



# Insights into IFRS 15

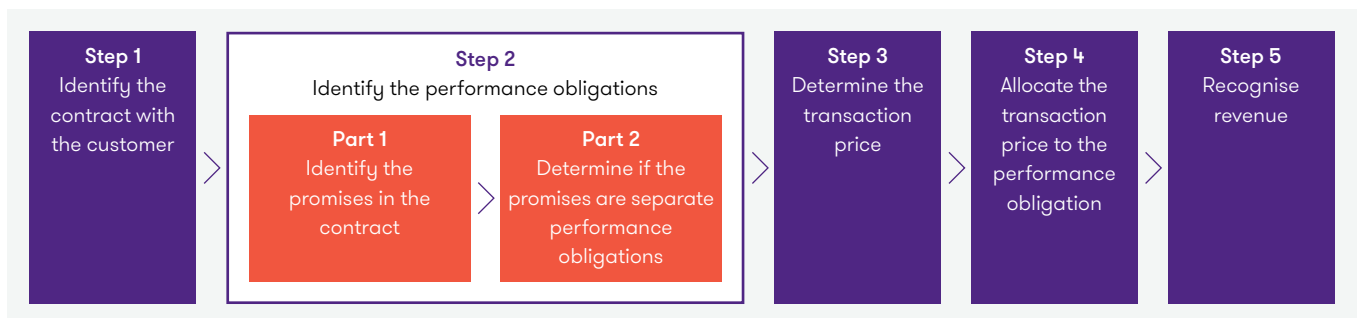
## Step 2: Identifying a performance obligation

Accurate and consistent revenue recognition is a cornerstone of sound financial reporting for all businesses, ensuring comparability across industries and markets. IFRS 15 ‘Revenue from Contracts with Customers’ was jointly developed by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) to align revenue reporting practices under IFRS and US GAAP. The objective of the standard is not to alter the definition of revenue, but to improve comparability by establishing a clear framework for recognising and measuring revenue.

Our ‘Insights into IFRS 15’ series summarises the key areas of the Standard, highlighting some areas that are challenging to apply in practice, to assist reporting entities in understanding how to apply IFRS 15’s requirements.

IFRS 15 introduced the five-step model for revenue recognition and applies specifically to contracts with customers. This article deals with Step 2 of the five-step model which covers the identification of performance obligations – the key units of account of IFRS 15. For a summary of the five-step model, refer to our article ‘[Insights into IFRS 15 – Overview and scope](#)’.

Step 2 is a two-part process. Before an entity can identify its performance obligations, it must first identify all the promised goods or services in the contract. Only after an entity identifies its promises can it then determine which of those promised goods or services constitute performance obligations.



# Identifying the promises in the contract

Promises are often explicitly specified in a contract but also may be implied by an entity's customary business practices, published policies, or specific statements that, at contract inception, create a reasonable expectation of the customer that the entity will transfer a good or service.

When identifying promises, an entity should consider the customer's perspective because contractual promises are part of the negotiated exchange between the entity and the customer. In addition, implied promises do not need to be enforceable by law. If a customer has a valid expectation that the entity has made a promise, the customer would view the promise as part of the contract. Some examples of promises in connection with customer contracts are listed below.

<b>Promise</b>	<b>Example</b>
<b>Sales of goods produced</b>	A manufacturing entity sells inventory
<b>Resale of goods purchased</b>	A retail entity sells purchased merchandise
<b>Resale of rights to goods or services purchased by an entity</b>	A hospitality entity that purchased a concert ticket resells the ticket, acting as principal
<b>Performing tasks</b>	A professional services entity provides consulting services
<b>Providing a service of standing ready to provide goods or services or of making goods or services available for a customer to use as and when the customer decides</b>	A manufacturing entity provides maintenance services on machines sold to a customer when the customer decides it wants the services performed
<b>Providing the service of arranging for another party to transfer goods or services</b>	A general maintenance entity acting as an agent provides a service of arranging for an unrelated party to provide specialised elevator maintenance to a customer
<b>Constructing, manufacturing, or developing an asset on behalf of a customer</b>	A contractor builds a hospital
<b>Granting licenses</b>	An entity grants a license to use its trade name
<b>Granting options to purchase additional goods or services that create a material right</b>	A retailer grants a customer an option to buy three items and to receive 60% off on a fourth item at a later date

