



**FRS 102 in
Practice:
Revenue from
contracts with
customers**

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1. Introduction

Background

On 27 March 2024, the Financial Reporting Council (FRC) issued amendments to FRS 102 and other Financial Reporting Standards (FRSs) following the conclusion of its second periodic review. These amendments aim to achieve greater alignment with International Financial Reporting Standards (IFRS), particularly those issued in recent years. While the amendments introduce various incremental improvements and clarifications to the existing FRS 102, the most significant changes are in the areas of revenue and lease accounting.

As a result of the amendments, Section 23 Revenue has been replaced by Section 23 *Revenue from Contracts with Customers*. Section 23 now establishes a single, comprehensive framework for revenue recognition, closely aligned with IFRS 15 *Revenue from Contracts with Customers*. This publication provides a brief summary of the requirements, offering practical implementation perspectives on the five-step model as outlined in Section 23. Additionally, the publication highlights the key differences between IFRS 15 and Section 23. It is important to note that the publication does not offer a complete list of all differences between IFRS 15 and Section 23 rather, it aims to identify areas that may lead to differences in practice.

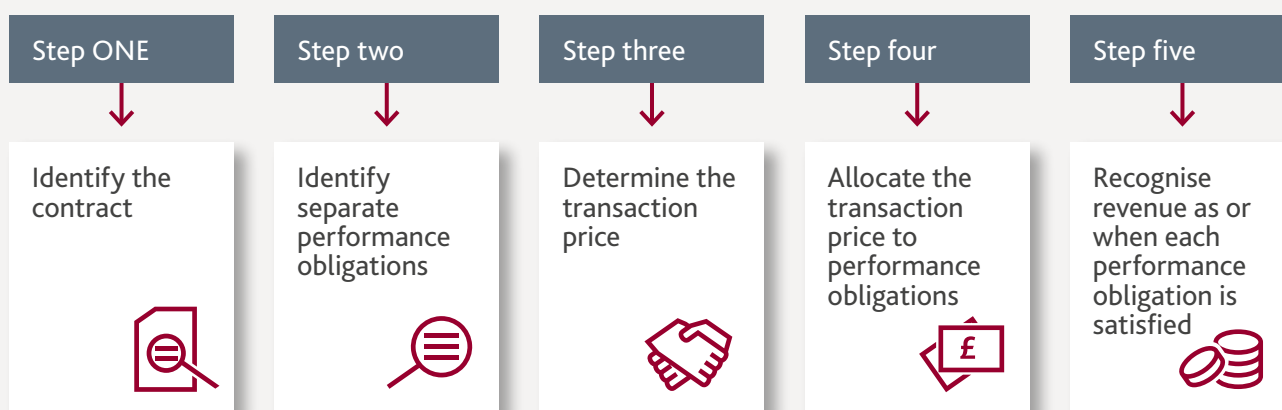


2. Overview of Section 23

Section 23 establishes a single and comprehensive framework which sets out how much revenue is to be recognised, and when. The core principle is that a vendor should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the vendor expects to be entitled in exchange for those goods or services.

Revenue is recognised by a vendor when control over the goods or services is transferred to the customer. In contrast, old Section 23 based revenue recognition around an analysis of the transfer of risks and rewards. An assessment of risks and rewards now forms one of a number of criteria that are assessed in determining whether control has been transferred.

The application of the core principle in Section 23 is carried out in five steps:



The first step is to identify the contract(s) with the customer for accounting purposes, which may not be the same as the contract(s) for legal purposes. A contract for Section 23 purposes must create enforceable rights and obligations between a vendor and its customer.

After identifying the contract(s) with the customer for accounting purposes, in step two, a vendor identifies its separate 'performance obligations'. A performance obligation is a vendor's promise to transfer a good or service that is 'distinct' from other goods and services identified in the contract. Goods and services (either individually, or in combination with each other) are distinct from one another if the customer can benefit from one or more goods or services on their own (or in combination with resources readily available to the customer). Two or more promises (such as a promise to supply materials (such as bricks and mortar) for the construction of an asset (such as a wall) and a promise to supply labour to construct the asset) are combined if they represent one overall performance obligation.

In step three, a vendor determines the transaction price of each contract identified for accounting purposes in step one, and then in step four allocates that transaction price to each of the performance obligations identified in step two.

In step five, a vendor assesses when it satisfies each performance obligation identified in step two, which is determined by reference to when the customer obtains control of each good or service. This could be at a point in time or over time, with the revenue allocated to each performance obligation in step four recognised accordingly.

The five-step model is applied to individual contracts. However, as a practical expedient, Section 23 permits an entity to apply the model to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects would not differ materially from applying it to individual contracts. This practical expedient will often be applied to situations involving measurement estimates where an entity may have many contracts which are affected by a particular issue and an estimate is more appropriately made on the population of contracts rather than on each contract individually. For example, in a retail sale which gives the customer a right of return, it may be more appropriate to estimate the aggregate level of returns on all such retail transactions, rather than at the contract level (which is each individual retail sale on which a right of return is granted).

3. Scope

Section 23 applies to all contracts with customers, except for:

- ▶ Lease contracts within the scope of Section 20 Leases.
- ▶ Insurance contracts within the scope of FRS 103.
- ▶ Financial instruments and other contractual rights and obligations within the scope of Section 9 Consolidated and Separated Financial Statements, Section 11 Basic Financial Instruments, Section 12 Other Financial Instruments, Section 14 Investments in Associates and Section 15 Investments in Joint Ventures.
- ▶ Non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.
- ▶ Incoming resources from non-exchange transactions for public benefits entities in scope of Section 34 Specialised Activities.



Example 3.1

Entity A, known as “Speedy Deliveries,” is a courier company with a robust network of delivery vans operating throughout England. They have established a reputation for timely and efficient parcel delivery services across major cities such as London, Manchester, and Birmingham. Entity B, “Highland Couriers,” operates similarly in Scotland, covering key areas including Edinburgh, Glasgow, and Aberdeen. Both companies have a strong presence in their respective regions but face limitations in extending their reach beyond their borders.

Speedy Deliveries enters into a contract with Highland Couriers whereby Speedy Deliveries will handle parcels destined for England from Highland Couriers’ customers, while Highland Couriers will manage deliveries for Speedy Deliveries’ customers in Scotland. No other consideration is provided by the parties.

This arrangement is not within the scope of Section 23, as non-monetary exchanges in the same line of business to facilitate sales to customers or potential customers are excluded from the scope of Section 23.



As noted above, under Section 23, revenue is derived from contracts entered into by a vendor for the sale of goods or services, arising from its ordinary activities, to a customer. Its recognition is linked to changes in a vendor's assets and liabilities. This can be in the form of cash inflows or increases in receivable balances, or decreases in a liability that represents deferred revenue. All changes in those assets and liabilities are recognised in profit or loss, other than those relating to transactions with owners (for example, shareholders) of the vendor if the owners enter into transactions with the vendor in their capacity as such.

A contract may be partially within the scope of Section 23 and partially within the scope of other sections of FRS 102. In this situation a vendor takes the approach summarised in the following diagram:



Therefore, if one or more other sections of FRS 102 specify how to separate and/or measure certain parts of a contract, those other sections are applied first. Those other sections take precedence in accounting for the overall contract, with any residual amount of consideration being allocated to those part(s) of the contract that fall within the scope of Section 23.



Example 3-1

A car manufacturer leases a fleet of cars to a customer for three years. As part of the contract it also deals with various administrative matters for the customer such as arranging insurance, providing breakdown cover and annual servicing.

Section 20 require contracts to be separated into their lease and non-lease components. A vendor applies Section 23 to the amounts received from the customer that relate to the non-lease components of the contract.

A vendor is also required to assess whether, instead of a transaction being a sale, the counterparty to a contract shares the risks and benefits that result from an activity or process (such as developing an asset). If so, the counterparty is not a customer, and the transaction falls outside of the scope of Section 23. Judgement will be required because the nature of the relationship (supplier-customer or collaborative arrangement) will depend on the specific contractual terms and conditions. Care may also be needed in assessing transactions with related parties, as their relationship with the vendor may be more complex than those with third parties.

4. The 'Five Step' approach

4.1. Step One – Identify the contract

Section 23 is applied to contracts with customers that meet all of the following five criteria:

- ▶ The contract has been approved and the parties are committed to perform their obligations in the contract
- ▶ Each party's rights regarding the goods or services to be transferred can be identified
- ▶ The payment terms for the goods or services to be transferred can be identified
- ▶ The contract has commercial substance (i.e. the risk, timing or amount of the vendor's future cash flows is expected to change as a result of the contract)
- ▶ It is probable that the consideration for the exchange of the goods or services that the vendor is entitled to will be collected. For the purposes of this criterion, only the customer's ability and intention to pay amounts when they become due are considered.

The last point above includes a collectability threshold for revenue recognition, which goes beyond the contractual terms of an arrangement with a customer.

The focus will often be on the price included in the contract between a vendor and its customer. However, it is possible that the amount of consideration that the vendor ultimately expects to be entitled to will be less, because it may offer a price concession or discount. In these cases, the assessment of the customer's ability and intention to pay is made against the lower amount, which will be determined in accordance with the guidance in Section 23 for variable consideration.

In some cases, an entity may consider it probable that it will receive only some of the stated consideration in an otherwise fixed price contract. In these cases, although it can be concluded the probability of collection condition is met, it is also necessary to apply the guidance on variable consideration. The accounting for variable consideration is discussed in more detail in [section 4.3](#) below.



Example 4.1-1

A vendor sells a product to a customer in return for a contractually agreed amount of CU1 million. This is the vendor's first sale to a customer in the geographic region, and the region is experiencing significant economic difficulty. The vendor therefore expects that it will not be able to collect the full amount of the contract price. Despite the fact that it may not collect the full amount, the vendor believes that economic conditions in the region will improve in future. It also considers that establishing a trading relationship with this customer could help it to open up a new market with other potential customers in the region.

This means that instead of the contract price being fixed at CU1 million, the amount of promised consideration is variable. The vendor assesses the customer's intention and ability to pay and, based on the facts and circumstances and taking into account the poor economic conditions, it is concluded that it is probable that it will be entitled to an estimated amount of CU500,000 and that the customer will pay this amount.

Assuming that the other four criteria set out above are met, the vendor concludes that it has entered into a contract for the sale of the product in return for variable consideration of CU500,000.

Combination of contracts

Two or more contracts that are entered into at (or near) the same time, and with the same customer or related parties of the customer, are accounted for as if they were a single contract for accounting purposes, if one of the following criteria are met:

- ▶ The contracts are negotiated as a package with a single commercial objective;
- ▶ The amount of consideration in one contract depends on the price or performance of the other contract(s); or
- ▶ The goods or services that are promised in the contracts (or some of the goods or services) represent a single performance obligation (see discussion on step 2 in [section 4.2](#) below).

BDO comment

The requirement to consider contracts which are entered into with two or more separate parties that are related to each other has been included because there may be interdependencies between or among those contracts. This is because the amount and timing of revenue to be recognised might differ depending on whether the contracts are accounted for as separate contracts as opposed to a single contract. The term 'related parties' has the same meaning as the definition in Section 33 Related Party Disclosures, which encompasses a wide range of entities and individuals, and careful analysis may be required to ensure that all of these are considered.

Contract modifications

A contract modification is a change in the scope and/or price of a contract that is approved by the parties to that contract. This might be referred to as change order, variation, and/or an amendment. Consistent with the provisions of Section 23, adjustments are only made for a contract modification when either new enforceable rights and obligations are created, or existing ones are changed.

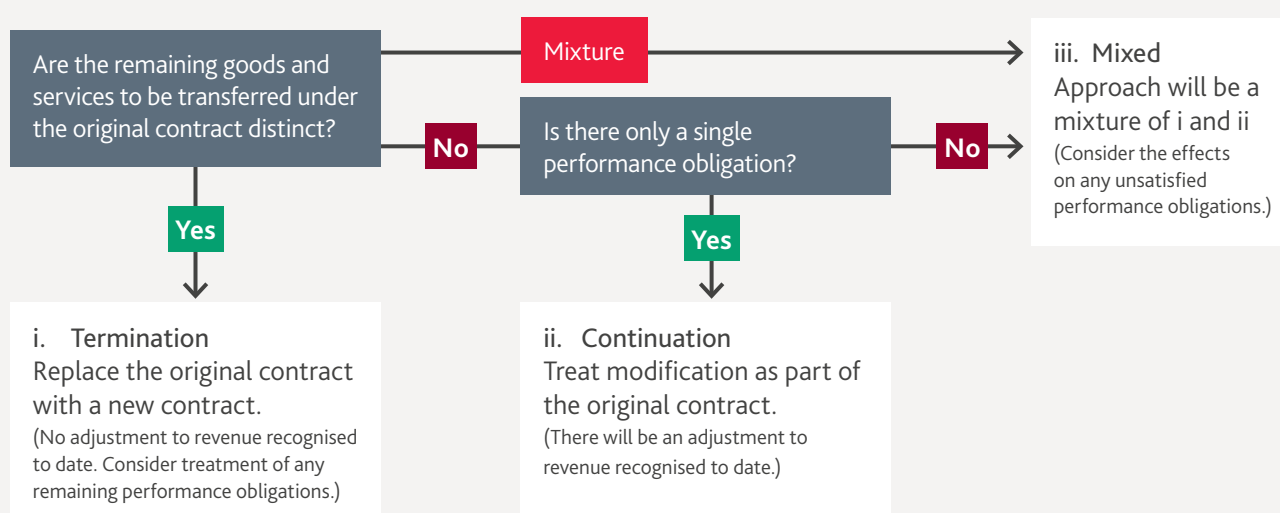
A vendor accounts for a contract modification as a separate contract to the original one, such that the

accounting for the original contract remains unchanged, only if:

- ▶ the scope of the contract changes due to the addition of promised goods or services that are distinct for the purposes of step 2 of the five-step model (see [section 4.2](#) below); and
- ▶ the price of the contract increases by an amount of consideration that reflects the vendor's stand-alone selling price of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract (e.g. a discount to reflect that the vendor did not incur the same costs as it would do for a new customer).

If both of these criteria are met, then the contract modification is, for accounting purposes, a separate contract which is subject to the same five-step model as any other contract.

When a contract modification is not accounted for as a separate contract (i.e. one or both of the above two criteria are not met), the vendor identifies the total goods or services that have not yet been transferred. This will be comprised of the remaining goods or services from the original contract, and any new goods or services arising from the contract modification. The approach which is then followed is illustrated by the following diagram:



If the modification results in the original contract being accounted for as if it were terminated, then no adjustment is made on modification date to the cumulative revenue previously recognised on the original contract. Instead, the remaining goods and services and the remaining contractual consideration (i.e. the total consideration as modified less revenue recognised prior to modification) form the new contract for accounting purposes.

If, in contrast, the modification results in the original contract continuing, then the amount of revenue recognised prior to the modification will need to be adjusted to reflect the extent to which the performance obligation affected in the modified contract has been completed. This might apply to a construction contract for a building where revenue is being recognised over time, and there is a change to the building specification which increases the scope of work and affects the stage of completion. In some cases, the remaining goods and services to be delivered under the modified contract are not distinct from those that have already been delivered, and may be comprised of more than one performance obligation. In those cases, the entity will need to apply judgement to determine which elements of the original contract are being terminated and which elements are being continued.



Example 4.1-3 – sale of a product

A vendor enters into a contract with a customer to sell 200 units of a product for CU16,000 (CU80 per unit). These are to be supplied evenly to the customer over a four-month period (50 units per month) and control over each unit passes to the customer on delivery.

After 150 units have been delivered, the contract is modified to require the delivery of an additional 50 units (i.e. at the point of contract modification, the vendor is now required to supply a total of 100 units, being the 50 units not delivered under the original contract plus a further 50 units). At the point at which the contract is modified, the stand-alone selling price of one unit of the product has declined to CU75.

Assuming the additional units to be delivered are distinct (considered under step 2 in [section 4.2](#) below), the accounting for the contract modification will depend on whether the sales price for the additional units reflects the stand-alone selling price at the date of contract modification (CU75).

Scenario A – the price of each of the additional units is CU75

The selling price of the additional units is the stand-alone price at the date of contract modification. Consequently, the additional units are accounted for as being sold under a new and separate contract from the units to be delivered under the terms of the original contract.

The vendor recognises revenue of CU80 per unit for the remaining 50 units specified in the original contract, and CU75 per unit for the 50 units that are added as a result of the contract modification.



BDO Comment

In our view, if the units are fungible, revenue should be recognised on a FIFO basis. That is, the first 50 units delivered to the customer after the modification satisfy the remainder of the original promise to deliver 200 units in the original contract, and which will result in revenue of CU80 being recognised as each of the first 50 units of the remaining 100 units are delivered. The second tranche of 50 units delivered relate to the contract modification (which, for accounting purposes, is a separate contract) on which revenue of CU75 is recognised as each unit is delivered. To permit a different approach could result in structuring of the amount of revenue to be recognised, by 'specifying' whether deliveries of the remaining 100 units following the contract modification relate to the original contract or the contract modification.

Scenario B – the price of each of the additional units is CU65, reflecting a CU10 discount as compensation for past poor service



When the contract modification for the additional 50 units was being negotiated, the vendor agreed to a price reduction of CU10 for each of the additional units, to compensate the customer for poor service. Some of the first 50 units that had been delivered were faulty and the vendor had been slow in rectifying the position.

At the point of contract modification, the vendor recognises the CU10 per unit discount as an immediate reduction in revenue of CU500. This is because the discount relates to units that have already been delivered to the customer; the allocation of the discount to the price charged for units that are to be sold in future does not mean that the discount is attributed to them.

The selling price of the additional units is therefore the stand-alone selling price (CU75) at the date of contract modification. Consequently, the additional units are accounted for as being sold under a new and separate contract from the units to be delivered under the terms of the original contract.

This means that, as in scenario A, the vendor recognises revenue of CU80 per unit for the remaining 50 units specified in the original contract, and then CU75 per unit for the 50 units that are delivered as a result of the contract modification.

Scenario C – the price of each of the additional units is CU60, solely reflecting a special discount given to the customer

The selling price of the additional units is not the stand-alone price at the date of contract modification. The 100 units still to be delivered after the contract modification are distinct from the 150 already delivered. Consequently, for accounting purposes, the original contract is considered to be terminated at the point of contract modification. The remaining units to be sold that were covered by the original contract, together with the additional units from the contract modification, are accounted for together as being sold under a new contract.

The amount of revenue recognised for each of the units is a weighted average price of CU70. This is calculated as $((50 * CU80) + (50 * CU60)) / 100$.

BDO comment

Care will be needed when determining the appropriate accounting approach in circumstances in which a contract is modified, and the selling price of remaining performance obligations reflects both compensation for poor past performance, and a revised price that does not represent the stand-alone selling price at the date of contract modification. This is to ensure that the adjustment to revenue previously recognised on contract modification (reflecting compensation payable to the customer for poor past performance) and the revenue to be reflected for the remaining goods to be delivered is appropriate.

BDO comment

Contract Enforceability and termination clauses

An entity only applies Section 23 to the term of the contract in which the parties to the contract have enforceable rights and obligations.

Example A

An entity enters into a service contract with a customer under which the entity continues to provide services until the contract is terminated. Each party can terminate the contract without compensating the other party for the termination (that is, there is no termination penalty).

The duration of the contract does not extend beyond the services already provided.

Example B

An entity enters into a contract with a customer to supply services for two years. Each party can terminate the contract at any time after fifteen months from the start of the contract without compensating the other party for the termination.

The duration of the contract is fifteen months.

Example C

An entity enters into a contract with a customer to provide services for two years. Either party can terminate the contract by compensating the other party.

The duration of the contract is the specified contractual period of two years.



4.2 Step Two - Identify separate performance obligations in the contract

Having identified the contract for accounting purposes in step one, a vendor is then required to identify the performance obligation(s) contained in that contract. A performance obligation is a promise to a customer to transfer:

- ▶ a good or service (or a bundle of goods or services) that is distinct; or
- ▶ a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

A single contract can have more than one performance obligation. For example, the purchase of a mobile handset and connection to a mobile network for two years, in return for 24 monthly fixed payments, is likely to be set out in a single contract. However, the contract will typically be analysed as containing two performance obligations for accounting purposes - the sale of the mobile handset on credit, and the provision of network services for two years.

Further, although two contracts between a vendor and its customer may be identified as a single contract for accounting purposes in step 1 (because, for example, they were negotiated at or near the same time, with interdependency in the amount of consideration allocated to each), the good(s) or service(s) specified in each of the two legal contracts could be separate performance obligations for accounting purposes. As a result, an entity is not able to obtain a particular accounting result by structuring obligations in different contracts with its customer. Continuing the example of a mobile handset and provision of network services above, a vendor might structure this as a contract for the purchase of a mobile phone and a separate contract for the connection of that phone to a mobile network rather than as a single contract. However, the two contracts would still have the same two performance obligations for accounting purposes as the more typical situation of both deliverables being set out in a single legal contract.

This has important consequences for the consistency of revenue recognition for similar arrangements that are structured differently. If the two separate contracts were priced on the basis of the relative fair values of the mobile handset and the network services, there would be no difference in the accounting compared to a single contract for both performance obligations. However, if the vendor structured the arrangement as being a contract (at overvalue) for the mobile handset and a contract (at undervalue) for the network services, the two contracts would be combined into one contract for accounting purposes in step 1, with the total consideration allocated to each performance obligation (the mobile handset and the network services) on the basis of their relative fair values.

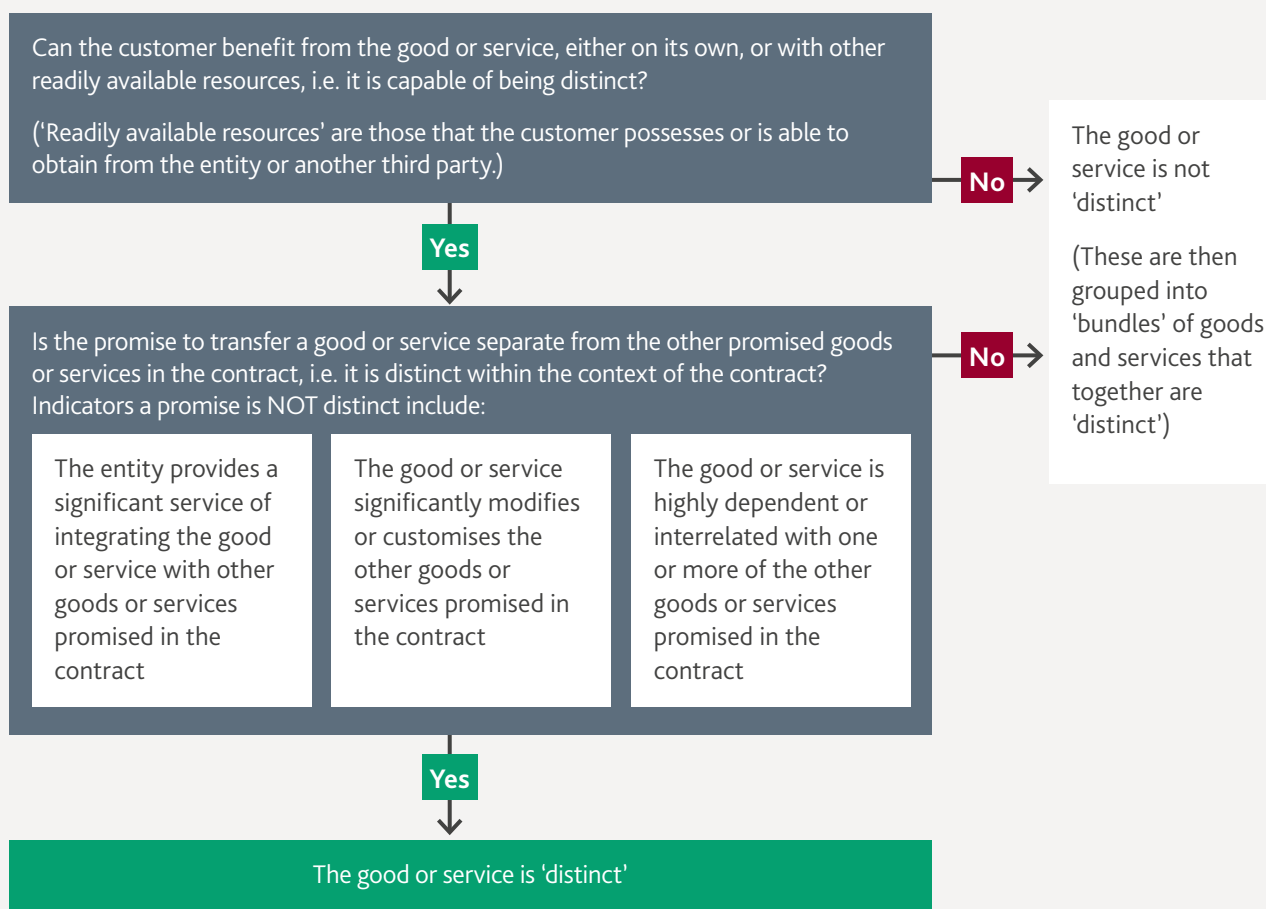
BDO comment

The identification of each of the distinct goods or services in contracts may require a detailed analysis of contractual terms, and linkage to Section 23's requirements on whether a promise in a contract is a distinct good or service (and hence constitutes a performance obligation) or needs to be combined ('bundled') with other promises in the contract to create a single performance obligation. Subtle differences in contractual terms and conditions, as well as individual facts and circumstances, can impact the analysis.

