1 STEP 1—IDENTIFY THE CONTRACT WITH THE CUSTOMER[1]

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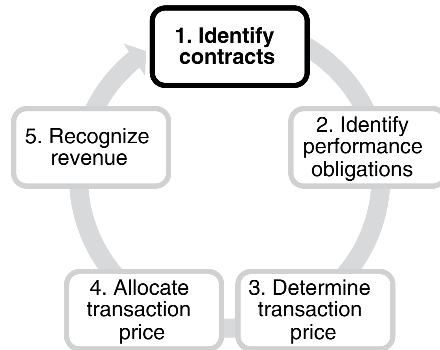
OVERVIEW

For the most part, guidance for Step 1 in applying the revenue recognition model is straightforward. However, the new guidance for contract modifications might be an aspect of this guidance that is somewhat trickier. Contract modifications are explored in detail in Chapter 6.

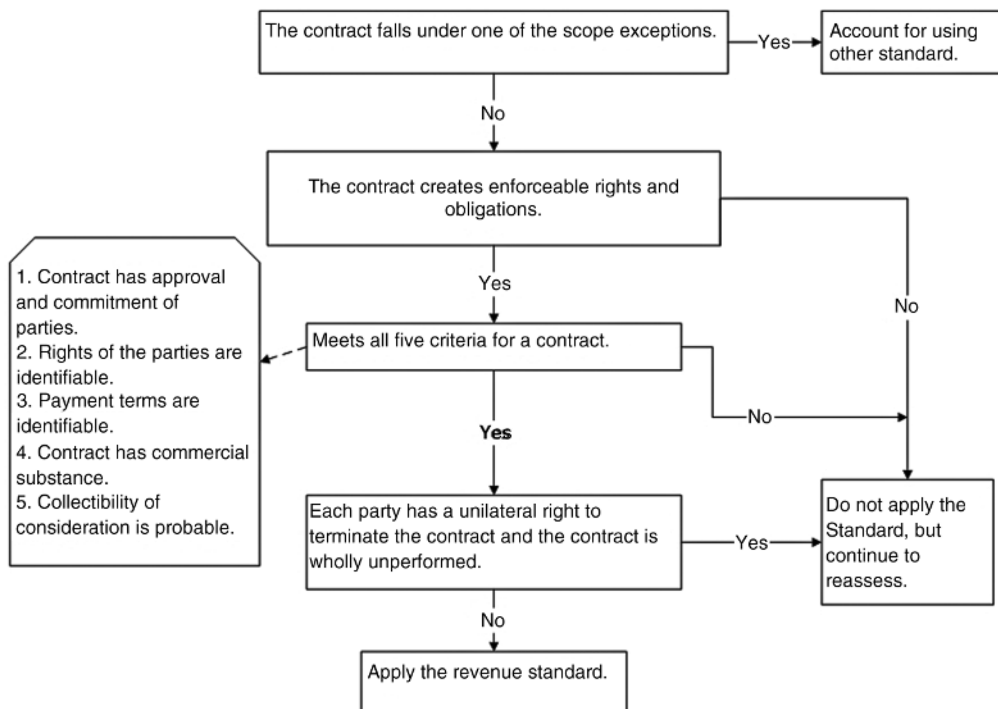
[1] The Boards issued two separate standards. For ease of reference, this volume refers to them as a single standard, "the revenue standard" or "the Standard."



Contract: *Agreement between two or more parties that creates enforceable rights and obligations.*
(ASC 606-10-20; IFRS 15 Appendix A)

Note: The IASB has, in effect, two definitions of contract. The revenue standard emphasizes legal enforceability, whereas IAS 32, *Financial Instruments: Presentation*, stops short of *requiring* legal enforceability. (IAS 32.13) The IASB decided not to amend IAS 32 because of concerns over creating unintended consequences in accounting for financial instruments.

Exhibit 1.1 Overview of Step 1 of the revenue recognition model—identify the contracts



To apply the revenue standard, entities should first determine whether a contract is specifically excluded from the guidance in the Standard. Scope exceptions are detailed in the Executive Summary chapter. The Executive Summary chapter includes a list of transactions excluded from the Standard and a related example regarding nonmonetary exchanges. After determining that a contract is not specifically excluded, entities must identify the contracts that meet the criteria in Step 1 of the revenue recognition model. If the entity determines that a contract does not meet the criteria for Step 1, the contract does not exist for the purposes of the Standard and the entity does not apply Steps 2 through 5. A contract as articulated in the Standard must exist before an entity can recognize revenue from a customer.

ASSESSING WHETHER CONTRACTS ARE WITHIN THE SCOPE OF THE STANDARD

To be within the scope of the revenue standard, and in accordance with the definition of contracts in the Standard, the agreement must not fall under one of the scope exceptions listed in the Executive Summary chapter and must

- create enforceable rights and obligations, and
- meet the five criteria listed in the Standard.