## Administrative or pre-production services and activities

IFRS 15 defines 'promises' as those activities that transfer goods or services to the customer. In addition to the promised goods and services, an entity may be required to perform certain administrative or pre-production services or activities (for example in a contract that requires significant setup costs). If these do not transfer a good or service to a customer, they are not considered promises in a contract with a customer, regardless of whether a payment from the customer is received when those services are provided. If payment is received for services or activities that do not directly transfer a good or service to the customer, the payment should be accounted for as part of the transaction price, which is allocated to the identified performance obligations.

## Inconsequential or perfunctory promises

There is no exemption in IFRS 15 from accounting for performance obligations that are considered to be perfunctory or inconsequential. Instead, in assessing promises in the contract and identifying performance obligations, an entity should consider both materiality and the overall objective of IFRS 15 to report useful information about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer.

## Shipping and handling

In some cases, an entity performs shipping and handling activities in connection with a contract for its goods. If the shipping and handling activities are performed before the customer obtains control of the goods, then the shipping and handling activities are not a promised service to the customer. Rather, shipping and handling are activities to fulfill the entity's promise to transfer the goods.

In contrast, if shipping and handling activities are performed after the customer obtains control of the goods, these activities may be providing a service to the customer.

To assess whether shipping and handling activities performed after the customer obtains control of the goods are a separate performance obligation, the nature of the underlying promise is critical.

If the contract consists of providing the customer with goods at the customer's premises at a lump sum price, this may indicate that there is a single performance obligation and revenue should be recognised once the performance obligation is met (ie the goods are delivered to the location). However, if the scope of the contract is not only to supply the goods but to arrange for shipping services at the request of the customer and the price is negotiated separately, this may indicate that there are two performance obligations – one for the goods and other for the shipping services.

### Stand-ready promises

A stand-ready promise is one where an entity provides a service of 'standing ready' to provide goods and/or services, or it makes the goods or services available for a customer to use as and when the customer decides.

#### Practical insight - What is the nature of the promise in a stand-ready obligation?

Entities will need to exercise judgement to determine whether the nature of the entity's promise is to stand ready to provide goods or services or to actually provide the underlying specified goods or services, which would not be a stand-ready obligation. An indicator as to the nature of the entity's promise might be when the entity's obligation is to provide a defined good or service, which would indicate that the nature of the entity's promise is to provide those underlying specified goods or services. If instead the entity determines that the nature of its obligation is to provide an unknown type or quantity of goods or services, this indicates that the nature of the entity's promise is to stand ready.

Judgement is necessary to determine when a promise is to stand-ready, as many contracts call for the entity to be prepared to provide the goods or services at the discretion of the customer, but not all such promises would necessarily lead to stand-ready performance obligations.



