculated annually to determine whether a liability should be recognized. If the advanced fees and periodic fees charged to the customer are insufficient to meet the costs of providing future services and the use of facilities, then the CCRC recognizes a liability for the excess of the anticipated costs over the anticipated revenue. This amount is generally recognized as an operating expense in the income statement.

Although the methodology used to calculate a potential loss on CCRC contracts has not changed, the deferred revenue and deferred costs of acquiring initial contracts included in that calculation could change as a result of applying the new standard. For example, a change could occur if an entity determines that there is a significant financing component in the contract because the customer pays an up-front fee or an entity has sales commissions that are capitalized and amortized differently under the new standard.

Prepaid health care service contracts

There is also specific guidance on loss provisions for prepaid health care service contracts. It uses the ‘probable’ threshold for recognizing losses when future health care costs and maintenance costs under a group of existing contracts will exceed anticipated future premiums, and stop-loss insurance recoveries on those contracts. These losses are generally recognized as an operating expense in the income statement.

Long-term power sales contracts

Under the guidance for long-term power sales contracts, if a contract is not accounted for as a derivative, then it is periodically reviewed to determine whether it is a loss contract. If it is determined to be a loss contract, then the loss is recognized immediately – generally as an operating expense in the income statement.

Federal government contracts

The guidance on federal government contracts requires a loss on the termination of a contract for default to be presented as a separate item in the income statement, or disclosed under the loss contingency guidance. These losses are generally recognized as an operating expense in the income statement.
11

Presentation

Overview

This section addresses the presentation requirements for the statement of financial position.

Requirements of the new standard

An entity presents a contract liability or a contract asset in its statement of financial position when either party to the contract has performed. The entity ‘performs’ by transferring goods or services to the customer, and the customer performs by paying consideration to the entity.

Any unconditional rights to consideration are presented separately as a receivable.

‘Contract liabilities’ are obligations to transfer goods or services to a customer for which the entity has received consideration, or for which an amount of consideration is due from the customer.

‘Contract assets’ are rights to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time.

‘Receivables’ are unconditional rights to consideration. A right to consideration is ‘unconditional’ if only the passage of time is required before payment becomes due. Receivables are presented separately from contract assets and cannot be netted against contract liabilities.

An entity accounts for receivables, including their measurement and disclosure, using the financial instruments guidance. On initial recognition of a receivable, any difference between the measurement of that receivable using the financial instruments guidance (e.g. impairment as a result of credit risk), and the corresponding amount of revenue recognized, is presented as an expense. Any subsequent impairment of the receivable is also accounted for as an expense.

An entity may use alternative captions for the contract assets and contract liabilities in its statement of financial position. However, it needs to provide sufficient information to distinguish a contract asset from a receivable.
On January 1, 2019, Manufacturer D enters into a cancellable contract to transfer a product to Customer E on March 31, 2019. The contract requires Customer E to pay consideration of 1,000 in advance on January 31, 2019. Customer E pays the consideration on March 1, 2019 – i.e. after the due date. Manufacturer D transfers the product on March 31, 2019. Manufacturer D records the following entries to account for:

- cash received on March 1, 2019 and the related a contract liability; and
- revenue on transfer of the product on March 31, 2019.

In this example, Manufacturer D does not have an unconditional right to consideration on January 31, 2019, and therefore it does not have a receivable.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 1, 2019</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
</tr>
<tr>
<td>Contract liability</td>
<td>1,000</td>
</tr>
<tr>
<td>To record cash of 1,000 received (cash is received in advance of performance)</td>
<td></td>
</tr>
<tr>
<td>March 31, 2019</td>
<td></td>
</tr>
<tr>
<td>Contract liability</td>
<td>1,000</td>
</tr>
<tr>
<td>Revenue</td>
<td>1,000</td>
</tr>
<tr>
<td>To record Manufacturer D’s satisfaction of performance obligation</td>
<td></td>
</tr>
</tbody>
</table>

Modifying Example 72, assume that Manufacturer D’s contract is noncancellable. Manufacturer D has an unconditional right to consideration on January 31, 2019, and therefore it recognizes a receivable. Manufacturer D records the following entries to account for:

- receivable on January 31, 2019 and the related a contract liability;
- cash received on March 1, 2019; and
- revenue on transfer of the product on March 31, 2019.
### Observations

#### Contract asset and contract liability – based on past performance

The new standard requires an entity to present a contract asset or contract liability after at least one party to the contract has performed. However, Example 38 in the new standard suggests that an entity recognizes a receivable when it is due if the contract is noncancellable, because the entity has an unconditional right to consideration. Refer to Future developments in US GAAP at the end of this section for FASB consideration of this issue.

#### Receivable – based on unconditional right to consideration

The new standard includes Example 39 illustrating the difference between a contract asset and a receivable. This example portrays a situation in which the right to consideration for a delivered product is conditional on the delivery of a second product – i.e. an entity has an unconditional right to consideration only after both products are transferred. Because the right to consideration under the contract is not unconditional, an entity recognizes a contract asset instead of a receivable.

The Boards believe that an entity’s possible obligation to refund consideration to a customer in the future will not affect the entity’s present right to the gross amount of consideration. For example, when a right of return exists, an entity recognizes a receivable and a separate refund liability for the amount of the estimated refund (see 10.1).

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<table>
<thead>
<tr>
<th>Date</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 31, 2019</td>
<td>Receivable</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>Contract liability</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>To record consideration due</td>
<td></td>
</tr>
<tr>
<td>March 1, 2019</td>
<td>Cash</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>Receivable</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>To record Manufacturer D’s receipt of cash</td>
<td></td>
</tr>
<tr>
<td>March 31, 2019</td>
<td>Contract liability</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>Revenue</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>To record Manufacturer D’s satisfaction of performance obligation</td>
<td></td>
</tr>
</tbody>
</table>

If Manufacturer D issued the invoice before January 31, 2019 – i.e. the payment due date – then it would not record a receivable before January 31, 2019 because it would not yet have an unconditional right to consideration.
The new standard indicates that if an entity has not performed, then a receivable is not recognized until consideration becomes due because the right to consideration is conditional – i.e. it is dependent upon both performance and passage of time.

An entity may invoice a customer before the date on which consideration is due. In this case, if the entity has not performed, then a receivable is not recognized even though an invoice is issued.

**Single contract asset or contract liability for contracts with multiple performance obligations**

An entity presents a contract asset or a contract liability in its statement of financial position when either party to the contract has performed. When a contract contains multiple performance obligations, it is possible that at a given point in time some performance obligations could be in a contract asset position, and others in a contract liability position. In this case, an entity presents a single contract asset or liability representing the net position of the contract as a whole. The entity does not present both a contract asset and a contract liability for the same contract. It may be challenging to determine a single net position in some circumstances if, for example, different systems are used for different performance obligations.

In addition, if under the contract combination guidance (see 5.1.4) an entity combines two or more contracts and accounts for them as a single contract, then it presents a single contract asset or contract liability for that combined contract. This is consistent with the guidance on the combination of contracts that specifies determining the unit of account based on the substance of the transaction, rather than its legal form.

**Contract assets and contract liabilities for multiple contracts are not netted**

A single contract is presented either as a net contract asset or as a net contract liability. However, if an entity has multiple contracts, then it cannot present on a net basis contract assets and contract liabilities of unrelated contracts (i.e. contracts that cannot be combined under Step 1). Therefore, it presents separately total net contract assets from total net contract liabilities, rather than a net position on all contracts with customers.

An asset arising from the costs of obtaining a contract is presented separately from the contract asset or liability.

The new standard does not specify whether an entity is required to present its contract assets and contract liabilities as separate line items in the statement of financial position or whether it can aggregate them with other items in the statement of financial position – e.g. include contract assets in an ‘other assets’ balance. Therefore, an entity applies the general principles for the presentation of financial statements and the offsetting requirements.
Classification as current versus non-current

An entity applies the general principles for presenting assets and liabilities as current or non-current in the statement of financial position to contract assets and contract liabilities arising under the new standard. In applying these principles, an entity considers the expected timing of performance, payment, or utilization under the contract.

Depending on the facts and circumstances, relevant considerations in assessing whether to present an item as current or non-current may include the following:

- If an entity applies the practical expedient not to recognize an asset for the costs of obtaining a contract for which the amortization period would be one year or less (see 6.1), then this indicates that costs to obtain a contract that the entity does recognize as an asset will not be realized within 12 months or the entity’s operating cycle. This suggests that classification as non-current would be appropriate. Conversely, if an entity does not elect to use this practical expedient, then the asset representing the costs to obtain a contract may be allocated between current and non-current.

- If an entity amortizes an asset for the cost of obtaining and fulfilling a contract over the term of the existing contract and anticipated future contracts (see 6.3), then this may indicate that the asset will not be realized within 12 months or the entity’s operating cycle. This suggests that classification as non-current may be appropriate.