Enforceable Rights and Obligations

The enforceability of the contract

- is a matter of law
- varies across legal jurisdictions, industries, and entities
- may vary within an entity
- may depend on the class of customer or nature of goods or services.

Determining whether an arrangement has created enforceable rights is a matter of law, and evaluating the legal enforceability of the contract can be particularly challenging. This is particularly true if multiple jurisdictions are involved. Entities also need to consider whether, in order to comply with jurisdictional or trade regulation, a written contract is required. Significant judgment may be involved for some cases, and qualified legal counsel may need to be consulted.

The Boards clarified that even though the contract must be legally enforceable to be within the scope of the guidance, the performance obligations within the contract may not be legally enforceable, but may be based on the valid expectations of the customer.

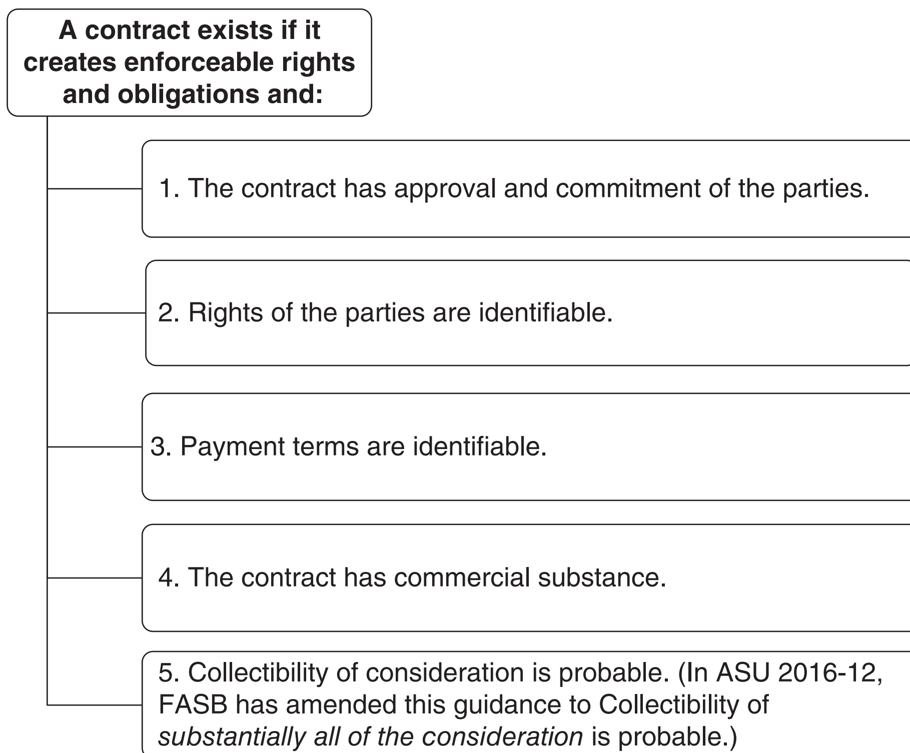
The Five Contract Criteria

The Standard lists five criteria that are assessed at contract inception and that must be met for agreements to be considered contracts subject to the guidance of the Standard.

The five criteria, shown in Exhibit 1.2, are essentially a financial accounting definition of a contract. The entity needs to exercise judgment when applying the criteria. The entity must also be aware that the parties may enter into amendments or side agreements that change the substance of the contract. So, it is important to understand the entire contract, including the amendments and side agreements.

A contract that has enforceable rights and obligations between two or more parties is within the scope of the revenue standard when *all* five of the above criteria are met. The criteria are discussed in more detail below.

Exhibit 1.2 The five contract criteria (ASC 606-10-25-1; IFRS 15.9)



The Contract has Approval and Commitment of the Parties. The approval of the parties can be

a. written,
b. oral, or
c. implied by the entity's customary business practice.

This criterion is included because if not approved, a contract may not be legally enforceable. The Standard focuses on the enforceability of the contract rather than its form (oral, written, or implied). An entity may take into consideration its past business practices when assessing this criterion. For example, an entity that has a practice of performing based on oral agreements may determine that those oral agreements meet the requirement. If an oral agreement meets the requirement, an entity may need to account for the contract as soon as performance begins rather than wait for a signed agreement.

Example 1.1: Oral Contract

Scan Safe provides virus scanning services over the Internet. A customer calls to sign up for the service and provides the sales representative with credit card authorization. The customer agrees to the terms, and the service begins immediately. The oral agreement that Scan Safe and the customer have entered into is legally enforceable in its jurisdiction. The

agreement meets the criteria for a contract with a customer, and the agreement falls under the guidance in the Standard.

Example 1.2: Product Delivered, but No Written Contract Exists

Office Supplier usually delivers products based on a written contract. However, a regular customer had a flood that destroyed furniture and computers. Because of the customer's urgent need, Office Supplier provides replacement products without a written contract. To determine whether an enforceable contract exists even though Office Supplier has deviated from its usual business practice and has no written agreement, Office Supplier must determine if it has legally enforceable rights and the oral agreement meets all five of the criteria to be a contract.