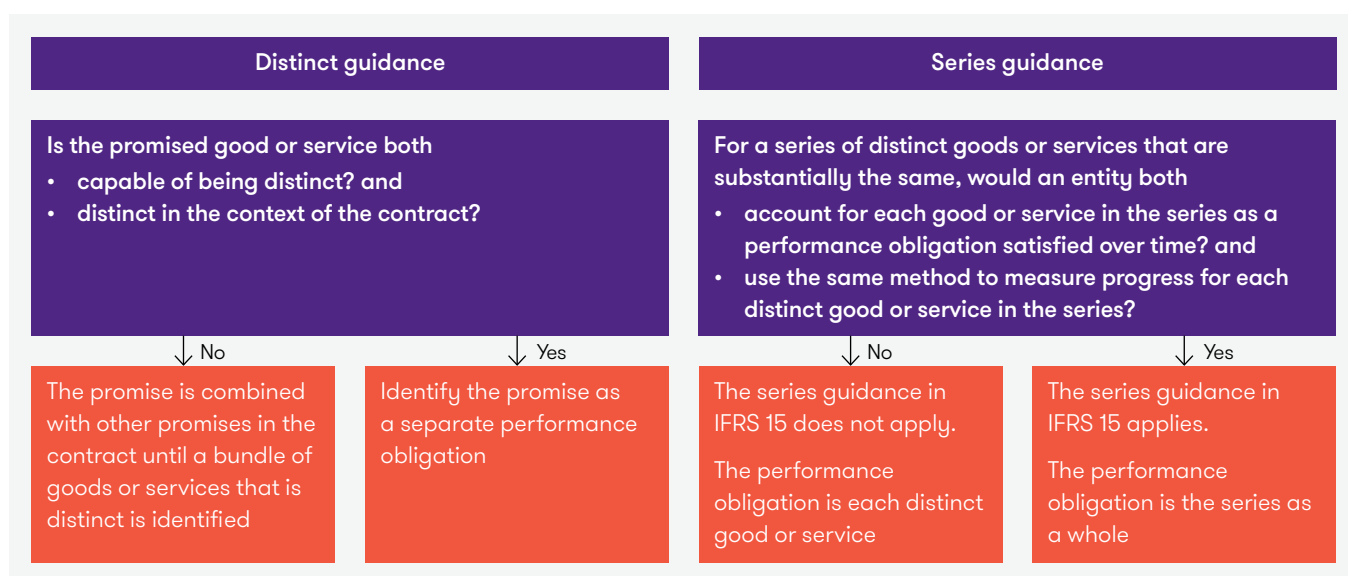
# Identifying performance obligations

After identifying the implicit and explicit promises in the contract, the entity must evaluate each promise to determine if that promise constitutes a performance obligation. This evaluation is performed at contract inception.

A performance obligation is a promise in a contract with a customer to transfer to the customer either:

- 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.

Accordingly, an entity accounts for a promise as a separate performance obligation if the promise meets the criteria to be distinct or if it represents a series of distinct goods or services. This is illustrated in the following flowchart:



## Capable of being distinct

The first criterion for being 'distinct' is that the customer can benefit from the good or service either on its own or together with other resources that are readily available (that is, the good or service is capable of being distinct).

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

Sometimes, a customer can benefit from a good or service only with other readily available resources. A 'readily available resource' is a good or service that is sold separately (by the entity or by another entity) or one that the customer has already obtained from the entity or from other events or transactions.

The fact that the entity regularly sells a good or service on its own is an indicator that the good or service is capable of being distinct.

The assessment of whether the customer can benefit from a good or service on its own should be based on the characteristics of the goods or services themselves, excluding contractual limitations that might preclude the customer from obtaining readily available resources from a source other than the entity. For example, if a contract states that a customer can purchase a specific good or service only from the entity, that would be irrelevant in determining if the customer can benefit from the goods or services on their own.

### Distinct within the context of the contract

In some situations, separately accounting for each promised good or service that is capable of being distinct would not faithfully represent the entity's performance in the contract. For instance, construction and production contracts often involve delivering a range of goods and services to the customer – such as building materials, labour, and project management – that are individually capable of being distinct. However, treating each of these components as separate performance obligations would lead to revenue being recognised when the materials and other inputs were supplied, rather than when the entity actually uses those inputs to carry out the construction or production activities. This would not reflect the substance of the entity's promise to the customer or the entity's performance.

As a result, a second criterion must also be met in order to conclude that a good or service is distinct and is therefore a performance obligation to be accounted for separately.

The second criterion for being 'distinct' is that the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract – that is, the promise to transfer the good or service is distinct within the context of the contract.