Comparison with current IFRS

A consistent, systematic approach to presentation

Under current IFRS, entities applying the percentage-of-completion method under IAS 11 present the gross amount due from customers for contract work as an asset, and the gross amount due to customers as a liability. For other contracts, entities present accrued or deferred income, or payments received in advance or on account, to the extent that payment is received before or after performance.

The new standard contains a single, more systematic approach to presentation in the statement of financial position and does not distinguish between different types of contracts with customers.
Comparison with current US GAAP

Under current US GAAP for construction- and production-type contracts, an entity applying the percentage-of-completion method recognizes:

- an asset for costs and recognized income not yet billed; or
- a liability for billings in excess of costs and recognized income.

An entity applying the completed-contract method recognizes:

- an asset for the excess of accumulated costs over related billings; or
- a liability for an excess of accumulated billings over related costs.

For other contracts, an entity presents accrued or deferred income, or payments received in advance or on account, to the extent that payment is received before or after performance.

The new standard contains a single, more systematic approach to presentation in the statement of financial position and does not distinguish between different types of contracts with customers. In addition, for performance obligations that are satisfied over time, an entity will not recognize work in progress or its equivalent because the customer controls the asset as it is created or enhanced.

Future developments in US GAAP

Receivable example may be clarified

Questions have been raised about when an asset should be presented as a receivable versus a contract asset under the new standard. The guidance in the new standard states that a receivable is the right to consideration that is unconditional and that right is unconditional if only the passage of time is required before payment is due. However, there is language in Example 38 Case B of the new standard that may suggest that an asset is not presented as a receivable until the consideration is due. The FASB staff have indicated that they intend to propose a technical correction to the Board to clarify the language in Example 38 and that they did not expect practice to change with respect to the timing of receivable recognition.
12 Disclosure

Overview

The new standard contains both qualitative and quantitative disclosure requirements for annual and interim periods. There are some differences between the disclosures required in interim financial statements for entities reporting under IFRS and US GAAP. In addition, certain entities applying US GAAP are exempted from some of the disclosure requirements.

12.1 Annual disclosure

Requirements of the new standard

The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of the financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

An entity is required to disclose, separately from other sources of revenue, revenue recognized from contracts with customers, and any impairment losses recognized on receivables or contract assets arising from contracts with customers. If an entity elects either the practical expedient not to adjust the transaction price for a significant financing component (see 5.3.2), or the practical expedient not to capitalize costs incurred to obtain a contract (see 6.1), then it discloses this fact.

The new standard includes disclosure requirements on the disaggregation of revenue, contract balances, performance obligations, significant judgments, and assets recognized to obtain or fulfill a contract. For further discussion on the required transition disclosures, see Section 13.

For US GAAP entities other than public business entities and not-for-profit entities that are conduit bond obligors can elect not to provide certain disclosures that are required for public business entities (see 12.3).
Extensive new disclosures introduced

Under the new standard, an entity discloses more information about its contracts with customers than is currently required, including more disaggregated information about revenue and more information about its performance obligations remaining at the reporting date. For entities applying US GAAP, much of this disclosure is also required in interim financial statements for public business entities, and not-for-profit entities that are conduit bond obligors. For entities applying IFRS, less extensive disclosures are required in interim financial statements than for public business entities applying US GAAP (see 12.2).

Entities will need to assess whether their current systems and processes are capable of capturing, tracking, aggregating, and reporting information to meet the disclosure requirements of the new standard. For many entities, this may require significant changes to existing data-gathering processes, IT systems, and internal controls.

Entities need to consider the internal controls necessary to ensure the completeness and accuracy of the new disclosures – especially if the required data was not previously collected, or was collected for purposes other than financial reporting. Because the new standard may require new judgments and perhaps different analyses, entities should consider the skill level, resource capacity, and training needs of employees who will be responsible for performing the new or modified controls.
Disclosure of potential effects of the new standard required before adoption

IFRS and SEC guidance require entities to disclose the potential effects that recently issued accounting standards may have on the financial statements when they are adopted. Therefore, for reporting periods after the issuance of the new standard, entities will be required to provide disclosures about the new standard’s potential effects. These disclosures are likely to become more detailed as the effective date approaches.

Difference between IFRS and US GAAP

Disclosure of accounting policy elections

The FASB version of the new standard includes accounting policy elections related to shipping and handling costs (see 5.2) and certain taxes assessed by governmental entities that an entity collects from a customer (see 5.3). For each of these US GAAP policy elections, the entity is required to comply with existing accounting policy disclosure guidance.

The IASB version of the new standard does not include these accounting policy elections.

Comparison with current IFRS

Additional disclosures

The new standard’s disclosures are significantly more extensive and detailed than the current requirements in IAS 18 and IAS 11. For example, detailed disclosures about an entity’s performance obligations – e.g. when an entity expects to satisfy its performance obligations – and significant payment terms at the level of performance obligations, are currently not required.

For a detailed guide to the new revenue disclosures under IFRS, see KPMG’s publication Guide to Annual Financial Statements – IFRS 15 Supplement.

Comparison with current US GAAP

Disclosures apply to all industries

US GAAP includes disclosure requirements in the general revenue topic and in specific industry revenue topics. For example, specific disclosures are required for multiple-element arrangements, construction- and production-type contracts, franchisors, and health care entities. The disclosure requirements in the new standard apply to all in-scope revenue contracts, regardless of the transaction or industry, and are generally more extensive than the transaction- and industry-specific disclosure requirements.
12.1.1 Disaggregation of revenue

Requirements of the new standard

The new standard requires the disaggregation of revenue from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors, and includes examples of these categories.

An entity also discloses the relationship between the disaggregated revenue and the entity’s segment disclosures.

In determining these categories, an entity considers how revenue is disaggregated in:

a. disclosures presented outside the financial statements – e.g. earnings releases, annual reports, or investor presentations;

b. information reviewed by the chief operating decision maker for evaluating the financial performance of operating segments; and

c. other information similar to (a) and (b) that is used by the entity or users of the entity’s financial statements to evaluate performance or make resource allocation decisions.
Company X reports the following segments in its financial statements: consumer products, transportation, and energy. When Company X prepares its investor presentations, it disaggregates revenue by primary geographical markets, major product lines, and the timing of revenue recognition – i.e. separating goods transferred at a point in time and services transferred over time.

Company X determines, based on its analysis, that the categories used in the investor presentations can be used for the disaggregation disclosure requirement. The following table illustrates the disaggregation disclosure by primary geographical market, major product line, and timing of revenue recognition. It includes a reconciliation showing how the disaggregated revenue ties in with the consumer products, transportation, and energy segments.

<table>
<thead>
<tr>
<th>Segments</th>
<th>Consumer products</th>
<th>Transportation</th>
<th>Energy</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Primary geographical markets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>North America</td>
<td>990</td>
<td>2,250</td>
<td>5,250</td>
<td>8,490</td>
</tr>
<tr>
<td>Europe</td>
<td>300</td>
<td>750</td>
<td>1,000</td>
<td>2,050</td>
</tr>
<tr>
<td>Asia</td>
<td>700</td>
<td>260</td>
<td>-</td>
<td>960</td>
</tr>
<tr>
<td></td>
<td><strong>1,990</strong></td>
<td><strong>3,260</strong></td>
<td><strong>6,250</strong></td>
<td><strong>11,500</strong></td>
</tr>
<tr>
<td><strong>Major goods/service lines</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Office supplies</td>
<td>600</td>
<td>-</td>
<td>-</td>
<td>600</td>
</tr>
<tr>
<td>Appliances</td>
<td>990</td>
<td>-</td>
<td>-</td>
<td>990</td>
</tr>
<tr>
<td>Clothing</td>
<td>400</td>
<td>-</td>
<td>-</td>
<td>400</td>
</tr>
<tr>
<td>Motorcycles</td>
<td>-</td>
<td>500</td>
<td>-</td>
<td>500</td>
</tr>
<tr>
<td>Automobiles</td>
<td>-</td>
<td>2,760</td>
<td>-</td>
<td>2,760</td>
</tr>
<tr>
<td>Solar panels</td>
<td>-</td>
<td>-</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Power plant</td>
<td>-</td>
<td>-</td>
<td>5,250</td>
<td>5,250</td>
</tr>
<tr>
<td></td>
<td><strong>1,990</strong></td>
<td><strong>3,260</strong></td>
<td><strong>6,250</strong></td>
<td><strong>11,500</strong></td>
</tr>
<tr>
<td><strong>Timing of revenue recognition</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goods transferred at a point in time</td>
<td>1,990</td>
<td>3,260</td>
<td>1,000</td>
<td>6,250</td>
</tr>
<tr>
<td>Services transferred over time</td>
<td>-</td>
<td>-</td>
<td>5,250</td>
<td>5,250</td>
</tr>
<tr>
<td></td>
<td><strong>1,990</strong></td>
<td><strong>3,260</strong></td>
<td><strong>6,250</strong></td>
<td><strong>11,500</strong></td>
</tr>
</tbody>
</table>
No minimum number of categories required

Although the new standard provides some examples of disaggregation categories, it does not prescribe a minimum number of categories. The number of categories required to meet the disclosure objective will depend on the nature of the entity’s business and its contracts.