Automatic Renewal Some contracts may automatically renew. Entities should apply the Standard to the period for which the parties have enforceable rights and obligations.

Example 1.3: Contract Extension

LMS provides web hosting services to Publishing Company. The written contract calls for Publishing Company to pay CU 1,500 per month for the services. The contract expires on June 30, 20X1 and contains no provision for automatic extensions. There are no performance issues and no expected changes in performance requirements. While the entities negotiate new payment terms, LMS continues to provide the hosting services for July and August and Publishing Company continues to pay CU 1,500 per month. The entities sign a new contract on August 27, 20X1 that requires Publishing Company to pay CU 2,000 per month.

In this case, a contract appears to exist because LMS performed and Publishing Company paid for the service under the terms of the previous contract. LMS should analyze the contract for legal enforceability and recognize revenue accordingly.

Commitment to Perform The Boards concluded that it is not necessary for the parties to be committed to fulfilling all of their rights and obligations, but there must be sufficient evidence that the parties are substantially committed.

Termination Clauses and Wholly Unperformed Contracts When determining the parties' commitment to perform under a contract, termination clauses are a key element to consider. Termination clauses are an indicator of both parties' commitment to perform under the contract. The contract *does not exist*, for the purposes of the revenue standard, if

- each party has a unilateral right to terminate, and
- the contract is wholly unperformed without compensating the other party.

However, the contract does exist for the purposes of the revenue standard if only one party has the right to terminate the contract without penalty. If both parties have a unilateral right to terminate the agreement, then the TRG members agreed that the agreement should be treated as a month-to-month contract. The TRG members also agreed that where a substantive termination clause exists, the contract term is the stated contract term or, if earlier, the date when the termination payment is no longer due.

A contract is considered *wholly unperformed* if the entity has

- not satisfied any part of its performance obligation
- not transferred any of the promised goods or services to the customer, and
- the customer has not paid, or is obligated to pay, any other consideration under the contract.

(ASC 606-10-25-4; IFRS 15.12)

Example 1.4: Meeting the Termination Criteria

Office Supplier enters into an agreement with Business Center to supply furniture and computers for an office complex under development in an economically disadvantaged country. Business Center agrees to pay an advance deposit. Office Supplier determines that the agreement does not meet the collectibility criteria. Office Supplier determines that it has fulfilled its performance obligations and Business Center has paid the consideration it was obligated to pay under the contract. The contract does not meet the wholly unperformed criteria for a terminated contract, therefore, the contract has not been terminated.

Rights of the Parties are Identifiable. This criterion is relatively straightforward and is necessary in order to assess when the entity has transferred control of the goods or services. If the rights of each party cannot be identified, revenue cannot be recognized.

Payment Terms are Identifiable. This criterion is necessary to determine the transaction price. It does not mean that the transaction price has to be fixed or explicitly stated. There must be an enforceable right to payment and sufficient information to estimate the transaction price. For more on determining the transaction price, see Chapter 3.

The Contract has Commercial Substance. Designed to prevent entities from artificially inflating revenue by transferring goods back and forth, this criterion requires the entity to demonstrate a substantive business purpose for the transaction. Commercial substance means that the contract is expected to change the risk, timing, or amount of the entity's future cash flows. No changes in cash flow likely indicate there is no commercial substance. This criterion also applies to noncash transactions. A noncash transaction may have commercial substance because it might result in reduced cash outflows in the future.

Collectibility of Consideration is Probable. For an entity to apply the Standard, it must be probable that the entity will receive the consideration it is entitled to for the goods and services that will be transferred to the customer. The transaction price may be less than the consideration stated in the contract if the consideration is variable. The assessment of collectibility is not based on all the consideration promised in the contract for all of the promised goods or services.

Technical Update

TRG discussions with the Boards raised a concern that there are potentially different interpretations of how to apply the collectibility criterion when it is not probable that the total consideration in the contract is collectible. Some interpreted the criterion to mean that all of the consideration must be collectible. Others interpreted it to mean that the contracts would meet the criterion if the entity could protect itself from credit risk.

The Boards pointed out that the assessment of collectibility considers

- the entity's exposure to the customer's credit risk, and
- business practices that would enable the entity to mitigate that risk.

These business practices include stopping services or delivery of goods or requiring advance payments. The Basis of Conclusion, paragraph 46, states that the entity would not consider the likelihood of payment for those goods or services that will not be transferred.

