

Insights into IFRS 15

Overview and scope



Revenue recognition is fundamental in all businesses, and it is important that it is recognised in a consistent and comparable way across industries and capital markets. IFRS 15 ‘Revenue from Contracts with Customers’ was a result of the joint International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) project to improve the financial reporting of revenue under the IFRS Accounting Standards and US GAAP. The Standard makes it clear that its purpose is not to redefine the concept of revenue, but rather to ensure that revenue is consistently recognised at the appropriate time and at the most reliable amount.

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. This article focuses on the objective and scope of IFRS 15.

Overview: A single model for revenue recognition

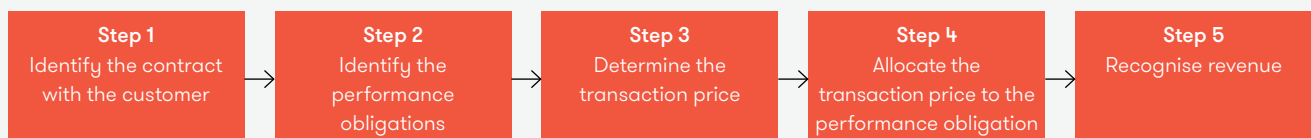
IFRS 15 is based on a core principle that requires an entity to recognise revenue:

- in a manner that depicts the transfer of goods or services to a customer, and
- at an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services.

IFRS 15 sets out a control-based model built around the following five steps:

The five-step model

An entity recognises revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.



In the following pages we will run through these individual steps in more detail.

Step 1 – Identifying the contract with a customer

IFRS 15 applies specifically to contracts with customers, so Step 1 in the model is to identify those contracts. A customer is defined as a party that contracts with an entity to obtain goods or services that are an output of its ordinary activities. A contract is defined as an agreement between two or more parties that creates enforceable rights and obligations and can be written, oral or implied by an entity's customary business practices. However, a contract does not exist if each party has a unilateral right to terminate a wholly unperformed contract without compensating the other party.

The five criteria for a contract within the scope of IFRS 15

In addition to meeting the definition of a legal contract, a contract falls within the scope of IFRS 15 only when all of the following criteria are met:

- the parties have approved the contract and are committed to performing their respective obligations
- the entity can identify each party's rights
- the entity can identify the payment terms
- the contract has commercial substance, and
- it is probable that the entity will collect the consideration to which it will be entitled.

If a contract does not meet all five criteria, then it would not be in scope of IFRS 15 and the following steps of the model would not be applied.

Combination of contracts

IFRS 15 also requires that entities consider the impact of multiple contracts entered into, at or near the same time with the same customer. If this occurs, the contracts must be accounted for as a single contract if one or more of the following criteria are met:

- the contracts are negotiated as a package with a single commercial objective
- the amount 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 in accordance IFRS 15.

As a practical expedient, contracts that meet specific criteria may be combined as a portfolio for accounting purposes, including recognising profits and determining the need for a provision for losses (where the criteria should be applied consistently to all contracts with similar criteria).

Reassessing the contract

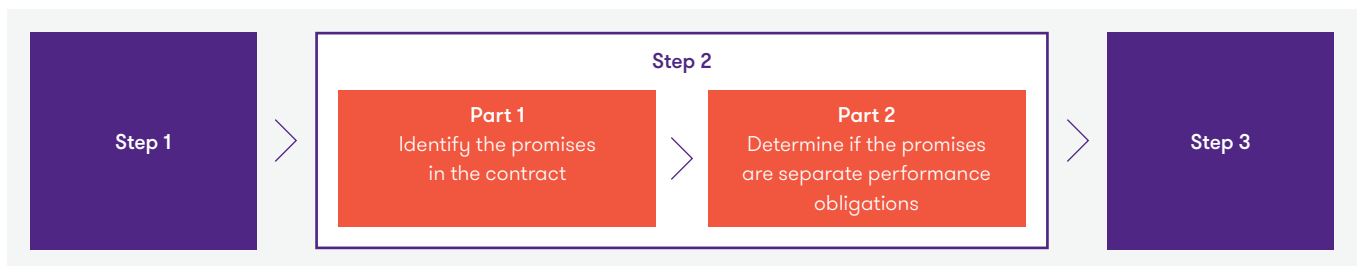
When conditions established at the inception date of the contract are unchanged, the contract should not be reassessed. Reassessment only occurs if there are significant changes in facts and circumstances of either the contract itself or the economic environment. During recent years we have seen some external factors, such as the COVID-19 global pandemic and the Russia-Ukraine War, that could affect collectability, as customers may experience an increased risk of economic difficulty. In such situations, the entity should reassess the contract to determine whether or not it is probable that the customer will be able to pay the consideration to which the entity was entitled, and thereby satisfy the collectability criterion.