Disaggregation of revenue may be at a different level from segment disclosures

The level of disclosure under the new standard is not restricted to the information that the chief operating decision maker uses to assess the entity’s performance and allocate its resources. Although an entity considers that information when preparing its disaggregation of revenue disclosures, it also considers other similar information that is used to evaluate performance or make resource allocation decisions. As a result, an entity may be required to disclose certain revenue streams below the segment level to satisfy the new standard’s disclosure objectives.

For example, an entity’s chief operating decision maker regularly reviews a single report that combines the financial information about economically dissimilar businesses – i.e. these businesses form part of one operating segment. However, if segment management makes performance or resource allocation decisions within the segment based on that disaggregated information, then those economically dissimilar businesses could include revenue that would meet the requirements for disaggregation disclosure under the new standard.

12.1.2 Contract balances

Requirements of the new standard

An entity is required to disclose all of the following:

- the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with customers (if they are not otherwise separately presented or disclosed);
- the amount of revenue recognized in the current period that was included in the opening contract liability balance;
- the amount of revenue recognized in the current period from performance obligations satisfied (or partially satisfied) in previous periods – e.g. changes in transaction price;
- an explanation of how the entity’s contracts and typical payment terms will affect its contract asset and contract liability balances; and
– an explanation of the significant changes in the balances of contract assets and contract liabilities, which should include both qualitative and quantitative information such as:

- changes arising from business combinations;
- cumulative catch-up adjustments to revenue (and to the corresponding contract balance) arising from a change in the measure of progress, a change in the estimate of the transaction price, or a contract modification;
- impairment of a contract asset; or
- a change in the time frame for a right to consideration becoming unconditional (reclassified to a receivable) or for a performance obligation to be satisfied (the recognition of revenue arising from a contract liability).

**Observations**

**Required disclosures already made in some industries**

Some entities with long-term contracts – e.g. construction contracts – already provide disclosures on unbilled accounts receivable or deferred revenue, which may limit the amount of new information that those entities have to gather to comply with the new disclosure requirements for contract balances.

**Changes in the transaction price may need to be disclosed**

To disclose the amount of revenue recognized in the current period that relates to performance obligations that were satisfied (or partially satisfied) in a prior period, as well as cumulative catch-up adjustments to revenue that affect the corresponding contract asset or contract liability, an entity may need to track separately the effects of changes in the transaction price. This may require changes in processes or system functionality for some entities.

For example, Manufacturer A enters into a contract containing a single performance obligation that is satisfied over time. The contract price includes 5,000 fixed consideration plus up to 1,000 variable consideration based on manufacturing targets.

At the end of Year 1, the contract is 35% complete and Manufacturer A estimates that variable total consideration will be 200. At the end of Year 2, the contract is 90% and Manufacturer A estimates that total variable consideration will be 1,000.
Manufacturer A therefore recognizes revenue as follows.

<table>
<thead>
<tr>
<th></th>
<th>Fixed consideration</th>
<th>Variable consideration</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At end of Year 1</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated transaction price</td>
<td>5,000</td>
<td>200</td>
<td>5,200</td>
</tr>
<tr>
<td>Revenue recognized in Year 1 (35%)</td>
<td>1,750</td>
<td>70</td>
<td>1,820</td>
</tr>
<tr>
<td><strong>At end of Year 2</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated transaction price</td>
<td>5,000</td>
<td>1,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Cumulative revenue to end of Year 2 as contract is 90% complete</td>
<td>4,500</td>
<td>900</td>
<td>5,400</td>
</tr>
<tr>
<td>Less revenue recognized in Year 1</td>
<td>1,750</td>
<td>70</td>
<td>1,820</td>
</tr>
<tr>
<td>Revenue recognized in Year 2</td>
<td>2,750</td>
<td>830</td>
<td>3,580</td>
</tr>
</tbody>
</table>

In the financial statements for Year 2, Manufacturer A discloses the amount of revenue recognized in Year 2 as a result of the change in the transaction price. Because the transaction price increased by 800 (1,000 - 200) and the contract was 35% complete at the end of Year 1, the amount to be disclosed is 280 (800 x 35%).

If Manufacturer A was a US public entity with quarterly reporting requirements, then the above computation would need to be performed for each quarterly reporting period (see 12.2).

### 12.1.3 Performance obligations

#### Requirements of the new standard

An entity provides the following information about its performance obligations:

- when the entity typically satisfies its performance obligations – e.g. on shipment, on delivery, as services are rendered, or on completion of service;

- significant payment terms – e.g. whether the contract has a significant financing component, the consideration is variable, and the variable consideration is constrained;

- the nature of the goods or services that it has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (if the entity is acting as an agent);

- obligations for returns and refunds, and other similar obligations;
- types of warranties and related obligations; and
- the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied) at the reporting date. The entity also provides either a quantitative (using time bands) or a qualitative explanation of when it expects that amount to be recognized as revenue.

As a practical expedient, an entity is not required to disclose the transaction price allocated to unsatisfied (or partially unsatisfied) performance obligations if:

- the contract has an original expected duration of one year or less;
- the entity applies the practical expedient to recognize revenue at the amount to which it has a right to invoice, which corresponds directly to the value to the customer of the entity’s performance completed to date – e.g. a service contract in which the entity bills a fixed hourly amount (see 5.5.3.1).

The entity also discloses whether it is applying the practical expedient and whether any consideration from contracts with customers is not included in the transaction price – e.g. whether the amount is constrained and therefore not included in the disclosure.

Future developments in US GAAP

In March 2016, the FASB decided to add a practical expedient that would allow an entity to not include the following types of variable consideration in the disclosure of remaining performance obligations:

- sales-based or usage-based royalties promised in exchange for a license of intellectual property; and
- variable consideration that is allocated entirely to a wholly unsatisfied performance obligation; or to a wholly unsatisfied distinct good or service that forms part of a single performance obligation, and meets the variable allocation criteria in paragraph 606-10-32-40.

This proposal will eliminate the requirement for entities to estimate certain variable consideration for disclosure purposes when those estimates do not have to be made for measurement and recognition of revenue. In conjunction with the option to remove certain quantitative disclosures, the FASB also decided to make improvements to the qualitative disclosure requirements for remaining performance obligations outlined in paragraph 606-10-50-15.

As of the date of this publication, the FASB has not yet issued an Exposure Document outlining this proposal. The FASB proposal does not amend the requirements of the new standard until a final ASU is issued.
### Observations

**Remaining performance obligation disclosures may differ from current backlog disclosures**

Some entities, including those with long-term contracts, currently publicly disclose bookings or backlog (i.e. contracts received but incomplete or not yet started). Bookings are typically a metric defined by management to facilitate discussions with investors and, under SEC regulations, “backlog” is subject to legal interpretation.

The disclosure about remaining performance obligations is based on a US GAAP determination of the transaction price for unsatisfied (or partially unsatisfied) performance obligations, and therefore it may differ from the disclosure of bookings or backlog, because it does not include orders for which neither party has performed and each party has the unilateral right to terminate a wholly unperformed contract without compensating the other party.

**Contract renewals are only included if they provide a material right**

The new standard requires passive and active renewals to be accounted for in the same way, because the customer is making the same economic decision. For example, a one-year service contract with an option to renew for an additional year at the end of the initial term is economically the same as a two-year service contract that allows the customer to cancel the contract at the end of the first year without penalty and avoid payment for the second year.

Contracts with passive or active renewals that do not give the customer a material right are not included in the disclosure of remaining performance obligations, but a one-year contract with a renewal period that is a material right is included to the extent of the material right. Similarly, a two-year contract that provides the customer with a cancelation provision after the first year is included in the disclosure of remaining performance obligations if the second year of the contract provides the customer with a material right.

**Certain contracts can be excluded from remaining performance obligation disclosures**

The practical expedient allows an entity to exclude from the remaining performance obligations disclosure contracts that have an original expected duration of one year or less. However, an entity is not precluded from including all contracts in the disclosure.

**Constrained transaction price is used in the remaining performance obligation disclosures**

The transaction price used in the remaining performance obligations disclosure is the constrained amount. An entity also explains qualitatively whether any consideration is not included in the transaction price – e.g. constrained variable consideration – and, therefore, is not included in the remaining performance obligations disclosure.
12.1.4 Significant judgments when applying the new standard

Requirements of the new standard

606-10-50-17 [IFRS 15.123]
An entity discloses the judgments and changes in judgments made in applying the new standard that affect the determination of the amount and timing of revenue recognition — specifically, those judgments used to determine the timing of the satisfaction of performance obligations, the transaction price, and amounts allocated to performance obligations.