The IASB concluded that the current guidance and the explanatory information in the Basis for Conclusion are sufficient, and pointed out that an entity generally will not enter into

a contract with a customer if the entity does not consider it to be probable that the entity will collect the consideration for which it will be entitled in exchange for the goods or services transferred to the customer. (Clarifications to IFRS 15.BC88–93)

The FASB, in contrast, decided to amend its implementation guidance and examples. The FASB changes confirm that the collectibility assessment may be based on a portion of the consideration promised in the contract to which it will be entitled in exchange for the goods or services transferred to the customer. This clarification was added by ASU 2016-12, where the FASB changed this criterion to: "Collectibility of substantially all of the consideration is probable." [ASC 606-10-25-1(e)] The IASB has not added a similar clarification.

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The assessment of collectibility must reflect the customer's *ability and intent* to pay. This criterion acts as a collectibility threshold. A more detailed discussion of the collectibility threshold can be found below.

Source: ASC 606-10-25-1(e); IFRS 15.9(e).

COLLECTIBILITY THRESHOLD

Comparison with Legacy Guidance

The revenue standard includes some significant changes from legacy guidance. Under legacy U.S. guidance (ASC 605-10-25-1), revenue must be earned and realized or realizable before it can be recognized. The revenue standard is not based on the realization principle. Revenue is recognized based on what the entity expects to receive—what is collectible. For SEC filers, SAB Topic 13 clarifies that collectibility is one of four criteria for revenue recognition and must be reasonably assured. For IFRS filers, IAS 18.14 includes a similar criterion: for revenue to be recognized, it must be probable that the economic benefits associated with the transaction flow to the vendor.

To be considered a contract with a customer under the Standard, it must be probable that the entity will collect the consideration to which it is entitled. In addition, under legacy guidance, collectibility is evaluated when revenue is recognized, whereas in the new revenue standard, collectibility is assessed when determining whether a contract exists. The Boards consider the customer's credit risk an important part of determining whether a contract is valid. It is not an indicator of whether revenue is recognized, but an indicator of whether the customer is able to meet its obligation.

The criterion replaces specific guidance in U.S. GAAP for health care entities and real estate transactions.

Differences between IFRS and U.S. GAAP

Collectibility is an area of difference between ASU 2014-09 (codified as ASC 606) and IFRS 15. Both documents use the term "probable." However, there is a difference in the underlying definition of probable. U.S. GAAP defines probable as "likely to occur." This is generally interpreted as a 75 to 80% probability. The collectibility threshold is similar to that in ASC 985-605, *Software*: *Revenue Recognition*. The threshold is slightly higher than that in SEC

SAB Topic 13, which is "reasonably assured." IFRS define probable as "more likely than not," interpreted as greater than 50%. This opens the door to some differences in practice between what is considered a contract with customers under the two standards. The boards believe that the number of instances of differences will be minimal because an entity would not likely enter into a high-credit-risk contract without protection to ensure it can collect. On the contrary, there could be a subsequent deterioration of the customer's ability to pay.

Assessing Collectibility

To be accounted for under the Standard, a contract must have commercial substance. To have commercial substance, the consideration must be collectible. So, the underlying objective of the collectibility assessment is to determine if there is a substantive transaction.

Collectibility is a "gating" question designed to prevent entities from applying the Standard to problematic contracts and recognizing revenue and an impairment loss at the same time.

Judgment. Applying the collectibility criterion requires judgment. It is partly a forward-looking assessment and requires the entity to look at all the factors and circumstances, including the entity's customary business practices and knowledge of the customer.

Timing of Assessment. Collectibility must be evaluated, like the other criteria, at contract inception, but also must be re-evaluated when significant facts and circumstances change. Most entities will not enter into a contract where there is a significant credit risk. However, even in cases where at contract inception there is no significant credit risk, there could be a subsequent deterioration in the customer's ability to pay.

Collectibility = Intent and Ability to Pay. Collectibility refers only to the company's credit risk—the customer's intent and ability to pay—and in making the collectibility assessment not to any other uncertainty or risk. Credit risk is the risk that the entity will not be able to collect the contract consideration to which it is entitled from the customer.

Consider Only Transaction Price. When making the collectibility assessment, entities should be aware that collectibility relates to the *transaction* price, a term introduced in the revenue standard, not the *contract* price. The transaction price is the amount the entity expects to be entitled to. The transaction price is not adjusted for credit risk. The entity may have to consider the transaction price in Step 3 before making a conclusion regarding Step 1's collectibility threshold.

Technical Update

In ASU 2016-12, the FASB clarified that U.S. GAAP reporters should take into account factors that might mitigate credit risk, such as

- payment terms, like upfront payments, or
- the ability to stop transferring goods or services.

A factor that should not be considered is the ability of the entity to repossess an asset. (ASC 606-10-55-3c)

Variable Consideration in the Transaction Price The revenue standard requires an entity to consider whether the price is variable because if so, the entity may wind up offering a price concession. The collectibility assessment is made after taking into account any price concessions that may be made to the customer. The transaction price may be less than the stated contract price if the entity intends to offer a price concession.