There are certain other scenarios, such as when the criteria for a contract are not initially met or performance obligations are partially satisfied, which might require reassessment of the contract.

Step 2 – Identify the performance obligations in the contract

Step 2 is a two-part process. Before an entity can identify its performance obligations, it must first identify all of the promised goods or services in the contract. Promises can be either explicitly stated in the contract or may be implied by an entity's customary business practices, but the key element is that the promise creates a reasonable expectation of the customer that the entity will transfer a good or service. Only after an entity identifies its promises can it then determine which of those promised goods or services constitute performance obligations.

The diagram below demonstrates this process:



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.

Under IFRS 15, a performance obligation is a promise in a contract with a customer to transfer either (1) a good or service, or a bundle of goods or services, that is 'distinct', or (2) a series of distinct goods or services that are substantially the same and have the same pattern on 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. A promised good or service is 'distinct' if both:

- the customer benefits from the item on its own or together with other readily available resources, and
- it is separately identifiable from other promises (eg the supplier does not provide a significant service integrating, modifying or customising the promised goods or services).

In other words, the promised good or service must be capable of being distinct as well as distinct within the context of the contract.

For example, if an undelivered service is essential to the functionality of the delivered product, the undelivered service is not inconsequential or perfunctory, and revenue for the entire unit of accounting should be deferred until the seller fulfills the remaining performance obligations. Each performance obligation should be accounted for as separated deliverable.

Step 3 – Determine the transaction price

After an entity has applied Steps 1 and 2, it can then go on to determining the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (eg sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both. In order to determine transaction price, IFRS 15 requires an entity to consider the terms of the contract as well as its customary business practices. Once an estimate of transaction price is determined at inception, an entity must update the estimate at each reporting period to reflect any changes in facts and circumstances.

In addition to the fixed component of the transaction price, an entity should consider the following components and their effects:

- variable consideration, such as discounts and bonuses
- constraining estimates of variable consideration
- the existence of a significant financing component in the contract, which can affect the consideration due to the time value of money
- non-cash consideration (eg the customer contributes materials, goods or services to fulfill the contract), and
- consideration payable to a customer, which could include credits or other items such as a coupons or vouchers, which can be applied against amounts owed to the entity.

For the purpose of determining the transaction price, an entity should assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed or modified.

In a situation where the transaction price includes any of the components listed above, the entity must take them into consideration before recognising revenue. Determining the transaction price can be complex and careful considerations should be made by the entity in order to correctly account for the revenues in accordance with IFRS 15.



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

The objective of Step 4 is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in a manner that best represents the amount of consideration which the entity expects to receive in exchange for transferring the promised goods or services. This implies that Step 4 is only applicable if the entity has identified more than one performance obligation or if the entity has identified a series of distinct goods or services as a single performance obligation (application of ‘series guidance’). The best way to achieve this objective is typically to allocate the transaction price to each identified performance obligation based on relative stand-alone selling price.