In assessing whether an entity's promise to transfer a good or service to the customer is distinct within the context of the contract, the objective is to determine whether the nature of the contractual promise is to transfer each of the goods or services individually or instead to transfer a combined item to which the promised goods or services are inputs. Significant judgement may be required to determine whether promised goods or services are distinct within the context of the contract.

IFRS 15 provides factors that indicate that a promise to transfer goods or services is not separately identifiable from other goods or services in the contract, and these are as follows:

- The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services. In other words, the entity is using the goods or services as inputs to create a combined output specified by the customer.
- One or more of the goods or services significantly modifies or customises one or more of the other goods or services promised in the contract.
- The goods or services are highly interdependent or highly interrelated. In other words, the entity must evaluate whether each of the promised goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

Given the wide variety of revenue arrangements that are within the scope of IFRS 15, there may be instances where the factors will be less relevant to the evaluation of the separately identifiable principle. The list of indicators in IFRS 15 is explicitly not exhaustive so entities should consider the objective of the principle, in addition to the indicators provided when performing this assessment.



### Example 1 – Distinct goods and services

A manufacturing entity sells its customer a product. The contract also provides the customer with the right to receive up to 20 hours of training services on how to operate the product at no additional cost.

The entity assesses the goods and services in the contract to determine whether they are distinct and therefore give rise to separate performance obligations.

#### Analysis

The product is distinct because it meets both of the criteria in IFRS 15. The product is capable of being distinct because the customer can benefit from the product on its own without the training services. The entity regularly sells the product separately without the training services (as the training services, for instance, can be provided/supported by other participants in the market). In addition, the product is distinct within the context of the contract, because the entity’s promise to transfer the product is separately identifiable from other promises in the contract.

In addition, the training services are distinct because they meet both of the criteria in IFRS 15. The training services are capable of being distinct, because the customer can benefit from the training services on its own or together with the product that has already been provided by the entity. In addition, the training services are distinct within the context of the contract, because the entity’s promise to transfer the training services is separately identifiable from other promises in the contract. The entity does not provide a significant service of integrating the training services with the product. The training services are not significantly modified or customised by the product. The training services are not highly dependent on, or highly interrelated with, the product.

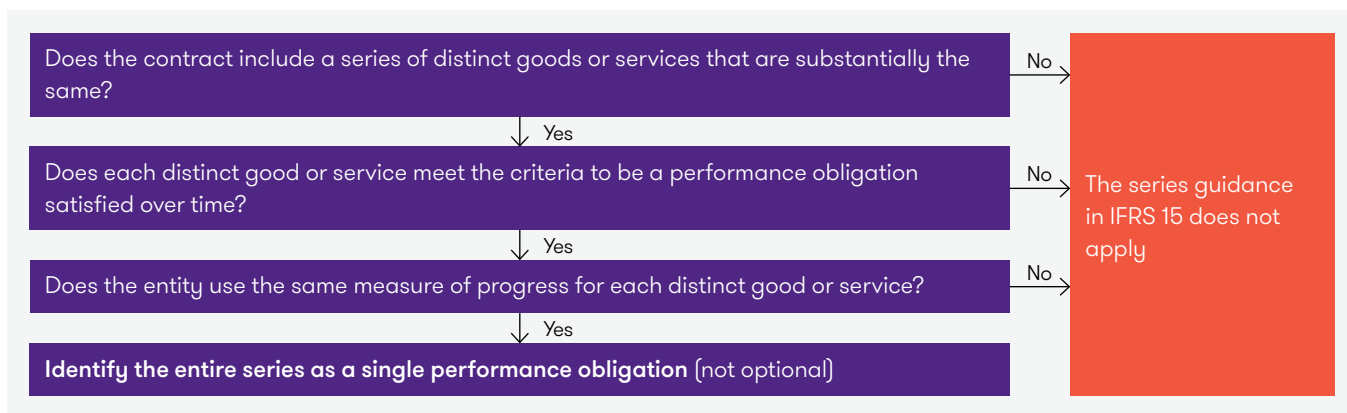
The product and training services are each distinct and therefore give rise to two separate performance obligations.