606-10-50-18 [IFRS 15.124]
For performance obligations that are satisfied over time, an entity describes the method used to recognize revenue — e.g. a description of the output or input method and how those methods are applied — and why the methods are a faithful depiction of the transfer of goods or services.

606-10-50-19 [IFRS 15.125]
For performance obligations that are satisfied at a point in time, the new standard requires a disclosure about the significant judgments made to evaluate when the customer obtains control of the promised goods or services.

606-10-50-20 [IFRS 15.126]
An entity also discloses information about the methods, inputs, and assumptions used to:
- determine the transaction price, which includes estimating variable consideration, assessing whether the variable consideration is constrained, adjusting the consideration for a significant financing component, and measuring noncash consideration;
- allocate the transaction price, including estimating the stand-alone selling prices of promised goods or services and allocating discounts and variable consideration; and
- measure obligations for returns and refunds, and other similar obligations.

Observations

Greater specificity provided

ASU 2014-09.BC355 [IFRS 15.BC355]
IFRS and US GAAP currently have general requirements for disclosing an entity’s significant accounting estimates and judgments, but the new standard provides specific areas for which disclosures about the estimates used and judgments made in determining the amount and timing of revenue recognition are required.
12.1.5 Assets recognized for costs to obtain or fulfill a contract with a customer

Requirements of the new standard

An entity discloses the closing balance of assets that are recognized from the costs incurred to obtain or fulfill a contract with a customer, separating them by their main category – e.g. acquisition costs, pre-contract costs, set-up costs, and other fulfillment costs – and the amount of amortization and any impairment losses recognized in the reporting period. An entity describes the judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer and the method used to determine the amortization for each reporting period.

12.2 Interim disclosures

Requirements of the new standard

Both IFRS and US GAAP require entities to include information about disaggregated revenue in their interim financial reporting. US GAAP further requires public business entities, not-for-profit entities that are conduit bond obligors, and employee benefit plans that file or furnish financial statements with the SEC to provide the following disclosures for interim financial reporting, if they are material:

- the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with customers (if they are not otherwise separately presented or disclosed);
- the amount of revenue recognized in the current period that was included in the opening contract liability balance;
- the amount of revenue recognized in the current period from performance obligations that were satisfied (or partially satisfied) in previous periods – e.g. changes in transaction price; and
- information about the entity’s remaining performance obligations.
12.3 Disclosures for all other entities (US GAAP only)

Requirements of the new standard

Disaggregation of revenue

All other entities that apply US GAAP – i.e. other than public business entities and not-for-profit entities that are conduit bond obligors – can elect not to provide the quantitative disaggregation of revenue disclosures that is required for public business entities (see 12.1.1).

However, they are still required to disclose, at a minimum, information about the disaggregation of revenue, including:

- the timing of the transfer of goods or services – e.g. revenue from goods or services that are transferred to customers at a point in time and revenue from goods or services that are transferred over time; and

- qualitative information about how economic factors – e.g. type of customer, geographical location of customers, and type of contract – and significant changes in those economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows.

Contract balances and contract costs

All other entities can elect not to provide the disclosures about contract balances and the costs to obtain or fulfill a contract with a customer. These entities are required to disclose the opening and closing balances of contract assets, contract liabilities, and receivables from contracts with customers if they are not otherwise separately presented or disclosed in the statement of financial position.
Performance obligations

All other entities can elect not to disclose the amount of the transaction price allocated to remaining performance obligations, including the explanation of when those amounts are expected to be recognized as revenue.

Significant judgments in applying the guidance

All other entities disclose the significant judgments and any changes in judgments when applying the new standard that significantly affect the determination of the amount and timing of revenue from contracts with customers. In meeting this requirement, they explain those judgments that are made in determining the:

- timing of the satisfaction of performance obligations, the transaction price, and the amounts allocated to performance obligations;

- methods used to recognize revenue – e.g. a description of the output or input methods and how those methods are applied for performance obligations that are satisfied over time; and

- methods, inputs, and assumptions used when determining whether an estimate of variable consideration is constrained.

These entities can elect not to provide the other qualitative disclosures about their judgments that significantly affect the determination of the amount and timing of revenue from contracts with customers described in 12.1.4.

Interim disclosures

All other entities are not required to apply the revenue-specific interim disclosures described in 12.2.
13 Effective date and transition

Overview

The following table lists the mandatory effective date and early adoption provisions of the new standard for IFRS and US GAAP entities.

<table>
<thead>
<tr>
<th>Type of entity</th>
<th>Annual periods commencing on or after</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRS entities</td>
<td>January 1, 2018 (with early adoption permitted for any annual period)</td>
</tr>
<tr>
<td>Public business entities and not-for-profit entities that are conduit bond obligors applying US GAAP</td>
<td>December 16, 2017 (with early adoption permitted for annual periods beginning on or after December 16, 2016, which was the original effective date)</td>
</tr>
<tr>
<td>All other US GAAP entities</td>
<td>December 16, 2018 (with early adoption permitted for annual periods beginning on or after December 16, 2016, which was the original early-adoption date)</td>
</tr>
</tbody>
</table>

An entity can elect to adopt the new standard in a variety of ways, including retrospectively with or without optional practical expedients (see 13.2), or from the beginning of the year of initial application with no restatement of comparative periods (see 13.3).

The examples used to illustrate the application of the transition methods in this section reflect a calendar year-end entity that applies the new standard as of January 1, 2018 and includes two years of comparative financial statements.

For additional examples on applying the transition methods, refer to our publication Transition to the new revenue standard.

For examples of transition disclosures, refer to our publications Guide to annual financial statements – IFRS 15 supplement and Illustrative Disclosures – Revenue.
13.1 Effective date

Requirements of the new standard

US GAAP

The new standard is effective for annual periods beginning after December 15, 2017, and interim reporting periods therein, for public business entities and not-for-profit entities that are conduit bond obligors applying US GAAP.9

IFRS

The new standard is effective for annual periods beginning on or after January 1, 2018 for entities applying IFRS.

Differences between IFRS and US GAAP

An entity that applies IFRS may elect to apply the new standard for any annual reporting period beginning earlier than January 1, 2018 if it has not yet issued financial statements. If an entity early adopts the new standard, then it discloses that fact.

When the FASB decided to defer the mandatory effective date of the new standard by 12 months, it also decided that entities applying US GAAP could elect to adopt the new standard as of the original effective date for public business entities (annual periods beginning after December 15, 2016). Early adoption before this date continues to be prohibited under US GAAP.

IFRS has one effective date for all entities adopting the new standard, while US GAAP has different effective dates for different types of entity. Entities that are not public business entities or not-for-profit entities that are conduit bond obligors have the option to defer application of the new standard for one year for annual reporting purposes and two years for interim reporting purposes.

The effective date of the US GAAP version of the new standard is consistent with its typical mid-month convention, which requires entities with fiscal year-ends near the end of the calendar year – e.g. 52/53 week reporting entities – to adopt the new standard at about the same time as entities with calendar year-end financial reporting dates. The effective date of the IFRS version of the new standard is consistent with its typical beginning-of-year convention.

9. There is a one-year deferral for annual reporting and a two-year deferral for interim reporting for other entities applying US GAAP (see 13.1.1).
13.1 Effective date

Observations

Boards reached different decisions on early adoption

In deciding to prohibit early adoption before 2017 for public business entities and not-for-profit entities that are conduit bond obligors, the FASB prioritized comparability between entities reporting under US GAAP. In particular, the FASB wanted to avoid having public business entities in the same line of business reporting under different revenue recognition requirements in the same year.

However, when the FASB decided to defer the mandatory effective date of the standard by one year, it received feedback that some entities would incur additional costs if they were not permitted to adopt the standard as of the original effective date. As a consequence, the FASB decided that some degree of noncomparability among entities was an acceptable cost-benefit trade-off. Therefore, it decided to allow early adoption, but only by one year, for public business entities and not-for-profit entities that are conduit bond obligors.

By contrast, the IASB has throughout prioritized the improvements in financial reporting that it believes will be achieved by the new standard. In particular, the IASB believes that the new standard will help resolve certain application issues that arise under current IFRS – e.g., associated with IFRIC 15. On balance, the IASB concluded that the potential improvements in financial reporting outweighed the reduction in comparability between entities before the mandatory effective date.