The importance of appropriately identifying the performance obligations in a contract cannot be underestimated as they each form a separate 'unit of account' for the purposes of determining how much revenue should be recognised and when revenue should be recognised. The conclusions reached in Step 2 could also bring substantial changes to the amount and timing of revenue recognition in comparison with current standards.



The following diagram illustrates the approach to determine whether a promise in a contract (i.e. a contract for accounting purposes determined in step 1) is a distinct good or service, and hence a performance obligation:



The two criteria that need to be met in order for a good or service to be distinct are set out in more detail below:

Criterion 1

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).

A customer can benefit from a good or service if the good or service can be used, consumed, or sold, or it can be held in a way that generates economic benefits. A customer may benefit from some goods or services on their own, while for others a customer may only be able to obtain benefits from them in conjunction with other readily available resources.

A readily available resource is either a good or service that is sold separately (either by the vendor or another vendor), or a resource that the customer has already obtained from the vendor (this includes goods or services that the vendor has already transferred to the customer under the contract) or from other transactions or events.

If the vendor regularly sells a good or service separately, this indicates that a customer can benefit from it (either on its own, or in conjunction with other resources).

Criterion 2

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 good or service is distinct within the context of the contract).

To assist in making this assessment, FRS 102 23.24 includes indicators that a vendor's promise to transfer two or more goods or services to the customer are not distinct within the context of the contract. The guidance is explicit that these are not the only circumstances in which two or more promised goods or services are not distinct:

- ▶ The vendor provides a significant service of integrating one good or service with other goods or services promised in the contract into a bundle, which represents a combined output for which the customer has contracted (i.e. the vendor is using one good or service as an input to produce the combined output specified by the customer).

- ▶ One good or service significantly modifies or customises other goods or services promised in the contract.
- ▶ One good or service is highly dependent on (or highly interrelated with) other promised goods or services. That is, if the customer decides not to purchase the good or service it would not significantly affect any of the other promised goods or services in the contract.

To determine whether the vendor's promise to transfer a good or service is separately identifiable from other promised goods or services in the contract (i.e. distinct within the context of the contract) requires judgement in light of all relevant facts and circumstances. The three factors included in FRS 102 23.24 are therefore intended to assist entities in making that judgement. Further, the three factors are not mutually exclusive, because they are based on the same underlying principle of inseparable risks.

The principle is whether two or more goods or services that might be capable of being distinct are used as inputs that are then combined to produce one single identifiable item. In contrast, if a vendor's promise to its customer contains two or more goods or services that depend on each other (that is, they have a functional relationship), such as equipment and related consumables that are needed to operate the equipment, these would be distinct in the context of the contract because the supply of the consumables does not make any changes to the machine.



Example 4.2-1 - Telecoms

A telecoms company enters into a contract for the sale of a mobile device and connection to its mobile network. The contract, which lasts for two years, gives the customer:

- ▶ X minutes of calls per month;
- ▶ Y gigabytes of data per month; and
- ▶ Z texts per month.

The telecoms company frequently sells mobile devices without connecting them to the network. Although different combinations of minute, data and texts are available, it is not possible to buy only minutes, only data or only texts.

The telecoms company concludes that although the customer can benefit from the minutes, data and texts independently from one another (i.e. they are capable of being distinct), they are interrelated with each other because the risks associated with the promise to transfer of minutes, texts and data are not separable as part of the network connection. Therefore, two performance obligations are identified

- ▶ The sale of a mobile phone; and
- ▶ Network services.



Example 4.2-2 – Construction of a wall

A building company contracts with a customer to build a wall. It identifies two activities that are necessary to complete the wall:

- ▶ Arrange for raw materials (such as bricks) for the purposes of building a wall to be available at the customer's premises; and
- ▶ Provide construction services to build a wall with the raw materials.

The sale of raw materials and the provision of services for the construction of a wall are capable of being distinct. Although the failure to purchase construction services would not significantly affect the delivery of bricks (which, by itself, might result in a vendor identifying two distinct performance obligations), the nature of the overall promise is to build the customer a wall. Consequently, the risks associated with each activity are not separable, and hence they are not distinct within the context of the overall contract. This is for the following reasons:

- ▶ the raw materials and construction services are both inputs that combined and result in the creation of a single identifiable output (the wall);
- ▶ the provision of construction services significantly modifies the nature of the raw materials (i.e. it transforms the raw materials into something that performs a very different function to the raw materials on their own).

The analysis would be the same even if the arrangement was structured as two contracts negotiated at or around the same time (i.e. a legal contract for the sale of bricks and a separate legal contract for construction services) because for accounting purposes there would be a single contract. Although there are two activities that are capable of being distinct, in the context of the single accounting contract, the assessment of whether they would be distinct within the context of that accounting contract remains the same.

**Example 4.2-3 – Construction of a building**

A building contractor (the vendor) enters into a contract to build a new office block for a customer. The vendor is responsible for the entire project, including procuring the construction materials, project management and associated services. The project involves site clearance, foundations, construction, piping and wiring, equipment installation and finishing.

Although the goods or services to be supplied are capable of being distinct (because the customer could, for example, benefit from them on their own by using, consuming or selling the goods or services, and could purchase them from other suppliers), they are not distinct in the context of the vendor's contract with its customer. This is because the vendor provides a significant service of integrating all of the inputs into the combined output (the new office block) which it has contracted to deliver to its customer.

**Example 4.2-4 - Software – scenario A**

A vendor enters into a contract with a customer to supply a licence for a standard 'off the shelf' software package, install the software, and to provide unspecified software updates and technical support for a period of two years. The vendor sells the licence and technical support separately, and the installation service is routinely provided by a number of other unrelated vendors. The software will remain functional without the software updates and technical support.

The software is delivered separately from the other goods or services, can be installed by a different third party vendor, and remains functional without the software updates and technical support. Therefore, it is concluded that the customer can benefit from each of the goods or services either on their own or together with other goods or services that are readily available. In addition, each of the promises to transfer goods or services is separately identifiable; because the installation services does not significantly modify or customise the software, the installation and software are separate outputs promised by the vendor, and not one overall combined output.

The following distinct goods or services are identified:

- ▶ Software licence
- ▶ Installation service
- ▶ Software updates
- ▶ Technical support.

**Example 4.2-4 - Software - scenario B**

The vendor's contract with its customer is the same as in scenario A, except that as part of the installation service the software is to be substantially customised in order to add significant new functionality to enable the software to interface with other software already being used by the customer. The customised installation service can be provided by a number of unrelated vendors.

In this case, although the installation service could be provided by other entities, the analysis required by Section 23 indicates that within the context of its contract with the customer, the promise to transfer the licence is not separately identifiable from the customised installation service. In contrast, and as before, the software updates and technical updates are separately identifiable.

The following distinct goods or services are identified:

- ▶ Software licence and customised installation service
- ▶ Software updates
- ▶ Technical support.

**Example 4.2-4 - Software – scenario C**

The vendor's contract with its customer is the same as in scenario B, except that:

- ▶ The vendor is the only supplier that is capable of carrying out the customised installation service
- ▶ The software updates and technical support are essential to ensure that the software continues to operate satisfactorily, and the customer's employees continue to be able to operate the related IT systems. No other entity is capable of providing the software updates or the technical support

In this case, the analysis indicates that in the context of its contract with the customer, the promise is to transfer a combined service. This combined service is identified as the single performance obligation.

**Example 4.2-4 - Software – scenario D1**

A vendor enters into a contract with a customer to supply them with a three-year licence for tax software for the upcoming tax year along with software updates for the next three years to be provided in December of each year. The software updates are to provide tips and news on tax legislation each year. The vendor routinely sells the licence and updates together and the software

remains functional during the licence period regardless of the software updates. The functionality of the software will only allow the single tax year to be filed (i.e. the updates will not allow subsequent years in the licence period to be filed using the software).

The customer can benefit from the software licence on its own without the software updates, as it has standalone functionality, therefore, the licence and the software updates are capable of being distinct. The licence and the software updates are also distinct in the context of the contract as the software remains functional without the updates and the updates do not significantly modify or customise the software. Therefore, two performance obligations are identified: a software licence and software updates.



Example 4.2-4 - Software – scenario D2

Same fact pattern as scenario D1, except the software updates will allow the customer to file tax returns in any of the years covered by the three-year licence, as well as receive monthly updates for changes in tax legislation and regulation.

The customer can benefit from the software licence on its own without the software updates, as it has standalone functionality, therefore, the licence and the software updates are capable of being distinct. However, the licence and the software updates are not distinct in the context of the contract as the benefit a customer would obtain from the licence is significantly limited without the software updates. That is because the updates are necessary for the second and third years in the licence period to be functional, since changes for legislation and tax regulation would need to be updated in the software. The monthly updates for changes in tax legislation and regulation also limit the benefits obtained otherwise. Therefore, one performance obligation is identified in the contract.



Example 4.2-5 – Equipment and consumables

A vendor enters into a contract to supply a customer with an item of equipment and consumables that are required to operate the equipment. The contract also requires the vendor to provide replacement consumables on specified dates over the next three years. The consumables are specific to the equipment and only produced by the vendor, although they are sold separately to customers who have bought the equipment second hand.

The item of equipment and the consumables are both capable of being distinct, because each of them are

regularly sold separately by the vendor. The customer can benefit from the consumables that will be delivered under the contract together with the item of equipment.

The item of equipment and the consumables are also distinct in the context of the contract. This conclusion is based on the following:

- ▶ There is no service being provided that integrates and transforms the equipment and consumables into a single combined output
- ▶ Neither the equipment nor the consumables are significantly customised or modified by the other
- ▶ The equipment and consumables are not highly inter-related because they do not significantly affect each other

Consequently, although there is a functional relationship between the equipment and the consumables because the consumables are needed in order to make the equipment work, the absence of any transformation (or integration) of the two components means that they represent separate performance obligations. The vendor would be able to fulfil each of its promises in the contract independently of each other; it could transfer the equipment to the customer even if the customer did not purchase any consumables, and could transfer consumables to the customer separately if the customer had acquired the equipment from another third party.

Combining a good or service with other promised goods or services

If a good or service is not distinct, the vendor is required to combine that good or service with other promised goods or services until a bundle of goods or services that is distinct can be identified. This may result, in some cases, in a vendor accounting for all the goods or services promised in a contract as a single performance obligation.



Example 4.2-7

A mobile application (app) is a computer program designed to run on mobile devices such as smartphones and tablets. Typically, such devices are sold with several apps bundled as preinstalled software. Apps that are not preinstalled are usually available through distribution platforms known as app stores. Mobile app providers are usually the owners of a licence to distribute, using their own channels, specific online applications.

It is common for software providers to make mobile applications available to users on mobile devices for free. For games, users can often then purchase virtual goods (non-physical objects) to enhance their experience of using the app (game).

The typical rights and obligations between the entity and user are:

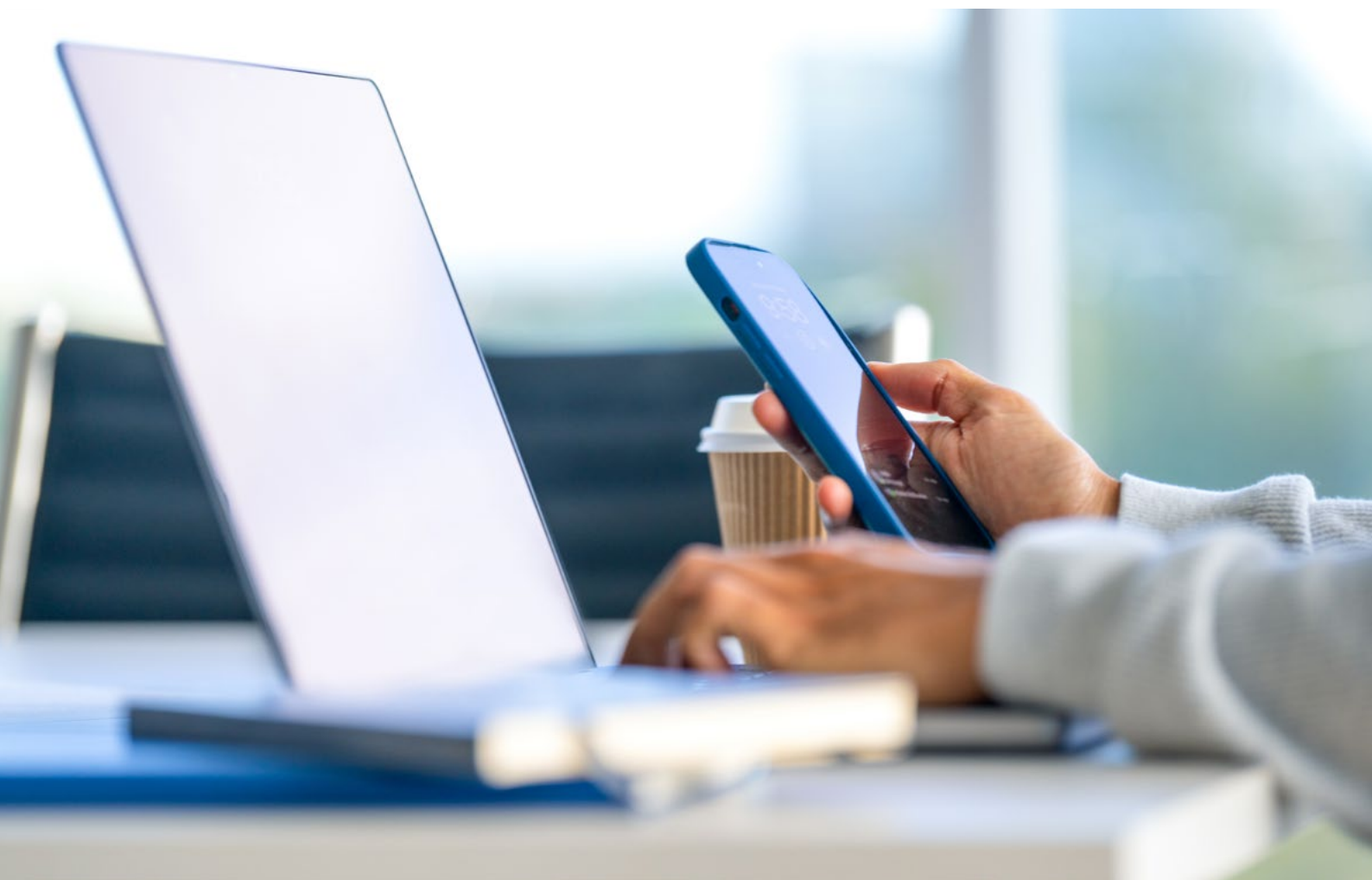
- ▶ Users can log on to the entity's server and use the application for free on the entity's server after agreeing to the terms and conditions of the underlying license arrangement with the entity.
- ▶ Users can make 'in-app' purchases of virtual goods/services. Some of these are consumable and will be used immediately or at some point after purchase and others are durable and will be used for a period of time after purchase.
- ▶ The entity is responsible for operating the application, but it can terminate its operation of the application at any time at its discretion without any penalty.
- ▶ The costs of operating the application are recovered by revenue from these "in-app" purchases.
- ▶ Upgrades/future developments of the application are neither anticipated nor included in the terms and conditions of the hosted underlying licence agreement.

Assuming the entity is the principal in the arrangement with users, given it is responsible for maintaining and operating the application on its server, the issue is whether the 'in-app' purchases of virtual items are separate performance obligations or whether should they be combined into a single performance obligation along with the provision of access to the application.

Access to the application and the virtual goods should be accounted for as separate performance obligations. The virtual goods will be recognised either at a point in time or over time depending on the nature of the virtual good.

The virtual goods meet the criteria to be distinct in FRS 102 23.21 for the following reasons:

- ▶ Users can use the application without purchasing anything further and in many cases that is what users will do. The underlying application is therefore 'capable of being distinct' because it is used by customers on a stand-alone basis.
- ▶ Users can decide not to purchase the virtual items without affecting the utility of the application. Therefore, the virtual items are not highly dependent on or highly interrelated with the application.
- ▶ Once the users have access to the application, the virtual items are also capable of being distinct because the customer can benefit from the virtual goods together with other resources that are readily available (i.e. the underlying application).
- ▶ No significant integration or modification service is provided by the entity, regardless of whether or not gamers choose to use the application with the additional virtual items.



Series Provision

Under Section 23 a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer are accounted for as a single performance obligation. This is known as the 'series provision'.

A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

- ▶ each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria to be a performance obligation satisfied over time (see [section 4.5](#) below); and
- ▶ the same method would be used to measure the entity's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer

There are three primary areas in which the accounting treatment may vary for a performance obligation if it is determined that a promise is a single performance obligation comprised of a series of distinct goods rather than a single performance obligation comprised of goods or services that are not distinct from each other

- ▶ contract modifications (see [section 4.1](#) above) because if the remaining undelivered goods or services are distinct (even if part of a single performance obligation under the series provision), the entity will account for the modified contract on a prospective basis, whereas if the remaining goods or services are not distinct from those already provided, there will be a cumulative effect adjustment resulting from the modification.
- ▶ changes in transaction price (see [section 4.3](#) below) because Section 23 requirements are applied differently, in some cases, to a single performance obligation comprised of non-distinct goods or services than to a single performance obligation resulting from the series provision; and
- ▶ allocation of variable consideration (see [section 4.4](#) below) because the amount of the variable consideration that is recognised at each reporting date could be affected

The need to consider whether the series provision should apply will be relevant to many service contracts and also contracts involving the delivery of a quantity of similar items where those items are not all delivered at the same time, but over the contractual period.

BDO Comment

Although the series provision does simplify application of the standard in many situations, it is mandatory if the conditions for its application are met. It is not a practical expedient which entities have a choice of applying.

Implicit promises in a contract

Goods or services that are to be transferred to a customer are normally specified in a contract. However, a contract may also include promises that are implied by a vendor's customary business practices, published policies, or specific statements if those promises create a valid customer expectation that the vendor will transfer a good or service to it. The performance obligations identified in a contract with a customer may not be limited to the goods or services that are explicitly promised in that contract.

Performance obligations do not include activities that a vendor must perform in order to fulfil a contract, unless the vendor transfers a good or service to the customer as those activities occur. For example, a service provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed and are therefore not performance obligations.



4.3 Step Three - Determine the transaction price of the contract

The transaction price is the amount of consideration that a vendor expects to be entitled to in exchange for the goods or services. This will often be the amount specified in the contract. However, the vendor is also required to consider its customary business practices and, if these indicate that a lower amount will be accepted, then this would be the transaction price.

Although a number of estimates about the future may need to be made when determining the transaction price, these are based on the goods and services to be transferred in accordance with the existing contract. They do not take into account expectations about whether the contract will be cancelled, renewed or modified.

The vendor must also consider the effects of the following:

- ▶ Variable consideration
- ▶ Constraining estimates of variable consideration
- ▶ The existence of a significant financing component
- ▶ Non-cash consideration
- ▶ Consideration payable to a customer.

Variable consideration

Instead of the amount of consideration specified in a contract being fixed, the amount receivable by a vendor may be variable. In other cases, the consideration may be a combination of fixed and variable amounts.

Variable consideration can arise for a wide range of reasons including discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. If there is any potential variation in the amount that a vendor will receive in return for its performance, then the provisions in Section 23 dealing with variable consideration apply.

However, the transaction price is not adjusted for the effects of a customer's credit risk. In some cases, such as when a discount is offered between the date of supply of goods or services and the payment date, it may be difficult to determine whether a vendor has offered a price concession (which will result in a reversal of revenue recognised for performance to date), or has chosen to accept that the customer has defaulted on the contractually agreed amount of consideration (which will result in the recognition of a bad debt expense rather than the reversal of revenue previously recognised).

As with the identification of contractual terms themselves, it is necessary to look more widely than the contract between a vendor and its customer. Variability in the amount of consideration receivable may arise if the customer has a valid expectation arising from a vendor's customary business practices, published policies or specific statements that the vendor will accept an amount of consideration that is less than the price stated in the contract. In addition, it is necessary to consider whether there are any other facts and circumstances that suggest the vendor has the intention of offering a price concession to its customer. For example, a manufacturer of retail goods might expect to offer a retailer a discount (or additional discount) from that specified in a contract in order to enable the retailer to sell the goods to its own customers at a discount and therefore to increase sales volumes.



Example 4.3-1

Variable consideration may be challenging to identify in some situations. For example, it is common in the mining and extractives industry for provisional pricing to occur upon delivery of goods to customers.

On 28 December, 20X6 a vendor sells 1,000 tonnes of copper concentrate to a customer. At this point, control of the copper concentrate transfers to the customer. At the time of transfer, a provisional price of CU700 per tonne is established for the core concentrate, which will be finalized in January 20X7 once final assaying occurs and the final quantity and quality of copper in the concentrate is established.

Is the provisional pricing in the contract variable consideration?

The variability arises from the fact that the precise quantity and quality of the underlying good being sold (the ore) is unknown at the time the performance obligation is satisfied (i.e. when control passes to the customer). As such, the variable consideration guidance would apply in this situation.

Additionally, as the seller's right to consideration is contingent on more than just the passage of time (i.e. it is not unconditional), their right to consideration is reflected as a contract asset, and not a trade receivable within the scope of Section 11 Basic Financial Instruments.

When the consideration promised in a contract with a customer includes a variable amount, a vendor estimates the amount of consideration to which it expects to be entitled in exchange for the transfer of the promised goods or services. There are two possible methods which can be used, and which are required to be applied consistently throughout the term of each contract:

▶ **Expected value method**

The sum of probability weighted amounts in a range of possible outcomes. This may be an appropriate approach if the vendor has a large number of contracts which have similar characteristics.

▶ **Most likely amount**

The most likely outcome from the contract. This may be an appropriate approach if a contract has two possible outcomes, such as a performance bonus which either will or will not be received.

The approach chosen is not intended to be a free choice, and instead the approach chosen for each contract should be the one which is expected to provide a better prediction of the amount of consideration to which a vendor expects to be entitled.



Example 4.3-2

Variable consideration – expected value method

On 1 January 20X6, a vendor enters into a contract with a customer to build an item of specialised equipment, for delivery on 31 March 20X6. The amount of consideration specified in the contract is CU2 million, but that amount will be increased or decreased by CU10,000 for each day that the actual delivery date is either before or after 31 March 20X6.

In determining the transaction price, the vendor considers the approach that will better predict the amount of consideration that it will ultimately be entitled to, and determines that the expected value method is the appropriate approach. This is because there is a range of possible outcomes.

Variable consideration – most likely amount

A vendor enters into a contract with a customer to construct a building for CU1 million. The terms of the contract include a penalty of CU100,000 if the building has not been completed by a specified date.

In determining the transaction price, the vendor considers the approach that will better predict the amount of consideration that it will ultimately be entitled to. It concludes that the most likely amount method is the appropriate approach. This is because there are only two possible outcomes: either the penalty will be applied (such that it will receive CU900,000) or it will not (such that it will receive CU1 million).

The estimated amount of variable consideration is updated at each reporting date to reflect the position at that date, and any changes in circumstances since the last reporting date.

