Applying IFRS

The revenue recognition standard – automotive industry

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What you need to know

- Application of the requirements of IFRS 15 requires automotive entities to use a significant degree of judgement.
- Original equipment manufacturers and automotive parts suppliers may identify several performance obligations that they may not traditionally have considered to be promises to a customer.
- Automotive parts' suppliers may be required to recognise revenue for contracts to supply customised parts over time, while revenue for many industrial products might be recognised at a point in time, e.g., upon completion of the performance obligation.
- The standard has now been effective from annual periods beginning on or after 1 January 2018, with early adoption permitted. Some clarifications were released in 2016, but there was no change to the underlying principles of IFRS 15.

Overview

Some automotive entities (including automotive parts suppliers (APSs) and original equipment manufacturers (OEMs)) needed to change certain revenue recognition practices as a result of applying the revenue recognition standard, IFRS 15 *Revenue from Contracts with Customers*, that was jointly issued by the International Accounting Standards Board (the IASB) and the Financial Accounting Standards Board (the FASB) (collectively, the Boards). These standards superseded virtually all previous revenue recognition requirements in IFRS and US GAAP.

IFRS 15 includes accounting requirements for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers in the ordinary course of business (except for contracts that are specifically excluded from the scope of IFRS 15, such as lease contracts within the scope of IFRS 16 *Leases*). The standard also provides a model for the measurement and recognition of gains and losses arising from the sale of certain non-financial assets, such as property, plant and equipment (PP&E) and intangible assets.

To support stakeholders with the implementation of the new standard, the Boards established a Joint Transition Resource Group for Revenue Recognition (TRG). The TRG was created to help the Boards determine whether more application guidance or education is needed on implementation issues and other matters submitted by stakeholders. Work carried out by the TRG led to clarifications to the standards, but did not led to any fundamental change. This publication summarises the key implications of the IASB's standard (including all amendments) for automotive entities. Separately, the American Institute of Certified Public Accountants (AICPA) had established 16 industry task forces to help develop a new accounting guide on revenue recognition and to aid industry stakeholders in implementing the standard. A task force has not been established for the automotive industry. Views or guidance produced by the TRG or AICPA is non-authoritative.

This publication, which contains a summary of the standard in the Appendix, supplements our Applying IFRS, *A closer look at IFRS 15, the revenue recognition standard* and should be read in conjunction with it.[1]

The topics we cover in this publication are based on the most frequently discussed topics during the implementation phase of the standard and, subsequently, some observed practice developed by Automotive companies. We may identify additional issues as we continue to observe the way the automotive industry is developing (e.g., creating new activities or new ways to operate). Accordingly, the views we express in this publication may evolve as additional issues are identified. Conclusions in seemingly similar situations may differ due to differences in the underlying facts and circumstances.

[1] Available on www.ey.com/IFRS.

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Key considerations primarily for OEMs

When applying IFRS 15, OEMs have to carefully assess the transfer of control for the vehicles sold to their dealers. They also have to analyse their incentive policies, as well as their product warranties, to determine the appropriate accounting treatment under the standard. Sales with repurchase options and residual value guarantees are also typical transactions that need careful consideration. OEMs will have to apply significant judgement to identify separate performance obligations (i.e., units of account).

Transfer of control of the vehicles sold to dealers

An OEM typically sells the vehicles it produces to a dealer, who then sells the vehicles to consumers. Under the standard, an OEM recognises revenue for the sale of a vehicle when it transfers control of the vehicle to its customer (i.e., the dealer). Control of the vehicle transfers to the dealer when the dealer has the ability to direct the use and obtain substantially all the remaining benefits of the vehicle.

Determining the point in time when control of a vehicle has transferred requires an in-depth analysis of the dealership agreements. This may differ depending on the country of operation because of differing local market practices. In addition, specific sales organisations may exist, which may influence the way control of a vehicle is transferred by the OEM to the dealer. Although physical possession is an indication that control has transferred according to IFRS 15, a number of other indicators will also be relevant to the assessment. The ability for dealers to exchange vehicles as soon as they are entered into the distribution system, for example, may be an indication that the control has been transferred by the OEM to its dealers. Other indicators that control has been transferred could include, for example, the transfer of title, when the OEM has the right to payment from the dealer or when the OEM has transferred the significant risks and rewards of ownership to the dealer. None of these indicators is determinative by themselves. Accordingly, the balance between the various indicators should be carefully assessed to make the final determination.