IFRS 15 defines the stand-alone selling price (‘SSP’) as the price at which an entity would separately sell a promised good or service to a customer. The observable selling price charged by the entity in similar circumstances to similar customers, if available, provides the best evidence of SSP. If the SSP is not observable, which may be the case in certain industries such as real estate or construction, the entity must estimate the price using all available information including market conditions, entity specific factors and information about the customer, maximising the use of observable inputs. IFRS 15 suggests, but does not require, three possible methods for estimating the SSP shown in the table below:

Estimating the SSP	
Adjusted market assessment approach	Involves evaluating the market in which an entity sells goods or services and estimating the price that customers in that market would pay. An entity might also consider price information from its competitors and adjust that information for differences in product features, cost structure and expected margins
Expected cost plus margin approach	Involves forecasting expected costs of providing the goods or services and adding an appropriate margin
Residual approach	Involves beginning with the total transaction price and subtracting the sum of the observable SSP for other goods and services promised under the contract. This method is permitted only if an entity: <ul style="list-style-type: none">• sells the same good or service to different customers (at or near the same time) for a broad range of amounts, or• has not yet established a price for the good or service and has not previously sold it on a stand-alone basis

When estimating the SSP, a combination of methods may need to be used if two or more of those goods or services promised in the contract have highly variable or uncertain SSPs. For example, an entity may use a residual approach to estimate the aggregate SSP for those promised goods or services with highly variable or uncertain SSPs and then use another method to estimate the SSP of the individual goods or services relative to that estimated aggregate SSP determined by the residual approach. When an entity uses a combination of methods, it is critical to ensure that the entity maximises reliance on observable inputs and that the entity meets the objective of the allocation principle (ie that the allocation is representative of the consideration received for the specified goods or services).

Allocating discounts and variable consideration

A discount is present in a contract whenever the sum of the SSPs for the promised goods or services exceeds the total consideration to be paid. The relative selling price method allocates this discount proportionately to each of the identified performance obligations, as illustrated in the example below. In certain cases, such as when there is observable evidence that the discount relates to a specific performance obligation, it is possible to allocate the discount to the relevant performance obligation rather than ratably to all. Similar to discounts, variable consideration may be allocated to either the entire contract ratably or to specific performance obligations depending on the circumstances. For example, if a bonus is contingent on completion of a specific performance obligation, then the entire variable consideration would be allocated to that performance obligation.

Example 1 - Relative SSP method

A construction services company enters into a contract for the construction of a hospital and adjacent pharmacy for a total contract price of CU250 million. Assume for purposes of this example that construction of the hospital and pharmacy are determined to be separate performance obligations.

Analysis

The company is required to allocate the total contract price between the hospital and pharmacy using the relative selling price method. The company is able to observe or estimate SSPs for the hospital and pharmacy at CU280 million and CU20 million, respectively. The total contract price of CU250 million is allocated as follows:

	SSP (CU)	Relative SSP (%)	Relative SSP (CU)
Hospital	280 million	93.3% ¹	233.3 million ²
Pharmacy	20 million	6.7%	16.7 million
Total	300 million	100%	250.0 million

¹ $280/300 = 93.3\%$

² $93.3\% \times 250 \text{ million} = 233.3 \text{ million}$



Step 5 – Recognise revenue as and when the entity satisfies a performance obligation

Step 5 is the final step of the revenue recognition model and specifies when revenue is to be recognised and at what amounts. The model specifies that revenue should be recognised as an entity transfers control of goods or services to customers for the amount that the entity expects to have the right to receive. This transfer can occur either over time or at a point in time.

A customer obtains control of an asset, whether it is a good or a service, when it can direct the use of and obtain substantially all the remaining benefits from it. Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset. Control is transferred over time if any of three following conditions are met:

- the customer receives and consumes the benefits as the entity performs (this applies to most services)
- the customer controls the asset as it is created or enhanced, or
- the asset has no alternative use to the seller and the seller has an enforceable right to payment for its performance to date.

If none of these conditions are satisfied, the seller recognises revenue at a point in time. Note that for this purpose, services are also considered to be assets, even if only momentarily, when they are received and consumed by the purchaser. The first of these criteria is most often (and most readily) satisfied when dealing with routine services like office cleaning, building maintenance or administrative support. But for certain leasing or development activities it may be less clear whether the benefit of those services is received and consumed at the time the services are performed.

Practical insight – Revenue versus income

An important aspect of IFRS 15 is the differentiation of revenue and income. IFRS 15 defines ‘Revenue’ as income arising in the course of an entity’s ordinary activities. Income is defined as increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.