Constraining estimates of variable consideration

Estimating the amount of variable consideration introduces uncertainty to the measurement of revenue. In order to reduce the possibility that variable consideration recognised in one period is reversed in a subsequent period, Section 23 only permits an entity to include in the transaction price an amount of variable consideration to the extent it is highly probable that it will be entitled to the cumulative amount of revenue recognised when the uncertainty associated with the variable consideration is subsequently resolved. This is known as the 'variable consideration constraint'. The estimated amount of variable consideration may change at each reporting date as more information becomes available and there is greater certainty about the expected amount of consideration.



BDO Comment

Section 23 does not provide specific guidance on constraining estimates of variable consideration. While there is a simplification in the description of constraints on estimates of variable consideration compared to IFRS 15, entities may refer to the guidance provided in IFRS 15 to apply this principle.

In assessing the constraining estimates of variable consideration, IFRS 15 requires an entity to consider both the likelihood and the magnitude of the revenue reversal once the uncertainty is subsequently resolved. Factors that could increase the likelihood or magnitude of a revenue reversal include, but are not limited to, any of the following:

- ▶ The consideration is highly susceptible to factors outside the vendor's influence, including:
 - Volatility in a market
 - The judgement or actions of third parties (e.g. when the amount of variable consideration varies based on the customer's subsequent sales)
 - Weather conditions
 - A high risk of obsolescence of the promised good or service.
- ▶ Where uncertainty regarding the amount of variable consideration is not expected to be resolved for a long period of time
- ▶ The vendor's experience (or other evidence) with similar types of contracts is limited or it has limited predictive value

- ▶ The vendor has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances
- ▶ The contract has a large number and broad range of possible variable consideration amounts.

The requirement to assess variable consideration in this way might lead to a change in the timing of revenue recognition for some transactions.

In situations where variable consideration has a wide range of potential outcomes (e.g. anywhere from nil to CU100,000 depending on number of website visits), it is unlikely that the transaction price would be constrained to nil, as the wide number of possible outcomes means that this outcome would be highly unlikely.

Additionally, when an entity uses portfolio approach as permitted by FRS 102 23.6, where multiple similar contracts or performance obligations are grouped together into one unit of account, it would also be rare for the amount of variable consideration included in the transaction price to be constrained to nil, as doing so would be assuming that the outcome of every instance of uncertainty would be nil.

The constraint may reduce the amount of variable consideration included in the transaction price to nil in situations where the outcome is binary (e.g. nil or CU100,000) and significant uncertainty exists relating to the outcome.



Example 4.3-3

The example and two scenarios set out below illustrate the interaction between variable consideration and constraining estimates.

On 1 January 20X6, a vendor sells 1,000 identical goods to a distributor, which sells them to its own customers. The vendor's selling price is CU100 per unit, and payment is due from the distributor when the distributor sells each of the goods to its own customers. Typically, those onward sales take place 90 days after the goods have been obtained by the distributor. Control of the goods transfers to the distributor on 1 January 20X6.

The vendor expects that it will subsequently grant a price concession (a discount) so that the distributor can in turn offer its own customers a discount and increase sales volumes. Consequently, the consideration in the contract is variable.

Scenario 1 – the vendor's estimate of variable consideration is not constrained

The vendor has substantial past experience of selling the goods and, historically, has granted a subsequent price concession of approximately 20% of the original sales price. Current market conditions indicate that a similar reduction in price will be applied to the contract entered into on 1 January 20X6.

The vendor considers the approach which will better predict the amount of consideration to which it will be entitled, and concludes that the expected value method should be used. Under this method, the estimated transaction price is CU80,000 (CU80 x 1,000 units).

In addition, the vendor considers the requirements for constraining the estimate of variable consideration to determine whether the transaction price can be the estimated amount of CU80,000. In this scenario, the vendor determines that it has significant previous experience with the particular good and that current market information supports the estimate. In addition, despite there being some uncertainty (because the vendor will only receive payment when the distributor sells the goods to its own customers), this will be resolved in a relatively short time period.

Consequently, the vendor recognises revenue of CU80,000 on 1 January 20X6, the date on which control of the goods passes to the distributor.

Scenario 2 – the vendor's estimate of variable consideration is constrained

Although the vendor has experience of selling similar goods, these goods (including the goods being sold in this transaction) have a high risk of obsolescence and the ultimate pricing is very volatile. Historically, the vendor has offered subsequent price concessions of 20-60%

from the sales price for similar goods, and current market information indicates that a range of 15-50% might apply to the current transaction.

The vendor considers the approach which will better predict the amount of consideration to which it will be entitled, and concludes that the expected value method should be used. Under this method, it is estimated that a 40% price concession will apply, meaning that the estimated transaction price is CU60,000 (CU60 x 1,000 units).

In addition, the vendor considers the requirements for constraining the estimate of variable consideration. This is in order to determine whether the transaction price can be the estimated amount of CU60,000. In this scenario, the vendor determines that the ultimate amount of consideration is highly variable and susceptible to factors outside its control, and that there is a wide range of possible price concessions that will need to be offered to the distributor. Consequently, the vendor cannot use its estimate of CU60,000 because it is unable to conclude that it is highly probable that there will not be a significant subsequent reversal in the cumulative amount of revenue that has been recognised.

Although historic information shows that price concessions of 20-60% have been given in the past, current market information indicates that a price concession of 15-50% will be needed for the current transaction. The vendor has carried out an analysis of past prices and can demonstrate that they were consistent with the current market information that was available at that time. Consequently, it is concluded that it is highly probable that a significant reversal in the cumulative amount of revenue recognised will not occur if a transaction price of CU50,000 is used.

Consequently, the vendor recognises revenue of CU50,000 on 1 January 20X4, and reassesses its estimates of the transaction price at each subsequent reporting date until the uncertainty has been resolved.

In scenario 2 above, although the uncertainties resulted in a restriction over the amount of revenue that was recognised when the goods were supplied to the distributor, there was still sufficient evidence to support the immediate recognition of a portion of the estimated transaction price. For those entities in the early stages of their operations, in particular those operating in relatively new sectors, it is possible that the constraint over estimates of variable consideration will result in no revenue being recognised on the date on which control

over goods passes to a customer, with recognition being postponed until a later date. However, in these circumstances the inventory sold would be derecognised with an associated cost of sale (and gross loss) at the point at which control passes to the customer. The estimate of variable consideration and appropriate constraint would then be reassessed at each reporting date, with a corresponding amount of revenue being recognised as appropriate.

Sales - and usage- based royalties

Note that there are specific requirements for revenue relating to sales- or usage-based royalties that are receivable in return for a licence of intellectual property. In those cases, revenue is recognised when (or as) the later of the following events takes place:

- ▶ The subsequent sale or usage occurs
- ▶ The performance obligation to which some or all of the sale- or usage-based royalty has been allocated has been satisfied (in whole or in part).

This is discussed in more detail in [section 5.10](#) below.

BDO Comments

Section 23 of FRS 102 does not clarify whether the constraint on variable consideration should be applied at the contract level or the performance obligation level. Our view is that the constraint should be applied at the contract level, as the unit of account for determining the transaction price in Step 3 is the contract.

Estimating the transaction price using the evidence obtained from other similar contracts ('portfolio of data') is not the same as applying the portfolio approach as permitted by FRS 102 23.6. The practical effect of this could be where an entity is developing an estimate of variable consideration for a single contract using the expected value method. Although the entity might consider historic data for other, similar, contracts that have been carried out in the past does not mean that it is applying the portfolio practical expedient. Consequently, there is no need to comply with the restriction on the use of the portfolio practical expedient, which is to conclude that there is a reasonable expectation that the effects on the financial statements from applying the guidance to a portfolio of contracts would not differ materially from applying the guidance to individual contracts within the portfolio.

A question also arises whether the constraint can be applied to a portfolio of contracts when a 'portfolio of data' was used to estimate variable consideration or whether the constraint can be applied at an individual contract level. We consider that the approach to be followed is linked to whether the entity concludes that it should use the expected value approach or the most likely amount method when it estimates the transaction price. If the expected value approach is used, it is consistent and appropriate to utilise the 'portfolio of data' to estimate variable consideration. Conversely, if the most likely amount method is chosen, a portfolio approach should not be employed.

Time value of money

The timing of payments specified in a contract may be different from the timing of recognition of the related revenue (and, consequently, the timing of transfer of control of the related goods or services to the customer). If payment is deferred beyond normal business terms or is financed (by the entity) at a rate of interest that is not market rate, the arrangement constitutes a financing transaction. A vendor is required to adjust the promised amount of consideration for the effects of the time value of money and recognise the interest revenue in accordance with Section 11 Basic Financial Instruments or Section 12 Other Financial Instruments Issues. Interest revenue should be presented separately from revenue from contracts with customers.

Again, it is necessary to look more widely than the documented contractual terms. A financing component may exist regardless of whether a financing component is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

If payment is received in advance, a vendor has a policy choice regarding whether to adjust the payment received for the effects of the time value of money. Such policy choice is not available under IFRS 15.

As a practical expedient, adjustments for the effects of time value of money are not required if, at contract inception, the vendor expects that the period between when revenue is recognised for the transfer of the goods or services and the date of payment from the customer will be one year or less.

The objective of including adjustments for the effects of the time value of money is to require revenue to be recognised at the amount that would have been paid if the customer had paid for the goods or services at the point at which they are supplied (that is, when control transfers to the customer). This is because the result of excluding the effects of (say) a substantial payment in advance from a customer could result in two economically similar transactions giving rise to substantially different amounts of revenue.

BDO comments

The following factors can help in assessing whether a contract contains a financing component:

- ▶ The difference, if any, between the amount of consideration and the cash selling price of the goods or services
- ▶ The combined effect of:
 - The expected length of time between the point at which the vendor transfers the goods or services to the customer, and the point at which the customer pays for those goods or services; and
 - The prevailing interest rates in the relevant market.

The following circumstances are unlikely to give rise to a significant financing component, even though there is a difference between when goods or services are transferred and when payment is received:

- ▶ A customer has paid in advance, and is able to call off the related goods or services at any point (such as a prepaid phone card)
- ▶ A substantial amount of consideration payable by the customer is variable, and the amount or timing of that consideration will be determined by future events that are not substantially within the control of either the vendor or the customer (such as a sales-based royalty)
- ▶ The timing of payment in comparison with the timing of supply of goods or services is for a reason other than financing such as to provide the customer with protection that the vendor has or will adequately complete its obligations, e.g.
- ▶ to ensure any necessary remedial works on a newly constructed or refurbished building are completed subsequent to ownership transferring to the customer.

When the existence of a financing component is identified, the applicable interest rate should be the borrowing rate that would have been charged by an unrelated third party to the entity (vendor or customer) which receives the benefit of the financing. Consequently, in addition to considering any difference between the amount of consideration and the cash selling price of the goods or services, the interest rate that would apply to a particular borrowing arrangement needs to be considered.

**Example 4.3-5**

A vendor enters into a contract with a customer to supply a new machine. Control over the machine will pass to the customer immediately at inception of the contract (the vendor's performance obligation is satisfied at a point in time). The contract contains two payment options. Either the customer can pay CU5 million in two years' time, or the customer can pay CU4 million on inception of the contract when it obtains control of the machine.

The customer decides to pay CU5 million in two years' time.

The vendor concludes that because of the significant period of time between the date of transfer of the machine to the customer and the date of payment by the customer, together with the effect of prevailing market rates of interest, that there is a financing component

The interest rate implicit in the transaction is 6% - ie the rate that discounts the CU5 million receivable in two years to an amount equal to the current cash price of CU4 million is 6%.

The accounting entries required are as follows:

Contract inception:

| | CU'000 | CU'000 |
|----------------------|--------|--------|
| Accounts receivables | 4,000 | |
| Revenue | | 4,000 |

Recognition of revenue for sale of machinery at date of transfer of control to the customer

Over the two years construction period:

| | | |
|----------------------|-------|-------|
| Accounts receivables | 1,000 | |
| Interest income | | 1,000 |

Recognition of interest income on financing component at a rate of 6%

At the date of payment from the customer:

| | | |
|----------------------|-------|-------|
| Cash | 5,000 | |
| Accounts receivables | | 5,000 |

**BDO comment**

For the purposes of identifying whether there is a financing component, the comparison made is between the timing of payment and the timing of transfer of control of the related goods or services. For those entities that provide goods or services where revenue is recognised at a point in time (such as in the above example) an adjustment for financing may be required even if the services are being carried out over a period of time. [Section 4.5](#) below discusses in more detail whether revenue should be recognised at a point in time or over time.

Non-cash consideration

In some cases, a vendor might enter into a contract with a customer where the payment is in the form of non-cash assets. For example, a vendor might accept shares as payment (in particular from a customer listed on a public market).

When determining the transaction price, the vendor should measure the non-cash consideration at its fair value. If it is not possible to measure the fair value of the non-cash consideration, then the vendor is required to estimate this by using the stand-alone selling prices of the goods or services subject to the contract.

A customer might contribute goods or services to a vendor (for example, a customer for a construction contract might supply materials, equipment or labour which the vendor is to use in performing the construction services). In those circumstances, the vendor is required to assess whether it obtains control of the contributed goods or services. If so, they are accounted for as non-cash consideration and the contractual transaction price will be greater. If the vendor does not obtain control of the contributed goods or services, then their value should not be included as part of the contractual transaction price.

Care should also be taken to ensure that contracts involving the exchange of non-cash consideration are within the scope of Section 23. For example, Section 23 would not apply to:

- ▶ Barter transactions in which two entities exchange non-monetary items in the same line of business to facilitate sales to customers (see [section 3](#) above); and
- ▶ Transactions in which a vendor accepts a non-cash item (such as shares in a customer) in settlement of a debt owed to the vendor.

Consideration payable to a customer

A contract between a vendor and its customer might require the vendor to pay consideration to the customer (or to other parties that purchase the vendor's goods or services from the customer). Such consideration could include cash, credits or other items (such as coupons or vouchers) that can be applied against amounts owed to the vendor.

Consideration might be payable from the vendor to the customer if, for example, the customer is selling goods or services to the vendor at the same time as the vendor provides goods or services to the customer. If the payment by the vendor is for distinct goods or services provided by the customer to the vendor, then the vendor accounts for this as a purchase transaction, i.e. separate from the sales transaction (on which revenue is recognised) for the provision of goods and services to the customer. If the amount of consideration payable to the customer exceeds the fair value of a distinct good or service that the entity receives in exchange, the difference is accounted for as a reduction in the vendor's sales transaction price.

If, in contrast, the payment to the customer is not in exchange for distinct goods and services provided by the customer, then the vendor accounts for the full amount of that payment as a reduction of the transaction price (and hence, a reduction of revenue).



Example 4.3-6

Entity V, a vendor, sells goods to Entity C, its customer, for CU100. As part of the contract Entity V is required to pay Entity C CU25.

Scenario A

Entity C is not providing any distinct goods and services to Entity V. Therefore the transaction price (and hence total revenue) recognised by Entity V on the sale of goods to Entity C is CU75.

Scenario B

As part of the contract, Entity C is also providing a service to entity V with a fair value of CU25. Therefore the transaction price (and hence total revenue) recognised by Entity V on the sale of goods to Entity C is CU100. Entity V separately recognises the services purchased from Entity C for CU5.

Scenario C

As part of the contract, Entity C is also providing goods to entity V with a fair value of CU15. Therefore the transaction price (and hence total revenue) recognised by Entity V on the sale of goods to Entity C is CU90 (CU100 – (CU25 – CU15)). Entity V separately recognises the goods purchased from Entity C for CU15.



If a vendor cannot reasonably estimate the fair value of a good or service received from the customer, then the full amount of the consideration payable to the customer is deducted from the vendor's own transaction price (and hence reduces revenue).

When any of the consideration payable to a customer is treated as a reduction of the transaction price, it is accounted for when (or as) the later of either of the following occurs:

- ▶ The vendor recognises revenue for the transfer of the related goods or services to the customer
- ▶ The vendor pays, or promises to pay, the consideration, even if the payment is conditional on a future event. Such a promise may be implied by the vendor's customary business practices.

A key point is that any amount paid by a vendor to its customer will be accounted for as a reduction in revenue, unless that payment is in return for a distinct good or service.



Example 4.3-7

A vendor that manufactures retails goods enters into a contract to sell goods to a customer (a large supermarket group) for a period of one year. The customer is required to purchase at least CU20 million of goods during the year.

The contract requires the customer to make changes to the shelving and display cabinets at the stores from which the retail goods will be sold. On the date on which the contract is entered into, the vendor makes a non-refundable payment of CU2 million to the customer to compensate for the related costs.

The payment by the vendor to its customer does not result in it obtaining any distinct good or service. This is because, although the shelving and display cabinets will be used by the customer to sell the retail goods, the vendor does not obtain control of any rights to those shelves or display cabinets.

Consequently, the CU2 million payment is accounted for as a reduction in the transaction price when the vendor recognises revenue for the transfer of retail goods. To achieve this, the CU2 million payment is recorded as an asset and is amortised to the revenue line in the income statement as the related sales of retail goods are recorded, resulting in total revenue of CU18 million being recognised by the vendor.

Consideration is often paid by a manufacturer to a retailer to obtain a prominent positioning of its goods in the retailer's shops. These are sometimes referred to as slotting fees. Whether the retailer provides a distinct good or service can depend on the precise facts and circumstances, specifically whether the manufacturer obtains control of any good or service provided by the retailer. Careful analysis will be required, as control is not the same as obtaining the risks and rewards of the shelf or other space.



BDO comment

The requirement to focus on whether a vendor receives any distinct goods or services in return for a payment to a customer represents a subtle, but potentially significant, change. In some cases, vendors may currently account for these types of payments as marketing costs, rather than a reduction in revenue.

Section 23 provides limited guide on how a vendor should account for consideration payable to a customer, but it does not address directly how an entity should account for amounts received from a supplier. In our view, the above example should result in the supermarket reflecting a reduction in the cost of inventory purchased (and hence ultimately a reduction in cost of sales) and not either revenue or a contribution to be offset against the costs of changing shelving and display cabinets. To the extent the receipt from the supplier relates to future purchases from the manufacturer, which is the contractual minimum purchase of CU20 million, the supermarket should recognise a liability, which is offset against the cost of inventory when the future products to which the payment relates are purchased.

The manufacturer is not the retailer's customer in this situation, i.e. the adaption of shelving space and cabinets are not an output of the supermarket's ordinary activities and do not represent a good or service that is distinct from its purchases from the manufacturer. This results in consistency in the accounting because, if the manufacturer is not receiving a distinct good or service for the consideration paid to the retailer, then the supermarket is similarly not providing a distinct good or service to the manufacturer.

However, in other circumstances, a retailer can receive consideration from manufacturers that do constitute revenue. This is illustrated by the following three scenarios:

Scenario A - Discount granted based on purchases not related to manufacturers' products

A manufacturer agrees with a retailer a promotion under which:

- ▶ the retailer's customers receive coupons based on their total purchases in the retailer's store;
- ▶ the retailer's customers use the coupons in order to acquire the manufacturers' products at a discounted price in the retailer's stores; and
- ▶ the difference between the sales price and the discounted price granted to the customer is borne by the manufacturer.

Suppose, a customer receives coupons of CU10 for each CU100 of purchases in the retailer's store. The manufacturer's product has a selling price of CU60. The customer purchases the product for 3 coupons (with a value of CU30) and cash of CU30. The manufacturer reimburses cash of CU30 to the retailer, being the face value of the coupons. The retailer will record revenue of CU60, being the cash received from the customer (CU30) and the cash reimbursement from the manufacturer (CU30).

Scenario B - Promotional discount granted to the customer

A manufacturer and a retailer agree the annual commercial strategy, which includes promotional activities. For instance, the retailer normally purchases the manufacturer's product for a price of CU85. The retail selling price of the product is CU102. During the promotional period, the retailer sells the product for CU97 to its customers, with the discount of CU5 to the regular retail price of CU102 being reimbursed by the manufacturer.

The retailer will record revenue of CU102, being the price paid by its customer (CU97) plus the amount reimbursed by the manufacturer (CU5).

Scenario C - Discount granted to the end-customer based on coupons issued by the manufacturer

A manufacturer initiates a promotional campaign under which end customers receive coupons issued by the manufacturer when they purchase the manufacturer's products. When customers use the coupons, the difference between the normal retail price and the discounted price is borne by the manufacturer. For example, a customer receives coupons of CU10 for each CU100 of purchases of the manufacturer's products. Manufacturer's Product A has a selling price of CU60. The customer purchases Product A for 3 coupons (with a value of CU30) and cash of CU30. The retailer receives CU30 from the manufacturer.

Although the payments received by the retailer in all three scenarios are from the manufacturer (i.e. its supplier), the payments are received on behalf of the retailer's end customer and, as a result, the retailer recognises the amounts due from the manufacturer as revenue. As long as the manufacturer reimburses the retailer at an amount that exactly matches the discount that the end-customer receives, the coupon has in effect been issued by the manufacturer (not the retailer) to the end-customer and therefore is recognised as revenue by the retailer. Therefore, it is not a payment to a customer from the perspective of the retailer (the end customer has not paid the retailer anything), and is therefore not a rebate for the cost of inventory sold.

However, from the manufacturer's perspective it is a payment to its customer (i.e. the retailer), and so should result in a reduction to the amount of revenue recognised by the manufacturer.



4.4. Step Four - Allocate the transaction price to the performance obligations

Having determined the transaction price of the contract in step 3, it is then necessary to allocate that transaction price to each of the performance obligations identified in step 2. The objective is to allocate an amount to each performance obligation that reflects the consideration to which a vendor expects to be entitled in exchange for transferring the distinct goods or services (comprising each identified performance obligation in step 2) to the customer. The starting point for the allocation is to determine the stand-alone selling prices of each of those performance obligations.

Allocating the transaction price based on the stand-alone selling price

At contract inception a vendor is required to determine the stand-alone selling price of the good or service underlying each performance obligation and then allocate the transaction price proportionately based on these stand-alone selling prices. The 'stand-alone selling price' is the price at which a vendor would sell a good or service separately to a customer. The best evidence of a stand-alone selling price is the observable price charged for that good or service sold in similar circumstances and to similar customers. Although a contractually stated price or a list price for a good or service may represent the stand-alone selling price, this will not always be the case. For example, a vendor might typically grant discounts from its list prices, or it might not sell the distinct good or service separately from others.

When a stand-alone selling price is not directly observable, it is estimated. The objective is to determine the amount of consideration that the vendor expects to be entitled in return for the good or service. This is achieved by using all available information that is reasonably available to the entity, including market conditions, vendor-specific factors and information about the customer or class of customers. In all cases, the use of observable inputs is required to be maximised to the extent possible.

Approaches that might be used include:

- ▶ **Adjusted market assessment**
Estimating the price that a customer in the particular market would be prepared to pay, which might include referring to prices charged by the vendor's competitors for similar goods or services, and adjusting those prices as necessary to reflect the vendor's costs and margins.
- ▶ **Expected cost plus margin**
Estimating the expected costs of satisfying a performance obligation and adding an appropriate margin.

- ▶ **Residual**
Deducting observable stand-alone selling prices that are available for other goods or services to be supplied from the total contract price. However, the use of this approach is restricted to those goods or services for which the selling price is highly variable, or in circumstances in which the selling price is uncertain because no selling price has been set for the good or service and it has not previously been sold on a stand-alone basis.



BDO Comment

In some situations a distinct good or service is never sold separately by the vendor. Instead it is sold as part of a bundle and the bundle may be sold for a broad range of amounts. This is common in the software industry where software licenses are often bundled with maintenance for an initial period. Software maintenance (or PCS – Post Contract Support) can typically be renewed after the initial period on a stand-alone basis. However, the licence and the PCS could represent separate performance obligations despite the fact that the vendor might never sell one without the other (see [section 4.2](#) above which discusses factors to take into account in determining whether two deliverables are distinct within the context of the contract).

In certain circumstances, an entity may have strong pricing policies for PCS where the entity charges customers a fixed amount for maintenance renewals and the price does not vary from customer to customer. This could also be the case if PCS renewals are stated as a percentage of a licence's list price (that is, the list price prior to any customer specific discounts or adjustments) provided that the list price was not subject to significant regular, artificial adjustments.