It is also important to remember that, if the control passes to the dealer prior to shipment, the OEM may still have a performance obligation to satisfy to transport the vehicle to the dealer, depending on the terms of the distribution agreement. Unlike IFRS 15, entities reporting under US GAAP can elect to account for shipping and handling activities performed after the control of a good has been transferred to the customer either as a fulfilment cost (i.e., an expense) or as a performance obligation.

Accounting for typical transactions entered into by automotive entities may not be as straightforward as it appears; significant judgement may be required.

Incentives

OEMs frequently offer sales incentives in contracts to sell vehicles to dealers. These sales incentives may include cash rebates, bonuses or other types of incentives made available to dealers and retail customers (who purchase the vehicle from the dealer). These may also include free, or heavily discounted, goods or services provided to retail customers, such as a free satellite radio or free maintenance for a specified period. Under the standard, the accounting for these incentives may differ depending on their nature.

Under IFRS 15, cash incentives (i.e., cash, credits or other items that can be applied against amounts owed to the OEM) paid by the OEM to dealers and retail customers either represent a fixed discount or result in variable consideration. A cash incentive is a discount if the amount is fixed and not contingent on future events. Cash incentives are variable consideration if the amount varies. OEMs may need to review their processes for estimating rebates and other forms of variable consideration to make sure they fully address the requirements for estimating the transaction price (and applying the constraint).

Furthermore, cash incentives are consideration payable to a customer and will generally be treated as a reduction of the transaction price and, therefore, of revenue. In much less frequent cases, the payment to the customer is in exchange for a distinct good or service that the customer transfers to the OEM (for instance, contribution to local advertising). If the OEM is able to reasonably estimate the fair value of the distinct good or service transferred by the customer, the OEM accounts for that purchase in the same way it accounts for other purchases from suppliers.

The accounting for free goods and services offered to customers will depend on the facts and circumstances of the offer. OEMs will need to carefully assess incentives (whether directly from the OEM to retail customers or indirectly through dealers) that provide free or discounted goods to determine whether they represent promised goods or services in their contracts with dealers (i.e., revenue elements or marketing incentives). With increasing diversity in the types of incentives used to sell a car, more careful analysis and judgement is needed. While many of the free goods or services that OEMs offer as sales incentives are ultimately used by the retail consumer after they buy the vehicle from the dealer, they may represent promises the OEM makes to the dealer if those rights existed when the OEM sold the vehicle to the dealer. This applies to both explicit or implicit rights and promises. An example of such indirect incentives provided to a retail customer is free maintenance services performed by a dealer for which the OEM provides reimbursement. The Boards concluded that, even if such incentives are not explicit promises in a contract, they would, nonetheless, be an implied promise if the OEM has a customary business practice that results in the retail customer having a valid expectation that the OEM is obligated to provide the maintenance services. Therefore, such amounts are considered as promises in the contract and the OEM will be required to account for the free services as a revenue element.

Product warranties

Product warranties are included with the sale of a vehicle by an OEM. They are frequently governed by laws and regulations, but an OEM may also specify additional terms that go beyond the minimum required by law.

IFRS 15 specifies two types of product warranties: assurance-type and service-type warranties. Assurance-type warranties provide the customer with assurance that the vehicle will comply with agreed-upon specifications. If the customer has the option to purchase the warranty separately, or if it provides a service to the customer, beyond fixing defects that existed at the time of sale (e.g., covering preventive maintenance to avoid defects occurring in the future or to cover replacement of parts (such as brake pads or clutches) due to use, rather than defects), the entity is providing a service-type warranties.

Assurance-type warranties are within the scope of the IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and OEMs need to recognise a provision for the expected costs associated with the fulfilling the warranty obligation. Although estimating the expected costs may not be straightforward, dealing with this type of warranty provision is common. Service-type warranties are quite different because they constitute a separate performance obligation and require allocation of a portion of the transaction price to it. In this case, an OEM would need to determine the appropriate period of recognition for revenue from the service-type warranty and the appropriate method to measure progress. Measuring the stand-alone selling price of a service-type warranty may not be an easy exercise if an OEM does not sell such warranties separately.