Basis of Assessment May Be Less than Total Consideration. The assessment is not necessarily based on the entire amount of consideration for the entire duration of the contract. For example, the entry may have the ability and expectation to stop transferring goods or services if the customer stops paying consideration when due. In another example, if an entity expects to receive only partial payment for performance, the contract may still meet the contract criteria. The expected shortfall is similar to a price concession. The entity must determine if the partial payment is

- an implied price concession
- an impairment loss
- a contract lacking commercial substance.

When an entity expects a shortfall, the entity must exercise significant judgment to determine the proper accounting.

Example 1.5: Assessing Collectibility—Implied Price Concession

ACME enters into a contract to sell 1000 desks to a customer for CU 200,000. The customer is based in a geographic area suffering significant economic difficulty. This is a new customer and a new region for ACME. ACME expects that it will not be able to collect the full contract amount. However, because it wants to establish a customer base in the region, ACME enters into the contract expecting to accept a lower amount of consideration. With the implied price concession, ACME expects to be entitled to CU 160,000. Considering the customer's intent and ability to pay, and the region's economic difficulty, ACME concludes that it is probable that it will collect the CU 160,000.

Example 1.6: Assessing Collectibility—Meeting the Collectibility Threshold

Truman Construction, a real estate developer, enters into a contract to sell to Pearl River, Inc. a commercial building in the downtown area. The consideration is CU 1,000,000 broken down as follows:

- CU 50,000 nonrefundable fee paid at the contract inception, and
- CU 950,000 financed long term by Truman Construction.

The financing is provided on a nonrecourse basis. This means that if Pearl River defaults on the debt, Truman can repossess the property and keep the deposit, but cannot seek further compensation.

Pearl River intends to open an Asian fusion restaurant in the facility. Pearl River has business experience from its previous import–export endeavor, but this is its first venture into the highly competitive restaurant industry. Truman evaluates the facts and circumstances of the agreement. It determines that the factors below put the entity's intent and ability to pay substantially all of the consideration in doubt and, therefore, the agreement does not meet the collectibility threshold:

- The debt will be repaid by proceeds from the risky restaurant venture.
- Pearl River has no other assets or income to repay the debt.
- Pearl River's liability under the terms of the loan is limited because the loan is nonrecourse.

Truman does not recognize the receivable from the real estate asset. Because the contract does not meet the collectibility threshold, the contract does not meet the criteria for a contract and is out of scope of the Standard. So, initially Truman

- monitors the situation to determine if, and when, the contract does meet the contract criteria, and

- looks to the guidance in ASC 606-10-25-7 through 25-8 or IFRS 15.15–16 to determine the accounting for the nonrefundable deposit.

CONTRACT RECOGNITION

Exhibit 1.3 summarizes the qualifications of contracts that fall under the guidance in the Standard and those that do not.

Exhibit 1.3 Contracts in or out of scope

Apply the revenue standard if the contract creates enforceable rights and obligations and:	Do *not* apply the revenue standard to a contract if:
1. The contract has approval and commitment of the parties. 2. The rights of the parties are identifiable. 3. Payment terms are identifiable. 4. The contract has commercial substance. 5. Collectibility of consideration is probable. (ASC 606-10-32-17; IFRS 15.62)	Each party has a unilateral right to terminate the contract **and** The contract is wholly unperformed.

A contract that meets the qualifications for recognition under the Standard

- gives the entity the right to receive consideration, and
- creates obligations for the entity to deliver goods and services.

This combination of rights and obligations gives rise to net assets or net liabilities. These assets and liabilities are not recognized until one or both parties perform. Entities must monitor contracts for when performance has begun. Once performance has begun, a contract that is enforceable and meets the five contract criteria exists for the purposes of the revenue standard. Even if a contract has not been signed, the entities may determine that a contract exists and may need to account for a contract as soon as performance begins rather than delay revenue recognition for an executed contract. In some cases, timing of revenue recognition may differ from that under legacy standards.

ARRANGEMENTS WHERE CONTRACT CRITERIA ARE NOT MET

What happens if the entity receives consideration from the customer, but the contract fails Step 1? In that case, the entity should apply what is sometimes referred to as the alternate recognition model and recognize the consideration received only when *one* of the following occurs:

a. The entity has no remaining obligations to transfer goods or services to the customers, and all or substantially all of the consideration promised by the customer has been received by the entity and is nonrefundable.

b. The contract has been terminated, and the consideration received from the customer is nonrefundable.
c. For U.S. GAAP only—The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods and services to the customer and has no obligation to transfer additional goods or services, and the consideration received from the customer is nonrefundable.

(ASC 606-10-25-7; IFRS 15.15)

Technical Update

Subsequent to issuance of the Standard in May 2014, the TRG brought an issue to the Boards regarding the criteria in ASC 606-10-25-7 and IFRS 15.15. Some TRG members and other stakeholders held the view that for certain arrangements, the criteria were unclear. Therefore, in ASU 2016-12, the FASB added criterion “c” to clarify when revenue would be recognized if an entity did not meet the criteria in Step 1 above of the revenue recognition model.