The question that arises is whether it would be acceptable for an entity to apply the residual approach to establish the standalone selling price for a licence that is never sold separately.

In our view, a residual approach to calculating the stand-alone selling price of the software licence is appropriate if an entity is able to identify that the pricing variability that exists in the software licence and PCS bundle is attributable to the software licence and that the standalone selling price of the PCS is not highly variable. Although the entity does not sell the software licence on its own for a broad range of amounts, the entity does sell a bundle that contains both software and PCS for a broad range of amounts. However, there is observable evidence that PCS renewals are always sold for either a fixed amount or a fixed percentage of the list price of the software being sold. The entity can identify that it is the licence component of the bundle that is sold to different customers for a broad range of amounts, and not the PCS, because there is an observable stand-alone selling price for the PCS. This means that the use of the residual approach is appropriate to calculate the stand-alone selling price of the licence.

Allocating discounts

A discount exists if the sum of the stand-alone selling prices of the goods or services in a contract exceeds the consideration payable by the customer. A discount is allocated proportionately to all performance obligations in the contract based on their stand-alone selling prices, unless this basis does not depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation in the contract. In that case, the entity shall allocate that discount or variable consideration using a method that reflects such an amount (eg a variable payment may be allocated entirely to one performance obligation in the contract if the terms of that variable payment relate specifically to the entity's efforts to satisfy that performance obligation).



Example 4.4-1

A vendor sells three products (A, B and C) to a customer for CU100. Each product will be transferred to the customer at a different time. Product A is regularly sold separately for CU50, but products B and C are not sold separately. The estimated stand-alone selling prices of products B and C are CU25 and CU75 respectively.

There is no evidence that suggests the discount of CU50 relates entirely to one, or a group of two, of the products being sold. Consequently the discount is allocated proportionately to the three products and revenue is recognised as follows:

| | | |
|---|------------------|------|
| A | (100 x (50/150)) | CU33 |
| B | (100 x (25/150)) | CU17 |
| C | (100 x (75/150)) | CU50 |

Difference between FRS 102 and IFRS

IFRS 15 requires discounts to be allocated on a relative stand-alone selling price basis unless the criteria in IFRS 15.83 is met.

Section 23 follows a more judgemental approach (as opposed to requiring a specific criteria to be met) in determining an appropriate basis for the allocation of discounts.

Allocation of variable consideration

- ▶ An entity shall allocate variable consideration to all the performance obligations in the contract on a relative stand-alone selling price basis, unless this basis does not depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation in the contract. In that case, the entity shall allocate that variable consideration using a method that reflects such an amount (eg a variable payment may be allocated entirely to one performance obligation in the contract if the terms of that variable payment relate specifically to the entity's efforts to satisfy that performance obligation).

To account for changes in the estimate of the transaction price, an entity shall allocate any changes to performance obligations in the contract on the same basis as at contract inception.

Consequently, an entity shall not reallocate the transaction price to reflect changes in stand-alone selling prices after contract inception. Amounts allocated to a performance obligation that has been satisfied shall be recognised as revenue, or as a reduction of revenue, in the period in which the estimate of the transaction price changes.

Example 4.4-3

A vendor enters into a contract with a customer for two licences of intellectual property (licences A and B). Assume each licence represents a separate performance obligation, which is satisfied at a point in time (the transfer of each licence to the customer). The stand-alone selling prices of Licences A and B are CU1,200 and CU1,500 respectively.

The prices specified in the contract are as follows:

- ▶ Licence A: a fixed amount of CU1,200
- ▶ Licence B: a royalty payment of 5% of the selling price of the customer's future sales of products that use the intellectual property to which licence B relates

The vendor estimates that the amount of sales-based royalties that it will be entitled to in respect of licence B will be approximately CU1,500.

The vendor then determines the allocation of the transaction price to each of the two licences. It is concluded that the allocation should be as follows:

- ▶ Licence A: CU1,200
- ▶ Licence B: the variable royalty payment

This allocation is made because both of the following conditions apply:

- ▶ The variable payment relates solely to the transfer of licence B (the subsequent royalty payments); and
- ▶ The fixed amount of licence A, and the estimated amount of sales-based royalties for licence B, are equivalent to their stand-alone selling prices.

Although revenue will be recognised for licence A on its transfer to the customer, no revenue will be recognised when licence B is transferred to the customer. Instead, revenue attributable to licence B will be recognised when the subsequent sales of the customer's products that use licence B take place (see [section 5.11](#) below).

In contrast, the allocation of variable consideration is different if the prices included in a contract do not reflect stand-alone selling prices.



4.5. Step Five - Recognise revenue when each performance obligation is satisfied

Having allocated in step 4 the transaction price (as determined in step 2) to the performance obligations (identified in step 3) it is then necessary to determine when the revenue allocated to each performance obligation should be recognised. A vendor recognises revenue when (or as) goods or services are transferred to a customer. A vendor satisfies a performance obligation (that is, it fulfils each promise to the customer) by transferring control of the promised good(s) or service(s) underlying that performance obligation to the customer.

Existing requirements for revenue recognition are based on an assessment of whether the risks and rewards of ownership of a good or service have been transferred to a customer. Under the control model, an analysis of risks and rewards is only one of a number of factors to be considered and this may lead to a change in the timing and profile of revenue recognition in certain industries.

Control in the context of FRS 102 is the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. It includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. Indicators that control has passed include that the customer has:

- ▶ A present obligation to pay
- ▶ Physical possession of the asset(s)
- ▶ Legal title
- ▶ Risks and rewards of ownership
- ▶ Accepted the asset(s).

The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly, such as by:

- ▶ Using the asset to produce goods or provide services (including public services)
- ▶ Using the asset to enhance the value of other assets
- ▶ Using the asset to settle liabilities or reduce expenses
- ▶ Selling or exchanging the asset
- ▶ Pledging the asset to secure a debt liability
- ▶ Holding the asset.

When evaluating whether a customer obtains control of an asset, a vendor considers any agreement to repurchase the asset transferred to the customer, or a component of that asset.

For each performance obligation, a vendor determines at contract inception whether control is transferred over time or at a point in time. If it is determined that a vendor does not satisfy a performance obligation over time, the performance obligation is deemed to be satisfied at a point in time.



Performance obligations satisfied over time

A vendor satisfies a performance obligation and recognises revenue over time when one of the following three criteria is met:

- i. The customer simultaneously receives and consumes the economic benefits provided by the vendor's performance
 - ii. The vendor creates or enhances an asset controlled by the customer
 - iii. The vendor's performance does not create an asset for which the vendor has an alternative use, the vendor has an enforceable right to payment for performance completed to date.
- i. The customer simultaneously receives and consumes the economic benefits provided by the vendor's performance*

This criterion applies to certain contracts for services, and in some cases it will be straightforward to identify that it has been met. For routine or recurring services (such as certain cleaning contracts) it will be clear that there is simultaneous receipt by the customer of the vendor's performance. The concept of control of an asset applies, because services are viewed as being an asset (if only momentarily) when they are received and used. However, even in cleaning contracts care is needed. For example, take a three-year cleaning contract of an office block in which the windows are cleaned once every 6 months (taking 5 days to complete), carpets deep cleaned once a month (taking place over a weekend), bins are emptied daily, with vacuuming and dusting undertaken on a continuous basis outside normal office working hours. Each

cleaning activity is likely to constitute a separate performance obligation and so it would be necessary to allocate the total contractual price to each of those performance obligations. The contractual price allocated to window cleaning and the deep cleaning of carpets would be recognised as those activities take place, and not spread evenly over the three-year contractual period.

For other performance obligations, it may be less straightforward to identify whether there is simultaneous receipt and consumption of the benefits from the vendor's performance. In these cases, a key test is whether, in order to complete the remaining performance obligations, another vendor would need substantially to re-perform the work the vendor has completed to date. If another vendor would not need to re-perform the work, then the customer is simultaneously receiving and consuming the economic benefits arising from the vendor's performance.

In determining whether another entity would need substantially to re-perform the work completed to date, the vendor is required to:

- ▶ Disregard any contractual or practical barriers to the transfer of the remaining performance obligations to another entity; and
- ▶ Presume that any replacement vendor would not have the benefit of any asset that the entity currently controls, and would continue to control (such as a partially completed service or item of property, plant and equipment), were the remainder of the contract to be fulfilled by the entity.





Example 4.5-1 – Shipping Company

Entity S, a shipping company enters into a contract to transport goods from New York to Rotterdam. When Entity S enters into the contract, the ship to be used to transport the goods is docked in Miami. On Entity S's reporting date, the goods have been collected from New York and are half-way across the Atlantic Ocean.

Entity S concludes that it can recognise revenue for its performance to date (being the transport of goods from New York to appoint half-way across the Atlantic Ocean) because another entity would not need to re-perform the transportation services provided to date. In reaching this conclusion Entity F disregards the practical limitation associated with a hypothetical transfer of the goods from its ship to another shipping company's ship mid-Atlantic. Entity S therefore recognises revenue over time to reflect its partial performance to date.



BDO Comment

Careful analysis of shipping contracts is needed because, in some circumstances, shipping contracts may contain a lease of the ship used to transport goods because control of the ship is transferred to the customer. In such cases, Section 20 would apply to the contract rather than Section 23 Lease income would be recognised from the date control of the ship passes to the customer, which could result in lease income being recognised as the ship sails from Miami to New York.

If the contract is not, or does not contain, a lease of the ship then a shipping company would apply Section 23 for the shipping services provided to its customer. As noted above, if Section 23 applies, revenue is not recognised to reflect the journey from Miami to New York because Entity S does not provide any service to the customer during this part of the ship's overall journey. Instead it recognises revenue at the reporting date to reflect the extent to which the goods have been transported from New York to Rotterdam.

Alternative use

A vendor does not have an alternative use for an asset if the vendor is unable, either contractually or practically, readily to direct the asset (which may be an asset to be constructed in future, or a partially completed asset) for another use during the creation or enhancement of that asset. The assessment is made at contract inception, and takes into account the characteristics of the asset that will ultimately be transferred. It is not updated unless there is a modification to the contract that results in a substantive change to the vendor's performance obligation(s).

The contractual 'alternative use' restriction applies if the vendor would expect the customer to enforce its rights to the promised asset if the vendor (hypothetically) sought to direct the asset for another use. However, a contractual restriction is not substantive if, for example, an asset is largely interchangeable with other assets that the vendor could transfer to the customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract. This might apply when the asset being sold is mass produced, and it would be straightforward for a particular item subject to an existing contract with a customer to be substituted for another, with the original item being sold to another customer. This would apply even if each of the items produced (for example, a car) could be specified individually by each customer from a range of optional extras, because it is straightforward for another car to be produced with the same options and therefore still to meet the requirements of the original contract.

A vendor does not have a practical alternative use for an asset if the vendor would incur significant economic losses to direct the asset for another use, for example,

- ▶ Incurring significant costs to rework the asset; or
- ▶ Only being able to sell the asset at a significant loss.

This may occur in some manufacturing contracts where the customisation of the asset being produced under one contract is substantial, and therefore it would not be possible to redirect it to another (hypothetical) customer during production. This is because it would either require significant rework or result in the entity not being able to transfer the asset to the original customer in accordance with the contractual timescales.

A vendor does not consider the possibility of a contract termination in assessing whether the vendor is able to redirect the asset to another customer.



Enforceable right to payment for performance completed to date

The second condition that needs to be satisfied is that the entity has to have an enforceable right to payment for performance completed to date throughout the contract (except in circumstances in which the contract is terminated due to the vendor's failure to carry out its obligations). In assessing that enforceability a vendor considers the terms of the contract as well as any laws or regulations that relate to the contract.

If a customer were to terminate (or take steps to terminate) a contract without having the right to do so, or if the customer fails to perform its obligations as promised, the contract (or other laws) might entitle the vendor to continue to carry out its obligations set out in the contract and require the customer to pay the contractual consideration. In this circumstance the vendor does have a right to payment for performance completed to date because the vendor has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations which include paying the promised consideration.

If, as is commonly the case, a contract (or other laws) does not grant the vendor these rights when the customer seeks to terminate the contract without the vendor having defaulted on its obligations, the amount which the vendor could force the customer to pay must at least compensate the vendor for performance completed to date (i.e. it must be an amount that approximates the selling price of the goods or services transferred to date), whether or not the customer has a contractual right of termination. This means a vendor must be able to demonstrate that at all times throughout the contract it would be entitled to compensation for recovery of costs incurred to date plus either of the following amounts:

- ▶ a proportion of the expected profit margin under the contract, reasonably reflecting the extent of the vendor's performance under the contract before termination by the customer or another third party; or
- ▶ a reasonable return on the vendor's cost of capital for similar contracts (that is, the vendor's typical operating margin in similar contracts or transactions) if the contract specific margin is higher than the return the vendor usually generates from similar contracts.

A vendor's right to payment for performance completed to date does not need to be a present unconditional right to payment. In many cases, a vendor will have that right only at an agreed-upon milestone or upon complete satisfaction of the performance obligation, and not throughout the contract term. However, in the event of contract termination, the vendor must always be entitled to payment for performance completed to date.

In assessing the existence and enforceability of a right to payment, a vendor considers whether:

- ▶ Legislation, legal precedent or administrative practice gives the vendor a right to payment for performance to date even though that right is not specified in the contract
- ▶ A court (or other relevant legal precedent) has previously decided that similar rights to payment for performance to date in similar contracts have no binding legal effect
- ▶ Its own customary business practices of choosing not to enforce a right to payment have caused that right to be unenforceable in that legal environment. If the vendor concludes that the right would still be enforceable, the vendor would have a right to payment for performance to date notwithstanding that the vendor has previously chosen, and may in the case being analysed choose, to waive that right.

In the absence of terms in the contract itself that provide evidence of an enforceable right to payment for performance completed to date, entities may need to review relevant legal precedent in their jurisdiction. Different countries and sub-national jurisdictions may provide entities with legal rights that are applicable but are not explicitly included in a contract itself (for example, a contract might refer to compliance with applicable laws but not specify precisely what these laws are). Therefore, entities should not always automatically conclude that they do not satisfy this particular criteria solely based on the reading of the contract.

For entities operating in the real estate industry, in particular those that sell residential units in multi-unit apartment blocks, properties being sold in real estate contracts typically cannot be readily redirected to another customer (that is, the vendor's performance does not create an asset for which the vendor has an alternative use because it is unable to sell the unit specified in the contract to any other party). The focus is therefore on whether the contract requires the customer to pay for performance to date in all circumstances other than vendor default. If that right exists then revenue will be recognised over time. However, many real estate contracts do not require the customer to pay for performance to date, with the customer instead either forfeiting a deposit or having to pay a penalty for the vendor's loss of profit. In those cases, a vendor recognises the sale on completion of the contract (at a point in time) and not over time as construction progresses.



Example 4.5-2

Entity R, a residential development company, is developing a block of apartments and enters into binding contracts with customers to sell units before construction is complete. Entity R assesses whether it should recognise revenue over time (i.e. from the period it enters a contract for a unit until the residential unit is completed) or whether it should recognise revenue at a point in time (i.e. on the date the completed unit is transferred to the customer).

Entity R observes that the first two situations in which revenue is recognised over time are clearly not met (FRS 102 23.81 (a) and (b)):

- iv. Customers do not simultaneously receive and consume the economic benefits provided by the vendor's performance (i.e. a customer does not consume the economic benefits of a unit as the units are constructed, only after it has been constructed); and
- v. Control of residential unit does not pass to customers until each one is complete, and therefore Entity R does not create or enhance an asset controlled by the customer.

Entity R therefore looks to the third situation in which revenue must be recognised over time, i.e. that its performance does not create an asset for which the vendor has an alternative use and for which it has an enforceable right to payment for performance completed to date.

Entity R concludes that the first of these sub-criteria is met, because its performance does not create an asset for which it has alternative use. The contract with each customer specifies exactly which unit in the apartment block each customer will buy. Therefore, as construction progresses, it is not possible for Entity R to direct a pre-sold unit to another customer whilst at the same time being able to meet its contractual obligations. However, Entity R concludes that it cannot demonstrate an enforceable right to payment throughout the contract. This is because if a customer cancels the contract before completion (even though it has no contractual right to do so):

- ▶ legal precedent would not entitle Entity R to sue the customer for the full contractual price even if Entity R completes the development.
- ▶ irrespective of any contractual right granted to Entity R to complete the unit for full payment, legal precedent requires the entity to mitigate any loss. Developers are required to make reasonable efforts to find a replacement customer and the courts would only award compensation equal to the difference between the stated contractual price with the original customer and the price obtained from a replacement customer (i.e. loss of profit). In almost all circumstances this would be less than Entity R's cost of developing the unit plus a reasonable profit margin. Consequently, Entity R cannot demonstrate it would have an enforceable right to payment from its customer for performance completed to date throughout the period of the contract.

Therefore, Entity R concludes it cannot recognise revenue over time as it progresses development of units sold. Instead it must recognise revenue at a point in time when the pre-sold units are completed and provided to customers.





Example 4.5-3:

Entity A entered into an agreement with Entity B to produce a highly specialised product. It has no alternative use to Entity A because it is prohibited from selling the product to another customer. Entity B commits to purchase certain volumes of the product over the contract term because it needs a continuous supply of the product to avoid interruptions to its production process.

The contract also contains the following features:

- ▶ Entity B is required to compensate Entity A if it terminates the contract without cause for an amount equal to all costs incurred by Entity A to date plus an agreed upon margin;
- ▶ Payment is due upon delivery of the product;
- ▶ Products are shipped under FOB destination terms* to B's international premises and A insures shipment against potential losses and damages that might affect the product. Therefore, B will not pay for the products before they are delivered;
- ▶ Shipment term is around 30 days (from A's warehouse to B's international premises).

The contract does not meet the over time recognition criteria in FRS 102 23.81(a) because Entity B does not consume the economic benefits of any product whilst they are being produced by Entity A. The contract also does not meet the over time recognition criteria in FRS 102 23.81(b) because Entity B does not control the products whilst they are in production because, *inter alia*, they are being produced on Entity A's premises.

Regarding the third scenario in which revenue must be recognised over time (i.e. no alternative use and enforceable right to payment for performance completed to date), the following issues arise:

- ▶ Does a termination clause imply that 'an enforceable right to payment for performance completed to date' does not exist?

If a customer has a contractual right to terminate a contract, then whether the vendor has an enforceable right to payment for performance to date depends on the facts and circumstances. In the facts above, Entity A has a contractual right to recover all costs plus an appropriate margin and

therefore the condition is met. In some contracts, however, the vendor receives stage payments and on cancellation of the contract by the customer, there may be no contractual right to receive stage payments otherwise due after the cancellation date. In those cases, careful analysis would be needed on inception of the contract to ensure that on any potential customer cancellation date the total amounts received by the vendor would equal costs incurred up to that date plus an appropriate margin. Unless this can be demonstrated, the vendor would not have an enforceable right to payment for performance completed to date and would be required to recognise revenue at a point in time rather than over time.

- ▶ If the customer has no obligation to pay in the event that products are lost or damaged during the shipping period can Entity A still demonstrate a right to performance completed to date?

A failure by the vendor to complete its contractual obligations because the products are lost or damaged during the shipping period does not mean Entity A would not have an enforceable right for performance completed to date. The possibility that a vendor might not perform its contractual obligations is not something that is relevant to the analysis of over time or point in time. Further, an entity might conclude in its step 2 analysis of the contract, that an obligation to deliver manufactured products constitutes a separate performance obligation, i.e. separate from the obligation to manufacture the products, with the transaction price determined in step 3 then allocated to the two performance obligations in step 4. The vendor would then need to conclude separately for each of those performance obligations whether the criteria for recognising revenue over time are met. If there were a significant risk that a vendor might not be able to perform its contractual obligations such that it would not be entitled to payment, then it might not be able to conclude it is probable it will receive consideration, and hence for accounting purposes a contract would not exist ([see Section 4.1 above](#)).

* *FOB stands for "Free on Board". FOB destination terms mean that the buyer takes delivery of goods being shipped to it by a supplier once the goods arrive at the buyer's receiving dock.*



Example 4.5-4

Entities often create original parts for sale to Original Equipment Manufacturers (OEMs) in the development of new products. Initially, these parts will not typically have an alternative use (i.e. they can only be sold to the OEM) and the entity will often have a present right to payment for any production completed to date. Therefore the contract would meet the criteria in FRS 102 23.81(c) to recognise revenue over time.

Once an aftermarket emerges, the parts which were originally sold only to the OEM and for which there was no alternative use can now be sold to the other customers, as further parts are manufactured under subsequent contracts entered into with either the OEM or other customers in the aftermarket. The existence of several customers for the parts means that as more parts are manufactured under a new contract with one customer, those parts could typically be sold to other customers, with subsequent production of additional units being used to satisfy the original contract. This in turn means that, once an aftermarket emerges, the manufacturer will typically have an alternative use for products being manufactured under any particular contract with a customer. Therefore, the conditions for recognising revenue over time would no longer be met.

Measuring progress toward complete satisfaction of a performance obligation

For each performance obligation that is satisfied over time, revenue is recognised by measuring progress towards completion of that performance obligation based on either:

- i. Output methods
These include appraisals of results, milestones reached, units produced and units delivered; or
- ii. Input methods
These include resources consumed, labour hours expended, costs incurred, time lapsed or machine hours used.

Only those goods or services for which the vendor has transferred control of are included in the assessment of progress to date.

For each separate performance obligation, the same input or output method of assessing progress to date is required to be used. The same method is also required to be applied consistently to similar performance obligations and in similar circumstances.

Output methods result in revenue being recognised based on the measurement of the value of goods or services transferred to date in comparison with the remaining goods or services to be provided under the contract. When evaluating whether to apply an output

method, consideration is given to whether the output selected would reflect the vendor's performance toward complete satisfaction of its performance obligation(s). An output method would not reflect the vendor's performance if the output selected fails to measure a material amount of goods or services (for example, work in progress or finished goods) which are controlled by the customer.



BDO comment

For performance obligations that meet the conditions for over time recognition of revenue, an entity would not recognise any work-in-progress under Section 13. This is because the fundamental principle underlying over time recognition is that control of the good or service is transferred to the customer continuously as the vendor fulfils its contractual obligations. Therefore, such costs would be expensed as incurred. If an output method is used to measure performance to date then entities will often find that profit margins will vary over the contractual period. In some cases, losses may be experienced in some periods, particularly in the early stages of the contract, even though the contract is anticipated to be profitable overall. This is because the measurement of cumulative (or periodic) outputs driving the amount of revenue to recognise may not be commensurate with the cumulative (or periodic) costs incurred.

In most cases, the measurement of revenue (when recognised over time) will not be the same as amounts invoiced to a customer. In these circumstances an entity recognises either a contract asset or a contract liability for the difference between cumulative revenue recognised on a contract and cumulative amounts invoiced to the customer. However, as a practical expedient, if the amount of a vendor's right to consideration from a customer corresponds directly with the value to the customer of the vendor's performance completed to date (e.g. a service contract in which a vendor bills a fixed amount for each hour of service provided), the vendor recognises revenue at the amount to which the vendor has the right to invoice.

When the information that is required to apply an output method is not observable, or is not available without undue cost, it may be necessary to use an input measurement method.

Input methods result in revenue being recognised based on the vendor's efforts or inputs towards the satisfaction of a performance obligation. When the vendor's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for a vendor to recognise revenue on a straight-line basis.

A drawback of input methods is that there may not be a direct relationship between the vendor's inputs and the transfer of goods or services to a customer. Therefore, when using a cost-based input method, an adjustment to the measure of progress may be required if certain costs incurred do not contribute to the vendor's progress in satisfying its performance obligation(s). This would be the case when costs incurred are attributable to significant inefficiencies in the vendor's performance which were not reflected in the price of the contract.



Example 4.5-5

As part of a contract to refurbish a building, Entity X needs to install new elevators. Entity X has analysed the contract in accordance with the requirements of FRS 102 and made the following judgements:

- ▶ The refurbishment constitutes a single performance obligation, i.e. the supply and installation of the elevators is not distinct from the overall obligation to refurbish the building.
- ▶ Revenue should be recognised over time because the customer controls the output of the refurbishment as the work takes place (because the customer owns the property).
- ▶ An input method should be used to measure progress to date, specifically cumulative costs incurred as a proportion of total expected contracts costs.