Assessing the type of warranty that is granted may require significant judgement and the conclusion may not be the same for all markets or for all vehicles. The key is in the analysis of the promise made to the customer and in the existence of promises that go beyond repairing what went wrong compared to the agreed-upon specifications of the vehicle. There is no bright line in the standard as to what constitutes a service-type warranty, beyond the requirement that it be separately priced. However, the standard requires entities to consider factors such as whether the warranty is required by law, the length of the warranty coverage and the nature of the tasks that the entity promises to perform.

Repurchase options and residual value guarantees

OEMs may sell vehicles with a repurchase option or a residual value guarantee (e.g., when they sell fleets to rental car companies). While the economics of a repurchase agreement and a residual value guarantee may be similar, the accounting outcome could differ under the standard. In practice, sales with residual guarantees generally have a higher probability of being recognised as sales than vehicles sold with a repurchased option under IFRS 15, because of the transfer of control requirements.

Under IFRS 15, arrangements with repurchase options must be evaluated to determine whether they represent a sale, lease or financing, based on specified criteria. This evaluation includes considering factors such as the likelihood of a customer exercising a put option or the relationship between the repurchase price and the original selling price. IFRS 15 also requires an entity to assess whether the repurchase price is expected to significantly exceed the market value of the asset at the date of the repurchase (and, therefore, provide the customer with a significant economic incentive to exercise the option).

OEMs frequently agree to compensate the customer (‘make whole’) for the difference between the resale price the customer obtains in an open market and the guaranteed minimum resale value. Judgement is needed to determine the appropriate accounting treatment, which will depend on the specific facts and circumstances. In some situations, other IFRSs will apply to the guarantee and IFRS 15 will apply to the sale. In other situations, IFRS 15 will apply to the entire transaction. If IFRS 15 applies, an OEM would need to assess whether the guarantee affects control of the vehicle being transferred, which will depend on the promise to the customer. In some cases, it may not affect the transfer of control (i.e., the customer is not constrained in its ability to direct the use of, and obtain substantially all of the benefits from, the vehicle), but it may affect the transaction price. In practice, the compensation to the customer is generally accounted for by OEMs as variable consideration payable to a customer that reduces of the transaction price.

Significant financing component

For some transactions, the receipt of consideration does not match the timing of the transfer of goods or services to the customer. For example, an OEM may receive consideration in advance for a separately purchased service-type warranty for which the related service is provided over a period of time (typically in excess of the legal warranty period). Under IFRS 15, OEMs need to assess whether that prepayment provides them with a significant benefit of financing.

OEMs are not required to adjust the transaction price for a financing component if, among other things, it is not significant to the contract or the period between the customer's payment and the entity's transfer of the goods or services is less than one year. If the timing of the transfer of the goods or services under maintenance plans or service-type warranties is at the discretion of the customer, the OEM would also not be required to adjust the transaction price for a financing component.

Key considerations primarily for APSs

When applying IFRS 15, APSs need to evaluate long-term supply contracts and their various elements (tooling, development of parts, transfer of control of the parts) and may need to apply significant judgement to identify performance obligations (i.e., units of account).

Identifying a contract with a customer

APSs typically enter into multi-year supply arrangements with OEMs to design, manufacture and supply parts that OEMs use in the production of vehicles. These arrangements usually are governed by a master supply arrangement (MSA) that establishes the overall terms and conditions of the business arrangement between the suppler and OEM. To make a purchase, the customer typically must issue a purchase order or make another approved authorisation that references the MSA and specifies the products and quantities to be delivered. In these types of arrangements, generally an MSA will not create enforceable rights and obligations and will not be considered a contract in the scope of the standard, because each party's rights and obligations regarding the goods to be transferred are not identifiable. This is because, while the MSA may specify the pricing or payment terms, it usually does not include the specific goods or quantities of goods to be transferred. However, it is likely that the MSA and the customer order, taken together, would be considered a contract in the scope of the standard. Therefore, APSs need to evaluate both the MSA and the subsequent customer order(s), together, to determine whether and when the contract criteria in IFRS 15 are met.

Tooling equipment and development of new parts

APSs commonly enter into long-term arrangements with OEMs to provide specific parts, such as instrument panels, steering wheels or mechanical parts for an engine. An arrangement typically includes the construction of the tooling, which is required to be used when manufacturing the parts to meet the OEM's specifications. In many cases, the APS will construct and transfer the legal title for the tooling to the OEM after construction, even though they will retain physical possession of it in order to produce the parts.

