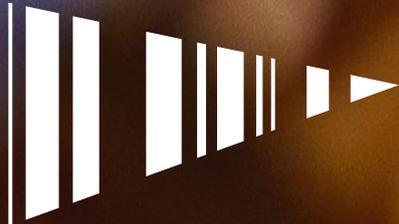


Applying IFRS in Technology

The new revenue recognition standard - technology

January 2015



EY

Building a better
working world

Overview

Technology entities may need to change their revenue recognition policies and practices as a result of IFRS 15 *Revenue from Contracts with Customers*, a new standard jointly issued by the International Accounting Standards Board (the IASB) and the Financial Accounting Standards Board (the FASB) (collectively, the Boards). The new revenue recognition standard will supersede virtually all revenue recognition standards in IFRS and US GAAP, including any industry-specific requirements that technology entities may use today.

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

The new standard could change practice for technology entities that sell their products through distributors or resellers. Under IAS 18 *Revenue*, if the sale price charged to the distributor or reseller is not finalised until the product is sold to the end-customer, entities may wait until the product is sold to the end-customer to recognise revenue. Under the new standard, based on the facts and circumstances of an arrangement, technology entities could reach different conclusions than they do today and recognise revenue earlier because they will be required to estimate variable consideration and include these amounts in the transaction price, subject to a constraint. Applying the constraint on variable consideration introduces a threshold for recognition and measurement that differs from IAS 18.

The requirement to capitalise the incremental costs of obtaining a contract (e.g., sales commissions), if the entity expects to recover them, will also be a significant change for entities that expense such costs. The practice is divided today. Some technology entities may already capitalise these costs under current IFRS. However, entities will need to evaluate if there will be any changes to the amounts capitalised under the new requirements.

This publication considers the key implications of IFRS 15 for technology entities. It provides an overview of the revenue recognition model in IFRS 15 and highlights key considerations for the technology industry, such as accounting for contract modifications, warranties, customer options, non-refundable upfront fees, principal versus agent considerations, right of returns, extended payment terms, consignment and bill-and-hold arrangements. This publication supplements our *Applying IFRS, A closer look at the new revenue recognition standard* (June 2014)¹ (general publication) and should be read in conjunction with that publication. For a discussion of the key considerations for technology entities that currently apply software requirements, refer also to our *Applying IFRS, The new revenue recognition standard - software and cloud services* (January 2015).

¹ Available on www.ey.com/ifrs

To support stakeholders in the implementation of the new standard, the Boards have established a Joint Transition Resource Group for Revenue Recognition (TRG). The TRG was created to help the Boards determine whether additional interpretation, application guidance or education is needed on implementation issues and other matters submitted by stakeholders. The TRG will not make formal recommendations to the Boards or issue guidance. Issues highlighted in this publication have been, and continue to be, discussed by the TRG. Technology entities should closely follow the TRG's discussions and possible subsequent discussions by the Boards.

The American Institute of Certified Public Accountants (AICPA) established a software industry task force as one of 16 industry task forces that have been formed to help develop a new Accounting Guide on revenue recognition under US GAAP and to aid industry stakeholders in implementing the standard. The software task force will focus on software issues and possibly broader issues related to technology entities. Any views discussed by the TRG or guidance produced by the AICPA is non-authoritative.

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

Contents

| | |
|--|----|
| Overview | 1 |
| 1. Summary of the new standard | 5 |
| 2. Effective date and transition | 5 |
| 3. Scope | 6 |
| 4. Identify the contract with the customer | 6 |
| 4.1 Contract modifications | 8 |
| 5. Identify the performance obligations in the contract | 9 |
| 5.1 Maintenance services..... | 12 |
| 5.2 Customer options for additional goods or services..... | 12 |
| 5.3 Non-refundable upfront fees..... | 13 |
| 5.4 Principal versus agent considerations..... | 13 |
| 6. Determine the transaction price | 15 |
| 6.1 Variable consideration | 15 |
| 6.2 Significant financing component | 19 |
| 6.3 Consideration paid or payable to a customer..... | 19 |
| 7. Allocate the transaction price to the performance obligations.. | 20 |
| 8. Satisfaction of performance obligations | 21 |
| 8.1 Consignment arrangements..... | 22 |
| 8.2 Bill-and-hold arrangements..... | 23 |
| 9. Reseller and distributor arrangements | 23 |
| 10. Contract costs | 24 |
| 10.1 Costs of obtaining a contract | 24 |
| 10.2 Costs of fulfilling a contract | 25 |
| 10.3 Amortisation and impairment | 26 |
| 11. Warranties | 26 |
| 12. Next steps | 27 |

What you need to know

- ▶ IFRS 15 creates a single source of revenue requirements for all entities in all industries. Although principles-based, like current IFRS, the new standard may result in a significant change and will require technology entities to exercise more judgement than they do currently.
- ▶ The new standard applies to revenue from contracts with customers and replaces all of the revenue standards and interpretations in IFRS, including IAS 11 *Construction Contracts*, IAS 18 *Revenue* and related Interpretations. When there are more than two parties to an arrangement, determining whether to present gross or net revenue for the sale of goods or services will continue to be challenging and require significant judgement.
- ▶ IFRS 15 could change practice for technology entities that sell their products through distributors or resellers, potentially accelerating the recognition of revenue.
- ▶ Entities will be required to capitalise incremental costs of obtaining a contract (e.g., sales commissions) that meet certain criteria. This will change practice for entities that currently expense such costs.
- ▶ The recognition and measurement requirements in IFRS 15 also apply to the sale of certain non-financial assets.
- ▶ The standard is effective for annual reporting periods beginning on or after 1 January 2017, with early adoption permitted.

1. Summary of the new standard

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

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

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

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

2. Effective date and transition

IFRS 15 effective for annual periods beginning on or after 1 January 2017. Early adoption is permitted for IFRS preparers and first-time adopters of IFRS.

The effective date of the standard for public entities applying US GAAP is for fiscal years beginning after 15 December 2016, which is essentially the same as for IFRS preparers. However, US public entities will not be permitted to early adopt the standard.²

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

Under the modified retrospective approach, financial statements will be prepared in the year of adoption using IFRS 15, but prior periods would not be adjusted (i.e., they will continue to be presented in accordance with prior revenue standards). Instead, an entity will recognise a cumulative catch-up adjustment to the opening retained earnings (or other appropriate component of equity) at the date of initial application for contracts that still require performance by the entity (i.e., contracts that are not completed). In addition, an entity will have to disclose the amount by which each financial statement line item was affected as a result of applying IFRS 15 and an explanation of significant changes.³

² US non-public entities will be required to apply the new standard to reporting periods beginning after 15 December 2017. Early adoption is permitted, but not prior to reporting periods beginning after 15 December 2016.