Shortly after signing the contract, and by its reporting date, Entity X has purchased the elevators and arranged for them to be delivered to the premises being refurbished. However, although it is assessed that control of the elevators has been transferred to the customer at Entity X's reporting date, the elevators have not been installed and limited other refurbishment work has been carried out. The cost of the elevators represents 50% of the overall costs to be incurred on the contract.

Entity X must expense the cost of the elevators. It would be inappropriate to recognise them as an asset because control of the elevators has passed to the customer. However, Entity X also concludes that it would be inappropriate to recognise 50% of total contract revenue and related profit because it has made limited progress in refurbishing the building. Consequently, it restricts the amount of revenue recognised to the cost of procuring the elevators. As a result, although Entity X recognises revenue equal to the cost of the elevators, it recognises no profit from their transfer to the customer because its performance obligation is to refurbish the building.

In some cases, a vendor may not be able to reasonably measure the outcome of a performance obligation, but may expect to recover the costs incurred in satisfying that performance obligation (e.g. in the early stages of a contract). In these circumstances, the vendor recognises revenue only to the extent of the costs incurred to date, until such time that it can reasonably measure the outcome of the performance obligation.



BDO comment

Accounting for partial satisfaction of performance obligations prior to identifying the contract

For some arrangements, an entity may start to provide goods and services before the criteria for the recognition of a contract are met. Other than the absence of a contract (which is required for step 1 of the five-step approach in Section 23), revenue would be recognised over time. This might be the case where an entity starts to manufacture a highly customised good or provide a service in advance of obtaining an expected contract from a customer. It could also apply to an entity that constructs apartments in circumstances when the entity is able to demonstrate the criteria for overtime revenue recognition are met on inception of the contract

When the entity subsequently determines that the criteria for identification of a contract have been met, it would begin to apply the remaining four steps of the five-step model. If the terms of the arrangement are such that revenue for the related good or service is required to be recognised over time, the question that arises is whether revenue is recognised prospectively from inception of the contract or if there is a cumulative catch-up adjustment for the work done to date.

In our view, revenue should be recognised on a cumulative catch-up basis because Section 23 requires an entity to recognise revenue when, or as, an entity satisfies performance obligations by transferring promised goods or services to a customer. This occurs when (or as) the customer obtains control of the good or service. If, at the point at which the criteria for the identification of a contract have been met, the entity satisfies part or all of certain performance obligations by transferring fully or partially completed goods or services to its customer, it is required to recognise the related amount of consideration to which it expects to be entitled.

Recognising revenue on a prospective basis only from the point at which the contract criteria have been met would be inconsistent with the control model underlying revenue recognition in accordance with Section 23, as control of certain goods or services is transferred to the customer on inception of the contract.

Revenue recognition at a point in time

If a performance obligation is not satisfied over time, a vendor satisfies the performance obligation at a point in time. A vendor considers indicators of the transfer of control, which include the following:

- i. The vendor has a present right to payment for the asset. If the customer is obliged to pay for the asset, this indicates that the customer may have the ability to obtain substantially all of the remaining benefits from the asset.
- ii. The customer has legal title to the asset. Legal title may indicate that the customer has the ability to direct the use of and obtain substantially all of the remaining benefits from an asset or to restrict the access of other entities to those benefits. If a vendor retains legal title over an asset solely as protection against the customer's failure to pay, this is a protective right and does not preclude a customer from obtaining control of that asset.
- iii. The customer has physical possession of an asset. This may indicate that the customer has the ability to direct the use of and obtain substantially all of the remaining benefits from the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset; for example, consignment stock or bill and hold arrangements may result in physical possession but not control.
- iv. Significant risks and rewards of ownership. When evaluating whether the customer has the risks and rewards of ownership of an asset, a vendor considers any risks that may give rise to a performance obligation in addition to the performance obligation to transfer the asset. For example, a vendor may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.
- v. Acceptance of the asset. The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of and obtain substantially all of the remaining benefits from the asset.



Example 4.5-6

Entity P, a property development company, enters into contracts to sell properties (for example, stand-alone residential or commercial properties, or individual units in apartment blocks) to its customers. The arrangements have the following features:

- ▶ On date X, customers enter into a binding contract for the property and pay a deposit of 10% of the contractually agreed purchase price.
- ▶ If the property is incomplete at date X (for example, it may have been sold 'off plan' or some, but not all, construction activities may have been completed), Entity P completes the construction of the property.
- ▶ From the point construction of a property, which is subject to a sales contract with a customer, is complete (date Y, which could be the same as date X) the customer assumes certain ownership risks, including risks associated with damage to the property caused by an event (such as severe weather) or by unrelated third parties.
- ▶ On date Z, which is typically a few weeks after date Y (the point at which Entity P has completed its construction activities), customers pay the balance of consideration and take ownership, with legal title passing from Entity P to its customer.

From date X, because the customer has entered into a binding sales contract, the customer is exposed to subsequent changes in the market value of the property.

However, even though the construction activities are completed on date Y, up to date Z the customer is not permitted to occupy or sublet the property, and may have either limited or no rights to access the property. The customer also has no right to make any changes to the property or to pledge it as security in transactions such as a lending arrangement.

If a customer does not fulfil its contractual obligation to pay the balance of consideration on date Z, Entity P will retain the 10% deposit that was paid on date X. The contract also requires the customer to pay compensation to Entity P for any loss of profit. This means that if Entity P sells the property to another customer, but is unable to obtain a price of at least 90% of the original contractually agreed price with the original customer, the original customer is required to pay the shortfall to Entity P. There is substantial past history in Entity P's jurisdiction that the courts will enforce this compensation clause.

Entity P first considers whether it meets any of the criteria to recognise revenue over time. It concludes that it does not, meaning that revenue will be recognised at a point in time.

Entity P then considers whether the contractual terms and the legal environment mean that the transfer of control of the properties (the point at which revenue is recognised in accordance with Section 23) is different from the point at which revenue has previously been recognised (which is the point at which it had been considered that substantially all of the risks and rewards of ownership had passed to the customer). Although the customer assumes certain risks associated with the property at dates X and Y, Entity P concludes that the restrictions over the customer's physical and other use of the property up to date Z mean that control does not pass until that date.

Consequently, Entity P will recognise revenue from the sale of properties on date Z and not the earlier date Y

BDO Comment

In determining when to recognise revenue, it is very important to understand the legal environment as well as the precise contractual terms and conditions. This is particularly true for transactions involving real estate as subtle differences in property law and the way it is applied to a contract for the sale of real estate could affect the assessment of whether control passes at a point in time or over time and, if at a point in time, the specific date on which control passes.



5. Other issues

5.1 Contract costs

Section 23 of FRS 102 contains requirements in relation to contract costs, distinguishing between costs to obtain a contract (FRS 102 23.113 - 115) and costs of fulfilling a contract (FRS 102 23.116 - 118).

Costs to obtain a contract

An entity may incur costs in its effort to obtain a contract with a customer. An entity may recognise such costs as an asset if these costs are:

- a. Incremental costs; and
- b. the costs are expected to be recovered.

Incremental costs incurred in obtaining a contract are those that would not have been incurred had that individual contract not been obtained. This is restrictive and includes only costs such as a sales commission that is paid only if the contract is obtained, unless the costs can be explicitly recharged to a customer.

Entities have an accounting policy choice over whether to capitalise costs meeting the above criteria, that policy shall be applied consistently to all costs that meet the criteria of FRS 102 23.113, except for costs that the entity would recognise as an asset with an amortisation period of one year or less, which may be expensed when incurred. Costs that do not meet the criteria in FRS 102 23.113 are recognised as an expense when incurred.

Notwithstanding the requirements of FRS 102 23.113 and 114, costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognised as an asset if those costs are explicitly chargeable to the customer regardless of whether the contract is obtained

Difference between FRS 102 and IFRS

Under IFRS 15, if costs incurred to obtain a contract are incremental and recoverable then an asset is required to be recognised for these costs. FRS 102 offers a policy choice instead regarding the capitalisation of such costs.



Example 5.1-2

Engineering Co enters into a contract with Customer Z to design a water treatment plant. The design project is expected to take two years to complete. Assume that Engineering Co will transfer the services to Customer Z over time.

In order to win the project Engineering Co incurred the following costs:

- ▶ External marketing company for CU100,000 as part of developing the tender
- ▶ Other internal labour costs amounting to CU350,000 as part of developing the tender

After Engineering Co won the tender the following costs were incurred:

- ▶ Solicitor's fee of CU50,000 to draw up the contract with Customer Z
- ▶ Commission of CU120,000 to a PR Agent after the contract was signed (this amount would not have been paid if the contract had ultimately not been signed)
- ▶ After the contract is signed, the PR Agent is also paid an additional CU50,000 bonus

Question:

How should Engineering Co account for the costs incurred?

- a. CU100,000 marketing fee
- b. CU350,000 labour costs
- c. CU50,000 solicitor's fee
- d. CU120,000 PR Agent commission

Part a Marketing fee

The CU100,000 fee paid to the external marketing company was incurred as part of the tender process to win the contract and would have been incurred by Engineering Co even if had lost the tender. Consequently, this fee would not be considered an incremental cost of obtaining the contract in accordance with FRS 102 23.113. Engineering Co should therefore expense the CU100,000 marketing fee as incurred in accordance with FRS 102 23.113

Part b Labour cost for tender

The internal labour costs incurred, of CU350,000, were incurred in connection with the development of the tender and would have been incurred by Engineering Co even if had lost the tender. This means that these costs would not be considered incremental costs associated with obtaining the contract in accordance with FRS 102 23.113

Engineering Co should expense the CU350,000 labour costs as incurred, in accordance with FRS 102 23.113.

Part c Solicitor's fee

The solicitor's fees were only incurred because Engineering Co won the tender. However, judgement may be required in some cases. For example, if the solicitor was engaged to draft template contracts for use in multiple tenders then the fees would not be incremental.

Part d PR Agent commission

The PR Agent commission and bonus were only incurred and were only payable after the contract had been signed. The commission and bonus are considered incremental costs of obtaining the contract in accordance with FRS 102 23.113, since these amounts would not have been paid unless the contract has been signed. Engineering Co may capitalise the PR Agent commission and bonus as a 'costs to obtain a contract' asset and amortise it over the project period (i.e. to reflect the pattern of transfer of the design service to Customer Z).

Costs to fulfil a contract

In contrast with the incremental costs of obtaining a contract, which fall wholly within the scope of FRS 102 Section 23, the requirements of Section 23 apply only to costs to fulfil a contract which do not fall within the scope of another FRS 102 section. (for example, Section 13, Section 17 and Section 18). For those costs which do fall within the scope of Section 23, the threshold for recognising costs to fulfil a contract is lower than the 'incremental' threshold for costs in obtaining a contract. However, there are still restrictions and all of the following criteria need to be met:

- ▶ The fulfilment costs relate directly to a contract or to an anticipated contract that can specifically be identified
- ▶ The costs generate or enhance resources of the vendor that will be used to satisfy performance obligations in future; and
- ▶ The costs are expected to be recovered.



Example 5.1-3

Entity A enters into a contract with Entity B that is within the scope of Section 23. As part of the services that Entity A will provide to Entity B, Entity A must incur training costs to train its own employees to utilise Entity B's equipment and learn about their processes. The requirement to train its own staff does not meet the definition of a performance obligation for Entity A as the act of training its own employees does not transfer a distinct good or service to the customer, Entity B (FRS 102 23.17). Instead, the staff training enables Entity A to provide the service that it has promised to Entity B.

The training is included in a specific section of the contract between Entity A and Entity B, with a specified recharge which will at least cover the costs incurred. The recharge covers the number of Entity A's employees who require training at the start of the contract, and the training of new employees if operations expand. Costs associated with training replacement employees (because employees leave their employment with Entity A) are not covered and must be paid by Entity A.

The question which then arises is whether training costs incurred relating to fulfilling a contract with a customer should be recognised as a contract asset (i.e. as an asset arising from a cost to fulfil a contract (FRS 102 23.117)).

In our view training costs should not be capitalised as a cost to fulfil a contract, regardless of whether they are explicitly chargeable in the contract with the customer.

An entity shall account for the costs incurred in fulfilling a contract with a customer in accordance with the relevant section of this FRS for those costs (eg Section 13 Inventories, Section 17 Property, Plant and Equipment, or Section 18 Intangible Assets other than Goodwill). [FRS 102 23.116]

If the costs incurred in fulfilling a contract are not within the scope of another section of FRS 102, an entity shall recognise those costs as an asset if:

- a. the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify;
- b. 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; and
- c. the costs are expected to be recovered.

Therefore, FRS 102 23.117 first requires that another applicable Section does not address the accounting for the costs incurred prior to the criteria in FRS 102 23.117 being considered. Training costs are specifically addressed in Section 18 which prohibits training activities from being capitalised as intangible assets and requires such amounts to be expensed. FRS 102 18.8C states (extract):

"An entity shall recognise expenditure on the following items as an expense and shall not recognise such expenditure as intangible assets:

- a. Internally generated brands, logos, publishing titles, customer lists and items similar in substance.
- b. Start-up activities (ie start-up costs), which include establishment costs such as legal and secretarial costs incurred in establishing a legal entity, expenditure to open a new facility or business (ie pre-opening costs) and expenditure for starting new operations or launching new products or processes (ie pre-operating costs).
- c. Training activities.
- d. Advertising and promotional activities (unless it meets the definition of inventories held for distribution at no or nominal consideration (see paragraph 13.4A)).
- e. Relocating or reorganising part or all of an entity.
- f. Internally generated goodwill."

In some cases, expenditure is incurred that does not meet the criteria for recognition as part of an internally generated intangible asset, for example, because there is no intangible asset that can be recognised in accordance with the criteria set out in FRS 102 18.8H, or because the costs cannot be distinguished from the cost of developing the business as a whole.

Consequently, training costs that are incurred in respect of a contract with a customer which is within the scope of Section 23 cannot be recognised as an asset and must be expensed as incurred.



5.2. Changes in the transaction price after contract inception

The transaction price can change subsequent to contract inception either because the contract contains variable consideration or because the contract is renegotiated with the customer.

Any change to the transaction price arising from re-estimating the amount of variable consideration receivable (or the amount of variable consideration being confirmed due to the resolution of uncertain events) is allocated to the performance obligations on the same basis as at contract inception. Therefore, no reallocation of the transaction price to performance obligations is made to reflect changes in stand-alone selling prices since contract inception. Amounts allocated to performance obligation(s) which have already been satisfied are recognised as revenue (or as a reduction of revenue if necessary) in the period in which the variable consideration is re-estimated.

A change in the transaction price arising from re-estimating variable consideration is allocated entirely to one or more distinct goods or services only if the criteria for allocation of variable consideration to performance obligations are met. These are that:

- ▶ The terms of a variable payment relate specifically to the satisfaction of a performance obligation or to distinct goods or services
- ▶ The allocation meets the objective that the amount allocated to each performance obligation or distinct good or service reflects the amount to which the vendor expects to be entitled in exchange for transferring the goods or services to the customer.

Changes in stand-alone selling prices after contract inception are not reflected in the basis of determining the reallocation of the transaction price.

The guidance on contract modifications applies to changes in the transaction price that occurs as a result of a contract modification (see [section 4.1](#) above). However, careful consideration needs to be given when identifying the performance obligations to which any change in the revised contract price should be allocated, particularly when the modification involves the addition of new performance obligations, the transaction price contains variable consideration, and estimates of that variable consideration change subsequent to contract modifications. For changes in the transaction price that occur after a contract modification, a vendor allocates the change in the transaction price in whichever of the following ways is applicable:

- ▶ The change in the transaction price is allocated to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for as termination of the original contract and the establishment of a new contract
- ▶ In all other cases, being those in which the modification is not accounted for as a separate contract, the change in the transaction price is allocated to the performance obligations in the modified contract (i.e. the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).





Example 5.2-1

Background

Entity X enters a contract involving the delivery of Products A and B (which are two distinct performance obligations with the same stand-alone selling price) for a fixed amount of CU5,000 plus variable consideration. The variable consideration cannot be allocated specifically to one of the two products. Entity X includes variable consideration of CU1,000 in the transactions price (i.e. a total of CU6,000) because it concludes that it is highly probable there will not be a significant reversal of this amount. Entity X therefore allocates CU3,000 to each of Products A and B.

Change in price arising from contract modification

After delivering product A (and recognising revenue of CU3,000), the contract is modified, with a new performance obligation being added to the contract (delivery of Product C) for an additional CU1,500, but which has a standalone selling price of CU2,000. The remaining total contract consideration is therefore CU4,500 (i.e. original price of CU6,000 plus modification of CU1,500 less CU3,000 of revenue recognised on delivery of product A). In accordance with the guidance on contract modifications, this is accounted as a termination of the original contract because the remaining deliverables (Products B and

C) are distinct from those that have already been delivered. The future consideration to be received of CU4,500 is therefore allocated to products B and C in proportion to their relative standalone selling prices, i.e. CU2,700 to Product B and CU1,800 to Product C. The estimate of variable consideration not yet recognised as revenue of CU500 (and previously included within the CU3,000 allocated to Product B) is included in the price allocation to both Products B and C.

Change in contract price arising from re-estimation of variable consideration

Prior to delivering either Product B or Product C, Entity X revises its estimate of variable consideration from CU1,000 to CU1,600. Because the increase of CU600 to the transaction price is attributable to variable consideration promised before the modification and the modification was accounted for as a termination of the original contract, it is necessary to allocate some of this to Product A. The amount to allocate is based on the same proportion of variable consideration that was originally attributed to Product A (i.e. 50%), which means Entity X immediately recognises additional revenue of CU300 as Product A has already been delivered. The remaining CU300 is then allocated to each of Products B and C at the date of contract modification based on their relative standalone selling prices, i.e. CU180 to Product B and CU120 to Product C.



5.3. Sale with a right of return

A right to return enables a customer to receive:

- ▶ A full or partial refund of any consideration paid
- ▶ A credit that can be applied against amounts owed or that will be owed to the vendor
- ▶ Another product in exchange
- ▶ Any combination of the above.

A right to return may be given for various reasons such as customer dissatisfaction with the product or simply given if the customer changes their mind.

Although a right of return falls within the variable consideration guidance in Section 23, the price per item sold (i.e. the contractual price) does not vary. Unlike other situations in which there is variable consideration the entity will receive back the goods sold when a right of return is exercised. However, the aggregate amount of revenue recognised is subject to variability. Consequently, Section 23 requires that the variable consideration provisions in the standard (including the requirements for constraining variable consideration) should apply when measuring the amount of revenue to recognise for goods sold with a right of return.

For those items which are expected to be returned, the vendor does not recognise revenue. Instead, it recognises a refund liability together with an asset representing item(s) expected to be returned. Any refund liability is reassessed and updated at each reporting date. If the realisable value of the item to be returned (including any adjustment for expected costs of recovering the item and any potential decrease in value) is expected to be less than the cost of the related inventory, an adjustment is made to cost of sales.

Example 5.3-1

Entity R, a clothes retailer, grants customers a right to return any goods within 3 months of purchase for a full refund or an exchange of goods for equivalent value, if undamaged. At the reporting date, sales made in the previous 3 months amount to CU1 million, with those goods costing Entity R CU750,000. It has therefore made the following entries before accounting for customers' rights of return:

| | |
|------------------|-------------|
| Dr Cash | CU1,000,000 |
| Cr Revenue | CU1,000,000 |
| Dr Cost of Sales | CU750,000 |
| Cr Inventory | CU750,000 |

Entity R's historical experience is that 8% (by sales value) of goods on average are returned, with a 90% confidence that the value of goods that are returned will fall in the range of 6% to 10% of sales value. Therefore, Entity R's best estimate is that goods sold for CU920,000 will not be returned (i.e. it estimates there will be a reversal of revenue recognised to date of CU80,000), even though in theory all of the goods sold for CU1,000,000 could be returned. It further concludes that it is highly probable that goods sold for CU900,000 will not reverse (i.e. it is highly probable there will not be a significant reversal in excess of CU100,000).

Entity R applies the variable consideration requirements in Section 23 and processes the following accounting entries at the reporting date.

| | |
|-----------------------------|---------|
| Dr Revenue | 100,000 |
| Cr Refund liability | 100,000 |
| Dr Inventory to be returned | 75,000 |
| Cr Cost of Sales | 75,000 |

Entity R separately considers whether the asset of CU75,000, reflecting the cost of goods to be returned as a result of customers exercising their right of return, is recoverable.



BDO Comment

FRS 102 23.52 states that exchanges by customers of one product for another of the same type, quality, condition and price (for example one colour or size for another) are not considered returns. Although goods might be returned, there is no variability in the aggregate amount of revenue that will be received by the entity. This paragraph therefore ensures that those entities which only give such restrictive rights of return do not need to apply the variable consideration requirements in Section 23.

In our view, where customers are granted a general right of return (i.e. there is no restrictions on what products store credits can be used to purchase), there is no need to determine how any cash refund or store credit is subsequently used. If the customer chooses to use the store credit to purchase a similar product (for example, a different coloured shirt), this is a second transaction. However in other cases, where there are restrictions on the right of return, entities may be required to know to what extent customers ultimately return goods for a product of the same type as opposed to taking cash, store credits, or exchanging the returned goods for a different type of product. In the above example, therefore, had Entity R not offered a general right of return, it would also need to know which customers ultimately return an item for one of the same type, quality, condition and price. This would in turn lead to the refund liability (and associated adjustment to revenue for variable consideration) being less than CU100,000. The asset reflecting inventory to be returned (and associated adjustment to cost of sales) would similarly be less than CU75,000.

In cases where an entity needs to know the extent to which returned goods are exchanged for a product of the same type, it may need to update its inventory systems to track this information. Determining whether such information must be tracked will be a matter of judgment as the level of restriction placed on returns could vary.

When a vendor transfers products with a right of return, revenue is recognised only to the extent that the vendor expects to be entitled to it. To determine the amount of consideration to which it expects to be entitled, a vendor:

- ▶ Applies the guidance regarding constraining estimates of variable consideration
- ▶ Considers the nature of the products expected to be returned.

In subsequent periods the vendor updates:

- ▶ Its assessment(s) of amounts to which it expects to be entitled in exchange for the transferred products
- ▶ The measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds
- ▶ The measurement of the asset (i.e. so that it corresponds with changes in the measurement of the refund liability and any impairment recognised).

Note that a vendor's obligation to accept a returned product during the return period is not accounted for as a performance obligation in addition to the obligation to provide a refund.

5.4. Warranties

An entity shall account for the warranty in accordance with Section 21 Provisions and Contingencies unless the warranty, or part of the warranty, provides the customer with an additional service. An additional service is a service in addition to the assurance that the product complies with agreed-upon specifications. In assessing whether a warranty provides the customer with an additional service, an entity shall consider:

- ▶ Whether the warranty can be purchased separately – if the entity provides the customer with the option to purchase a warranty separately, the warranty provides the customer with an additional service.
- ▶ Whether the warranty is required by law – if required by law then this indicates the warranty is not a separate performance obligation
- ▶ The length of the warranty coverage period – the longer the coverage, the more likely it is that the promised warranty is a performance obligation
- ▶ The nature of the tasks that the vendor promises to perform – if the vendor must perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (e.g. a return shipping service for a defective product), then those tasks are unlikely to give rise to a performance obligation.

BDO comment

In some cases, careful consideration will be needed of whether a warranty goes beyond providing assurance that a product complies with agreed-upon specifications, and needs at least partially to be accounted for separately. For example, in some jurisdictions car manufacturers include a warranty period which goes well beyond the period required by law, and is used as a marketing tool to enhance sales.



5.5. Principal vs. agent

When a third party is involved in providing goods or services to a customer, the vendor is required to determine whether the nature of its promise is a performance obligation to:

- ▶ provide the specified goods or services itself (principal); or
- ▶ arrange for a third party to provide those goods or services (agent).

A vendor acting as principal controls a good or service before the vendor transfers the good or service to the customer. It may satisfy a performance obligation by itself or engage another party (for example, a subcontractor) to satisfy some or all of a performance obligation on its behalf. When a vendor, in its role as a principal, satisfies a performance obligation, it recognises revenue at the gross amount. However, the vendor is not necessarily acting as a principal if the vendor obtains legal title of a product only shortly before legal title is transferred to a customer.