APSs need to evaluate whether these activities are promises in a contract with a customer (and potentially performance obligations) under the standard. When making this evaluation, entities need to determine whether the activity transfers a good or service to their customer. For example, if an automotive supplier is performing engineering and tooling development to create a new mold for an OEM to use in production and the OEM prevents the supplier from using it for other purposes than the production for the OEM, the automotive supplier may conclude that it is transferring control of the mold and that the engineering and tooling development activities are a promised good or service in the contract.

Assessing whether control transfers in such arrangements may be challenging for APSs. In some arrangements, legal title of the good or service created by the pre-production activity is transferred to the customer. However, an entity should consider all indicators of control because the transfer of legal title is not a presumptive indicator.[2]

If these activities do not result in the transfer of control of a promised good or service to a customer, APSs should consider other requirements that may be

[2] TRG Agenda paper no. 46, *Pre-Production Activities,* dated 9 November 2015.

applicable (e.g., IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets*, IFRS 15 for costs to fulfil a contract). If an APS determines that these activities are promised goods or services, it must also determine whether or not they are a separate performance obligation.

Under IFRS 15, to determine whether the tooling is a performance obligation, the entity must determine whether the tooling is distinct (i.e., both capable of being distinct and distinct within the context of the contract). In making this determination, an APS will have to consider whether the tooling is separately identifiable from the production of the specified parts (e.g., whether the tooling is highly interdependent on, or highly interrelated with, the production of the specified parts).

An entity recognises revenue when it transfers control of the promised goodor service to the customer, which can occur over time or at a point in time. If the tooling is a performance obligation, an APS would account for the tooling separately from the production of the other specialised parts. Revenue would be recognised for the tooling either over time or at a point in time, depending on how control of the tooling transfers to the OEM. If the tooling is not distinct, the APS would combine the tooling with the production. Revenue would be recognised when (or as) control of the specialised parts are transferred to the OEM.

There may be additional complexity if the tool is used to produce parts for the OEM, but is also used to produce parts for the specialised retail industry (with the OEM's permission) and its use triggers an obligation for the APS to pay a royalty to the OEM.

Development costs for parts specific to the OEM may also be part of arrangements, which have some characteristics that are consistent with tooling arrangements. As a result, and although it is usually less frequent that this activity is distinct (as defined by IFRS 15), the same type of analysis and thought-process should be carried out.

Customised parts

Recognising revenue for the supply of customised parts is less straight forward than it looks.

Under its supply agreements, an APS may provide OEMs with a customised part (e.g., a car seat) that is designed and constructed to specifically fit within a particular make and model of vehicle. In these types of arrangements, APSs have to carefully consider whether each individual part is a separate performance obligation or whether some, or all, the parts supplied in the contract are considered a single performance obligation. After the performance obligations are identified, the APS will also need to evaluate whether the performance obligations meet the criteria for recognising revenue over time (rather than at a point in time, such as when delivery occurs, see Step 5 in the Appendix). While two of the criteria are unlikely to be met for APS contracts, the other criterion, "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",[3] may be met in certain instances. Automotive suppliers need to carefully analyse their contracts to determine whether they meet this criterion.

When the supplier's performance creates an asset with an alternative use to it, the supplier can redirect the asset to another customer. In those cases, the supplier (not the customer) controls the asset as it is created because the customer does not have the ability to direct the use of the asset or restrict the entity from directing that asset to another customer. The Boards concluded

[3] IFRS 15.35(c).

that, when an entity is creating something that is highly customised for a particular customer, which may be the case in an APS contract, it is less likely that the entity could use that asset for any other purpose. When determining whether an asset has alternative use, IFRS 15 states that an entity needs to consider the effects of contractual restrictions and practical limitations on its ability to readily direct that asset for another use (i.e., sell it to a different customer). A contractual restriction needs to be substantive (i.e., the customer could enforce its rights to the promised asset if the entity directed the asset for another use). A practical limitation only exists if an entity would incur significant economic losses to direct the asset for another use. An APS may need to consider these concepts in the context of selling customised parts to an after-market supplier. The evaluation of whether an asset has alternative use will require significant judgement. The analysis may have to be conducted together with the one performed for tooling and development costs, especially in relation to sales of such customised parts to after-market suppliers.

APSs also have to evaluate whether they have an enforceable right to payment for performance completed to date, considering the terms of the contract and any applicable laws or regulations. IFRS 15 states that the right to payment for performance completed to date need not be for a fixed amount. However, at any time during the contract term, an entity must be entitled to an amount that at least compensates it for performance completed to date if the customer (or another party) terminated the contract for reasons other than the entity's failure to perform as promised.