³ For more information about the effective date and transition options, see our *Applying IFRS, A closer look at the new revenue recognition standard*, available at ey.com/ifrs.

3. Scope

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

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

4. Identify the contract with the customer

The model in IFRS 15 applies to each contract with a customer. Contracts may be written, oral or implied by an entity's customary business practices, but must be legally enforceable and meet specified criteria.

The Boards acknowledged that the determination of whether an arrangement has created enforceable rights is a matter of law and the factors that determine enforceability may differ by jurisdiction. In addition, the Boards identified certain criteria that must be present in order for an arrangement to meet the definition of a contract within the scope of the model in IFRS 15. These criteria include: approval of the contract by all parties; identification of each party's rights in respect of goods and services to be transferred and the associated payment terms; and determination that the contract has commercial substance. In addition, an entity must conclude that it is probable that it will collect the consideration to which it expects to be entitled in exchange for the goods or services that will be transferred to the customer. These criteria are assessed at contract inception. If met, they are not reassessed, unless there is a significant change in facts and circumstances. An entity is also required to combine two or more contracts that it enters into at, or near, the same time with the same customer and account for them as a single contract, if they meet specified criteria.

Contracts may be written, oral or implied by an entity's customary business practices, but must be legally enforceable.

How we see it

Regardless of whether a contract is written, oral or implied, entities will need to exercise judgement to determine whether the contract creates enforceable rights and obligations. For example, a customer may sign and return a contract that the entity has not yet signed. Careful consideration of the facts and circumstances will be required to determine when enforceable rights and obligations exist. This evaluation will be affected by laws or legal precedent involving enforceability in the relevant jurisdiction and will require significant judgement.

Technology entities will need robust documentation to demonstrate that a contract is legally enforceable. Technology entities may also need to develop or update processes to reflect the change in the accounting requirements.

An assessment of collectability is included as one of the criteria for determining whether a contract with a customer exists. That is, an entity must conclude that it is probable that it will collect the consideration to which it expects to be entitled (i.e., the transaction price). The transaction price may differ from the stated contract price (e.g., if an entity intends to offer a concession and accept an amount less than the contractual amount). When performing the collectability assessment, an entity only considers the customer's ability and intention to pay the expected consideration when due. This criterion essentially acts as a collectability threshold similar to current IFRS, in which revenue is only recognised if it is probable that the economic benefits associated with the transaction will flow to the entity (assuming the other revenue recognition criteria have been met).

However, the Boards acknowledged that an entity may enter into an arrangement not expecting to collect the full contractual amount (e.g., the contract contains an implied price concession). Therefore, the entity needs to assess collectability of the amount to which it expects to be entitled, rather than the stated contractual amount. While this requirement is similar to current IFRS, applying the concept to a portion of the contractual amount, instead of the total, is a significant change. This difference could result in the earlier recognition of revenue for arrangements in which a portion, but not the entire amount, of the contract price is considered to be at risk. Refer to Section 6 below on determining the transaction price.

Illustration 4-1 – Collectability is probable

Tech Co. decides to enter a new region that is currently experiencing economic difficulty. Tech Co. expects the economy to recover over the next two to three years and determines that building a relationship in the current environment could result in potential growth in future years. Tech Co. enters into an arrangement with a customer in the new region for networking products for promised consideration of CU1 million. At contract inception, Tech Co. expects that it may not be able to collect the full amount from the customer.

Assuming the contract meets the other criteria to be within the scope of the model in IFRS 15, Tech Co. assesses whether collectability is probable. In making this assessment, Tech Co. considers whether the customer has the ability and intent to pay the estimated transaction price, which may be an amount less than the contract price (e.g., the entity may offer a price concession to the customer). For the purpose of this example, assume Tech Co. determines at contract inception that it may be forced to grant the customer a price concession and it is willing to do so, up to CU200,000, if necessary. As a result, Tech Co. determines that the amount to which it expects to be entitled is CU800,000. It performs the collectability assessment based on that amount, rather than the contractual price of CU1 million.

Refer to our discussion of implied price concessions in the variable consideration in Section 6.1.1 below.

How we see it

Technology entities may struggle with applying the collectability criterion. Under current IFRS, when technology entities have significant concerns about whether they will collect the stated contractual amount (i.e., they are unable to conclude that it is probable that the economic benefits will flow to the entity), they may defer the recognition of revenue until cash is collected. Under the new standard, technology entities will need to carefully evaluate the customer's ability and intent to pay the amount to which they expect to be entitled, which may not necessarily be the stated contractual price. As a result, entities may reach different conclusions than they do today and may recognise revenue earlier in some cases.

4.1 Contract modifications

A contract modification is a change in the scope or price (or both) of a contract. Changes to existing contracts, such as modifications to the quantity or placement of online advertisements that would change the contract price, are examples of contract modifications that may occur in technology arrangements.

An entity must determine whether the modification creates a separate contract or whether it will be accounted for as part of the existing contract. Two criteria must be met for a modification to be treated as a separate contract: (1) the additional goods and services are distinct from the goods and services in the original arrangement (see Section 5); and (2) the amount of consideration expected for the added goods and services reflects the stand-alone selling price of those goods or services (see Section 7). Only modifications that meet these criteria can be treated as separate contracts. In determining the stand-alone selling price, entities have some flexibility, depending on the facts and circumstances. For example, an entity may conclude that, with additional purchases, a customer qualifies for a volume-based discount.

Illustration 4-2 – Contract modification represents a separate contract

Tech Co. enters into an arrangement to provide subscription-based services to a customer over a 12-month period for CU1 million. After six months, Tech Co. and the customer agree to modify the contract by adding another 12 months of subscription-based services. The price for the additional service is CU800,000. Tech Co. determines that the additional 12 months of subscription-based services are distinct, and the pricing for the additional term of subscription-based services reflects the stand-alone selling price of the services at the time of the contract modification, adjusted for the discount frequently awarded to returning customers. The contract modification is considered a separate contract for the additional months of services and would not affect the accounting for the existing contract.

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

- ▶ A termination of the original contract and creation of a new contract (i.e., on a prospective basis), if the goods and services subject to the modification are distinct from the other goods and services provided within the original contract, but the consideration does not reflect the stand-alone selling price of those goods or services.
- ▶ A continuation of the original contract if the goods or services added or removed are not distinct from the goods and services already provided. Such modifications are accounted for on a cumulative catch-up basis.