As a result, the entity allocates the transaction price to the two performance obligations (the product and the training services) and recognises revenue when (or as) those performance obligations are satisfied.

### Series of distinct goods or services

When an entity provides the same distinct goods or services over a period of time (for example, a repetitive service contract for cleaning), it needs to consider if the promised goods or services in the contract meet the requirements of the ‘series guidance’. Under the series guidance, an entity is required to account for a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer as a single performance obligation. The guidance is not optional, which means that an entity is required to account for the series as a single performance obligation rather than accounting for the goods or services as individual performance obligations if the criteria in IFRS 15 are met.

The following flowchart explains how to apply the series guidance:



### **Practical insight – What are some examples of goods or services that constitute a series?**

There are various examples of services that constitute a series, including the following:

- an entity provides weekly cleaning services to a customer for three years
- a hotel manager provides hotel management services to a customer for 20 years
- an entity provides monthly payroll processing services to a customer for one year
- an entity provides asset management services to a client for five years

Even though each instance of service (that is, each hour or day of service) is distinct, the entity accounts for each of these contracts as a single performance obligation because the entity transfers a series of distinct services that are substantially the same and that have the same pattern of transfer to the customer in each case. In other words, each service meets the over time criteria in IFRS 15 and the entity uses the same method to measure its progress (ie a time-based measure) in each case.

Other goods or services that might constitute a series include, but are not limited to, the following examples:

- a software as a service (SaaS) company providing a customer with continuous access to its platform
- a telecommunications company providing network access to customers over a period of time

### **Practical insight – How should an entity consider whether the performance obligation consists of distinct goods or services that are ‘substantially the same’?**

An entity first determines the nature of its promise in providing the service to the customer. If the nature of the entity’s promise is to deliver a specified quantity of a service, the entity should evaluate whether each service is distinct and substantially the same. If the nature of the entity’s promise is the act of standing ready or providing a single service for a period of time, the entity may consider whether each time increment (for example, each day or hour), rather than the underlying activity, is distinct and substantially the same. A series could consist of either distinct time increments or the good or service delivered, depending on the nature of the promise.

For example, an entity enters into a contract to provide monthly payroll processing services to a customer for one year. The nature of the entity’s promise is to deliver a specified quantity of a service – 12 distinct instances of payroll processing. It is not a promise to stand ready to perform an undefined number of processing tasks. As a result, the entity evaluates whether each instance of payroll processing is distinct and substantially the same.

In contrast, a hotel manager enters into a contract with a customer to manage a customer-owned property for 20 years. The hotel management service comprises various activities that may vary by day (for example, cleaning service, reservation services, and property maintenance). In this contract, the nature of the promise is the act of standing ready to provide the hotel management service each day because the entity has promised to provide an unspecified quantity of activities rather than a defined number of services. Accordingly, the entity considers whether each time increment is distinct and substantially the same.

### **Practical insight – In order to apply the series guidance, must the goods be delivered or services be performed consecutively?**

In order to apply the series guidance, the entity need not deliver the goods nor perform the services consecutively. In other words, the guidance still applies when there is a gap in delivery or service, provided the other criteria are met.

For example, an entity has contracted with a customer to provide a manufacturing service in which it will produce 24,000 units over a two-year period. The entity does not plan to perform evenly over the two-year service period. To meet the production targets, the entity produces 2,000 units in some months and zero units in other months. That is, the entity does not produce 1,000 units a month, continuously. Instead, the entity plans to perform the manufacturing service over the two-year period.

The units produced under this service arrangement are substantially the same and are manufactured to the specifications of the customer. The entity does not incur significant up-front costs to develop the production process. Assume that its service of producing each unit is a distinct service in accordance with the criteria in IFRS 15. Additionally, the service is accounted for as a performance obligation satisfied over time because the units are manufactured specific to the customer (such that the entity’s performance does not create an asset with an alternative use to the entity), and if the contract were to be cancelled, the entity has an enforceable right to payment (cost plus a reasonable profit margin).