The obligation of an agent is to arrange for the provision of goods or services by another third party. When a vendor represents an agent, and satisfies a performance obligation, it recognises revenue as the amount of any fee or commission to which it expects to be entitled. A vendor's fee or commission might be the net amount of consideration that the vendor retains after paying the third party the consideration received in exchange for the goods or services to be provided by that party. A vendor acting as agent does not control the good or service before it is transferred to the principal's customer.

Indicators that an entity is acting as principal include:

- ▶ having primary responsibility for fulfilling the promise to provide the specified good or service
- ▶ assuming inventory risk before the specified good or service has been transferred to the customer or after transfer of control to the customer (e.g. the customer has a right of return)
- ▶ having discretion in establishing the price for the specified good or service.

The relevance of each of these indicators depend on the nature of the specified good or service, and different indicators may provide more evidence in different contracts.





BDO comment

In practice it is sometimes difficult to identify whether a vendor is acting as principal or agent. For example, transactions involving virtual goods and services are often executed in milliseconds and involve multiple counterparties. Consequently, control over a virtual good may, in some cases, transfer almost instantaneously.

Assessing whether a vendor is acting as a principal or an agent may also be complex in situations where collaboration exists between two parties to deliver a product on demand to a customer. For example, Entity A installs water filtration systems on Entity B's retail premises, where the product (filtered water) is delivered on demand from a municipal water supplier, with Entity B receiving a portion of the proceeds from the customer. Neither party would appear to control the underlying good (the water) prior to delivery to the customer, so assessing which entity is acting as the principal or the agent is challenging. In our view, a principal must be identified in any revenue transaction, meaning gross presentation of revenue should be presented by at least one party in a transaction, even if significant collaboration does exist with other entities in delivering an underlying good or service.

It is likely that significant focus will need to be placed on the precise contractual terms of the arrangements to determine the nature of the promises made (that is, what each party is providing) and the consideration payable to each party. This links to the first of the five steps in Section 23, which is to identify the contract, including the goods or services to be transferred and the payment terms.

The complexity of this issue can also be seen in situations with 'drop shipment' arrangements. Drop shipping is a supply chain management in which an entity does not keep physical stock of the goods it sells; it simply arranges for the sale between a customer and its supplier, and the supplier ships directly to the customer. This is becoming more common in the online retail environment, where online retailers are keeping less physical inventory on hand, as customers do not ever need to interact with inventory held by a retailer.

In such instances, physical possession and legal title are less likely to be relevant in establishing whether the retailer who facilitates the shipment between its supplier and the end customer is a principal or an agent in the transaction. In this case, entities should carefully consider other factors in determining whether they are acting as a principal or an agent, including:

- ▶ Does the entity have latitude in establishing price?
- ▶ Does the entity only receive a fixed fee for establishing the relationship between the supplier and the customer?
- ▶ Who does the customer deal with in the case of product quality issues or returns?
- ▶ Are the goods customised or interchangeable for other goods?
- ▶ Which entity has the primary (or greater) responsibility towards the customer that receives the goods?

5.6. Customer options for additional goods or services

Customer options to acquire additional goods or services (either free of charge or at a discount) come in many forms, including sales incentives, customer award credits (or points), contract renewal options, or other discounts on future goods or services. Such customer options give rise to a performance obligation in the contract when the option provides a material right to the customer that it would not receive without entering into the contract. In those cases, the entity is required to defer the portion of payment received from its customer that relates to those future goods or services and recognise that portion as revenue only when those future goods or services are transferred to the customer (or when the option expires).

The allocation is based on the relative stand-alone selling prices of the goods or services and, if the prices of the future potential goods or services are not observable, they are estimated. This estimate takes into account any discount that the customer would receive without exercising the option together with the likelihood that the option will be exercised (FRS 102 23.71).



Example 5.6-1

Entity P, A pizza restaurant chain, undertakes a promotional campaign giving customers a voucher entitling them to a 50% discount on their next purchase (valid until 30 June 20X7) if they spend more than CU50 in a single transaction during December 20X6. Entity P considers that each voucher issued grants the customer with a material right (i.e. a discount of 50% off their next purchase) and therefore constitutes a separate performance obligation to which revenue on each qualifying meal sold should be allocated.

During December 20X6 Entity P issued 10,000 vouchers on sales of CU600,000 (i.e. an average spend of CU60). Total sales during December 20X6 were CU700,000 as some customers spent less than CU50 in a single transaction (generating sales of CU100,000 in total) and therefore did not receive a discount voucher.

Based on historical experience of recent similar promotions, Entity P anticipates 25% of customers receiving a voucher will return and use the voucher during the first 6 months of 20X7, with the expected average spend to which the discount will apply being CU80. Entity P therefore estimates the standalone selling price of each voucher to be CU10 (i.e. $CU80 \times 50\% \times 25\%$).

Entity P therefore allocates the CU60 received on each qualifying purchase during December 20X6 as follows:

| | | |
|--|--------------------------------------|---------|
| Revenue: | $CU60 / (CU60 + CU10) \times CU60 =$ | CU51.43 |
| Consideration allocated to each voucher: | $CU10 / (CU60 + CU10) \times CU60 =$ | CU 8.57 |
| | | CU60.00 |

Consequently, Entity P processes the following accounting entries in December 20X6:

| | | |
|---------|--------------------|---------|
| Dr Cash | 700,000 | |
| | Cr Revenue | 614,300 |
| | Cr Deferred income | 85,700 |

Assuming that there is no change in the number of vouchers that Entity P expects to be used, Entity P recognises the deferred income as revenue on the earlier of:

- ▶ the voucher being used; and
- ▶ expiry of the voucher (30 June 20X7).

5.7. Renewal options

A renewal option is different from customer loyalty programmes and many discount vouchers. With loyalty programmes and vouchers, the underlying goods or services in the contract with the customer will often have a different nature, and accordingly they would be considered as separate deliverables rather than being similar to the original goods or services in the original contract. A renewal option, in contrast, gives a customer the right to acquire additional goods or services of the same type as those supplied under an existing contract.

If an entity grants a customer the option to acquire additional goods or services, that option only gives rise to a performance obligation if it provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given). Similarly, an option to acquire additional goods or services at a price that would reflect their stand-alone selling price also does not constitute a material right even if it can be exercised only by entering into an earlier contract.



Example 5.7-1

Entity G operates gyms for its members. To become a member, a customer must pay a one-off upfront joining fee of CU1,000 and an annual subscription fee. The joining fee therefore entitles the customer to renew the contract, i.e. an option to acquire gym services in the future by paying the annual subscription and avoiding the upfront joining fee in subsequent years.

Entity G assesses whether the joining fee relates to the transfer of a promised good or service on inception of the customer's membership and concludes that it does not. Instead, the joining fee is an advance payment for future gym services. To determine whether the upfront fee should be recognised over the contract period (e.g. one year) or based on expected renewal behaviour (e.g. potentially longer than one year), Entity G must assess whether the renewal option gives rise to a material right.

Entity G concludes that the renewal option (i.e. the right to continue beyond year one as a gym member) is a separate performance obligation because it results in a material right being given to members. As a member does not pay the upfront fee in renewed membership years, the option to purchase additional goods and services is a material right, as it essentially discounts subsequent membership periods in comparison to a gym member signing up for a new membership.

Entity G therefore recognises the CU1,000 on a straight-line basis over the period it expects customers to remain as gym members. The annual subscription fee is recognised over the annual period to which it relates.

If a renewal option does constitute a material right, as a practical alternative to estimating the stand-alone selling price of the option, an entity can allocate the transaction price to the optional goods and services as the difference between the transaction price for the original contract and the amount of the total expected consideration (including from exercise of option) allocated to the goods or services to be provided under the original contract if the following two conditions are met:

1. The additional goods or services are similar to the original goods or services in the contract (i.e. a vendor continues to provide what it was already providing). Consequently, it is more intuitive to view the goods or services underlying such options as part of the initial contract.
2. The additional goods or services are provided in accordance with the terms of the original contract. Consequently, the vendor's position is restricted because it cannot change those terms and conditions and, in particular, it cannot change the pricing of the additional goods or services beyond the parameters specified in the original contract.



Example 5.7-2

Entity F, a professional football club, offers season tickets for the following season (season one) at a price of CU5,000. As part of a promotion drive it offers supporters the opportunity to buy a season ticket for the following season (season 1) for CU8,000, which will also grant those supporters the right to a 25% discount off the standard season ticket price for the subsequent four seasons (seasons two to five).

It is expected that the price of annual season tickets in future years will remain at CU5,000. In addition, it is expected that all supporters that purchase a season ticket for CU8,000 will exercise the option to purchase season tickets at a discount in seasons two to five (that is, there will be a 100% renewal rate).

Entity F concludes that the practical expedient applies because:

- ▶ The services to be provided in seasons two to five are similar to the services to be provided in season one; and
- ▶ The services to be provided in seasons two to five will be provided in accordance with the terms of the contract (with no contractual right to change or withdraw the 25% discount offer).

Under the practical expedient, the total transaction price is allocated across all of the season tickets that are expected to be sold over the five-year period.

This results in the contract being viewed as being a single contract for its expected term (in this case a term of five years as all renewal options are expected to be exercised), and not a one-year contract with a series of renewal options.

This means that the total consideration receivable (CU8,000 in season one plus CU3,750 for each of seasons two to five) is recognised evenly over the five-year period, resulting in revenue of CU4,600 $((\text{CU}8,000 + (\text{CU}5,000 * 4 * 0.75))/5)$ being recognised in each year.

Hence, the renewal option recognised in season one is CU3,400 ie CU8,000 (transaction price for the original contract) less CU4,600 (consideration allocated to services to be provided under the original contract) [FRS 102 23.35].

Consequently, Entity F processes the following accounting entries for each ticket sold for CU8,000 in season one:

| | |
|--------------------|-----------|
| DR Cash | CU8,000 |
| CR Revenue | (CU4,600) |
| CR Deferred income | (CU3,400) |

If all supporters exercise the option as expected, the deferred income would be evenly released to profit or loss as part of revenue from season two to five.

Note that in order to simplify this example, no adjustment has been made for any potential financing component.

It might be thought that an appropriate approach would be, for each season ticket sold for CU8,000, Entity F recognises revenue of CU5,000 during season 1 and allocates CU3,000 to customer renewal options rather than allocating amounts based on relative stand-alone selling prices. However, this is incorrect as it results in separate contracts being accounted for in the initial and subsequent periods instead of as a single overall contract for a five-year period. The allocation of CU3,000 would also be similar to the use of a residual approach for the allocation of the transaction price to the renewal options, which would also be inappropriate.



Accounting for early renewal rights

It is common for entities to offer non-cancellable contracts that provide the customer with the option to renew the contract prior to contract expiry. This would be common in telecommunications industry and other industries where a product is sold on day one of the contract with ongoing services to be provided over the contract period.



Example 5.7-3

Company X is in the telecommunications industry, and offers the following contract to customers:

- ▶ 24 month non-cancellable contract which includes a device and a package of services.
- ▶ Customers pay 24 equal monthly instalments. Company X allocates each instalment between the device and the services on the same basis.
- ▶ The contract states that the customer has an option to renew their contract at any time after 21 months without penalty (no recovery is made of instalments that would have been made during the period from renewal up to the end of the original 24 month contract period).
- ▶ The early renewal results in the customer obtaining a new device and the same services for a subsequent 24 months from the renewal date.
- ▶ The renewed contract is priced at the stand-alone selling price for that contract at the time that the customer exercises the early renewal right.

The issue is how the customer's option to renew early (prior to the full contract term of 24 months ending) should be accounted for in accordance with Section 23.

The early renewal right was embedded in the rights and obligations agreed to by the parties at contract inception. Therefore, the early renewal option is not a contract modification because it is not an amendment to the original rights and obligations of the parties. FRS 102 23.13 states that a contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract.

The option to renew early affects the amount of consideration to which the entity expects to be entitled for the device provided to the customer on day one. This is because the amount of consideration could vary depending on when customers exercise their option to renew. Consequently, the amount of consideration in respect of the device is variable consideration as described in FRS 102 23.43.

Company X will therefore need to estimate the amount of variable consideration to which it will be entitled, in accordance with FRS 102 23.44-47. This requires that variable consideration (in this case the monthly instalments between months 21 and 24) will only be recognised as revenue to the extent that it is highly probable that it will be entitled to the cumulative amount of revenue recognised when the uncertainty associated with the variable consideration is subsequently resolved.

In this case, the uncertainty will be resolved when it is known whether the customers will exercise their renewal rights early. This will affect the allocation of monthly instalments between the handset (for which revenue will be recognised on inception of the contract with a related receivable being settled through the partial allocation of future monthly instalments) and the services (for which revenue will be recognised over the period of the contract, being the residual amount after deduction of the amount allocated to the handset).

The amount of variable consideration that is taken into account will depend on the facts and circumstances in each case. However, for a period of more than 21 months to be taken into account for part or all of the customer base, clear evidence would be required of the expected pattern of exercise of the early renewal option.



5.8. Breakage (unexercised rights)

Breakage refers to situations where customers do not exercise all of their contractual rights to receive goods or services in the future. Common examples include:

- ▶ forfeiting balances on gift cards;
- ▶ not claiming loyalty points or air miles; and
- ▶ non-refundable theatre and travel tickets, where the customer foregoes amounts paid in advance if they do not turn up.

When a vendor expects to be entitled to a breakage amount, it recognises revenue in proportion to the expected pattern of rights that customers will exercise (i.e. by comparing the goods or services delivered to date with those expected to be delivered overall). This increases the transaction price allocated to the individual goods or services transferred to include revenue from the vendor's estimate of unexercised rights.

When the vendor does not expect to be entitled to a breakage amount, it is recognised as revenue when the likelihood of the customer exercising its remaining rights becomes remote. As with the variable consideration constraint, it would only recognise breakage as revenue to the extent it was highly probable that it will be entitled to the cumulative amount of revenue recognised when the uncertainty is resolved.

Example 5.8-1 (continued from example in section 5.7)

Entity F sells 10,000 season tickets for CU8,000 each that grant supporters the right to a 25% discount in each of seasons 2 to 5. At the start of season 1 Entity F has therefore received a total of CU80 million of which CU50 million is recognised as revenue in season 1 and CU30 million relates to supporters' renewal options.

At the two extremes of potential outcomes:

- ▶ if no supporter exercises their renewal option CU80 million would have been received for season 1; and
- ▶ if every supporter exercises their renewal options for all of seasons 2 to 5, then CU7.5 million will be recognised as revenue in each of seasons 2 to 5 (i.e. a total of CU30,000,000 or CU750 per season ticket holder per season).

The contractual terms of the renewal option stipulate that if a supporter fails to renew a season ticket in any year, they lose their right to the 25% discount in all subsequent seasons (e.g. if a season ticket holder renews at a 25% discount in season 2, but does not renew their season ticket in year three, they would lose their right to a 25% discount in seasons 4 and 5).

At the start of season 2, the price of a standard season ticket rises to CU5,500. 800 supporters do not exercise their renewal option and hence also forfeit rights to a 25% discount in seasons 3 to 5. 9,200 supporters renew their season ticket at a price of CU4,125 being the standard price of CU5,500 less the 25% discount.

Scenario A

Entity F has no prior experience of offering such discounts to supporters and therefore cannot estimate whether it will be entitled to any breakage. Consequently, it concludes that it cannot recognise any of the CU30 million as breakage revenue prior to knowing that supporters have forfeited their option (i.e. by not renewing their season ticket) as to do otherwise could result in recognising cumulative revenue higher than the amount it may eventually be entitled to. Therefore, Entity F does not recognise any revenue in season 1 for breakage.

At the start of season 2 Entity F recognises CU2,400,000 as breakage (i.e. CU750 x 800 x 4). This reflects that 800 supporters have forfeited their renewal rights (valued at CU750 per season for each of seasons 2 to 5 inclusive) and is therefore accounted for as additional revenue earned for services provided in season 1. Entity F also recognises:

- ▶ CU6,900,000 during season 2 (i.e. CU750 x 9,200) reflecting that 9,200 supporters exercised their renewal right for season 2; and
- ▶ CU37,950,000 during season 2 (i.e. CU4,125 x 9,200) reflecting the amounts paid by those 9,200 supporters for the price paid for the season ticket.

Scenario B

Entity F estimates based on past experience that 60% of supporters buying such season tickets will renew their season ticket for all 4 subsequent seasons, with the remaining 40% relinquishing their renewal options broadly on a linear basis (i.e. 10% or 1,000 supporters in each of the 4 seasons to which a discount is available). It therefore recognises breakage in year one of CU4,812,500. This is calculated as follows:

| Season | Supporters not expected to renew in following season | Rights expected to be forfeited at end of each season | Value of breakage CU | Allocate season 2 breakage to seasons 1 and 2 | Allocate season 3 breakage to seasons 1, 2 and 3 | Allocate season 4 breakage to seasons 1, 2, 3 and 4 | Expected attribution to each season CU |
|--------------|--|---|----------------------|---|--|---|--|
| 1 | 1,000 | 4,000 | 3,000,000 | 1,125,000 | 500,000 | 187,500 | 4,812,500 |
| 2 | 1,000 | 3,000 | 2,250,000 | 1,125,000 | 500,000 | 187,500 | 1,812,500 |
| 3 | 1,000 | 2,000 | 1,500,000 | | 500,000 | 187,500 | 687,500 |
| 4 | 1,000 | 1,000 | 750,000 | | | 187,500 | 187,500 |
| 5 | n/a | 0 | | | | | |
| Total | | 10,000 | 7,500,000 | 2,250,000 | 1,500,000 | 750,000 | 7,500,000 |

In season 2, Entity F:

- ▶ recognises revenue of CU6,900,000 for the 9,200 supporters who actually exercised their renewal right for the season ticket (i.e. CU750 x 9,200);
- ▶ recognises revenue of CU37,950,000 reflecting the amounts paid by those 9,200 supporters for the price paid for the season ticket (i.e. CU4,125 x 9,200);
- ▶ reverses revenue of CU600,000 to reflect the fact that in recognising breakage in season 1 it overestimated by 200 the number of supporters (1,000 estimate vs 800 actual) that would not exercise their renewal rights in season 2 (i.e. CU750 x 200 x 4); and
- ▶ re-assesses the rate of attrition for the 9,200 supporters over the remaining 3 seasons (i.e. a total of 27,600 renewal options) and recognises breakage attributable to seasons 1 and 2 accordingly.

 **BDO comment**

In some cases, customers' options may be perpetual and not have an expiration date (e.g. air miles often have no expiry date). The question that arises in these cases is whether an entity should apply the guidance in FRS 102 23.129-130 on unexercised rights.

In our view, an entity should apply the guidance on unexercised rights, subject to the guidance on constraining estimates of variable consideration.

The guidance on options requires an entity to estimate the standalone selling price of the option at contract inception, considering the likelihood that the option will be exercised. The guidance also requires an entity to recognise any change in the likelihood that the option will be exercised when estimating the measure of progress of the performance obligation related to the option.

As a result, the standalone selling price of the option is not updated; instead, the entity updates its estimate of the portion of the option that will be redeemed. This

results in the entity recognising revenue in proportion to the pattern or recognition of other performance obligations in the contract.

Once the number of options expected to be exercised have actually been exercised, the entity would no longer recognise a contract liability.

In situations where a single option exists and the portfolio approach is not or cannot be applied, the standalone selling price of the option would still include the likelihood that the option will be exercised. The revenue related to the option would be recognised when the option is exercised or when it is determined that the likelihood of the option being exercised becomes remote.

Existing guidance is less prescriptive on this issue, and some entities may need to change their accounting approach.

5.9. Non-refundable upfront fees

A vendor may charge a customer a non-refundable upfront fee at (or near) contract inception, which may be related to an activity that the vendor is required to undertake at (or near) contract inception in order to fulfil the contract (for example, gym membership joining fees as discussed in [section 5.7](#) above). The vendor is required to determine whether the fee relates to the transfer of a promised good or service, in order to identify the performance obligations within the contracts.

When the non-refundable upfront fee is not related to a performance obligation but to setup activities or other administrative tasks, the non-refundable upfront fee is accounted for as an advance payment for future goods or services and is therefore only recognised as revenue when those future goods or services are provided.

In practice, non-refundable upfront fees typically relate primarily to setup activities, and not to a performance obligation.



5.10. Licencing

A licence establishes a customer's rights over the intellectual property of a vendor, such as:

- ▶ Software and technology
- ▶ Media and entertainment (e.g. motion pictures)
- ▶ Franchises
- ▶ Patents, trademarks, and copyrights.

A contract to transfer (provide) a licence to a customer may include obligations to provide other goods and services in addition to the promised licence. Those obligations may be specified in the contract or implied by the vendor's customary business practices, published policies or specific statements. The accounting treatment depends on whether or not the licence is 'distinct' from those other promised goods or services.

When the licence is not distinct from those other goods or services, they are accounted for together as a single performance obligation. This would be the case, for example, when the licence forms a component of a tangible good and is integral to the good's functionality (for example, a software license which requires ongoing maintenance and upgrade services in order for it to continue to operate), or it is a licence that the customer can benefit from only in conjunction with a related service (for example, a software hosting agreement on an internet site).

When the licence is distinct from the other promised goods or services, the licence is accounted for as a separate performance obligation. Revenue is then recognised either at a point in time, or over time, depending on whether the nature of the vendor's promise in transferring the licence to the customer is to provide that customer with either:

- ▶ Access to the vendor's intellectual property as it exists at any given time throughout the licence period (i.e. the vendor continues to be involved with its intellectual property); or
- ▶ A right to use the vendor's intellectual property as it exists at the point in time the licence is granted.



Example 5.10-1

ABC is a pharmaceutical company that discovers, develops and commercializes medications for cardiovascular disease. ABC owns a regulator-approved drug compound that, for a specified period, is patent protected for preventing heart disease in patients with high-cholesterol.

ABC enters into a licencing arrangement with a customer for the following:

- ▶ a licence to make and commercialise the drug compound, and
- ▶ a licence to a trademark for the drug compound (for branded product sales).

Customer can sell the generic product (without the use of the trademark) only after the patent period expires.

The issue is whether the licence to make and commercialise the drug and the licence relating to the trademark for branded product sales are distinct performance obligations. The conclusion as to whether they are distinct or not is important, as it may affect the timing of revenue recognition.

The analysis of whether the two licences are distinct or not will depend heavily on the particular facts and circumstances.

ABC appears to be able to benefit from the two licences separately from each other (i.e. in accordance with FRS 102 23.21(a) the two licences are capable of being distinct). Despite the fact that ABC must use the trademark for the brand name, this is only for a particular period of time. ABC can produce generic drugs subsequent to the patent period expiring.

The trademark for the brand name of the product does not significantly affect the characteristics of the drug itself, meaning the promise is separately identifiable (i.e. in accordance with FRS 102 23.21(b) the two licences are distinct in the context of the contract). This is similar to the analysis in [section 4.2](#) concerning goods and services and associated installation services. While a functional relationship exists between the two licences, there is no 'transformative' relationship in their use; the two products are added to each other, but they are not combined into a single overall output.

The conclusion on whether the two licences are distinct might differ if the fact pattern was altered. For example, if the patent period was of such a length that the potential benefits arising from generic drug

manufacturing subsequent to the patent period elapsing were minimal, then ABC might conclude that the trademark for the brand name is necessary in order to obtain any economic benefit from the licence to produce the drug. In this case, the two licences would not satisfy the condition in FRS 102 23.21(b) (i.e. they would not be distinct in the context of the contract) as the nature of the promise in that case would be to allow an entity only to produce a combined branded drug, which is accomplished by granting two licenses in legal form only.

A vendor continues to be involved with its intellectual property by undertaking activities that do not transfer goods or services to the customer, but instead change its intellectual property to which the customer has rights. This applies if all of the following criteria are met:

- i. The contract requires, or the customer reasonably expects, that the vendor will undertake activities that significantly affect the intellectual property to which the customer has rights (that is, the intellectual property to which the customer has rights is dynamic).

Factors that may indicate that a customer could reasonably expect that a vendor will undertake activities that will significantly affect the intellectual property include:

- ▶ The vendor's customary business practices
- ▶ Published policies
- ▶ Specific statements
- ▶ The existence of a shared economic interest (e.g. a sales-based royalty) between the

vendor and the customer related to the intellectual property licenced to the customer.