Illustration 4-3 – Contract modification for additional products at a price that does not reflect the stand-alone selling price

A semi-conductor entity promises to provide 1,000 micro-processors to the customer for CU100,000 (CU100 per unit). The goods are transferred to the customer over a six-month period. The entity transfers control of each product upon delivery. After the entity has transferred 300 micro-processors, the contract is modified to require the delivery of an additional 500 micro-processors to the customer (i.e., total of 1,500 micro-processors).

The price for the additional 500 micro-processors is CU25,000 (CU50 per unit). The price for the additional micro-processors does not reflect the stand-alone selling price at the time the contract is modified and, therefore, does not meet the criteria to be accounted for as a separate contract. Since the remaining products are determined to be distinct from those already transferred (see Section 5), the semi-conductor entity accounts for the modification as a termination of the original contract and creation of a new contract.

The amount of revenue recognised for the remaining products under the new contract is a blended price of CU79.17 $\{[(700 \text{ micro-processors not yet transferred} \times \text{CU100}) + (500 \text{ micro-processors to be transferred under the contract modification} \times \text{CU50})] \div 1,200 \text{ remaining micro-processors}\}$.

5. Identify the performance obligations in the contract

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

Promised goods and services represent separate performance obligations if they are:

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

Or

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

A good or service (or bundle of goods and services) is distinct if the customer can benefit from the good or service on its own or together with other readily available resources (i.e., the good or service is capable of being distinct) and the good or service is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract). A promised good or service that an entity determines is not distinct is combined with other goods or services until a distinct performance obligation is formed.

Technology entities commonly enter into transactions involving the delivery of multiple goods and services, such as professional services provided in conjunction with hardware and networking or hosting services. Goods or services promised in a contract with a customer can be either explicitly stated in the contract or implied by an entity's customary business practice (e.g., free access to a vendor's online mobile controller application with the purchase of its audio hardware). IFRS 15 requires entities to consider whether the customer has a valid expectation that the entity will provide a good or service even when it is not explicitly stated. If the customer has a valid expectation, the customer would view those promises as part of the goods or services provided under the contract.

Goods or services promised in a contract can be either explicitly stated or implied by an entity's customary business practice.

How we see it

Current IFRS does not specifically address contracts with multiple components. IAS 18 indicates that an entity may need to apply its recognition criteria to separately identifiable elements in order to reflect the substance of the transaction.⁴ As a result, many IFRS preparers look to US GAAP for guidance in this area.

The first step of the two-step process to determine whether goods or services are distinct is similar to the principles for determining separate units of account under today's US GAAP requirements in the Accounting Standards Codification (ASC) 605-25 *Revenue Recognition – Multiple-Element Arrangements*. However, the second step (to determine if the goods or services are distinct within the context of the contract) is a new requirement. Therefore, entities may reach different conclusions about separate performance obligations under IFRS 15 than they do under current practice.

Technology entities will need to consider whether the good or service is separable from other promises in the contract, which may be challenging and will require judgement.

⁴ IAS 18.13

Illustration 5-1 – Bundling inseparable goods and services

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

Scenario A – All goods and services sold separately

Entity Z determines that all of the individual goods and services in the contract are distinct because the entity regularly sells each element of the contract separately. Entity Z also determines that the goods and services are separable from other promises in the contract because it is not providing a significant service of integrating the goods and services and the level of customisation is not significant. Furthermore, because the customer could purchase (or not purchase) each good and service without significantly affecting the other goods and services purchased, the goods and services are not highly dependent on, or highly interrelated with, each other. Accordingly, the hardware, professional services and hosting services are each accounted for as separate performance obligations.

Scenario B – Hardware not sold separately

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

Entity Z must determine which promised goods and services in the contract to bundle with the hardware. Entity Z likely would conclude that because the hardware is integral to the delivery of the hosted software, the hardware and hosting services should be accounted for as one performance obligation while the professional services, which are distinct, would be a separate performance obligation.

5.1 Maintenance services

Entities may provide maintenance services such as telephone support, bug fixes and unspecified upgrades or enhancements on software-enabled products. Under current IFRS, these maintenance services are often treated as a single component (combined with other goods or services).⁵ These services, using terminology taken from current US GAAP, are commonly referred to as post-contract support (PCS), are not unique services contemplated or defined in IFRS 15. As a result, entities must evaluate whether the individual services that comprise what is considered PCS under current US GAAP will be separate performance obligations. For example, a technology entity may conclude that the promise to provide unspecified future upgrades and enhancements is a promised good or service in the contract and, therefore, is a revenue element. The entity may also determine that bug fixes and telephone support are provided to ensure that the software is functioning as promised. As a result, those services are part of the assurance warranty coverage for the software and are not a revenue element (such warranties will be accounted for under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).

However, other entities may conclude that the promise to provide telephone support and bug fixes contains both an assurance warranty (non-revenue element) and service-type warranty (revenue element), as discussed further in Section 11 below.

Furthermore, when the contract includes the promise to provide unspecified future upgrades and enhancements, the entity must determine the nature of that promise. For example, an entity may conclude that it has established a clear pattern of only providing one significant upgrade or enhancement per year, and therefore, the obligation to provide 'future upgrades and enhancements' is actually an obligation to provide this single upgrade or enhancement. Alternatively, if the entity has a history of providing multiple upgrades each year with no clear pattern of timing as to when those upgrades are provided, the entity may conclude that obligation represents more of a 'stand-ready' obligation.⁶

5.2 Customer options for additional goods or services

Under some contracts, entities provide the customer with the right to future purchases of additional products or services for an amount below fair value. Under IFRS 15, such options are separate performance obligations if they provide a material right to the customer that it would not receive without entering into that contract. For example, it may convey a material right if the discount exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market. If an option is a separate performance obligation, a portion of the transaction price is allocated to the option (see Section 7 below). The allocated amount will be deferred until the option is exercised or until the right expires.

⁵ IAS 18.13

⁶ Refer to our *Applying IFRS, The new revenue recognition standard - software and cloud services* for further discussion on specified and unspecified software upgrades, available at ey.com/ifrs.