The IASB did not propose similar amendments. In its 2016 Clarification to the Revenue Standard, the IASB has included in its Basis of Conclusion additional discussion of collectibility. The additional discussion states that when assessing collectibility, entities should consider their ability to mitigate exposure to credit risk throughout the contract by, for example, stopping providing goods or services or requiring advance payments. The difference in the two approaches to this issue should not result in significant differences in financial reporting in most cases. Example 1 of the Standard is changed by the FASB and those changes result in different conclusions as to the timing of transfer of control for the fact pattern presented.

If an arrangement does not meet the contract criteria in the revenue standard, then consideration received should be accounted for as a liability until

- “a” or “b” or, for U.S. GAAP reporters only, “c” above occur, or
- the arrangement meets the contract criteria.

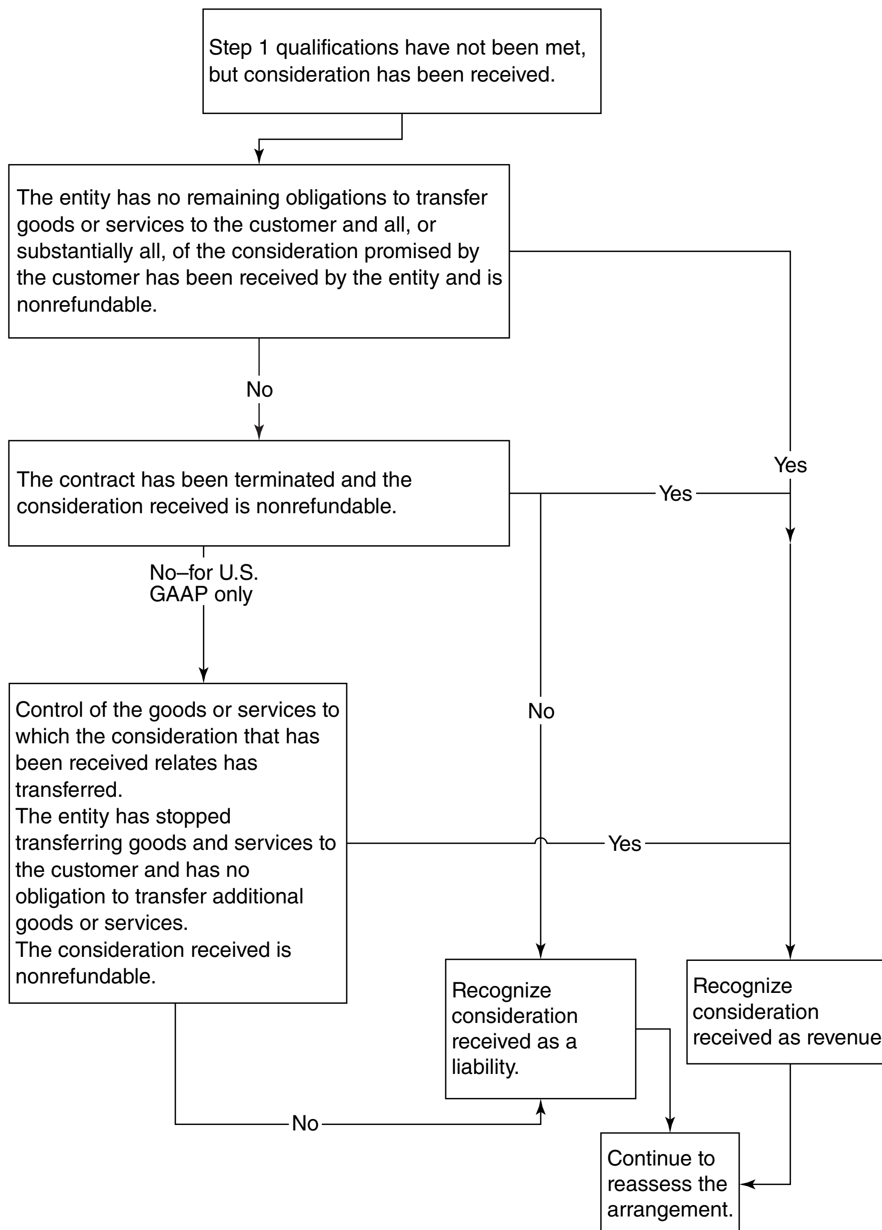
The liability is measured at the amount of consideration received from the customer. The liability represents the entity’s obligations to

- transfer goods or services in the future, or
- refund the consideration received.

(ASC 606-10-25-8; IFRS 15.16)

This can be contrasted with current standards where revenue may be recognized in the amount of cash received. Chapter 5 has a detailed discussion of recognizing revenue, contract assets, and contract liabilities.