In many instances, however, only firm orders for parts (not those indicated in the framework agreement, for which there is no firm commitment from the customer) are likely to generate enforceable rights to payment. This may then not be significant due to the widely spread just-in-time procurement practices.

Perspectives

IFRS 15 has been applied for some years now. The application of IFRS 15 is very dependent on the business of automotive entities. While practices have sometimes changed compared to the previous revenue requirements, it is clear that the use of judgement has become increasingly important in determining how revenue is recognised in the automotive industry. Since transactions in the automotive industry are constantly evolving, care should always be taken in understanding and analysing them under IFRS 15.

The IASB, together with the FASB, had a clear perception of the need for guidance when they established the TRG. For the IASB, the main outcome of the TRG discussions, was to issue an amendment, *Clarification to IFRS 15 Revenue from contracts with customers*, in April 2016. The TRG discussions covered topics such as identifying performance obligations, principal-versus-agent considerations, licensing, collectability and measuring non-cash consideration. The IASB decided to provide clarifications on the first three topics, and on transition requirements. However, these clarifications did not change the underlying principles of IFRS 15.

The automotive industry is currently experiencing an in-depth transformation, with some entities significantly changing the way they operate, as well as entering into new businesses around mobility. It is likely that new considerations relating to revenue recognition will emerge from these transformations, requiring new understanding of how IFRS 15 applies to this rapidly evolving industry.

Appendix: The five-step revenue model and contract costs

The standard's core principle is that an entity recognises revenue at an amount that reflects the consideration to which it expects to be entitled in exchange for transferring goods or services to a customer. That principle is applied using five steps that require entities to exercise judgement when considering the terms of their contract(s) and all relevant facts and circumstances. Entities have to apply the requirements of the standard consistently to contracts with similar characteristics and in similar circumstances. This table summarises the revenue model and the requirements for contract costs.

Step 1: Identify the contract(s) with the customer
Definition of a contract An entity must first identify the contract, or contracts, to provide goods and services to customers. A contract must create enforceable rights and obligations to fall within the scope of the model in the standard. Such contracts may be written, oral or implied by an entity's customary business practices, but must meet the following criteria: ‣ The parties to the contract have approved the contract (in writing, orally or based on their customary business practices) and are committed to perform their respective obligations ‣ The entity can identify each party's rights regarding the goods or services to be transferred ‣ The entity can identify the payment terms for the goods or services to be transferred ‣ The contract has commercial substance (i.e., the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract) ‣ It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer If these criteria are not met, an entity would not account for the arrangement using the model in the standard and would recognise any non-refundable consideration received as revenue only when certain events have occurred. *Contract combination* The standard requires entities to combine contracts entered into at, or near, the same time with the same customer (or related parties of the customer) if they meet any of the following criteria: ‣ The contracts are negotiated as a package with a single commercial objective ‣ The amount of consideration to be paid in one contract depends on the price or performance of another contract ‣ The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation *Contract modifications* A contract modification is a change in the scope and/or price of a contract. A contract modification is accounted for as a new contract, separate from the original contract, if the modification adds distinct goods or services at a price that reflects the stand-alone selling prices of those goods or services. Contract modifications that are not accounted for as separate contracts are considered changes to the original contract and are accounted for, as follows: ‣ If the goods and services to be transferred after the contract modification are distinct from the goods or services transferred on or before the contract modification, the entity should account for the modification as if it were the termination of the old contract and the creation of a new contract ‣ If the goods and services to be transferred after the contract modification are not distinct from the goods and services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification, the entity should account for the contract modification as if it were part of the original contract ‣ A combination of the two approaches above: a modification of the existing contract for the partially satisfied performance obligations and the creation of a new contract for the distinct goods and services

Step 2: Identify the performance obligation(s) in the contract

An entity must identify the promised goods and services within the contract and determine which of those goods and services (or bundles of goods and services) are separate performance obligations (i.e., the unit of account for purposes of applying the standard).

A promised good or service represents a performance obligation if: (1) the good or service is distinct (by itself or as part of a bundle of goods or services); or (2) the good or service is part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.