How we see it

Technology arrangements often include options to purchase additional goods or services that may be priced at a discount, such as sales incentives, contract renewal options (e.g., waiver of certain fees, reduced future rates) or other discounts on future goods or services. Current IFRS does not provide application guidance on how to distinguish between an option and a marketing offer. Nor does it address how to account for options that provide a material right. As a result, some entities may effectively account for such options as marketing offers, even if the options are substantive (i.e., the customer makes a separate buying decision and has the ability to exercise or not exercise its right). Careful assessment of the contractual terms will be important to distinguish between options that are accounted for as separate performance obligations under IFRS 15 and marketing offers. See also Section 11 for a discussion on warranties.

5.3 Non-refundable upfront fees

In many transactions, customers pay an upfront fee at contract inception, which may relate to the initiation, activation or set-up of a good to be used or a service to be provided in the future. Under the standard, entities must evaluate whether non-refundable upfront fees relate to the transfer of a good or service. In addition, the existence of such fees may indicate that there are other implied elements in the contract, such as the option to renew a service at a discounted rate because the upfront fee would not be charged for the renewal period. In such situations, the identified promised goods and services would also include those implied items.

Under IFRS 15, the non-refundable fee is allocated to the identified performance obligations in the contract (which may include some implied performance obligations) and it is recognised as revenue as the performance obligations are satisfied. By requiring allocation of the upfront fees to the future goods or services or renewal options, adoption of IFRS 15 may result in a change in practice for some entities.

5.4 Principal versus agent considerations

If an arrangement involves three or more parties, an entity will have to determine whether it is acting as a principal or an agent in order to determine the amount of revenue to which it is entitled. For example, technology entities may offer a platform to sell virtual or digital goods on behalf of a third party or they may contract with an advertising agency to deliver advertising content to a website or mobile application. When the entity is the principal in the contract, the revenue recognised is the gross amount (i.e., the amount to which the entity expects to be entitled as the principal). When the entity is the agent, the revenue recognised is the net amount (i.e., the amount to which the entity is entitled in return for its services as the agent).

A principal's performance obligations in a contract differ from those of an agent. The standard notes that a principal controls the goods or services before they are transferred to the customer. Consequently, the principal's performance obligation is to transfer the goods and services to the customer. However, an entity that momentarily obtains legal title of a product before legal title is transferred to the customer is not necessarily acting as a principal. In contrast, an agent does not control the goods or services before they are transferred to a customer. The agent is simply facilitating the sale of goods or services to the customer in exchange for a fee or commission. Therefore, the agent's performance obligation is to arrange for another party to provide the goods or services to the customer.

Principal vs agent assessments will continue to be challenging, particularly for the sale of intangible goods.

Entities may find it difficult to determine which party controls an intangible good or service prior to its transfer to the customer. In addition, it is not always clear which party is the customer. For example, for an online game developer, the customer may be the intermediary that provides the social networking platform or it may be the end-customer. Depending on an entity's conclusion, the amount and timing of revenue recognised could differ significantly.

As noted in the standard, for the entity to conclude it is acting as the principal in the arrangement, it must determine that it controls the goods or services promised to the customer before those goods and services are transferred to the customer. Because this determination is not always clear, the standard provides indicators to assist the entity in making it. While the indicators in the new standard are similar to those in current IFRS, they have a different purpose. The indicators in IFRS 15 reflect concepts such as identifying performance obligations and the transfer of control of goods or services. Appropriately identifying the entity's performance obligation in a contract is fundamental to the determination of whether the entity is acting as a principal or an agent.

Judgement will be required to apply the indicators to intangible goods or services because they have been written in respect of tangible goods. There may be additional complexity if the entity does not know the gross amount charged to the end-customer. That might be the case when an intermediary contracts directly with the end-customer and the intermediary pays the entity its portion of the consideration under the arrangement, but does not provide full details of its transaction with the end-customer.

How we see it

As they do today, technology entities will need to carefully evaluate whether a gross or net presentation is appropriate. IFRS 15 includes application guidance on determining whether an entity is a principal or agent in an arrangement that is similar to current IFRS. Entities may, therefore, reach similar conclusions to those under current IFRS.

However, the standard includes the notion of considering whether an entity has control of the goods and services as part of the evaluation, which adds an overarching principle for entities to evaluate in addition to the indicators. This may affect the assessment of whether an entity is a principal or agent in an arrangement.

The TRG discussed the implementation issues involving intangible (or virtual) goods or services when there are more than two parties in an arrangement. The TRG also discussed whether any of the indicators should be weighted more heavily than others.

6. Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled. It includes an estimate of any variable consideration, the effect of a significant financing component (i.e., the time value of money), the fair value of any non-cash consideration and the effect of any consideration paid or payable to a customer. The entitled amount is meant to reflect the amount to which the entity has rights under the present contract. It may differ from the contractual price. For example, there may be variable consideration (if the entity expects to receive or accept an amount less than the stated contract amounts) or if payment is received before or after the entity provides goods or services.

IFRS 15 limits the amount of variable consideration an entity can include in the transaction price to the amount for which it is highly probable that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. That is, the standard requires an entity to apply a constraint on variable consideration. See further discussion in Section 6.1.

For sales and usage-based royalties from licences of intellectual property, IFRS 15 restricts when this consideration is included in the transaction price. The standard requires that these amounts be recognised only at the later of: (a) when the sale or usage occurs; or (b) the performance obligation to which some or all of the sales or usage-based royalty has been allocated is satisfied (in whole or in part).

6.1 Variable consideration

Entities enter into contracts in which a portion of the transaction price could vary because of the contract terms or the entity's intention to act under the contract. For example, such terms could represent rights to return networking equipment, discounts or rebates offered on mobile devices or computer hardware and price concessions provided to customers in emerging markets.

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

Variable consideration will be estimated using either an 'expected value' or 'most likely amount' method, whichever better predicts the consideration to which the entity will be entitled. That is, the method selected is not a free choice. Rather, an entity needs to consider which method it expects to better predict the amount of consideration to which it will be entitled and apply that method consistently for similar types of contracts.

For a number of entities, the treatment of variable consideration under the new standard could represent a significant change from current practice. Under current IFRS, preparers often defer measurement of variable consideration until revenue is reliably measurable, which could be when the uncertainty is removed or when payment is received.

Furthermore, current IFRS permits recognition of contingent consideration, but only if it is probable that the economic benefits associated with the transaction will flow to the entity and the amount of revenue can be reliably measured. Some entities, therefore, defer recognition until the contingency is resolved.

In contrast, the constraint on variable consideration in IFRS 15 is an entirely new way of evaluating variable consideration and is applicable to all types of variable consideration in all transactions. As a result, depending on the accounting treatment that entities currently apply, some entities may recognise revenue sooner under the new standard, while others may recognise revenue later. Greater judgement will also be required to measure revenue.