Exhibit 1.4 No contract exists, consideration received



Example 1.7: No Contract Exists—Accounting for Consideration Received

Use the facts in Example 1.6. Because the contract between Truman Development and Pearl River does not meet the Step 1 qualifications, and the entity has not received substantially all of the consideration and has not terminated the contract, Truman accounts for the nonrefundable CU 50,000 as a liability and does not derecognize the real estate asset. Truman also does not recognize

a receivable. Truman continues to assess the contract until the five contract criteria have been met or the contract meets the termination criteria.

Reassessment

When an arrangement has been assessed and is considered a contract under the revenue standard, the entity is not required to reassess the contract unless there is an indication of a significant change. A significant change might be, for example, a significant deterioration in the customer's ability to pay. (ASC 606-10-25-5; IFRS 15.13) In that case, the entity needs to assess whether it is probable that the customer will pay the consideration for the remaining goods or services. In contrast, if the arrangement is not initially considered a contract and if there is an indication that there has been a significant change in facts and circumstances, the entity should reassess to determine whether the criteria are met subsequently. (ASC 606-10-25-6; IFRS 15.14) The entity applies the provisions of the Standard from the date the criterion are met.

Only the rights and obligations that have *not* transferred are reassessed. Therefore, a reassessment will not result in any reversal of revenue, receivables, or assets already recognized. Those assets are assessed for impairment under the relevant financial instruments standard. The entity does not recognize any additional revenue from the agreement.

The TRG members have acknowledged that the assessment of whether significant changes have occurred requiring a reassessment of collectibility or even a determination that a contract no longer exists under the Standard will be situation-specific and require judgment.

THE PORTFOLIO APPROACH AND COMBINING CONTRACTS

The revenue standard includes

- a practical expedient for combining groups of contracts, and
- a new requirement to combine contracts.

A Practical Expedient

An entity normally applies the revenue standard to individual contracts. However, in certain circumstances, an entity may use a practical expedient and apply the revenue standard to a group of contracts. This expedient allows for the portfolio approach—applying the revenue standard to a group of contracts or performance obligations under the following conditions:

- the contracts must have similar characteristics *and*
- the entity must reasonably expect that the effects of applying the guidance to a portfolio would not differ materially from applying it to individual contracts or performance obligations.

(ASC 606-10-10-4; IFRS 15.4)

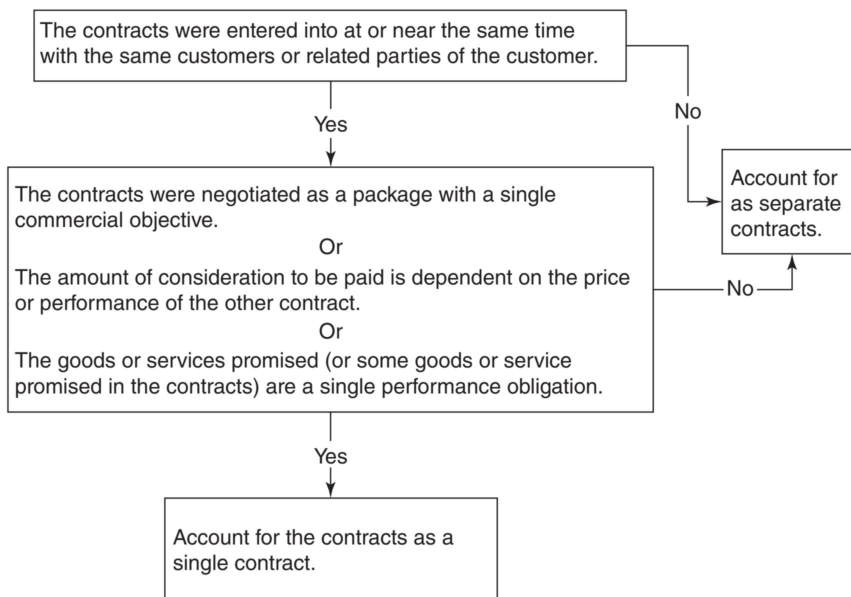
It is expected that in most cases entities will apply the revenue model to an individual contract. However, entities need to evaluate the cost versus benefit of using the portfolio approach. For some, the effort to assess what constitutes a portfolio and develop the processes needed to account for the portfolio may outweigh any benefit of this practical expedient.

Combination of Contracts Required

IFRS 11, *Construction Contracts*, provides that two or more contracts *must* be accounted for as a single contract if certain conditions are met, and IAS 18 has a similar provision. Under legacy

U.S. GAAP (ASC 605-25-25-3), the entity is *allowed* to combine contracts if certain conditions are met. The Standard *requires* a combination of contracts under certain circumstances. Entities have to assess existing contracts to determine whether combination is required and should also be mindful of the combination requirement when writing new contracts. The decision to combine contracts is made at the inception of the contracts.