13.1.1 All other entities (US GAAP only)

Requirements of the new standard

All other entities applying US GAAP – i.e., all entities other than public business entities and not-for-profit entities that are conduit bond obligors – have a one-year deferral for annual reporting on applying the new standard and a two-year deferral for interim reporting. For these entities, the new standard is effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods in fiscal years beginning after December 15, 2019. These entities may elect to early adopt the requirements of the new standard, but no earlier than the original effective date for public business entities (i.e., annual reporting periods beginning after December 15, 2016).

These entities may initially apply the standard for interim purposes either in the year of adoption or in the subsequent year.
Observations

Multiple adoption date options for all other entities under US GAAP

As a consequence of the FASB’s decisions to defer the effective date, to permit early adoption by other entities, and to permit other entities to initially apply the standard for interim purposes either in the year of adoption or in the subsequent year, other entities have six different possibilities for the adoption date of the new standard for interim reporting purposes. Specifically, they may initially apply the new revenue standard as follows.

<table>
<thead>
<tr>
<th>Option</th>
<th>Annual reporting periods beginning after December 15:</th>
<th>Interim reporting periods in the year beginning after December 15:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2016</td>
<td>2016</td>
</tr>
<tr>
<td>2</td>
<td>2016</td>
<td>2017</td>
</tr>
<tr>
<td>3</td>
<td>2017</td>
<td>2017</td>
</tr>
<tr>
<td>4</td>
<td>2017</td>
<td>2018</td>
</tr>
<tr>
<td>5</td>
<td>2018</td>
<td>2018</td>
</tr>
<tr>
<td>6</td>
<td>2018</td>
<td>2019</td>
</tr>
</tbody>
</table>

SEC’s quarterly supplemental data for Emerging Growth Companies

Emerging Growth Companies that have elected to follow non-issuer effective dates are not required to accelerate adoption of the new standard to interim periods within the annual reporting period of adoption for the sole purpose of reporting quarterly supplemental data.10

13.2 Retrospective method

Requirements of the new standard

Under the retrospective method, an entity is required to restate each period before the date of initial application that is presented in the financial statements. The ‘date of initial application’ is the start of the reporting period in which an entity first applies the new standard. For example, if an entity first applies the new standard in its financial statements for the year ended December 31, 2018, then the date of initial application is January 1, 2018. The entity recognizes the cumulative effect of applying the new standard in equity (generally, retained earnings or net assets) at the start of the earliest comparative period presented.

An entity that elects to apply the new standard using the retrospective method can choose to do so on a full retrospective basis or with one or more practical expedients. The practical expedients provide relief from applying the requirements of the new standard to certain types of contracts in the comparative periods presented. For further discussion on the expedients, see 13.2.1 to 13.2.4.

If an entity applies one or more practical expedients, then it needs to do so consistently for all goods or services for all periods presented. In addition, the entity discloses the following information:

- the expedients that have been used; and
- a qualitative assessment of the estimated effect of applying each of those expedients, to the extent reasonably possible.

An entity is also required to comply with disclosure requirements for a change in accounting policy, including the amount of the adjustment to the financial statement line items and earnings per share amounts affected. However, an entity that adopts the standard retrospectively is not required to disclose the impact of the change in accounting policy on the financial statement line items and earnings per share amounts for the year of initial application.

Example 75 – Full retrospective method

Software Company Y enters into a contract with a customer to provide a software term license and telephone support for two years for a fixed amount of 400. The software is delivered and operational on July 1, 2016. Software Company Y adopts the new revenue standard on January 1, 2018 and presents two years of comparatives.

Under current GAAP, Software Company Y recognizes revenue for the arrangement on a straight-line basis over the 24-month contract term, beginning on July 1, 2016.

Under the new standard, Software Company Y determines that the contract consists of two performance obligations: the software license and the telephone support. Software Company Y allocates 300 of the transaction price to the software license and 100 to the telephone support.

Software Company Y determines that the telephone support is a performance obligation satisfied over time, and its progress is best depicted by time elapsed data: 2016: 25; 2017: 50; and 2018: 25. The software license is a point-in-time performance obligation, and the 300 is recognized as revenue on the delivery date of July 1, 2016.
Software Company Y elects to adopt the new standard retrospectively and presents the following amounts.

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>325(a)</td>
<td>50</td>
<td>25</td>
</tr>
</tbody>
</table>

**Note**

a. Calculated as 300 for the software license plus 25 for the telephone support.

Software Company Y does not need to make an opening adjustment to equity at January 1, 2016 because the contract began on July 1, 2016.

Software Company Y also considers the effect of the change in revenue recognition on related cost balances, and makes appropriate adjustments.

**Observations**

**All contracts (open and closed) under current GAAP require consideration**

If an entity applies the new standard on a full retrospective basis, then all contracts with customers are potentially open – even if they are considered closed under current GAAP.

For example, entities with contracts that included after-sale services accounted for as sales incentives will be required to re-analyze those contracts to:

– determine whether the after-sale service is a performance obligation under the new standard; and

– assess whether any performance obligations identified have been satisfied.

**Cost and income tax line items may also require adjustment**

When making adjustments, the entity may also be required to adjust some cost and income tax balances in the financial statements if they are affected by the new requirements. For example, the entity is now required under the new standard to capitalize and amortize the costs of acquiring a contract, but under current GAAP it had expensed those costs as they were incurred. The capitalization of costs under the new standard may create temporary differences or affect other judgments and therefore impact deferred tax balances.

**Regulatory requirements need to be considered**

Entities that elect the retrospective method may also need to consider the effect on any additional historical data that forms part of, or accompanies, the financial statements, or that is filed in accordance with regulatory requirements.
Under Regulation S-K, SEC registrants are required to disclose at least five years of selected financial data to highlight significant trends in financial conditions and the results of operations. However, the SEC will not object if registrants that elect to apply the new standard retrospectively choose to do so only for the periods covered by the financial statements when preparing their selected financial data, provided that they clearly indicate that the earlier periods are prepared on a different basis from the most recent periods and briefly describe the accounting changes that affect the comparability of the information reflected in selected financial data.

**Registration statements with the SEC during 2018 may require earlier periods to be revised**

Registration statements filed with the SEC need to include or incorporate by reference financial statements that retrospectively reflect a change in accounting principle. For calendar year-end companies that adopt the standard on January 1, 2018 using the retrospective transition method, current rules would require registration statements filed during 2018 after the first quarter Form 10-Q is filed to include or incorporate by reference retrospectively revised historical financial statements for the three-year period ended December 31, 2017. This would include 2015, which is a period that would not otherwise require retrospective revision for annual reporting requirements.

As of the date of this publication, the SEC staff has not determined whether relief from this requirement will be available.

**Significance test for equity method investees not required to be recalculated**

Under Regulation S-X SEC registrants are required to provide separate audited financial statements for significant investments. The SEC has stated that when entities are applying the significance test to determine whether an investment requires separate financial statements, they will not be required to recalculate the significance test for years revised under a retrospective adoption of the revenue standard. Instead, registrants can use their pre-transition measure to apply the significance test.

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13.2.1 Practical expedient 1 – Contracts that are started and completed in the same annual reporting period

Requirements of the new standard

Under practical expedient 1, an entity need not restate completed contracts that begin and end within the same annual reporting period.

IFRS only

In addition, under IFRS an entity can choose not to restate contracts that are completed contracts at the beginning of the earliest period presented.

IFRS definition of a completed contract

Under IFRS, a ‘completed’ contract is one for which the entity has transferred all of the goods or services identified under IAS 11 Construction Contracts, IAS 18 Revenue, and related interpretations.

US GAAP definition of a completed contract

Under US GAAP, a completed contract is a contract for which an entity has recognized all (or substantially all) of the revenue under current US GAAP.

The FASB did not intend for the practical expedient to only eligible in all circumstances where 100 percent of revenue was recorded under legacy GAAP (e.g. product sales with return reserves). Entities will apply judgment to determine which contracts are complete.

Differences between IFRS and US GAAP

IFRS definition may create operational challenges for certain completed contracts

Under IFRS, a contract is completed when the entity has transferred all of the goods or services identified under current revenue accounting requirements regardless of whether all of the revenue has been recognized.

Conversely, under the revised FASB definition the contract is only completed when all (or substantially all) of the revenue has been recognized. This definition will result in fewer contracts meeting the definition of a completed contract than under the IFRS definition.

Under IFRS, a question arises about how an entity that elects to apply this expedient should account for revenue or adjustments to revenue arising after the beginning of the earliest period presented that relate to a contract that was a completed contract at that date. The IASB has indicated that an entity will continue to apply current revenue accounting requirements to these changes in the amount of revenue recognized for a completed contract.
Additional practical expedient available under IFRS is consistent with the cumulative effect method

The additional practical expedient available under IFRS (but not under US GAAP) not to restate contracts that are completed at the beginning of the earliest period presented results in an outcome similar to the cumulative effect method, except that all periods presented are required to be restated.

The FASB decided not to provide this additional practical expedient because of concern about the comparability between the periods when an entity applies the retrospective transition method.