6.1.1 Implied price concessions

In certain situations, entities may enter into a contract anticipating that they will be unable to fully collect the stated contractual price. When the entity is aware of that risk and still chooses to transact with the customer, there may be an implied price concession in the contract. Under the standard, implied price concessions are components of variable consideration and an entity must estimate these amounts at contract inception. For example, consider a technology entity that has a history of providing a price concession in a specific region that is 40% of the contract price. When determining the transaction price for a contract entered into in that region, the entity may determine that 60% of the contract price is the transaction price. That is, there is an implied price concession for the remaining 40% based on the entity's past practice.

Adjusting for implied price concessions could result in a significant change in practice for some entities. In some cases, entities currently recognise revenue from customers with these types of fact patterns on a cash basis due to the uncertainty in collectability. Although an entity may determine that the likelihood of an adjustment to the stated contract price is high (e.g., because price concessions will be granted), an entity must include its estimate of variable consideration in the transaction price, subject to the constraint, rather than deferring all revenue recognition until the uncertainty has been resolved.

How we see it

Technology entities may find it challenging to distinguish between implied price concessions (i.e., reductions of revenue) and customer credit risk (i.e., bad debt) for collectability issues that were known at contract inception. Technology entities will need to carefully evaluate all facts and circumstances that were available at contract inception, as well as any subsequent events that may affect the customer's ability to pay. Significant judgement will be required when making this determination and documentation of the judgement should be retained. Technology entities should develop clear policies and procedures for these evaluations to ensure consistent application across all transactions.

6.1.2 Right of return

A right of return, either explicitly stated in a contract or implied by an entity's customary business practice, is not a separate performance obligation. However, a right of return in a contract creates variability in the transaction price and, therefore, is a form of variable consideration. Under IFRS 15, an entity will estimate returns and include that estimate as a reduction of the transaction price (subject to the constraint). The entity will recognise the amount of expected returns as a refund liability, representing its obligation to return the customer's consideration. The entity will also recognise a return asset (and adjust cost of sales) for its right to recover the goods returned by the

customer measured at the former carrying amount of the inventory, less any expected costs to recover those goods. The new standard's requirements are not significantly different from current IFRS. However, IFRS 15 specifies the presentation of a refund liability and the corresponding debit entry.

At each reporting date, an entity will remeasure the refund liability and update the measurement of the asset recorded, if any, for any revisions to its expected level of returns, as well as any potential decreases in the value of the products expected to be returned. That is, a returned item is recognised at the lower of the original cost, less the cost to recover the asset or the fair value of the asset at the time of recovery.

Illustration 6-1 – Determine the transaction price - right of return

Entity Y sells networking equipment (such as routers, switches and hubs) and enters into a contract with a customer to sell 1,000 wireless routers for CU20,000 (i.e., CU20 per wireless router). The contract allows the customer to return unused and unopened products within 30 days. Because the contract provides the customer with a right of return, the consideration is variable.

Entity Y has significant experience in estimating returns and uses the expected value method to estimate the consideration to which it expects to be entitled. Entity Y estimates that 2% of the wireless routers will be returned based on historical return data and current expectations. Based on that estimate, Entity Y concludes that the transaction price is CU19,600 [(1,000 wireless routers sold to the customer – (1,000 x 2%) = 980 wireless routers not expected to be returned) x CU20].

Upon transfer of control to the customer, Entity Y recognises revenue of CU19,600, a refund liability of CU400. It also recognises a return asset, and corresponding reduction to cost of sales, at the inventory carrying amount (less any expected costs to recover the goods) of the 20 wireless routers expected to be returned.

The treatment of extended payment terms under IFRS 15 may be a significant change from current practice.

6.1.3 Extended payment terms

Under IFRS 15, when a contract provides the customer with extended payment terms, an entity will need to consider whether those extended payment terms create variability in the transaction price (i.e., are a form of variable consideration) and whether a significant financing component exists. Significant financing components are addressed in Section 6.2 below.

An entity will need to carefully evaluate contracts that include extended payment terms to determine whether it has an intention, or a valid expectation, that it will provide a price concession over the financing term. For example, an entity may have a business practice of providing price concessions in contracts that include extended payment terms in order to negotiate a contract renewal with its customers. Such price concessions are a form of variable consideration, which are required to be estimated at contract inception and deducted from the transaction price.

As discussed in Section 6.1.1 on implied price concessions above, some entities may defer revenue recognition today if their contracts contain extended payment terms. Other IFRS preparers may take a different view, believing that the economic benefits will flow to the entity and the amount of revenue is reliably measurable, and therefore recognise the revenue associated with the extended payment terms.

Depending on the accounting policy choices and judgements applied by an entity previously, some entities may recognise revenue earlier under IFRS 15 despite the extended payment terms, if they determine that the transaction price is not constrained. Others may recognise revenue later, if they had not previously deferred recognising any of the revenue, but will now have to do so when applying a constraint on variable consideration under IFRS 15.

Illustration 6-2 – Extended payment terms

Tech Co. enters into an arrangement with a customer for hardware products on 30 December 20X3 for CU1.5 million. Payment terms are as follows:

- ▶ CU250,000 due 31 January 20X4
- ▶ CU250,000 due 30 April 20X4
- ▶ CU250,000 due 31 July 20X4
- ▶ CU250,000 due 31 October 20X4
- ▶ CU250,000 due 31 January 20X5
- ▶ CU250,000 due 30 April 20X5

Tech Co.'s standard payment terms for such arrangements are net 45 days, and the entity has not provided this type of extended payment terms to customers in the past.

Analysis

Under current IFRS, Tech Co. defers the recognition of revenue because it has no history of offering and collecting on these types of extended terms. In this example, assuming all of the other revenue recognition criteria have been met, the vendor would then recognise revenue as the payments become due or it becomes probable economic benefits will flow to the entity.

Under IFRS 15, if Tech Co. expects that it will be entitled to the entire transaction amount (i.e., it did not anticipate providing concessions or rebates to the customer), the fixed arrangement fee of CU1.5 million will be recognised when control of the hardware products is transferred.