- ii. The rights granted by the licence directly expose the customer to any positive or negative effects of the vendor's activities that affect the intellectual property as and when the vendor undertakes those activities.
- iii. The vendor's activities do not transfer a good or a service to the customer as those activities occur (that is, the activities are not accounted for as performance obligations).

When all of the above criteria are met, a vendor accounts for the licence as a performance obligation satisfied over time because the customer will simultaneously receive and benefit from the vendor's performance as the performance occurs. An appropriate method is selected to measure the vendor's progress toward complete satisfaction of its performance obligation to provide access to the intellectual property.

When one or more of the criteria above are not met, the nature of the licence is to transfer a right to access intellectual property as it exists at the point at which the licence is granted. Because the intellectual property to which the customer has rights to is 'static' (i.e. is not affected by continuing involvement by the vendor), the right granted enables the customer to direct the use of and obtain substantially all of the remaining benefits from the intellectual property in its form at the point at which the licence is granted to the customer. Therefore, the promise of a licence that transfers a right is accounted for as a performance obligation satisfied at a point in time. The point in time cannot be before control of the licence is transferred to the customer. This means that, if the vendor provides (or otherwise makes available) to the customer an access code that is necessary to enable the customer to access or use licenced software, the vendor would not recognise revenue until the access code has been made available, even though the licence period could have started at an earlier date.

When determining the type of licence that has been granted (intellectual property as it exists at any point during the licence period or as it exists at the point at which the licence is granted), the following factors are disregarded:

- ▶ Restrictions of time, geography, or use. This is because these restrictions define the attributes of the promised licence, rather than define whether the vendor satisfies its performance obligation at a point in time or over time.
- ▶ Guarantees provided by the vendor that it has a valid patent to intellectual property and that it will defend that patent from unauthorised use. A promise to defend a patent right is not a performance obligation because it protects the value of the vendor's intellectual property asset and provides the customer with assurance that the licence transferred meets the related contractual specifications.

Activities affecting the intellectual property

FRS 102 23.110 states that activities that change the substance of the intellectual property includes activities that change the intellectual property's design, content or ability to perform a function or task (eg development activities that change the content to which the customer as rights). Activities that expose the customer to positive or negative effects of those activities include activities that support or maintain the value of intellectual property (eg ongoing activities that maintain the value of the brand to which the customer has rights).

Accordingly, if the intellectual property to which the customer has rights has significant stand-alone functionality, a substantial portion of the benefit is derived from that functionality. Consequently, the ability of the customer to obtain benefit from that intellectual property would not be significantly affected by the entity's activities unless those activities change its design, content or functionality. Types of intellectual property that often have significant stand-alone functionality include software, biological compounds or drug formulas, and completed media content (for example, films, television shows and music recordings).



Example 5.10-2

A vendor grants a franchise licence to a customer, which provides the right to use the vendor's trade name and sell its products for a period of ten years. During this period, the vendor will undertake activities that will affect the franchise licence, including analysing changes in customer preferences, implementing product improvements and undertaking marketing campaigns.

The nature of the vendor's promise to its customer is to provide access to the vendor's intellectual property in its form as it exists throughout the licence period, and not only as it exists at the start of the licence period. Consequently, the performance obligation is satisfied over time.

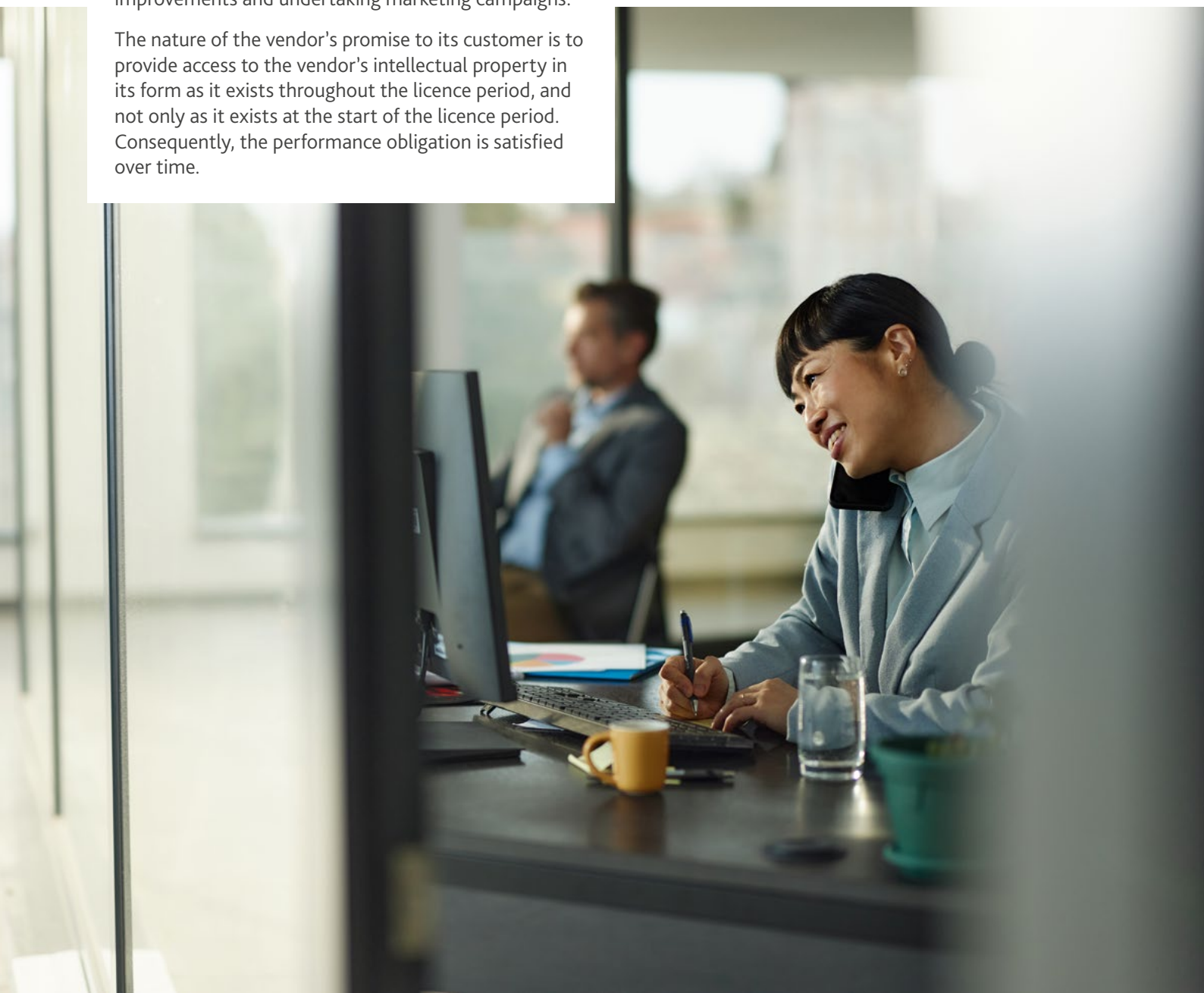


Example 5.10-3

A vendor (a music record label) licenses a specified recording of a Beethoven symphony to a customer for a period of two years. The customer has the right to use the recording in all types of advertising campaigns (including television, radio and online media) in a specified country. The contract is non-cancellable and the customer is required to pay CU10,000 per month.

The nature of the vendor's promise to its customer is to provide access to the recording in its condition as at the start of the licence period. Consequently, the customer's rights to the intellectual property are static and the vendor's performance obligation is satisfied at a point in time.

The vendor recognises all of the revenue (adjusted for a significant financing component, if appropriate) at the point at which the customer is able to use, and obtain substantially all the benefits, of the licensed intellectual property.



5.11. Sales-based or usage-based royalties

When an entity earns royalties based on the extent to which a customer uses or benefits (through onward sales) from a license of IP (intellectual property), it has transferred control of the IP to its customer, with uncertainty over the amount of consideration (i.e. the consideration is variable). As an exception to the general principles in Section 23 that revenue is recognised when control of a good or service has been transferred to a customer and measured at an amount to which it expects to be entitled, royalties earned from sales-based or usage-based licences of intellectual property are recognised only at the later of the following:

- ▶ The subsequent sale or usage takes place; and
- ▶ 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).

The interaction of this restriction, and the requirement to consider stand-alone selling prices when allocating consideration to multiple performance obligations in a contract, can lead to patterns of revenue recognition which differ from amounts stated in contracts. This arises, for example, in cases where two or more licences over intellectual property that are to be transferred to a customer at different times are included in a single overall contract, and the prices specified in the contract do not reflect the stand-alone selling prices of the licences. The approach required by Section 23 is designed to ensure that the timing and profile of revenue recognition is not affected by what might be considered to be artificial price allocations in contracts. See the example in [section 4.4](#) 'Allocation of variable consideration' above.

BDO comment

The term 'royalty' is not defined, and there are some cases where it is not clear whether a payment structure results in the sales- or usage-based royalty exception being applied. Certain payment terms may be 'in-substance' sales or usage-based royalties, even if the contract does not label the payments as royalties. In addition, there are situations where the amount of consideration is similar to a bonus and depends on the customer's subsequent sales or usage, even though the amount is not calculated on the basis of each sale or usage. For example:

- ▶ An entity licences IP in exchange for a payment of CU10 million if cumulative sales of the licensee's products making use of the IP exceeds CU100 million over a specified five-year period.
- ▶ An entity licences IP in exchange for 'stepped' payments. This might be no royalty if the sales of the licensee's products making use of the IP are between CU1 and 10 million, a royalty of 1% of sales between CU10 million and CU25 million and a royalty of 2% of sales above CU25 million.

In our view, the exception does apply to these situations (unless the 'licence' is in fact an in-substance sale of the IP) because the consideration is based on the sales to the customer's customer even though it might not be described as a royalty.

BDO Comment

Some arrangements that are licences in legal form are currently accounted for as 'in-substance sales'. Such arrangements are common in industries such as pharmaceuticals, where legal title to the IP may be retained by the vendor. The effect is that, although a transaction is described in the legal documents as being a licence, in reality it is a sale of the IP under which substantive control has been transferred to the customer.

In our view, the requirements in Section 23 dealing with sales and usage-based royalties in exchange for a licence of IP do not apply to outright sales of IP. Therefore, it should also not apply to what are genuinely 'in substance sales'. This view reflects 'substance over form' and faithfully represents the economic substance of the transaction.

The determination of whether a licensing arrangement is an 'in substance sale' is a matter of judgement. Therefore, an entity should also consider the requirements of FRS 102 8.6 related to disclosure of significant judgements. It is important to note that for a sale to be recognised in accordance with Section 23, control of the IP must be transferred. Looking only at risks and rewards is not sufficient to conclude that the arrangement is an 'in substance sale'. It should also be noted that if the arrangement is determined to be an 'in-substance sale' and an asset was previously recognised related to the IP, the related asset or a portion of that asset would also need to be derecognised.

BDO comment

Royalty revenue can only be recognised once the subsequent sale or usage and related performance have both occurred. This exception applies regardless of whether the underlying licence provides a 'right to access' to an entity's IP, or a 'right to use' an entity's IP as it exists at a point in time. Section 23 also requires that performance obligations satisfied over time in accordance with FRS 102 23.81-84 are recognised by measuring the progress towards satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (i.e. the satisfaction of an entity's performance obligation).

However, in some licenses that provide a customer with a right to access an entity's IP over time, royalty rates are not necessarily constant over the license term. A question therefore, arises as to whether the requirement to recognise royalties at the rate specified in a contract takes precedence over the requirement to measure revenue by reference to the entity's progress towards satisfying a performance condition.

In our view, it does not take precedence. It only overrides the requirement to constrain variable consideration.



Example 5.11-1

A vendor enters into a non-cancellable licence agreement for a five-year period in exchange for a small amount of fixed consideration plus a sales-based royalty and determines that the licence gives its customer the right to access the entity's intellectual property as it may exist from time to time throughout the licence period, and not at the point in time when the license was granted. The entity estimates that:

- ▶ the customer sales on which the royalty is based will be approximately equal for each of the five years under licence, and
- ▶ any activities undertaken by the entity affecting its intellectual property will be performed on an even and continuous basis throughout the licence period.

The licensee agrees to the following royalty rates: Year one: 10%, Year two: 8%, Year three: 6%, Year four: 4%, Year five: 2%.

Following the legal form of the royalty (i.e. recognising royalty rates of 10% in year one, 8% in year two, etc.) would not appropriately depict progress in satisfying the entity's performance obligation for providing access to its intellectual property as it may exist from time to time throughout the licence period. Although the requirement to recognise royalties on the later of (i) when the sale or usage occurs and (ii) satisfaction of the



performance obligation to which the royalty relates sets a limit on the maximum amount of revenue that can be recognised, it does not mean that the maximum royalty receivable should necessarily be recognised. The entity also needs to consider whether it is required to defer royalty income to ensure it continues to comply with the requirement to measure revenue based on performance to date. Therefore, the vendor decides it should initially apply an average expected royalty rate of 6%. It re-assesses this estimate on a regular basis throughout the license period to ensure the rate applied remains appropriate.

In some contracts an IP licence is offered with other goods or services in a contract (e.g., software licences with post-contract customer support, franchise licences with training services, biotechnology and pharmaceutical licences sold with research and development services or a promise to manufacture a drug for the customer), with the consideration again being in the form of a sales- or usage-based royalty. In some of those contracts the license and other goods or services are distinct and in other cases they are not distinct.

Whether or not the other goods or services are distinct from the license, FRS 102 23.48 clarifies that the requirement to recognise royalties on the later of (i) when the sale or usage occurs and (ii) satisfaction of the performance obligation to which the royalty relates applies to arrangements for which the licence is the predominant item. When the license is not the predominant item, the royalty income represents variable consideration which needs to be estimated, and would then be allocated to each performance condition (including the license) based on relative standalone selling prices. The revenue allocated to each performance condition would then be recognised at a point in time or over time depending on when control of the good or service is transferred to the customer.

The requirement to recognise royalty income on the later of (i) when the sale or usage occurs and (ii) satisfaction of the performance obligation to which the royalty relates would apply, however, when a single licence is not the predominant item to which the royalty relates, but the royalty predominantly relates to two or more licences promised in a contract.

BDO Comment

In some licenses for intellectual property that pay a sales-based or usage-based royalty, the royalties receivable are subject to a guaranteed minimum amount. The pattern of revenue recognition depends on whether the licence meets the criteria for recognition at a point in time or over time (see [section 5.10](#) above). When the licence meets the criteria for point-in-time revenue recognition, the fixed guaranteed minimum should be recognised when the performance obligation is satisfied, i.e. when the licence is transferred to the customer. This treatment would be consistent with treatment for a licence that is provided on a fixed fee basis.

When the licence meets the criteria for over time revenue recognition, entities will need to consider the facts and circumstances and apply judgement to determine an appropriate approach that depicts progress towards the satisfaction of the performance obligation. In determining the pattern of revenue recognition factors to consider include:

- ▶ What is the appropriate measure of progress, time or the underlying sales or usage?
- ▶ Is the guaranteed minimum substantive?
- ▶ Are the royalties expected to exceed the guaranteed minimum?

Example 5.11-2

A licensor enters into a five-year arrangement to licence intellectual property (IP). The licence requires the customer to pay a sales-based royalty of 5% of the customer's gross sales associated with the IP with a minimum guaranteed amount is CU5,000. Over the term of the licence the expected royalties are:

| | | |
|--------------|-----------|--------------|
| Year 1 | CU | 750 |
| Year 2 | CU | 1,500 |
| Year 3 | CU | 2,000 |
| Year 4 | CU | 1,000 |
| Year 5 | CU | 3,000 |
| Total | CU | 8,250 |

In each of the scenarios below, it is assumed actual royalties received in each year equal the above expected royalties.

Scenario A – Point in time

If the licence meets the criteria for recognition at a point in time, i.e. when the licence is transferred to the licensee, the licensor recognises revenue as follows:

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|----------------------|--------|--------|--------|--------|--------|
| Royalties Received | 750 | 1,500 | 2,000 | 1,000 | 3,000 |
| Cumulative Royalties | 750 | 2,250 | 4,250 | 5,250 | 8,250 |
| Annual Revenue | 5,000 | - | - | 250 | 3,000 |
| Cumulative Revenue | 5,000 | 5,000 | 5,000 | 5,250 | 8,250 |

Scenario B – Over time

If the licence meets the criteria for recognition over time, the licensor applies judgement in light of the specific facts and circumstances, with a number of potential approaches. Under the first approach, the licensor recognises the royalty as revenue as the customer's gross sales associated with the IP occur. This approach is based on the underlying sales/usage being the appropriate measure on which to recognise revenue and results in annual revenue equaling the amount of royalties received each year. It is only appropriate when the royalties are expected to exceed the minimum guarantee.

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|----------------------|--------|--------|--------|--------|--------|
| Royalties Received | 750 | 1,500 | 2,000 | 1,000 | 3,000 |
| Cumulative Royalties | 750 | 2,250 | 4,250 | 5,250 | 8,250 |
| Annual Revenue | 750 | 1,500 | 2,000 | 1,000 | 3,000 |
| Cumulative Revenue | 750 | 2,250 | 4,250 | 5,250 | 8,250 |

Under the second approach, the licensor estimates the transaction price for the performance obligation (including fixed and variable consideration) and recognises revenue using an appropriate measure of progress, subject to the royalty constraint. This approach is based on time being the appropriate measure on which to recognise revenue, and like the first approach, is only appropriate when royalties are expected to exceed the minimum guarantee. It requires periodic reassessment of the estimate of total consideration and, if appropriate, an update to the measure of progress. This will result in periodic cumulative catch-up adjustments to revenue. Under this approach CU1,650 (the expected total of CU8,250 over five years) will be recognised each year, subject to the constraint which results in only CU300 being recognised in year four.

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|----------------------|--------|--------|--------|--------|--------|
| Royalties Received | 750 | 1,500 | 2,000 | 1,000 | 3,000 |
| Cumulative Royalties | 750 | 2,250 | 4,250 | 5,250 | 8,250 |
| Annual Revenue | 1,650 | 1,650 | 1,650 | 300 | 3,000 |
| Cumulative Revenue | 1,650 | 3,300 | 4,950 | 5,250 | 8,250 |

Under the third approach, the licensor recognises the minimum guarantee (fixed consideration) using an appropriate measure of progress and recognises royalties only when cumulative royalties exceed the minimum guarantee. Assuming time is the measure of progress, CU1,000 (CU5,000 over five years) will be recognised each year. Royalties in excess of the CU5,000 are recognised in the year received, which result in the additional CU250 and CU3,000 recognised in years four and five.

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|----------------------|--------|--------|--------|--------|--------|
| Royalties Received | 750 | 1,500 | 2,000 | 1,000 | 3,000 |
| Cumulative Royalties | 750 | 2,250 | 4,250 | 5,250 | 8,250 |
| Annual Revenue | 1,000 | 1,000 | 1,000 | 1,250 | 4,000 |
| Cumulative Revenue | 1,000 | 2,000 | 3,000 | 4,250 | 8,250 |

5.12. Repurchase agreements

A repurchase agreement arises when a vendor sells an asset to a customer and is required, or has an option, to repurchase the asset. The asset itself could be the same one as was originally sold to the customer, one which is substantially the same, or another (larger) asset that includes as a component the asset which was originally sold. Typically, the arrangements come in the following three forms:

1. the vendor has an obligation to repurchase, and the customer an obligation to sell back, the asset (a forward contract);
2. the vendor has a call option, giving it a right but not an obligation to repurchase the asset; and
3. the customer has a put option, giving it the right but not an obligation to sell back the asset.

In the first two types of arrangement (a forward and a vendor call option), the customer is limited in its ability to direct the use of and obtain substantially all of the remaining benefits from the asset, meaning that it does not obtain control of the asset. Therefore, the vendor does not recognise any revenue from the sale and instead, depending on the contractual terms, the contract is accounted for as either a lease or a financing arrangement. To determine in which of these two ways the vendor accounts for the transaction it compares the repurchase price of the asset with its original selling price, taking into account the effects of the time value of money.

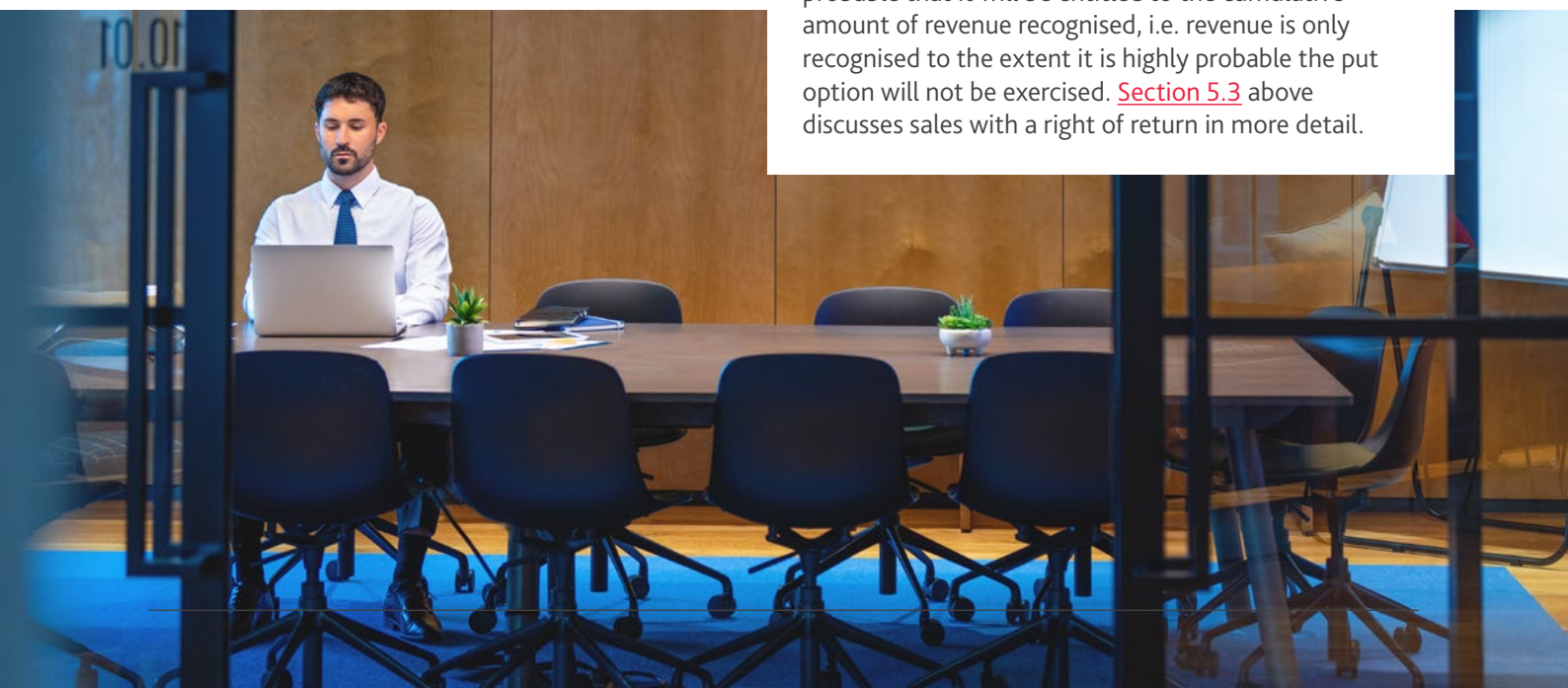
If the repurchase price is lower than the original selling price of the asset, the contract is accounted for as a lease in accordance with Section 20, unless the contract is part of a sale and leaseback transaction. If it is part of a sale and leaseback transaction, the vendor must continue to recognise the asset and also recognise a financial liability for any consideration received from the customer.

If the repurchase price is greater than or equal to the original selling price of the asset, the contract is accounted for as a financing arrangement and, therefore, the vendor recognises a financial liability for any consideration received from the customer and continues to recognise the asset. The difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer on repurchase is interest and, if applicable, processing or holding costs (e.g. insurance). When the repurchase agreement is a vendor call option rather than a forward and the option lapses unexercised, the vendor derecognises the liability and recognises revenue.