Example 76 – Applying practical expedient 1

Contract Manufacturer X has the following contracts with customers, each of which runs for eight months.

<table>
<thead>
<tr>
<th>Contract</th>
<th>Starts</th>
<th>Completes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>January 1, 2017</td>
<td>August 31, 2017</td>
</tr>
<tr>
<td>2</td>
<td>July 1, 2016</td>
<td>February 28, 2017</td>
</tr>
<tr>
<td>3</td>
<td>July 1, 2017</td>
<td>February 28, 2018</td>
</tr>
</tbody>
</table>

Contract timelines

Contract Manufacturer X determines that practical expedient 1:

- applies to Contract 1, because Contract 1 begins and ends in an annual reporting period before the date of initial application;
- does not apply to Contract 2, because it is not completed within a single annual reporting period; and
- does not apply to Contract 3, because Contract 3 is not completed under current GAAP by the date of initial application.
13.2.2 Practical expedient 2 – Exemption from applying variable consideration requirements

Requirements of the new standard

Under practical expedient 2, an entity may use the transaction price at the date on which the contract was completed, rather than estimating the variable consideration amounts in each comparative reporting period.

Example 77 – Applying practical expedient 2

Manufacturer X enters into a contract to sell 1,000 products to Customer Y on October 1, 2016. Manufacturer X also grants Customer Y the right to return any unused product within 120 days. In December 2016, Customer Y returns 200 unused products.

Manufacturer X considers the application of practical expedient 2 to its contract and determines that it can use the final transaction price for the contract. Therefore, Manufacturer X recognizes revenue for 800 products (being 1,000 products delivered less 200 products returned) on October 1, 2016, rather than estimating the consideration under Step 3 of the model, because the contract was completed before the date of initial application.
13.2 Retrospective method

## Observations

### Limited hindsight allowed

Practical expedient 2 only exempts an entity from applying the requirements on variable consideration, including the constraint in Step 3 of the model. The entity is still required to apply all other aspects of the model when recognizing revenue for the contract.

### Use of the practical expedient may bring forward revenue recognition

The use of this practical expedient will accelerate revenue recognition in many circumstances as compared with the full retrospective approach if the constraint in Step 3 of the model would otherwise have applied. This is because the final transaction price is used from inception of the contract.

## 13.2.3 Practical expedient 3 – Contract modifications before the earliest period presented

### Requirements of the new standard

Under practical expedient 3, an entity need not separately evaluate the effects of contract modifications before the beginning of the earliest reporting period presented using the contract modifications requirements in the new standard.

Instead, an entity may reflect the aggregate effect of all of the modifications that occur before the beginning of the earliest period presented in:

- identifying the satisfied and unsatisfied performance obligations;
- determining the transaction price; and
- allocating the transaction price to the satisfied and unsatisfied performance obligations.

### Observations

#### Exemption from restating for contract modifications that occur before the start of the earliest period presented

This practical expedient essentially allows an entity to use hindsight when assessing the effect of a modification on a contract. However, it does not exempt an entity from applying other aspects of the requirements to a contract – e.g., identifying the performance obligations in the contract and measuring the progress toward complete satisfaction of those performance obligations.
13.2.4 Practical expedient 4 – Disclosure exemption

Requirements of the new standard

Under practical expedient 4, an entity need not disclose for reporting periods presented before the date of initial application:

- the amount of the transaction price allocated to the remaining performance obligations; nor
- an explanation of when the entity expects to recognize that amount as revenue.

Example 78 – Applying practical expedient 4

Property Developer X has a contract with Customer C, to construct a building on Customer C’s land for a fixed amount of 20 million. Construction starts on January 1, 2016 and is expected to take five years to complete. Property Developer X determines that it satisfies its performance obligation over time, and that the cost-to-cost method best depicts performance.

If Property Developer X elects to apply the retrospective method including practical expedient 4, then its annual financial statements for the year ended December 31, 2018 are not required to comply with the remaining performance obligation disclosure requirements for the comparative periods presented (December 31, 2017 and December 31, 2016).

Assume that the building is 80% complete on December 31, 2018. Property Developer X provides the following disclosure.

**Transaction price allocated to remaining performance obligations**

At December 31, 2018, Property Developer X has yet to recognize as revenue 4 million of the 20 million transaction price for the construction of the building. Property Developer X expects to recognize this amount evenly over the next two years in line with the planned schedule for completion of its construction.

Using the transition requirements of the new standard, Property Developer X has elected not to provide information on the transaction price allocated to remaining performance obligations at December 31, 2017 and December 31, 2016.
13.3 **Cumulative effect method**

**Requirements of the new standard**

Under the cumulative effect method, an entity applies the new standard as of the date of initial application, without restatement of comparative period amounts. The entity records the cumulative effect of initially applying the new standard – which may affect revenue and costs – as an adjustment to the opening balance of equity at the date of initial application.

Under the cumulative effect method, an entity can choose to apply the requirements of the new standard to:

- only contracts that are not completed contracts at the date of initial application; or
- all contracts at the date of initial application.

An entity that applies the cumulative effect method may also use the contract modifications practical expedient (see 13.2.3).

**IFRS only**

Under IFRS, an entity can choose to apply the practical expedient either to all contract modifications that occur before the:

- beginning of the earliest period presented; or
- date of initial application.

**US GAAP only**

Under US GAAP, an entity applies the practical expedient to contract modifications that occur before the date of initial application.

An entity that elects the cumulative effect transition method is also required to disclose the following information:

- the amount by which each financial statement line item is affected in the current period as a result of applying the new standard; and
- an explanation of the significant changes between the reported results under the new standard and those under current GAAP.
Differences between IFRS and US GAAP

Different versions of the practical expedient for contract modifications

An entity choosing to apply the cumulative effect method could elect to use the practical expedient for contract modifications (see 13.2). However, the date up to which contract modifications are exempt differs for IFRS and US GAAP. Under IFRS, an entity can choose between the start of the earliest presented period and the date of initial application, while under US GAAP an entity can apply the practical expedient only at the date of initial application.

The new standard may apply to different contracts under IFRS and US GAAP

IFRS and US GAAP allow an entity to apply the guidance only to contracts that are not completed at the date of initial application. However, because the definitions of ‘completed contract’ are different in the two standards (see 13.2.1), an entity reporting under US GAAP may apply the guidance to a different population of contracts from an entity reporting under IFRS. This difference may create challenges upon adoption of the new standard and for an ongoing period after adoption for entities required to report under both US GAAP and IFRS (e.g. US multi-national entity reporting consolidated financials under US GAAP with required statutory filings for itself or its subsidiaries under IFRS).

For example, assume that at the transition date an entity had an arrangement to provide software, but under current GAAP revenue has not been recognized because the fee was not fixed and determinable. This contract would not be considered complete under the FASB’s definition because substantially all of the revenue had not been recognized before adoption. However, the contract may be considered complete under the IASB’s definition because the software had been transferred before adoption.

The entity’s US GAAP financial statements would apply the guidance in the new standard to this contract, which depending on the facts could result in revenue being pulled into the opening retained earnings adjustment. The entity’s IFRS financial statements would continue to report the contract under current GAAP after the adoption of the new standard, resulting in revenue after the adoption of the new standard.

Entities that report under both US GAAP and IFRS should consider the nature of their contracts and whether there is significant trailing revenue after delivery has occurred (e.g. revenue not fixed or determinable, collectibility not reasonably assured, royalty arrangements) and consider the extent of operational challenges at adoption and post adoption, when selecting their transition method.
Example 79 – Cumulative effect method

Modifying Example 75 in this publication, Software Company Y decides to apply the cumulative effect method, with the following consequences:

- Software Company Y does not adjust the comparative periods, but records an adjustment to opening equity at the date of initial application (January 1, 2018) for the additional revenue related to 2016 and 2017 that would have been recognized if the new standard had applied to those periods.

- Software Company Y also considers the effects of the revenue adjustments on related cost balances, and adjusts them.

- Software Company Y discloses the amount by which each financial statement line item is affected in the current period as a result of applying the new standard.

The following table illustrates the revenue amounts presented in Software Company Y’s financial statements.

<table>
<thead>
<tr>
<th>Contract</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>100(a)</td>
<td>200(a)</td>
<td></td>
</tr>
<tr>
<td>Adjustment to opening equity</td>
<td>-</td>
<td>-</td>
<td>80(b)</td>
</tr>
</tbody>
</table>

Notes

a. Amounts are not restated, and represent the amounts recognized under current GAAP for those periods.

b. Calculated as 300 for the software license plus 80 for the telephone support (for 2016 and 2017) minus 300 recognized under current GAAP (being 400 x 18 ÷ 24).