In contrast, assume at contract inception that Tech Co. anticipates that it may provide some amount of concession or discount to the customer because of the extended payment terms. Under IFRS 15, the transaction includes variable consideration and the entity will need to estimate the variable consideration to be included in the transaction price. Tech Co. will consider factors such as the customer's current financial status in estimating the variable consideration. Based on the results of its expected value calculation, Tech Co. estimates a transaction price of CU1.3 million. It also concludes that it is probable that a significant revenue reversal of that amount will not occur. Therefore, in this case, the constraint does not further reduce the amount of variable consideration included in the estimated transaction price. The entity will need to update its estimate of the transaction price throughout the term of the arrangement to depict conditions that exist at each reporting date.

This illustration does not consider whether a significant financing component exists. We discuss that concept further in Section 6.2.

6.2 Significant financing component

Entities often enter into arrangements under which the timing of the payment from the customer does not match the timing of the entity's transfer of goods or services (i.e., the customer pays in advance or in arrears). For example, payments for maintenance services are frequently made up front while those services are provided over the contractual term. As previously discussed, contracts also may include extended payment terms.

An entity is required to adjust the transaction price for the time value of money if there is a significant financing component. It uses the same discount rate that it would use if it were to enter into a separate financing transaction with the customer. The assessment of significance is done at the individual contract level, but IFRS 15 does not specify how this assessment would be made. As a practical expedient, an entity is not required to assess whether the contract contains a significant financing component unless the period between the customer's payment and the entity's transfer of goods or services is greater than one year.

How we see it

Technology entities will need to exercise judgement when assessing the significance of the financing component because the standard does not establish quantitative thresholds for significance. The treatment of the time value of money may have a significant effect on long-term contracts, such as multi-year maintenance arrangements with upfront payments. Even entities that do not believe a financing component is significant will need to make a formal assessment. Technology entities may be able to alleviate the burden of performing the significance assessment by using a practical expedient the Boards provided.⁷

6.3 Consideration paid or payable to a customer

Entities may agree to compensate a retailer up to a specified amount for shortfalls in the sales price or reimburse a customer for marketing activities related to certain products. Consideration payable to a customer is treated as a reduction of the transaction price (and, therefore, of revenue), unless the payment to the customer is in exchange for a distinct good or service. The payment for distinct goods and services received is limited to their fair value, with any amount in excess of the fair value recognised as a reduction of the transaction price.

Entities will need to carefully assess whether the consideration paid to the customer is actually a payment for a distinct good or service or whether it is a reduction of the transaction price for the goods and services the entity is transferring to the customer.

⁷ IFRS 15.63

7. Allocate the transaction price to the performance obligations

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

The stand-alone selling price is the price at which an entity would sell a good or service on a stand-alone basis at contract inception. When determining stand-alone selling prices, the entity is required to use observable information, if available. If stand-alone selling prices are not directly observable, the entity will need to make estimates based on information that is reasonably available. Possible estimation approaches include: (1) an adjusted market assessment approach; (2) an expected cost plus a margin approach; or (3) a residual approach. The use of one, or a combination, of the methods may be appropriate in estimating the stand-alone value of a good or service. Furthermore, these are not the only estimation methods permitted. IFRS 15 allows any reasonable estimation method, as long as it is consistent with the notion of a stand-alone selling price and maximises the use of observable inputs. The entity is required to apply estimation methods consistently in similar circumstances.

The new requirements for the allocation of the transaction price to performance obligations could result in a change in practice for many entities. IAS 18 does not prescribe an allocation method for multiple-element arrangements. IFRIC 13 mentions two allocation methodologies: allocation based on relative fair value; and allocation using the residual method. However, IFRIC 13 does not prescribe a hierarchy. Currently, entities use judgement to select the most appropriate methodology, taking into consideration all relevant facts and circumstances and ensuring the resulting allocation is consistent with IAS 18's objective to measure revenue at the fair value of the consideration.

Given the limited guidance in current IFRS on multiple-element arrangements, some entities look to the multiple-element arrangement literature in ASC 605-25 *Revenue Recognition - Multiple-Element Arrangements* to develop their accounting policies. The requirements in IFRS 15 are generally consistent with the estimation concepts in ASC 605-25, which set out a hierarchy starting with vendor-specific objective evidence (VSOE), then third-party evidence and then best estimate of selling price for determining selling price for each unit of account. IFRS 15, however, does not require an entity to follow the hierarchy.

Some entities may find it difficult to determine a stand-alone selling price, particularly for goods or services for which the historical selling price is highly variable or for goods or services that have not yet been sold or are never sold separately. IFRS 15 says an entity may be able to estimate the stand-alone selling price of a performance obligation using a residual approach if: (1) the entity sells the same good or service to different customers for a broad range of amounts (i.e., the selling price is highly variable); or (2) the entity has not yet established a price for that good or service (i.e., the selling price is uncertain).

IFRS 15 requires entities to estimate the stand-alone selling price of options that provide the customer with a material right.

Under IFRS 15, entities are required to estimate the stand-alone selling price of options for additional goods or services that provide the customer with a material right. Instead of estimating the stand-alone selling price of an option, entities may apply a practical alternative provided in the standard when the optional goods or services are both: (1) similar to the original goods and services in the contract; and (2) provided in accordance with the terms of the original contract (which may be common for contract renewals). Under this alternative, instead of valuing the option itself, the entity can assume the option is going to be exercised and include the optional additional goods and services (and related consideration) with the identified performance obligations when allocating the transaction price.

8. Satisfaction of performance obligations

An entity recognises revenue only when it satisfies a performance obligation by transferring control of a promised good or service to the customer. Control of an asset refers to the ability of the customer to direct the use of and obtain substantially all of the cash inflows, or the reduction of cash outflows, generated by the goods or services. Control also means the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service.

The standard indicates that an entity must determine at contract inception whether it will transfer control of a promised good or service over time.

If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. A performance obligation is satisfied at a point in time unless it meets one of the following criteria to be satisfied over time:

- ▶ The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs - by providing hosting services, for example.
- ▶ The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced. An example would be installing network equipment on the customer's premises, if the customer controls the equipment during the installation period.
- ▶ The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date. An example would be significantly customising an asset to the customer's specifications and the entity also has a right to payment for performance completed to date. As a result of the customisation, it is less likely that the entity would be able to use the asset for another purpose (e.g., sell to a different customer) without incurring significant costs to re-purpose the asset.

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

Output methods are used to recognise revenue on the basis of units produced or delivered, contract milestones, time elapsed or surveys of services transferred to date relative to the total services to be transferred. The Boards provided a practical expedient for an entity that has a right to payment from a customer in an amount that corresponds directly with the value of the entity's performance completed to date (e.g., a professional services contract in which a technology entity charges a fixed amount for each hour of service provided) to recognise revenue in the amount for which it has a right to invoice. However, this expedient only applies when the performance obligation is satisfied over time and an output method is used to measure progress.