This distinction can be important to reporting entities as income is a broader term than revenue and as a result, not all income is in scope of IFRS 15.

Example:

For a manufacturer of cement, the income from the sale of cement is revenue. However, if the same entity sells its surplus land, the profit on sale of land is a gain and not revenue. Total income would be made up of both revenue from the sale of cement as well as the gain on sale of land. It may be noted that changes in equity that relate to contributions from or distributions to owners are excluded from the definition of income and expenses in accordance with IAS 1 ‘Presentation of Financial Statements’.

In addition to the five-step model, the Standard provides application guidance on specific topics such as:






- performance obligations satisfied over time
- methods for measuring progress towards complete satisfaction of a performance obligation
- sale with a right of return
- warranties
- principal versus agent considerations
- customer options for additional goods or services
- customers’ unexercised rights
- non-refundable upfront fees (and some related costs)
- licensing
- repurchase agreements
- consignment arrangements
- bill-and-hold arrangements
- customer acceptance, and
- disclosure of disaggregated revenue.

Many of these topics are covered in separate articles in our ‘Insights into IFRS 15’ series.

Scope

IFRS 15 applies to contracts with customers to provide goods or services that are an output of the entity's ordinary activities in exchange for consideration. It does not apply to certain contracts within the scope of other IFRS Accounting Standards such as lease contracts, insurance contracts, financial instruments, guarantees other than product warranties and non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

It is also important to note that revenue can only be recognised when the five steps are met. For example, in a scenario where a contract does not meet Step 1 because collectability is not reasonably assured, the contract or transaction is not within the IFRS 15 scope at the inception date and should be accounted for under other IFRS Accounting Standards.

In scope of IFRS 15	Not in scope of IFRS 15
 <p>Revenue from contracts with customers (subject to specific exceptions), including contracts for</p> <ul style="list-style-type: none">• Sales of goods• Rendering of services, including construction services• Licensing of intellectual property• Exchanges of non-monetary assets other than scoped-out exchanges (see scope exclusions)	 <p>Non-contractual income (eg fair value of agricultural produce recognised under Ind IAS 41 'Agriculture')</p>  <p>Contracts within the scope of:</p> <ul style="list-style-type: none">• IFRS 16 'Leases'• IFRS 17 'Insurance contracts' *• IFRS 9 'Financial instruments' and other contractual obligations within other IFRS Accounting Standards  <p>Contracts that are not with customers (eg some risk and benefit sharing contracts)</p>  <p>Non-monetary exchanges between entities in the same line of business to facilitate sales to customers</p>

* Note: an entity may choose to apply IFRS 15 to insurance contracts that have as their primary purpose the provision of services for a fixed fee in accordance with IFRS 17.

The IASB decided that IFRS 15 should apply only to a subset of revenue – revenue from contracts with customers. Revenue from a transaction or event that does not arise from a contract with a customer is not within the scope of IFRS 15 and, therefore, those transactions or events will continue to be recognised in accordance with other IFRS Accounting Standards, for example:

- dividends received (although these requirements existed in the previous IFRS revenue standard, the IASB has moved them without changing their effect into IFRS 9 'Financial Instruments')
- non-exchange transactions (eg, donations or contributions received)
- for IFRS Accounting Standards, changes in the value of biological assets, investment properties and the inventory of commodity broker-traders, and
- for US GAAP, changes in regulatory assets and liabilities arising from alternative revenue programmes for rate-regulated entities in the scope of Topic 980 on regulated operations. (The FASB decided that the revenue arising from those assets or liabilities should be presented separately from revenue arising from contracts with customers. Therefore, the FASB made amendments to Subtopic 980-605 Regulated Operations—Revenue Recognition.)

It is also possible that a contract with a customer may be partially within the scope of IFRS 15 and partially within the scope of other IFRS Accounting Standards or have under scope of both, as is the case for fixed fees in insurance contracts noted above.

In certain cases such as contracts with collaborators or partners, an entity needs to consider all relevant facts and circumstances, such as the purpose of the activities undertaken by the counterparty, to determine whether the counterparty is a customer. A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities.