Exhibit 1.5 Combination of contracts required



The entity needs to assess whether the substance of the contract is that the pricing or economics of the contracts are interdependent. The Standard offers guidance to help make that judgment. The contracts should be accounted for as a single contract when the contracts are entered into at or near the same time with the same customers or parties related to the customer and if *any* of the following conditions are met:

a. The entity negotiates the contracts as a package with a single commercial objective.
b. The amount of consideration to be paid in the contract depends on the price or performance of the other contract.
c. The goods or services promised in the contracts (or some goods or services promised in the contracts) constitute a single performance obligation.

(ASC 606-10-25-9; IFRS 15.17)

The entity should apply the guidance on identifying performance obligations when assessing "c." (See Chapter 2.)

The fact that multiple contracts are negotiated at the same time is not sufficient evidence to demonstrate that the contracts represent a single arrangement. (ASC 2014-09 BC73; IFRS 15.BC73)

Tip: The entity needs to exercise significant judgment in determining what constitutes "at or near the same time." If the time period between execution of the contracts is short, contracts may meet the "at or near the same time" condition. Also, subsequent promises not considered at contract inception are generally accounted for as contract modifications.

If the criteria are met, contracts between the same customer or related parties of the customer should be combined. Related parties are those defined in the guidance ASC 850, *Related Parties Disclosures* and IAS 24, *Related Party Disclosures.*

In U.S. GAAP, related parties include

- affiliates of the entity
- entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
- trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
- principal owners of the entity and members of their immediate families
- management of the entity and members of their immediate families
- other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
- other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

(ASC 850-10-20)

IAS 24, *Related Party Disclosures* includes the following definition of related parties:

A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

a. A person or a *close member of that person's family* is related to a reporting entity if that person:
    i. has control or joint control of the reporting entity;
    ii. has significant influence over the reporting entity; or
    iii. is a member of the *key management personnel* of the reporting entity or of a parent of the reporting entity.

b. An entity is *related* to a reporting entity if any of the following conditions applies:
    i. The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).
    ii. One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
    iii. Both entities are joint ventures of the same third party.
    iv. One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
    v. The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
    vi. The entity is controlled or jointly controlled by a person identified in (a).

vii. A person identified in (a)(i) has significant influence over the entity or is a member of the *key management personnel* of the entity (or of a parent of the entity).

viii. The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

(IAS 24.9)

Assessing Collectibility of a Portfolio of Contracts

An issue was raised with the TRG regarding how to deal with situations in a portfolio of homogenous contracts where some customers will pay amounts owed, but the entity has historical experience indicating that some customers will not pay the full consideration. In that case, the entity should record revenue, but separately evaluate the contract asset or receivable for impairment. The entity will have to exercise judgment regarding whether to record a bad debt expense or reduce revenue for an anticipated price concession.

IDENTIFYING THE CUSTOMER

> Customer: A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
> (ASC 606-10-20; IFRS Appendix A)

Collaborative Arrangements

A collaborative arrangement is not in the scope of the Standard unless the collaboration meets the definition of a customer. In most cases, the identification of the customer is straightforward. However, the Boards decided not to offer additional application guidance and, therefore, a collaborative arrangement requires more careful analysis of the facts and circumstances. For example, an arrangement with a counterparty where both parties share the risks and benefits will most likely not result in a counterparty meeting the definition of a customer, and, therefore, the arrangement will not fall under the Standard. (ASC 606-10-15-3; IFRS 15.6) On the contrary, an arrangement where the entity is selling a good or service, even if the arrangement is labeled a collaboration, will likely fall under the scope of the Standard.

It is also possible that portions of the contract will be a collaboration, while other portions will be a contract with a customer. The latter portion will be in the scope of the revenue standard.

After a thorough analysis of the agreement, the entity should decide whether to apply the revenue standard and/or other guidance, such as ASC 808, *Collaborative Arrangements*, or IFRS 11, *Joint Arrangements*.

Example 1.8: Collaborative Arrangement

A company in the biotech industry enters into an agreement with a company in the pharmaceutical industry to share equally in the revenue from work on the development of a specific new drug. If the companies agree to simply work together, this collaborative arrangement is not in the scope of the revenue standard because there is no customer. If, on the contrary, the biotech company is selling its compound to the pharmaceutical company, then the arrangement is likely in the scope of the Standard.

Arrangements with Multiple Parties

There are cases where multiple parties are involved in the transaction. For example, pharmaceutical companies provide products to customers and parts of the fees are paid by an insurer and the remaining fees are paid by the customer. Or, manufacturers issue coupons directly to the consumer and reimburse the retailer for the coupons.

Tip: Careful analysis is needed to evaluate the substance of the transaction to determine

- who are the customers,
- whether the entity is a principal or an agent, and
- if the contracts can be combined.

The entity must also determine if it is the principal or agent in the transaction. This matters because the principal recognizes the revenue for the gross amount, and the agent recognizes the transaction at net—the amount that the entity expects to retain after paying the other party for goods or services provided. Principal versus agent guidance is discussed in detail in Chapter 6.