Input methods are used to recognise revenue on the basis of the entity's efforts (or inputs) to satisfy a performance obligation relative to the total expected inputs needed to satisfy that performance obligation. Input methods can include labour hours used, costs incurred, time elapsed or machine hours used. The standard does not indicate a preference for either type of method (output or input). However, it does require that the selected method be applied consistently to similar performance obligations and in similar circumstances.

Although IFRS 15 requires an entity to update its measure of progress, it does not allow a change in method. For example, it would not be appropriate for a technology entity to start recognising revenue for a performance obligation based on labour hours expended and then switch to milestones reached.

For performance obligations that are not transferred over time, control is transferred at a point in time. For example, when a customer purchases computer hardware, control generally transfers to the customer when the computer hardware is delivered. The standard provides indicators to help entities determine when control transfers, including right to payment, legal title, physical possession, risks and rewards of ownership and customer acceptance.

8.1 Consignment arrangements

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

Entities entering into consignment arrangements must determine the nature of the performance obligation (i.e., whether the obligation is to transfer the inventory to the consignee or to transfer the inventory to the end-customer). Under IFRS 15, this determination is based on whether control of the inventory has passed to the consignee upon delivery. Typically, a consignor will not relinquish control of consignment inventory until the inventory is sold to the end-customer or, in some cases, when a specified period expires. Consignees commonly do not have any obligation to pay for the inventory other than to pay the consignor the agreed-upon portion of the sales price once the consignee sells the product to a third party. As a result, revenue generally would not be recognised for consignment arrangements when the goods are delivered to the consignee because control has not transferred (i.e., the performance obligation to deliver goods to the customer has not yet been satisfied). This result is generally consistent with conclusions under current IFRS requirements.⁸

⁸ IAS 18.IE2

8.2 Bill-and-hold arrangements

In certain technology transactions, the entity fulfils its obligations and invoices the customer for the work performed, but does not ship the goods until a later date. These transactions, often called 'bill-and-hold' transactions, are usually designed this way at the request of the customer for a variety of reasons, including the customer's lack of storage capacity or its inability to use the goods until a later date.

The criteria for determining whether a bill-and-hold transaction qualifies for revenue recognition under the new standard are similar to current IFRS.⁹ We expect that most bill-and-hold transactions that qualify for revenue recognition under current IFRS will also qualify for revenue recognition under IFRS 15. However, consideration of a separate custodial performance obligation (as discussed in IFRS 15.B80) may be new to IFRS preparers, as this is not currently addressed in IAS 18.

9. Reseller and distributor arrangements

IFRS 15 could change practice for entities that sell their products through distributors or resellers.

IFRS 15 also could change practice for entities that sell their products through distributors or resellers (collectively referred to in this section as resellers). It is common in the technology industry for entities to provide resellers with greater rights than end-customers. For example, an entity may provide a reseller with price protection and extended rights of return.

Under IFRS 15, entities will need to first evaluate when control of the product transfers to the end-customer. To do this, first, entities may need to assess whether their contracts with resellers are consignment arrangements, under which control likely would not transfer until delivery to the end-customer (see Section 8.1 above). The standard provides three indicators that an arrangement is a consignment arrangement:

- ▶ The product is controlled by the entity until a specified event occurs (such as the sale of the product to a customer of the dealer) or until a specified period expires.
- ▶ The entity is able to require the return of the product or transfer the product to a third party (such as, another dealer).
- ▶ The dealer does not have an unconditional obligation to pay for the product (although, it may be required to pay a deposit).

An entity does not recognise revenue upon delivery of a product to a reseller if the delivered product is held on consignment because control of the product has not transferred. The entity would wait until the reseller sells the product to an end-customer to recognise revenue, which would be considered the point in time that the entity has transferred control of the product. The result would be similar to today's practice of deferring revenue recognition until the reseller sells the product to an end-customer.¹⁰

If an entity concludes that its contract with a reseller is not a consignment arrangement, the reseller will likely be considered a customer of the entity. The entity is required to recognise revenue upon the transfer of control of the promised goods in an amount that reflects the amount to which the entity expects to be entitled.

In determining the amount to which it expects to be entitled, the entity will be required to consider whether it will provide resellers with explicit or implicit

⁹ IAS 18.IE1

¹⁰ IAS 18.IE2(c), IE6

concessions (e.g., price protection, expanded return rights, stock rotation rights) that will make the transaction price variable. In these instances, the entity will need to estimate the transaction price and, considering the constraint, include only the amount for which the entity determines it is highly probable that a significant reversal will not occur. The entity will need to carefully consider whether it can include the variable consideration resulting from the concessions it offers to its reseller customer(s) in its transaction price. The standard indicates that an entity that 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 as a factor that could increase the likelihood (or magnitude) of a revenue reversal. Entities will need to assess the facts and circumstances of their contracts to determine whether current practice will change under the new standard.

10. Contract costs

Under the new standard, there are two types of contract costs for which an asset must be recognised:

- ▶ Incremental costs of obtaining a contract with a customer if the entity expects to recover those costs
- ▶ Costs incurred in fulfilling a contract with a customer that are not within the scope of another IFRS (e.g., IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*), provided these costs relate directly to a contract (or to an anticipated contract that the entity can specifically identify), generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future and are recoverable

IFRS 15 requires these costs to be recognised as an asset and amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. Impairment assessments are also required for such assets.

10.1 Costs of obtaining a contract

Under IFRS 15, the incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) will be recognised as an asset if the entity expects to recover them. Recovery can be direct (i.e., through reimbursement under the contract) or indirect (i.e., through the margin inherent in the contract). As a practical expedient, the standard permits immediate expense recognition of the contract acquisition costs when the asset that would have resulted from capitalising such costs would have been amortised in one year or less. While not explicitly stated, we believe entities are permitted to choose this approach as an accounting policy election and, if they do, must apply it consistently to all short-term contract acquisition costs.

Today, there is diversity in practice for capitalising costs incurred to obtain a contract because there is limited guidance. IFRS 15 represents a significant change for entities that currently expense the costs of obtaining a contract and will be required to capitalise them under the new standard. In addition, this may be a change for entities that currently capitalise costs to obtain a contract, particularly if the amounts currently capitalised are not incremental and, therefore, would not be eligible for capitalisation under IFRS 15.