Observations

Dual reporting still required

Because of the requirement to disclose the difference between:

- revenue and costs that would have been recognized under current GAAP in the current period; and

- the amounts that are recognized under the new standard,

an entity electing the cumulative effect method will still be required to maintain dual reporting for the year of initial application of the new standard to disclose the effect of adoption on line items in the statement of financial position, statement of comprehensive income, and statement of cash flows.
13 Effective date and transition

Choosing to apply the cumulative effect method to all contracts may improve comparability

If an entity elects to apply the cumulative effect method to all contracts, rather than only those not completed at the date of initial application, then this may result in financial information for the current reporting period that is more comparable with entities following the full-retrospective method. Because of the difference in the definition of a completed contract under IFRS and US GAAP, IFRS entities may find it less complex operationally than continuing to account for completed contracts under previous revenue standards, when all of the revenue for completed contracts has not yet been recognized.

13.4 First-time adoption (IFRS only)

Requirements of the new standard

A first-time adopter of IFRS may adopt the new standard when it adopts IFRS. It is not required to restate contracts that were completed before the date of transition to IFRS — i.e. the earliest period presented.

A first-time adopter may apply the practical expedients available to an entity already applying IFRS that elects the retrospective method. In doing so, it interprets references to the ‘date of initial application’ as the beginning of its first IFRS reporting period. If a first-time adopter decides to apply any of the practical expedients, then it discloses:

- the expedients that have been used; and
- a qualitative assessment of the estimated effect of applying each of those expedients, to the extent reasonably possible.

Timeline for a first-time adopter

![Timeline Diagram]

Note

a. Date of transition to IFRS.

15. For a first-time adopter, a completed contract is a contract for which the entity has transferred all of the goods or services identified under current GAAP.
Example 80 – First-time adopter of IFRS

Car Manufacturer M applies IFRS for the first time in its annual financial statements for the year ended December 31, 2017. Car Manufacturer M presents one year of comparative information in its financial statements, and therefore its date of transition to IFRS is January 1, 2016.

Car Manufacturer M sells cars to dealers with a promise to provide one free maintenance service to the end purchaser of a car.

Under current GAAP, Car Manufacturer M treats the free servicing component of the arrangement as a sales incentive, recognizing a provision with a corresponding expense when the vehicle is sold to the dealer. In addition, it recognizes revenue at the invoice price when the car is delivered to the dealer.

Under the new standard, Car Manufacturer M determines that the arrangement consists of two performance obligations – the sale of the car and a right to one free maintenance service. This treatment results in a different pattern of revenue recognition from current GAAP, because a portion of the transaction price is allocated to the free service and recognized as the performance obligation is satisfied.

If Car Manufacturer M elects to apply the new standard only to contracts that are not completed under current GAAP at the date of transition to IFRS, then it applies the new standard to its contracts for the sales of cars as follows.

- Car Manufacturer M makes no opening adjustments at the date of transition for contracts relating to cars that have already been delivered to the dealer, because a first-time adopter is not required to analyze contracts that are completed under current GAAP before the date of transition. This is because the cars have all been delivered and the free services are not considered to be part of the revenue transaction under current GAAP.
- If Car Manufacturer M elects to apply practical expedient 1, then it does not restate the comparative period because the car sales were recognized as point-in-time sales under current GAAP.
- If Car Manufacturer M does not elect to apply practical expedient 1, then it restates sales in the comparative period for the effect of allocating the transaction price between the car and the free maintenance service.
- Car Manufacturer M applies the new standard to all car sales, starting on January 1, 2017.

An IFRS entity could achieve the outcome described above for a first-time adopter in two ways:

- electing a practical expedient and therefore not restating contracts that are started and completed in the same annual reporting period before the date of initial application; or
- electing to apply the cumulative effect method.
Observations

**IFRS 15 can be applied in an entity’s first IFRS financial statements**

If an entity adopts IFRS before the mandatory effective date of IFRS 15, then it will have the option to adopt in its first IFRS financial statements:

- IAS 18, IAS 11, and related interpretations; or
- IFRS 15.

However, it is likely that many first-time IFRS adopters will elect to apply IFRS 15 in their first financial statements. Given the similarities in transition methods for first-time adopters and entities already applying IFRS, there does not appear to be any significant advantage in adopting IAS 18 and/or IAS 11 first and then transitioning to the new standard shortly afterwards.

A first-time adopter that applies the new standard in its first IFRS financial statements will have to decide precisely how to apply it. Although the cumulative effect method is not available, relevant practical expedients under the retrospective method may be used.
14 Implementation considerations

Overview

The new standard could have far-reaching impacts – not just changing the amounts and timing of revenue, but potentially requiring changes in the core systems and processes used to account for revenue and certain costs. Entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, and estimates. The change in revenue recognition resulting from implementing the new standard could also impact income tax reporting.

Although the mandatory effective date seems a long way off, now is the time for entities to assess how the new requirements will affect their organization. At a minimum, all entities will need to re-evaluate their accounting policies and will be subject to new qualitative and quantitative disclosures. For some, the new standard will have a significant impact on how and when they recognize revenue, while for others the transition may be less noticeable. Effective governance will be a key element of a successful implementation. This includes input from and involvement of the audit committee, a steering committee, and a program management team.

One key decision that management needs to make soon is how to transition to the new standard.

The next steps that an entity should consider taking are illustrated below, and are discussed in further detail in the sections that follow.
14.1 Accounting and disclosure

Observations

Identifying information gaps for applying new requirements

After gaining an understanding of the new standard, entities should perform an analysis to identify accounting policies that may need to change and additional disclosures that will be required. Factors to consider include:

- customer contracts with unique revenue recognition considerations or terms and conditions;
- the degree of variation in the nature and type of goods or services being offered;
- the degree to which contracts include multiple performance obligations, variable consideration, or licenses of intellectual property;
- the pattern in which revenue is currently recognized – i.e. point-in-time versus over-time;
- the current accounting treatment of costs incurred to acquire or fulfill a contract with a customer;
The new standard will require new judgments, estimates, and calculations. For example, entities may need to make judgments about whether a contract exists, the number of performance obligations in a contract, the transaction price when consideration is variable, the stand-alone selling price of performance obligations, whether performance obligations are satisfied over time or at a point in time, and the measure of progress on performance obligations that are satisfied over time. As changes in accounting policies and data availability are identified in the gap analysis, the areas that will require new judgments, estimates, and calculations will need to be identified.

14.2 Tax

Observations

Evaluating tax implications

The change in revenue recognition could impact tax reporting and the related financial reporting for taxes. Examples of impacts include:

- changes in the amount or timing of revenue or expense recognition for financial reporting purposes, which may result in changes to the recognition of taxes or deferred taxes;
- accounting for financial reporting purposes that may not be acceptable for tax purposes, resulting in changes in existing temporary differences or the creation of new temporary differences;
- revisions being required to transfer pricing strategies and documentation;
- changes being required to update policies, systems, processes, and controls surrounding income tax accounting and financial accounting; and
- revisions to sales or excise taxes because revenue may be recharacterized between product and service revenue.

Entities should therefore include representatives from their tax department in their implementation project team. Some next steps to consider may include:

- reviewing expected accounting changes with tax personnel and evaluating the extent to which tax resources will need to be involved in implementation; and
- determining the effects on income tax reporting, compliance, and planning.

For a more detailed discussion on how the new standard may affect the calculation of and financial reporting for income taxes and other types of taxes, particularly in the United States, see KPMG’s US publication Defining Issues No. 16-16, Revenue Standard Portends Potential Tax Changes.
14.3 Systems and processes

Observations

Updating accounting processes and IT systems

The new requirements will require some entities to gather information that has not historically been required for financial reporting purposes—e.g., costs incurred in obtaining a customer contract or when performance obligations are expected to be satisfied. Processes may also need to be reconsidered to ensure that management judgment is exercised at key points as financial information is prepared.

Preparing an inventory of the incremental information needed and mapping those needs to existing sources will be critical steps early on in the implementation process. Entities should consider what new IT reporting packages, if applicable, may need to be developed to meet the requirements of the new standard and what additional data needs to be captured. To achieve a cost-effective solution, entities could evaluate the best way to source incremental information by:

- establishing the level of effort required to obtain new information from existing feeder systems; and
- determining additional system requirements that might be required.

Entities should also assess how applying the new standard will affect existing processes, including how new contracts or modifications to existing contracts are reviewed and accounted for, and how sales are invoiced.

In particular, changes may arise related to accounting for multiple performance obligations, determining stand-alone selling prices, accounting for variable consideration, adjusting for a significant financing component, identifying and tracking contract modifications, and accounting for contract costs.

Dual reporting

Regardless of the method chosen to apply the new standard, an entity will be required to maintain dual reporting, although periods of dual reporting would vary depending on the method.

If an entity elects to adopt the new standard using the retrospective method, then it will need to maintain dual reporting before the year of initial application. The period of dual reporting will depend on whether the entity is required to present comparatives for one or more periods.