In the third situation (i.e. a customer put option), the accounting also depends on the relationship between the repurchase price of the asset and the original selling price of the asset.

If the repurchase price of the asset is lower than the original selling price of the asset, then at contract inception the vendor considers whether the customer has a significant economic incentive to exercise its right. This may be the case if, for example, the asset's repurchase price is expected to significantly exceed its market value in the period the put option becomes exercisable. If the customer does have an economic incentive to exercise the put option then it does not obtain control of the asset and the agreement is accounted for as a lease (unless the contract is part of a sale and leaseback transaction, in which case the contract is accounted for as a financing arrangement in the same way as a forward or vendor call option).

If the customer does not have a significant economic incentive to exercise its option, the customer obtains control of the asset and the vendor accounts for the transaction as a sale with a right of return. This means the transaction price is variable and so the amount of revenue is only recognised to the extent that it is highly probable that it will be entitled to the cumulative amount of revenue recognised, i.e. revenue is only recognised to the extent it is highly probable the put option will not be exercised. [Section 5.3](#) above discusses sales with a right of return in more detail.



BDO comment

The effects of this part of Section 23 may be significant in some industry sectors. For example, in many jurisdictions, cars are sold to customers together with the right for the customer to require the vendor to repurchase the cars for a specified price after a period of between two and four years. Careful consideration of the exercise price of these customers put options will be required, as well as identifying the various parties to the contractual arrangements. This includes whether the vendor or an unrelated third-party finance company grants the put option and, if the latter, whether there are any associated contractual arrangements between the vendor and that third party finance company.

Example 5.12-1

A manufacturer of industrial equipment (Entity X) enters into a sales contract with a customer, under which it sells equipment with a production cost of CU500 to the customer for a sales price of CU750.

The customer is granted a contractual right to return the equipment to Entity X after two years in exchange for a predetermined amount of CU450 (the repurchase price). The fair value of the equipment after two years is expected to be in the range of CU425 to CU475 with a linear distribution of expected values (that is, the mean of the various estimates is CU450). The present value of the repayment obligation, discounted at Entity X's incremental borrowing rate of 6%, is CU400.

The expected useful life of the equipment is five years.

At contract inception:

- ▶ the repurchase price of CU450 is less than the original sales price of CU750; and
- ▶ the customer does not have a significant economic incentive to exercise the right of return because the repurchase price is not significantly in excess of the expected market value of the equipment.

Consequently, Entity X accounts for the transaction as a sale with a right of return. This means that Entity X will only recognise revenue of CU750 and derecognise its asset (the equipment) of CU500 with an associated cost of sales, if it considers that it is highly probable that the customer will not exercise its option to require Entity X to repurchase the asset. This is likely to require consideration of past practice with other similar transactions and any other available evidence.

If Entity X has experience with other similar transactions (and, potentially, other supporting evidence), the transaction may be recorded as a sale. The accounting entry would be:

| | | |
|------------------|--------------|-----|
| Dr Cash | 750 | |
| Dr Cost of Sales | 500 | |
| | Cr Inventory | 500 |
| | Cr Revenue | 750 |



5.13. Consignment arrangements

A vendor may deliver a product to another party, such as a dealer or retailer which will sell the product to its own end customers. In these circumstances, the vendor is required to assess whether the other party has obtained control of the product. If the other party has not obtained control, the product may be held in a consignment arrangement. A vendor does not recognise revenue on delivery of a product to another party which is held on consignment.

The following indicates the existence of a consignment arrangement:

- ▶ the product is controlled by the vendor until a specified event occurs (e.g. sale of the product to a customer of the dealer or retailer, or until a specified period expires);
- ▶ the vendor is able to require the return of the product or transfer the product to a third party (e.g. transfer to another dealer or retailer); and
- ▶ the dealer or retailer does not have an unconditional obligation to pay for the product, even if it is required to pay a deposit.



5.14. Bill-and-hold arrangements

Bill-and-hold arrangements involve the vendor invoicing a customer for goods, but instead of delivering them to the customer, the vendor retains physical possession with the goods being shipped or delivered to the customer at a later date. A customer might request this type of arrangement if, for example, it does not have sufficient space of its own to accommodate the product. The effect is that in addition to selling the product, the vendor provides a custodial service.

FRS 102 23.86a states that in some situations a customer may obtain control of an asset, and an entity shall recognise revenue, even though the entity retains physical possession of the asset under a bill and hold arrangement. No further guidance is provided in Section 23; however, the customer is unlikely to have obtained control of the asset (in a bill and hold arrangement) if one or more of the following criteria are not met:

- ▶ The reason for the bill and hold arrangement is substantive (for example, the arrangement might be requested by the customer because of a lack of physical space to store the goods)
- ▶ The product is identified separately as belonging to the customer (that is, it cannot be used by the supplier to satisfy other orders)
- ▶ The product is currently ready for physical transfer to the customer
- ▶ The vendor does not have the right to use the product, or to direct it to another customer.

BDO Comment

Careful consideration of the terms of bill and hold arrangements will be needed to determine whether there are additional performance obligations (e.g. for custodial services) to which some of the transaction price for the sale of goods should be allocated.



5.15. Customer acceptance

If a customer accepts an asset, this may indicate that control over the asset has passed to the customer. However, contractual arrangements typically include clauses which enable the customer to require the vendor to take action if the asset does not meet its contractually agreed upon specifications, and might allow the customer to cancel the contract.

If a vendor can demonstrate that an asset that has been transferred to a customer meets the contractually agreed upon specifications, then customer acceptance is considered to be a formality that is not taken into account when determining whether control over the asset has passed to the customer. For example, if the sale of an asset is subject to it meeting certain size and weight specifications, the vendor would typically be able to confirm whether these had been met when the asset is delivered to the customer. However, if the vendor recognises revenue in advance of receiving customer acceptance, the vendor is required to consider whether there are any other performance obligations that have not yet been fulfilled.

If the vendor is not able to determine that the asset that has meets the contractually agreed upon specifications, then control over the asset does not transfer to the customer until the vendor has received the customer's acceptance. In addition, if products are delivered to a customer for trial purposes, and the customer has no commitment to pay any consideration until the trial period has ended, control of the asset does not pass to the customer until the earlier of the point at which the customer accepts the asset or the trial period ends.



5.16. Treatment of onerous contracts

Section 21 (Provisions and contingencies) applies to contracts within the scope of Section 23 (Revenue) that are or have become onerous. When assessing onerous contracts in accordance with Section 21, an initial question is whether the unit of account is the contract as a whole or the performance obligations identified through the application of Section 23.

FRS 102 Glossary defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

The above definition means the unit of account is the contract as a whole and not the individual performance obligations. Consequently, a provision would not be recognised for a contract with multiple performance obligations, in which one performance obligation was onerous but the overall contract was not. However, it is possible that two or more contracts would need to be combined into a single unit of account.

The contract level unit of account is consistent with Section 23, which clearly distinguishes between a contract and performance obligations in a contract. However, if two or more contracts are entered into at or near the same time with the same customer (or related parties of the customer) and they meet one of the following criteria from FRS 102 23.12, the contracts should be combined for the purposes of both Section 23 and Section 21:

- ▶ 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 the other contract; or
- ▶ the goods or services promised in the contracts are a single performance obligation.

An additional question, for the purposes of assessing onerous contracts in accordance with Section 21 is whether variable payments should be subject to the variable consideration constraint in accordance with the requirements of Section 23.

The FRS 102 Glossary defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

The definition of economic benefit should be interpreted more widely than revenue as measured under Section 23. When assessing an onerous contract under Section 21 all expected revenue should be included without, for example, applying the variable consideration constraint.





Example 5.16-1

A professional services company has entered into a contract with its customer and identified 2 distinct performance obligations (POs), which meet the conditions for recognising revenue over time. Total contract revenue is CU250,000 of which CU100,000 relates to PO 1 and CU150,000 relates to PO 2 (determined by reference to relative standalone selling prices). Expected costs on inception of the contract for PO 1 and PO2 were CU75,000 and CU120,000 respectively (i.e. a total of CU195,000) meaning that both POs were expected to be profitable as well as the overall contract.

The company measures its progress towards completion using the cost input method.

At the end of year one, costs incurred and expected to be incurred are as follows:

Scenario A

| | Incurred to date | Forecast future costs | Total costs | Forecast profit/(loss) |
|------------------|------------------|-----------------------|-------------|------------------------|
| | CU | CU | CU | CU |
| - PO 1 | 50 | 70 | 120 | (20) |
| - PO 2 | 30 | 95 | 125 | 25 |
| - Contract Total | 80 | 165 | 245 | 5 |

Amounts recognised in the income statement for year one prior to considering the need for an onerous contract provision is as follows:

| | |
|---------------------------------|----------|
| | CU |
| - PO 1: $50/120 \times 100,000$ | 41,666 |
| - PO 2: $30/125 \times 150,000$ | 36,000 |
| - Total Revenue | 77,666 |
| - Less costs incurred to date | (80,000) |
| - Net loss | 2,334 |

Because the overall contract is still expected to generate a profit in the end, no onerous contract provision is recognised, even though PO 1 is expected to be loss making.

Scenario B

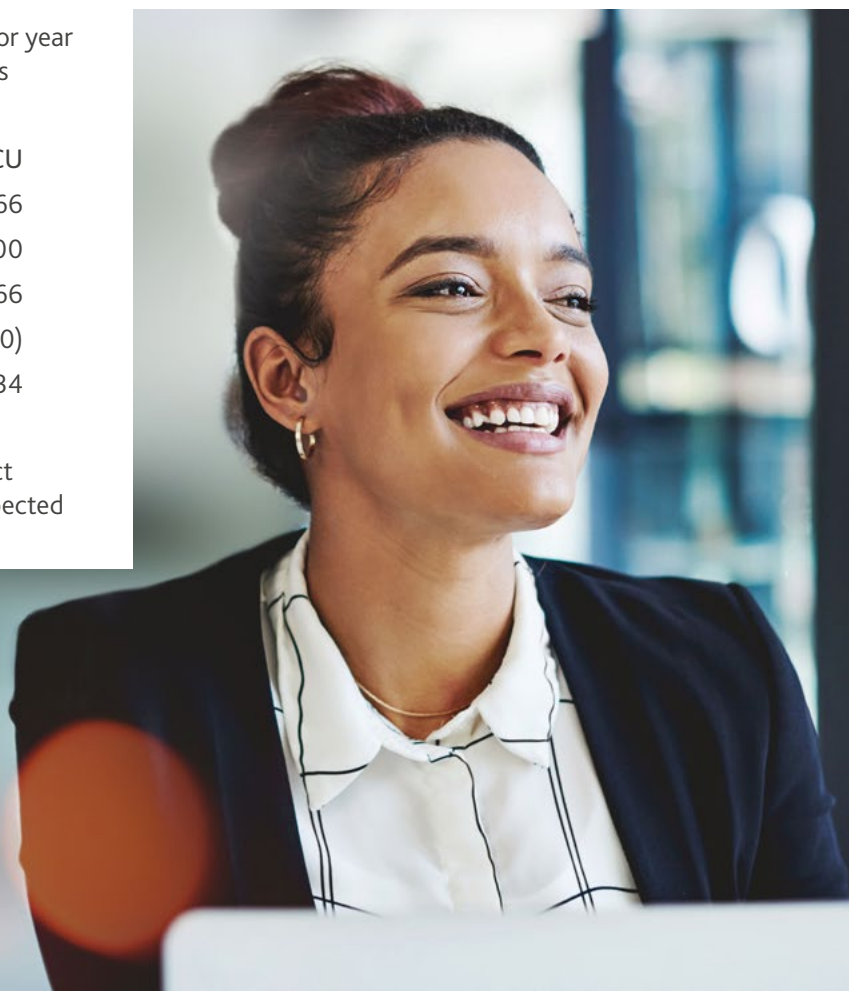
| | Incurred to date | Forecast future costs | Total costs | Forecast profit/(loss) |
|------------------|------------------|-----------------------|-------------|------------------------|
| | CU | CU | CU | CU |
| - PO 1 | 30 | 40 | 70 | 30 |
| - PO 2 | 40 | 160 | 200 | (50) |
| - Contract Total | 70 | 200 | 270 | (20) |

Amounts recognised in the income statement for year one prior to considering the need for an onerous contract provision is as follows:

| | |
|---------------------------------|----------|
| | CU |
| - PO 1: $30/70 \times 100,000$ | 42,857 |
| - PO 2: $40/200 \times 150,000$ | 30,000 |
| - Total Revenue | 72,857 |
| - Less costs incurred to date | (70,000) |
| - Net profit | 2,857 |

However, the contract is now expected to result in an overall loss of CU20,000. Consequently the company recognises an onerous loss provision in accordance with IAS 37 as follows:

| | |
|--------------------------------------|----------|
| Dr Income statement – contract costs | CU22,857 |
| Cr Provision for onerous contract | CU22,857 |



5.17 Success-based fees

In a purely success-based fee scenario (i.e. 100% of the consideration is contingent on a successful result being obtained), the customer is paying only for the service on which the success fee is based (e.g. 'no win, no fee' legal services). Therefore, any other services provided under the contract are ancillary to this primary service and are not the service for which the customer is paying.

In assessing whether revenue should be recognised over time or at a point in time, the criteria in FRS 102 23.81(a) are not met as the customer only receives and consumes any benefit from the entity's performance at the point in time at which success is achieved. In addition, the criteria in FRS 102 23.81(c) is not met as the entity does not have an enforceable right to payment until success is achieved.

In some scenarios the work performed would not need to be re-performed if the contract was cancelled and was to be completed by another entity. In these cases, the criteria in FRS 102 23.81(a) will have been met. If the work does not need to be re-performed, the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. Therefore, revenue to be earned from the success-based fee can potentially be recognised. However, even when it is concluded that FRS 102 23.81(a) or 81(b) apply such that overtime revenue recognition is appropriate, it must be remembered that the success fee is variable consideration. An entity can only recognise variable consideration to the extent it is highly probable that it will be entitled to the cumulative amount of the success fee estimated. This will often mean that the entity will be precluded from recognising revenue on a contract-by-contract basis, notwithstanding it is in an over-time recognition model, particularly, if the success fee is an 'all or nothing' fee. However, if the contracts are homogeneous or the portfolio of contracts can be split into sub portfolios of homogeneous contracts the practical expedient in FRS 102 23.6 may be applied when estimating and constraining the variable consideration (see [section 5.1](#) for further discussion on application of the portfolio approach to contract costs associated with success-based fees).



6. Presentation

Revenue would be presented as part of Turnover if the entity is applying the statutory profit or loss format or as revenue if that term is used. See [section 7](#) for requirements to provide disclosures disaggregating revenue from contracts with customers separately from other sources of income.

In its statement of financial position, a vendor is required to present separate amounts for contract assets, contract liabilities and receivables due from customers (FRS 102 23.134). Alternative descriptions can be used for these line items.

When a vendor transfers control over goods or services to a customer before the customer pays consideration, the vendor presents the contract as either a contract asset or a receivable. A contract asset is defined as a vendor's 'right to consideration in exchange for goods or services that the vendor has transferred to a customer when that right is conditioned on something other than the passage of time (for example the vendor's future performance)'. A receivable due from customers, in contrast, is a vendor's unconditional right to consideration, and is accounted for in accordance with Section 11 or Section 12. To have an unconditional right to consideration does not mean that the amount of consideration to be received is certain. Instead, it is that the vendor is exposed only to credit risk, and not to other risks such as performance risk.



Example 6-1

Entity C is a construction company and has entered into a contract for which revenue will be recognised over time. The terms of the contract are:

- ▶ a stated contract price of CU100 million
- ▶ CU25 million is invoiced on each of 4 specified milestones.
- ▶ If construction is completed after a specified date, the last milestone payment is reduced by a fixed CU10 million to CU15 million (i.e. a total transaction price of CU90 million) and if completed before a specified date the last milestone payment is increased by up to CU10 million to a maximum of CU35 million (i.e. a maximum total transaction price of CU110 million). Consequently, the contract is analysed as comprising for fixed consideration of CU90 million and additional variable consideration of somewhere between CU10 and CU20 million.

At its reporting date, Entity C is 80% of the way through the project, having just reached the third milestone, and is well ahead of schedule. Entity C considers it probable that it will receive CU110 million. However, uncertainties mean that it constrains this estimate to CU106 million to ensure that it is highly probable that it will be entitled to the cumulative amount of revenue recognised. Entity C therefore:

- ▶ recognises cumulative revenue of CU84.8 million (estimated transaction price of CU106m x 80%);
- ▶ recognises a receivable of CU25 million for the third milestone amount invoiced but not yet received; and
- ▶ recognises a total contract asset of CU9.8 million. Entity C is not unconditionally entitled to this amount, which is dependent on both achieving the 4th milestone (i.e. completing the construction) and also completing the construction by the date that will result in the 4th milestone payment being CU21m.

When a customer pays consideration in advance, or an amount of consideration is due contractually before a vendor performs by transferring a good or service, the vendor recognises a contract liability. A contract liability represents the excess of consideration received by a vendor (plus amounts that it is unconditionally entitled to for which a receivable has been recognised) over cumulative revenue recognised to date.



BDO comment

In determining how an entity should present balances with its customers, it is important to note the definition of a contract asset. Consider a situation where an entity pays a non-refundable up-front fee to its customer in exchange for becoming an approved supplier. This payment takes place prior to any goods or services being transferred to the customer. Such an amount could not be presented as a contract asset as it is not a 'right to consideration in exchange for goods or services that the entity has transferred to a customer...' as the payment occurs prior to the transfer of any goods or services. In determining whether such an amount could be recognised as some other type of asset, entities would have to give careful consideration to the contractual terms and the facts and circumstances surrounding the arrangement.

In the above example, the amount paid up front would be deducted from the overall transaction price. For example, if on agreeing to a contract with customer B with a sales price of CU100, entity A paid customer B CU10, the transaction price would be CU90.

7. Disclosure

Entities are required to comply with all disclosure requirements of Section 23 except if the information is immaterial or the entity is a qualifying entity. Qualifying entities may take advantage of some disclosure exemptions in their individual financial statements.

In accordance with the requirements of FRS 102 23.133, a vendor discloses revenue from contracts with customers separately from the vendor's other sources of revenue.

Section 23 requires an entity to disaggregate revenue recognised from contracts with customers into categories that depict how its revenue and cash flows are affected by economic factors (FRS 102 23.131). Entities applying IFRS 8 (operating segments) are required to disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue as required by FRS 102 23.131 and the revenue information that is disclosed for each reportable segment.



8. Effective date and transition

This section discusses the transitional requirements for an entity that already applies FRS 102.

8.1. Effective date

Section 23 is effective for periods commencing on or after 1 January 2026. Earlier adoption is permitted, provided all the Periodic Review 2024 amendments are applied at the same time.

The date of initial application is the beginning of the annual reporting period in which an entity first applies the Periodic Review 2024 amendments. For example, if an entity has a financial year from 1 January 2026 to 31 December 2026 and begins applying the Periodic Review amendments from 1 January 2026, the date of initial application for such an entity is 1 January 2026. The date of transition, which is the beginning of the comparative period for which the amendments are first applied, would be 1 January 2025.

8.2. Transition methods

Entities have two transition methods to choose from: full retrospective and modified retrospective. When deciding which method to follow, entities should consider the needs of investors, group reporting requirements and other users of the financial statements.

Full Retrospective Application (FRS 102.1.61(a))

This method involves applying the amendments to each prior reporting period presented, in line with FRS 102 10.12. In other words, the comparative period numbers affected by the change to Section 23 are changed as if the amended requirements had always applied.

An entity applying this approach is required to disclose:

- ▶ The nature of the change in accounting policy
- ▶ To the extent practicable, the amount of adjustment to each financial line item for the immediately preceding period presented
- ▶ the amount of the adjustment relating to periods before those presented to the extent practicable
- ▶ An explanation if it is impracticable to determine the amount to be disclosed in accordance with the above
- ▶ If an entity opts to use any of the practical expedients, disclose that fact

Modified Retrospective Approach (FRS 102.1.61(b))

This simpler method does not require restating prior periods. Instead, the entity recognises the cumulative effect of applying the amendments as an adjustment to the opening balance of retained earnings (or another component of equity) at the date of initial application. While simpler, it does still require additional disclosure requirements in the year of adoption.

- ▶ For the current period, to the extent practicable, the adjustment amounts to revenue and to profit or loss compared to how revenue would have been recognised under the previous standard
- ▶ An explanation of the reasons for significant changes
- ▶ An explanation if it is impracticable to determine the amounts to be disclosed in accordance with the above
- ▶ If an entity opts to use any of the practical expedients, disclose that fact

8.3. Practical expedients

FRS 102 permits a number of practical expedients upon transition to amended Section 23.

8.3.1. Practical expedients for full retrospective method

An entity may use one or more of the following practical expedients when applying the full retrospective approach:

Completed contracts (FRS 102.1.65(a))

An entity need not restate the contracts that:

- ▶ Are completed at the beginning of the earliest period presented; or
- ▶ Begin and complete within the same annual reporting period.

A completed contract, for the purpose of practical expedients, is defined in FRS 102 1.67 as a contract for which the entity has transferred all the goods or services identified in accordance with previous requirements for accounting for revenue from contracts with customers, which the (revised) Section 23 replaced.

Variable consideration (FRS 102.1.65(b))

For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed instead of estimating variable consideration amounts in the comparative reporting periods.

Contract modifications (FRS 102.1.65(c))

For contracts modified before the date of initial application, an entity need not retrospectively restate the contract for those modifications. Instead, an entity may reflect the aggregate effect of all modifications that occurred before the beginning of the earliest period presented or before the date of initial application when:

- ▶ Identifying the satisfied and unsatisfied performance obligations
- ▶ Determining the transaction price
- ▶ Allocating the transaction price to the satisfied and unsatisfied performance obligations

Disclosure (FRS 102.1.65(d))

For prior periods presented, an entity need not disclose the information required by FRS 102.23.137. This paragraph requires quantitative or qualitative information about unsatisfied performance obligations and when they are expected to be satisfied.

Consistently applied (FRS 102.1.66)

These expedients are optional but once used must be applied consistently to all contracts and periods presented.

8.3.2. Practical expedients for modified retrospective method

An entity applying the modified retrospective approach should:

- ▶ not restate comparative information
- ▶ apply the amended Section 23 to only those contracts that are not completed contracts at the date of initial application

A completed contract, for the purpose of practical expedients, is defined in FRS 102 1.67 as a contract for which the entity has transferred all the goods or services identified in accordance with previous requirements for accounting for revenue from contracts with customers, which the (revised) Section 23 replaced.

An entity may also use one or more of the following practical expedients when applying the modified retrospective approach:

Variable consideration (FRS 102.1.65(b))

For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed instead of estimating variable consideration amounts in the comparative reporting periods.

Contract modifications (FRS 102.1.65(c))

For contracts modified before the date of initial application, an entity need not retrospectively restate the contract for those modifications. Instead, an entity may reflect the aggregate effect of all modifications that occurred before the beginning of the earliest period presented or before the date of initial application when:

- ▶ Identifying the satisfied and unsatisfied performance obligations
- ▶ Determining the transaction price
- ▶ Allocating the transaction price to the satisfied and unsatisfied performance obligations

Consistently applied (FRS 102.1.62(c))

These expedients are optional but once used must be applied consistently to all contracts.

8.4. Illustration of completed contracts expedient

The following illustrates how different contracts would be treated on transition using both methods permitted in Section 23. This illustration assumes an entity with a financial year from 1 January 2026 to 31 December 2026, and the date of initial application is 1 January 2026.

| Contract completion date | Modified retrospective approach | Full retrospective approach |
|---------------------------|--|---|
| Begins and ends in 2025 | Contract completed before date of initial application – there is no impact as a result of transition and the new standard is not applied to this contract. | Begins and ends in same annual reporting period. Practical expedient is available to allow an entity not to restate such contracts. |
| Begins 2023 and ends 2025 | Contract completed before date of initial application – there is no impact as a result of transition and the new standard is not applied to this contract. | Adjust opening balance of equity for the earliest prior period presented (1 January 2025). |
| Begins 2023 and ends 2028 | Adjust opening balance of equity as of the date of initial application (1 January 2026). | Adjust opening balance of equity for the earliest prior period presented (1 January 2025). |



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