Entities will need to exercise judgement when determining whether costs incurred in obtaining a contract are incremental (i.e., costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained). The standard cites sales commissions as an example of an incremental cost that may require capitalisation under the standard. In contrast, bonuses and other compensation that are based on other quantitative or qualitative metrics (e.g., profitability, earnings per share, performance evaluations) likely do not meet the criteria for capitalisation because they are not directly related to obtaining a contract. Entities also may pay commissions upon the renewal of a contract or bonuses based on the achievement of an individual's sales goal or total bookings. Other bonus programmes may have escalation provisions under which the bonus amount increases as an individual meets performance targets. The standard provides little additional guidance about the types of costs that may be considered incremental to obtaining a contract. As such, this determination may be difficult for entities, particularly when such costs relate to multiple contracts or are incurred over a period of time.

10.2 Costs of fulfilling a contract

Entities may incur certain costs to fulfil a contract, such as set-up costs in hosting arrangements. An entity will, first, apply other standards to account for such costs (e.g., software development costs under IAS 38, inventory under IAS 2 and property, plant and equipment under IAS 16). If such costs are not within the scope of another standard, an entity will apply the requirements in IFRS 15. Under IFRS 15, entities will capitalise the costs to fulfil a contract if they relate directly to the contract, generate or enhance the resources used to satisfy performance obligations and are expected to be recovered.

The standard discusses and provides examples of costs that meet the first criterion for capitalisation (i.e., costs that relate directly to the contract). Examples include direct labour, direct materials, allocation of costs directly related to the contract, costs explicitly chargeable to the customer and other costs that are only incurred because the entity entered into the contract.

In order for costs to meet the 'expected to be recovered' criterion, they need to either be explicitly reimbursable under the contract or reflected in the pricing in the contract and recoverable through margin. The standard does not specify whether contract costs should be recoverable over the stated contractual period or the period of expected performance (i.e., the customer life). However, because the standard states that the amortisation period can exceed the contract period, it is likely that entities will use that longer period in determining whether contract costs are recoverable (i.e., using the customer life for this determination).

How we see it

The requirements to capitalise incremental costs of obtaining a contract and direct costs of fulfilling a contract may represent a significant change for technology entities that currently expense such costs as incurred.

Although the standard requires incremental costs of obtaining a contract to be capitalised (unless the practical expedient is applied), it is unclear whether certain costs will be considered incremental such as bonuses paid for total bookings or meeting individual sales targets (e.g., costs associated with obtaining a group of contracts).

10.3 Amortisation and impairment

Any capitalised contract costs are amortised on a systematic basis that is consistent with the transfer of the goods or services to which the asset relates. The standard permits entities to take into account the expected renewal period in their assessment of the appropriate amortisation period.

Any asset recorded by the entity is subject to an ongoing impairment assessment. An impairment exists if the carrying amount of any asset(s) exceeds the unconstrained amount of consideration the entity expects to receive in exchange for providing those goods and services, less the remaining costs that relate directly to providing those good and services.

Illustration 10-1 – Amortisation period

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

At the beginning of the third year, the customer renews the contract for an additional two years. Because Tech Co. will benefit from the set-up costs during the additional two-year period, it would change the remaining amortisation period from one year to three years. It adjusts the amortisation expense recognised in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* on changes in estimates.

However, if Tech Co. had anticipated the contract renewal at contract inception, Tech Co. would have amortised the set-up costs over the anticipated term of the contract, including the expected renewal (i.e., five years).

11. Warranties

A customer may have the option to separately purchase a warranty on a product (e.g., computer hardware, networking equipment) for a period of time at the point of sale or the warranty may be explicitly stated in the contract. The standard identifies two types of warranties:

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

If the customer has the option to purchase the warranty separately or if the warranty is not separately priced or negotiated, but provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a service-type warranty. This type of warranty represents a distinct service and is a separate performance obligation. Revenue related to the warranty is recognised over the period the warranty service is provided. This may represent a change from current practice, particularly in relation to the amount of transaction price that is allocated to the warranty performance obligation. Currently, entities that provide separate extended warranties may often defer an amount equal to the stated price of the warranty and record that amount as revenue evenly over the warranty period. IFRS 15 requires an entity to defer an allocated amount, based on a relative stand-alone selling price allocation, which, in most cases, will increase judgement and complexity.

Assurance-type warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a guarantee on quality (e.g., to replace or repair a defective product). Such warranties will continue to be accounted for in accordance with IAS 37.

If an entity provides both assurance-type and service-type warranties within an arrangement, it is required to accrue for the expected costs associated with the assurance-type warranty and account for the service-type warranty as a performance obligation. If the entity cannot reasonably account for them separately, the warranties are accounted for as a single performance obligation (i.e., revenue would be allocated to the combined warranty and recognised over the period the warranty services are provided).

12. Next steps

We encourage technology entities to gain an understanding of IFRS 15 and evaluate how it will affect their specific revenue recognition policies and practices.

Entities should perform a preliminary impact assessment so they can determine how to prepare to implement the new standard. While the effect on entities will vary, some may face significant changes in revenue recognition. All entities will need to evaluate the requirements of the new standard and make sure they have processes and systems in place to collect the necessary information to implement the standard and make the required disclosures, even if their accounting results will not change significantly or at all. This includes an evaluation of the impacts and whether any changes will be required to their accounting policies, accounting systems or internal controls over financial reporting.

Entities may also wish to monitor the discussions of the Boards, TRG and the software industry task force formed by the AICPA to discuss interpretations and the application of the new standard to common transactions.¹¹

Technology entities should also consider how they will communicate the changes with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards which are issued, but not yet effective, as required under IAS 8 *Accounting Policies, Changes in Accounting Estimate and Errors*.

¹¹ For more information see <http://www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/pages/revenuerecognition.aspx>

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

About EY's International Financial Reporting Standards Group

A global set of accounting standards provides the global economy with one measure to assess and compare the performance of companies. For companies applying or transitioning to International Financial Reporting Standards (IFRS), authoritative and timely guidance is essential as the standards continue to change. The impact stretches beyond accounting and reporting, to key business decisions you make. We have developed extensive global resources – people and knowledge – to support our clients applying IFRS and to help our client teams. Because we understand that you need a tailored service as much as consistent methodologies, we work to give you the benefit of our deep subject matter knowledge, our broad sector experience and the latest insights from our work worldwide.

© 2015 EYGM Limited.
All Rights Reserved.

EYG No. AU2829
ED None



In line with EY's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.