Although the services are not performed consecutively, the criteria for applying the series guidance are met, and therefore the services are accounted for as a single performance obligation in accordance with the series guidance in IFRS 15.

## Customer options for additional goods and services

An entity that sells goods or services may also provide customers with an option to acquire additional goods or services for free or at a discount, for example, sales incentives, award credits or points, and renewal options. Under IFRS 15, an entity must identify the option as a separate performance obligation if the option represents a 'material right' to the customer that the customer would not have received without entering into that contract. If the option does not provide the customer with a material right (eg if the option only allows the customer to buy additional goods or services at their stand-alone selling price), the option is considered a marketing offer which does not result in a separate performance obligation.

When an entity determines that an option provides the customer with a material right, it identifies that option, not the underlying goods and/or services, as a separate performance obligation. In other words, when an entity determines that an option provides the customer with a material right, it will estimate the stand-alone selling price of the option and allocate a portion of the overall transaction price (excluding the amount a customer would pay for purchasing the additional goods or services) to the option.

### Example 2 – An option that provides the customer with a material right

An entity enters into a contract for the sale of Product A for CU 100. As part of the contract, the entity gives the customer a 40% discount voucher for any future purchases up to CU 100 in the next 30 days. The entity intends to offer a 10% discount on all sales during the next 30 days as part of a seasonal promotion. The 10% discount cannot be used in addition to the 40% discount voucher.

#### Analysis

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

IFRS 15 does not contain explicit guidance on how an entity should account for a customer's exercise of a material right; however, the exercise of an option should not be accounted for as variable consideration. Instead, the Standard seems to support two reasonable approaches:

#### Approach

#### Insight article

**Account for the exercise of the option as a continuation of the existing contract (ie by updating the transaction price)**

'Insights into IFRS 15 – Determining the transaction price'

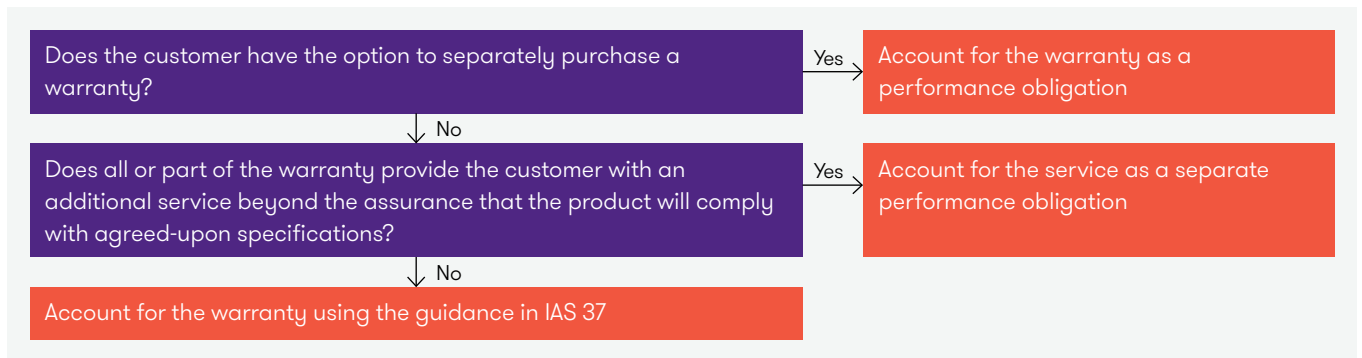
**Account for the exercise of the option as a contract modification**

'Insights into IFRS 15 – Contract modifications'

## Warranties

IFRS 15 contains guidance for the accounting for warranties provided to customers in connection with the sale of a good or service. If a customer has the option to separately purchase a warranty, then an entity accounts for that warranty as a separate performance obligation. If a customer does not have the option to separately purchase a warranty, then the entity accounts for the warranty using the guidance on product warranties in IAS 37 'Provisions, Contingent Liabilities and Contingent Assets', unless all or part of the warranty provides the customer with an 'additional service' beyond the assurance that the product complies with agreed-upon specifications.