A good or service (or bundle of goods or services) is distinct if both of the following criteria are met:

- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e., the good or service is capable of being distinct)
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the promise to transfer the good or service is distinct within the context of the contract)

In assessing whether an entity's promise to transfer a good or service is separately identifiable from other promises in the contract, entities will need to consider whether the nature of the promise is to transfer each of those goods or services individually or to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate two or more promises to transfer goods or services are not separately identifiable include, but are not limited to, the following:

- 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 represents the combined output or outputs for which the customer has contracted
- One or more of the goods or services significantly modify or customise, or are significantly modified or customised by, one or more of the other goods or services promised in the contract
- The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract

If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct.

Series requirement

Goods or services that are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer must be combined into one performance obligation. To meet the same pattern of transfer criterion, each distinct good or service in the series must represent a performance obligation that would be satisfied over time and would have the same measure of progress towards satisfaction of the performance obligation (both discussed in Step 5), if accounted for separately.

Customer options for additional goods or services

A customer's option to acquire additional goods or services (e.g., an option for free or discounted goods or services) is accounted for as a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market).

Principal versus agent considerations

When more than one party is involved in providing goods or services to a customer, an entity must determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal (and, therefore, records revenue on a gross basis) if it controls the specified good or service before transferring that good or service to the customer. An entity is an agent (and records as revenue the net amount it retains for its agency services) if its role is to arrange for another entity to provide the specified goods or services. Because it is not always clear whether an entity controls a specified good or service in some contracts (e.g., those involving intangible goods and/or services), the standard also provides indicators of when an entity may control the specified good or service, as follows:

- The entity is primarily responsible for fulfilling the promise to provide the specified good or service
- The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (e.g., if the customer has a right of return)
- The entity has discretion in establishing the price for the specified good or service

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 promised goods or services to a customer. When determining the transaction price, entities need to consider the effects of all of the following:

Variable consideration

An entity needs to estimate any variable consideration (e.g., amounts that vary due to discounts, rebates, refunds, price concessions, bonuses) using either the expected value method (i.e., a probability-weighted amount method) or the most likely amount method (i.e., a method to choose the single most likely amount in a range of possible amounts). An entity's method selection is not a 'free choice' and must be based on which method better predicts the amount of consideration to which the entity will be entitled. To include variable consideration in the estimated transaction price, the entity has to conclude that it is highly probable that a significant revenue reversal will not occur in future periods. This 'constraint' on variable consideration is based on the probability of a reversal of an amount that is significant relative to cumulative revenue recognised for the contract. The standard provides factors that increase the likelihood or magnitude of a revenue reversal, including the following: the amount of consideration is highly susceptible to factors outside the entity's influence, the entity's experience with similar types of contracts is limited or that experience has limited predictive value, the contract has a large number and broad range of possible outcomes. The standard requires an entity to estimate variable consideration, including the application of the constraint, at contract inception and update that estimate at the end of each reporting period.

Significant financing component

An entity needs to adjust the transaction price for the effects of the time value of money if the timing of payments agreed to by the parties to the contract provides the customer or the entity with a significant financing benefit. As a practical expedient, an entity can elect not to adjust the transaction price for the effects of a significant financing component if the entity expects, at contract inception, that the period between payment and performance will be one year or less.

Non-cash consideration

When an entity receives, or expects to receive, non-cash consideration (e.g., property, plant or equipment, a financial instrument), the fair value of the non-cash consideration is included in the transaction price.

Consideration paid or payable to the customer

Consideration payable to the customer includes cash amounts that an entity pays, or expects to pay, to the customer and credits or other items (vouchers or coupons) that can be applied against amounts owed to the entity. An entity should account for consideration paid or payable to the customer 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. However, if the payment to the customer exceeds the fair value of the distinct good or service received, the entity should account for the excess amount as a reduction of the transaction price.

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

For contracts that have multiple performance obligations, the standard generally requires an entity to allocate the transaction price to the performance obligations in proportion to their stand-alone selling prices (i.e., on a relative stand-alone selling price basis). When allocating the transaction price on a relative stand-alone selling price basis, any discount within the contract generally is allocated proportionately to all of the performance obligations in the contract. However, there are two exceptions.

One exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation, if both of the following criteria are met:

- The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service
- Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the objective of allocating consideration in an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer

The other exception requires an entity to allocate a contract's entire discount to only those goods or services to which it relates if certain criteria are met.