Arrangements like this are common in the pharmaceutical, bio-technology, oil and gas and health care industries. However, depending on the facts and circumstances, these arrangements may also contain a vendor-customer relationship component. Such contracts could still be within the scope of IFRS 15, at least partially, if the collaborator or partner meets the definition of a customer for some, or all, aspects of the arrangement.

Sales of non-financial assets

As a result of the new revenue guidance, certain conforming changes have been made to other IFRS Accounting Standards. IAS 16 'Property, Plant, and Equipment' and IAS 38 'Intangible Assets' now include new requirements for sales of non-financial assets that are not an output of the entity's ordinary activities. For example, for a gain or loss on the sale of fixed assets, an entity should now apply the guidance in IFRS 15 related to the transfer of control and measurement of the transaction price including the constraint on variable consideration, to evaluate the timing and amount of the gain or loss recognised for the sale of the asset before continuing with the guidance in IAS 16.

Example 2 – Sale of manufacturing facility – Transfer of control

Quality Paper (QP) is a manufacturer of paper goods that operates in seven locations across India. QP builds a new facility in Manesar, Haryana and sells its existing facility in Biwandi, Haryana to a third party. The sale of manufacturing facilities is not an output of QP's ordinary activities.

Analysis

Although the sale of manufacturing facilities is not an output of QP's ordinary activities, QP should still apply the contract existence, control and measurement provisions in IFRS 15 to the sale of its Biwandi facility. However, applying those provisions will not affect QP's profit or loss presentation of any resulting gain or loss from the facility sale.

Interaction with other IFRS Accounting Standards

A contract with a customer may be partially within the scope of IFRS 15 and partially within the scope of other IFRS Accounting Standards. If the other IFRS Accounting Standards specify how to separate and measure a portion of the contract, then that guidance should be applied first. The amounts measured under other IFRS Accounting Standards should be excluded from the transaction price and the remaining amount should be allocated to each performance obligation within the scope of IFRS 15. This results in any discount in the overall arrangement being allocated to the portion of the arrangement within the scope of IFRS 15.

If the other IFRS Accounting Standards do not stipulate how to separate and/or measure a portion of the contract, then IFRS 15 would be used to separate and initially measure that portion of the contract.

Example 3 – Lease or service contracts

An entity contracts with a customer to lease equipment and perform maintenance services for a two-year period. What guidance should be applied when separating the leasing and nonleasing components?

Analysis

The entity first applies the separation and measurement guidance in IFRS 16 to separate the leasing component from the nonleasing component (the maintenance services) and to determine the portion of the contract price that relates to the leasing component. The entity then applies the leasing guidance to subsequently account for the leasing component and the revenue guidance to the maintenance services component of the contract.

Non-monetary exchanges

IFRS 15 provides guidance for contracts involving non-cash consideration in exchange for goods, services or non-financial assets but excludes non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, if an entity transfers its inventory in exchange for non-cash consideration, that transaction will generally be in the scope of IFRS 15, because inventory is typically an output of the entity's ordinary activities. However, exchanges of inventory for inventory are not in scope of IFRS 15.

Example 4 – Relative SSP method

Entity A and Entity B both are engaged in manufacturing homogenous bottles. Entity A operates in northern, eastern and central India. Entity B operates in western and southern India. Entity A fulfils the demands of its customers in western and southern India by using the bottles manufactured by Entity B. Similarly, Entity B fulfils the demand of customer in northern, eastern and central India by delivering bottles manufactured by Entity A. How should Entity A and Entity B recognise the revenue?

Analysis

IFRS 15 does not apply to non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. In industries with homogenous products, it is common for entities in the same line of business to exchange products in order to sell them to customers or potential customers other than parties to the exchange.

In addition, Step 1 requires that contracts (including contracts for non-monetary exchanges) have commercial substance in order to meet the criteria for identifying a contract. If this criterion is not met, the contract would not be in scope of IFRS 15 and the following steps of the model should not be applied.

Therefore, the exchange of bottles qualifies as a non-monetary exchange between customers in the same line of business. Accordingly, Entity A and Entity B. should not recognise any revenue related to the exchange of goods as the contract is not in the scope of IFRS 15.

How we can help

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

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