If an entity elects to adopt the new standard using the cumulative effect method, then it will need to maintain dual reporting for the year of initial application to comply with disclosure requirements.

Entities will need to determine early whether they will be ready to run parallel processing under the new and current revenue standards for the close cycle and whether they will be able to produce financial reporting with appropriate disclosures at a more disaggregated level where required.
14.4 Internal control

Observations

Design and implementation of new internal controls or modification of existing controls

Entities will need to consider the potential effect of required changes to their systems and processes on their internal control environment, including internal controls over financial reporting. Some entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, and estimates.

New risk points may arise from changes to IT systems and reports that provide data inputs used to support the new estimates and judgments. To the extent that data is needed in order to comply with the new standard, entities will need to consider the internal controls necessary to ensure the completeness and accuracy of this information – especially if it was not previously collected, or was collected outside of the financial reporting system (e.g. projections made by the financial planning and analysis department for estimating variable consideration). Because the new standard may require new judgments and perhaps different analyses, entities should consider the skill level, resource capacity, and training needs of employees who will be responsible for performing the new or modified controls.

- Review of judgments and estimates
- Review of contract terms
- Review of historical data and adjustments
- General controls over system changes
- Application controls as information flows through system
- Controls over amended systems and processes
- Controls over implementation of new accounting guidance
- Report configuration
- Controls over completeness and accuracy for all reports used
SEC registrants will need to consider the potential effect of any changes in internal controls on management’s requirement to make certain quarterly and annual disclosures and certifications about disclosure controls, procedures, and internal controls.

Early in their implementation plan, entities should also consider what processes and related internal controls should be designed and implemented to assess the impact of, and record accounting adjustments arising upon, application of the new standard. For example, new internal controls may be required relating to:

- identifying changes to existing accounting policies;
- reviewing contracts for accounting adjustments on application of the new standard;
- recording accounting adjustments that have been identified; and
- preparing new qualitative and quantitative disclosures.

### 14.5 Determine the adoption date and a transition method

#### Observations

An entity can elect to adopt the new standard in a variety of ways, including retrospectively with a choice of optional practical expedients (see 13.2), and from the beginning of the year of initial application with no restatement of comparative periods (see 13.3).

**Early decision needed in developing an efficient implementation plan**

The expected adoption date and transition method (see Section 13) will have a significant impact on the timing of system and process changes. Therefore, determining which transition method should be adopted should be one of the first steps in the implementation process.

An entity should consider both the quantitative effects of each transition method and the relevant qualitative factors. Advance planning will allow time to address unanticipated complexities and will offer greater flexibility in maximizing the use of internal resources by spreading the implementation effort over a longer period.

Entities should therefore take steps to understand the new standard and then to evaluate the effects of the transition methods on their financial reporting. Although some entities may consider that the impacts are minimal, with the mandatory effective date fast approaching it is no longer appropriate to wait to evaluate the transition options. Some entities will be faced with substantial impacts requiring major effort, and should therefore start planning as soon as possible.
Entities should consider the following actions.

1. **Perform a high-level gap analysis to identify potential drivers of accounting change**
2. Determine the population of contracts that may need to be restated
3. Begin assessing the information that will be needed and compare this to currently available information to identify potential data gaps
4. Identify the qualitative factors that may influence the choice of transition methods and consider engaging key stakeholders to understand which factors are valued most
5. Ensure that transition methods are evaluated in conjunction with the broader implementation effort for the new standard
6. Monitor the activities of implementation groups established by the FASB/IASB and AICPA

Entities may want to consider implementing a sub-group within the overall project team responsible for implementation to focus on transition options.

For additional examples on applying the transition methods, refer to our publication *Transition to the new revenue standard*.

### 14.6 Other considerations

#### Observations

**Impact broader than just accounting**

Entities should evaluate how the new standard will affect their organization and the users of their financial statements. Among other things, management should consider:

- what training will be required for both finance and non-finance personnel, including the board, audit committee, senior management, and investor relations;
14 Implementation considerations

- the potential need to renegotiate current business contracts that include financial measures driven by revenue – e.g. a debt agreement with loan covenants;
- the effect on management compensation metrics if they will be affected by the new standard;
- what changes may be required to forecasting and budgeting processes; and
- communication plans to stakeholders – e.g. investors, creditors, customers, and suppliers.

In situations where there is a significant impact on the entity, effective governance will be a key element of a successful implementation. This includes input from and involvement of the audit committee, a steering committee, and a program management team.

The SEC has noted that it should be a high priority for companies to develop a change management plan that can be discussed with audit committees, executive management, and auditors.

**Resource constraints and competing priorities**

Entities will likely have competing priorities that demand attention and resources. For example, an entity can be planning a change in a business model, new products, or IT system upgrades. Entities also need to consider their efforts associated with the adoption of other new standards – e.g. on leases and financial instruments.

With competing priorities, effective management is critical. Entities will have to identify projects and initiatives that require coordination and prioritize them across people, process, technology, and governance. Developing a portfolio management strategy, governance framework, and performance measures will help to achieve desired goals.

To assess the impact of the new standard, an entity needs to have a detailed understanding of the business and its customer contracts and related costs. This knowledge resides with internal resources and entities will likely need to reconsider priorities for other projects or shift responsibilities to provide capacity to those required to be involved in implementing the new standard. Entities need to consider their budget processes and the challenges created by the degree of uncertainty about the level of change and required investment (e.g. how investment dollars to support the implementation are obtained if the required changes cannot be articulated).
Cross-functional efforts required during implementation

The implementation of the new standard will involve a diverse group of parties within the entity and outside of the entity and may require a significant effort from some groups. It will be challenging for entities to effectively and efficiently manage their implementation without senior leader buy-in that will influence the level of prioritization and cross-functional coordination.

In addition to Tax and IT departments, the following groups may need to be involved in the impact assessment and implementation of the new standard.

- **Multi-locations**: It will be important for entities to consider multi-locations both in the approach to implementation and in the impact assessment. For example, how will different lines of businesses or locations be involved in the impact assessment? Where do the controls and processes reside? Are the processes different depending on the location? Are the multi-locations appropriately trained?

- **Shared services**: The impact to shared services departments and the need to engage them in the impact assessment, design of new controls, and execution of new controls will need to be evaluated.

- **Business operations and legal**: Business operations will likely need to be involved in the impact assessment because an entity may face some issues that it did not face under current GAAP and will require a detailed understanding of the business. In addition, terms of contracts with customers will need to be reviewed by legal experts to analyze legal enforceability.

- **Sales and marketing, contracting and pricing**: The new standard requires an entity to account for all customer promises (explicit and implicit). Understanding contractual terms and why goods or services are priced in a certain way in contracts may be important to the conclusion on the accounting. This may require involvement from sales or marketing departments. Also, the new standard requires an entity to estimate stand-alone selling prices of goods or services that may never be sold separately. This may require the involvement of contracting and pricing department.

- **Financial planning and analysis (FP&A)**: The new standard may require entities to make various judgments and estimates that are not necessary under current GAAP. This may require significant involvement from FP&A groups.

- **Human resources**: Human resources departments may need to be involved in the assessment and implementation of the new standard because it may have an impact on the accounting for compensation plans, such as commissions and bonuses. Commissions may need to be capitalized under the new standard and therefore require re-evaluation and new controls, which typically reside within human resources departments.

- **Internal audit**: Entities and their audit committees will need to determine the most appropriate way to use internal audit in the implementation.

- **Investor relations**: Investor relations departments for public entities will need to be involved to assess the needs of its investors when selecting a transition method. They will also be key to communicating the impact of the new standard to investors.
Less predictable revenue metrics

As entities evaluate the changes in their revenue recognition patterns, management may determine that there is more volatility and less predictability under the new standard. As a result, entities need to develop internal and external communication plans so that interested parties can understand the implications of the new measures on historical and current key performance indicators. Entities may also adjust their long-term incentive plans with revenue-based metrics.

Communication with key stakeholders

Communication between management, the audit committee, and the external auditor is key to ensuring successful implementation. Management may want to discuss key transition considerations with the audit committee, including:

- whether the entity expects a significant change to its current accounting policies and disclosures;
- historical data availability and the importance of telling a consistent story about revenue trends;
- investors’ perceptions about revenue that bypasses profit or loss or is reported twice, or about one-time acceleration of an existing trend;
- the entity’s readiness for change, including IT systems and accounting, legal, sales, and tax knowledge of the new standard;
- whether the entity has long-term contracts, including their volume, duration, uniqueness, and significance; and
- comparability with industry peers.

As entities proceed with implementing the new standard, they should also consider the timing and content of communications to investors, analysts, and other key stakeholders, including:

- the expected impact of the new standard on the entity;
- the transition method that will be applied; and
- when the new standard will be adopted.
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