The following flowchart explains how to account for warranties:



IFRS 15 lists the following factors that an entity should consider in determining whether a warranty provides a customer with an ‘additional service’.

Factor	Description
<b>Whether the warranty is required by law</b>	A legal requirement to provide a warranty indicates that the warranty is intended to protect the customer from purchasing a defective product.
<b>Term of the warranty coverage period</b>	The longer the coverage period, the more likely it is that the promised warranty includes a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.
<b>The nature of the tasks the entity promises to perform under the warranty</b>	If an entity needs to perform certain tasks to provide assurance to the customer that the product complies with agreed-upon specifications, those services would not likely constitute a separate performance obligation.



### Example 3 – Assurance type warranty

A manufacturing entity provides its customer with a warranty when purchasing a product. The warranty provides assurance that the product complies with agreed-upon specifications and will operate as promised for one year from the date of purchase. The warranty is not required by law, and the customer does not have an option to separately purchase the warranty.

The entity assesses whether the warranty gives rise to a separate performance obligation.

#### Analysis

The entity assesses the promise to provide a warranty and observes that the warranty gives the customer the assurance that the product will function as intended for one year. This is less than the expected life of the product. The services to be provided do not go beyond the promise that the product complies with agreed-upon specifications. Therefore, the entity concludes that the warranty does not provide the customer with a good or service in addition to that assurance and, therefore, the entity does not account for it as a separate performance obligation.

As a result, the entity allocates the transaction price to the single performance obligation (the product) and recognises revenue when (or as) that performance obligation is satisfied.

### Example 4 – Lifetime warranties

A luggage company provides a lifetime warranty that states “If your baggage is broken or damaged, we will repair it for free.”

Factor	Analysis
<b>Whether the warranty is required by law</b>	This indicator states that if the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a separate performance obligation. In this example, because there is no law that requires the entity to make a promise for the lifetime of the product, this indicator suggests the warranty is, in fact, a performance obligation.
<b>Term of the warranty coverage period</b>	This indicator states that a longer warranty coverage period increases the likelihood that the warranty is a performance obligation. In this example, the length of the warranty is for the life of the baggage, so this indicator suggests that the warranty is a performance obligation.
<b>The nature of the tasks the entity promises to perform under the warranty</b>	In this example, the nature of the tasks not only includes repairing baggage that does not meet the promised specifications, but also includes replacing broken or damaged baggage for free. Because the baggage warranty goes beyond the promise that the baggage complies with agreed-upon specifications, this indicator suggests the warranty is a performance obligation.

#### Conclusion

The warranty provided by the baggage company constitutes an additional service, beyond the assurance that the product complies with agreed-upon specifications. Consequently, the additional service should be accounted for as a separate performance obligation.

Warranties that are not sold separately by the entity or negotiated separately with the customer should also be identified as performance obligations if the facts and circumstances suggest that the warranty (or a part of the warranty) provides a service to the customer in addition to the assurance that the entity's past performance was as specified in the contract. This provides a clear principle that allows an entity to account for economically similar warranties in a similar manner, regardless of whether the warranties are separately priced or negotiated.

The Standard clarifies that the following situations do not give rise to a performance obligation:

- a law that requires the entity to compensate the customer for harm or damage caused by its products when used by the customer for its intended purpose
- an entity's promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark, or other infringement by the entity's products

An entity accounts for such obligations in accordance with the guidance on loss contingencies in IAS 37.

Some warranties may include both assurance features and service features. If an entity cannot reasonably account for those assurance features of the warranty separately from the service features, the entity should be allowed to account for the warranties together as a single performance obligation. This ensures that the entity does not overstate the recognition of revenue at the time that the product transfers to the customer and also relieves the entity from identifying and accounting separately for the two components of the warranty coverage.

## How we can help

If you would like to discuss any of the points raised, please contact:

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