To allocate the transaction price on a relative stand-alone selling price basis, an entity must first determine the stand-alone selling price of the distinct good or service underlying each performance obligation. The stand-alone selling price is the price at which an entity would sell a good or service on a stand-alone (or separate) basis at contract inception. Under the model, the observable price of a good or service sold separately in similar circumstances to similar customers provides the best evidence of stand-alone selling price. However, in many situations, stand-alone selling prices will not be readily observable. In those cases, the entity must estimate the stand-alone selling price by considering all information that is reasonably available to it, maximising the use of observable inputs and applying estimation methods consistently in similar circumstances. The standard states that suitable estimation methods include, but are not limited to, an adjusted market assessment approach, an expected cost plus a margin approach or a residual approach (if certain conditions are met).

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation

An entity recognises revenue only when (or as) it satisfies a performance obligation by transferring control of the promised good(s) or service(s) to a customer. The transfer of control can occur over time or at a point in time.

A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case it is satisfied over time:

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

The transaction price allocated to performance obligations satisfied at a point in time is recognised as revenue when control of the goods or services transfers to the customer. If the performance obligation is satisfied over time, the transaction price allocated to that performance obligation is recognised as revenue as the performance obligation is satisfied. To do this, the standard requires an entity to select a single revenue recognition method (i.e., measure of progress) that faithfully depicts the pattern of the transfer of control over time (i.e., an input method or an output method).

Licences of intellectual property

The standard provides application guidance on the recognition of revenue for licences of intellectual property (IP) that differs from the model for other promised goods and services. The nature of the promise in granting a licence of IP to a customer is either:

- A right to access the entity's IP throughout the licence period (a right to access)
- A right to use the entity's IP as it exists at the point in time in which the licence is granted (a right to use)

The nature of an entity's promise in granting a licence is a promise to provide a right to access the entity's IP if all of the following criteria are met:

(a) The contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the IP to which the customer has rights

(b) The rights granted by the licence directly expose the customer to any positive or negative effects of the entity's activities identified

(c) Those activities do not result in the transfer of a good or a service to the customer as they occur

If the licensed IP does not have those characteristics, it provides a right to use IP, by default.

An entity's activities significantly affect the IP to which the customer has rights when either:

(a) Those activities are expected to significantly change the form (for example, the design or content) or the functionality (for example, the ability to perform a function or task) of the IP

Or

(b) The ability of the customer to obtain benefit from the IP is substantially derived from, or dependent upon, those activities. For example, the benefit from a brand is often derived from, or dependent upon, the entity's ongoing activities that support or maintain the value of the IP

A licence that provides an entity with the right to access IP is satisfied over time "because the customer simultaneously receives and consumes the benefit from the entity's performance as the performance occurs", including the related activities undertaken by entity.[4] This conclusion is based on the determination that when a licence is subject to change (and the customer is exposed to the positive or negative effects of that change), the customer is not able to fully gain control over the licence of IP at any given point in time, but rather gains control over the licence period. In contrast, when the licence represents a right to use the IP as it exists at a specific point in time, the customer gains control over that IP at the beginning of the period for which it has the right to use the IP. This timing may differ from when the licence is granted.

Revenue cannot be recognised from a right-to-use licence of IP before the beginning of the period during which the customer is able to use and benefit from the licence because it does not control the licence.

The standard specifies that sales-based and usage-based royalties on licences of IP are recognised when the later of the following events occurs: (1) the subsequent sales or usage occurs; or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied). This application guidance must be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a licence of IP (i.e., these types of arrangements are either entirely in the scope of this application guidance or entirely in the scope of the general variable consideration constraint requirements).

Contract costs

IFRS 15 specifies the accounting for costs an entity incurs to obtain and fulfil a contract to provide goods and services to customers. The incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognised as an asset if the entity expects to recover them. IFRS 15 cites commissions as a type of incremental cost that may require capitalisation. The standard provides a practical expedient that permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalising these costs would have been amortised in one year or less.

An entity accounts for costs incurred to fulfil a contract with a customer that are within the scope of other standards (e.g., inventory, property, plant and equipment, internal-use software) in accordance with those

[4] IFRS 15.B60.

standards. If the costs are not in the scope of other standards, an entity recognises an asset from the costs incurred to fulfil a contract only if those costs meet all of the following criteria:

- The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify
- The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future
- The costs are expected to be recovered

Any capitalised contract costs are amortised, with the expense recognised as an entity transfers the related goods or services to the customer. Any asset recorded by the entity is subject to an impairment assessment.

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