Applying IFRS

The new revenue recognition standard - Joint Transition Resource Group

January 2015

Contents

What you need to know

- TRG members discussed a number of implementation issues at their third meeting and reached general consensus on many of the topics.
- The TRG did not reach consensus on questions relating to: contract modifications during transition; non-cash consideration; collectability; and variable consideration payable to a customer. This suggests that the Boards may need to determine whether more application guidance is needed.
- The Boards' staff provided an update on their research regarding whether improvements can be made to the requirements for licences and identifying performance obligations. The staff will present their findings at a joint Board meeting in February 2015.
- The staff also indicated they are researching whether the Boards should consider adding a number of practical expedients to make it easier for entities to apply the standard.

1. Overview

The Joint Transition Resource Group for Revenue Recognition (TRG) again met in January 2015 to discuss a number of implementation issues that stakeholders have raised about the new revenue recognition standard, IFRS 15 *Revenue from Contracts with Customers*, that was jointly issued by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) (collectively, the Boards).

To help preparers implement the standard, the TRG addressed more issues than in previous meetings.

Although TRG members expressed similar views on several issues, they did not reach consensus on implementation questions involving: accounting for contract modifications during transition; non-cash consideration; collectability; and variable consideration payable to a customer. The Boards are monitoring the TRG's discussions to determine whether more application guidance is needed.

The issues on which TRG members generally agreed are summarised in the Appendix to this publication. While these views are non-authoritative, they represent the latest thinking on each topic and we believe entities should consider them as they continue to implement the new standard.

The staff also indicated they are researching whether the Boards should consider adding practical expedients to the new revenue standard. These could include practical expedients that would address: (1) the presentation of sales taxes (discussed at the July 2014 TRG meeting[1]); (2) whether shipping represents a performance obligation in an arrangement; and (3) the accounting treatment for contract modifications at transition.

The staff provided no further update on a possible deferral of the effective date of the new standard, other than to reiterate that the Boards plan to discuss the feedback received on a potential deferral at a joint Board meeting early in the second quarter of 2015.

2. Issues discussed without general consensus

2.1 Accounting for contract modifications during transition

TRG members generally agreed that the Boards could consider adding a practical expedient to alleviate the transition burden of accounting for contracts that have been modified prior to adoption of the new standard.

Preparers have raised concerns that, under the transition requirements, they would have to evaluate all prior modifications to contracts that are not completed as at the date of adoption (i.e., 1 January 2017). This assessment could be onerous for entities that have previously modified their multi-year contracts many times. We expect the staff to discuss with stakeholders how a practical expedient would be applied (e.g., whether it would be available under both transition methods, whether it would apply to all of an entity's contracts or a subset of contracts).

2.2 Non-cash consideration

TRG members agreed that, while the standard requires non-cash consideration (e.g., shares, advertising provided as consideration from a customer) to be measured at fair value, it is unclear when that fair value measurement must occur. The TRG discussed three measurement date options: contract inception;

[1] See *IFRS Developments* Issue 85: *Joint Transition Resource Group for Revenue Recognition debates implementation issues* (July 2014) available at www.ey.com/ifrs

when the non-cash consideration is received (or receivable); and the earlier of when it is received or when the related performance obligation is satisfied. Each view received support from some TRG members.

The standard also requires that the constraint on variable consideration be applied to non-cash consideration only if the variability is due to factors other than the form of consideration (i.e., it is unclear whether the entity will collect the consideration). The constraint will not apply if the non-cash consideration varies because of its form (e.g., listed shares that change in price). The standard does not address how the constraint would be applied when the non-cash consideration is variable due to both its form and other reasons. While some TRG members said the standard could be interpreted to require an entity to split the consideration based on the source of the variability, some members highlighted that this approach would be overly complex and would not provide useful information.

2.3 Collectability

TRG members debated when an entity would recognise revenue if it determines (either at contract inception or upon reassessment) that collectability is not probable. The standard states that when an arrangement does not meet the collectability criterion (or any of the other four criteria) to be considered a contract under the standard, an entity can only recognise non-refundable consideration received as revenue when the entity has completed performance and received substantially all consideration or the contract has been terminated. Several TRG members noted that this requirement would indefinitely delay recognition of non-refundable cash consideration received in a number of situations (e.g., a month-to-month service arrangement when the entity continues to perform). These TRG members questioned whether this was the Boards' intent.

How we see it

We agree that, in some situations, the requirements would be punitive because they would delay recognition of revenue beyond the timing of performance and receipt of non-refundable cash. We hope that additional application guidance can be provided in this area.

2.4 Variable consideration, specifically amounts payable to a customer

The TRG discussed when an entity would recognise a reduction in transaction price (and thus a reduction in revenue) for variable consideration that is in the form of consideration payable to a customer (e.g., rebates, coupons). TRG members noted that there is a conflict in the standard in relation to these topics. That is, the standard requires entities to estimate all potential variable consideration and reflect it in the transaction price at contract inception and as the entity performs. However, the requirements for consideration payable to a customer indicate that such amounts are recognised as a reduction of revenue when the related sales are recognised or the entity makes the promise to provide such consideration, whichever is later. TRG members generally agreed that entities will reach different conclusions on the timing of recognition of certain incentives (e.g., new incentive programmes offered after a good or service is transferred to the customer) unless the standard is clarified.

The TRG provided initial feedback on questions it may address at its next meeting on 30 March 2015.

3. Update on previous TRG issues

The Boards have directed their staff to research and discuss with preparers and other stakeholders whether improvements can be made to the standard on two of the topics that the TRG discussed in October 2014: licences; and identifying performance obligations, including determining whether goods or services are distinct within the context of the contract. The Boards plan to discuss these topics at a joint Board meeting in February 2015. The staff will continue to research possible changes to the principal versus agent (gross versus net) application guidance, which the TRG discussed in July 2014. This topic will not be discussed in February 2015 as the staff indicated that they are addressing the other two topics first.

Any changes made to the standard would be subject to the due process procedures of each Board, including seeking public comment.

The Boards have not planned further action on the other issues that the TRG discussed in October 2014 (i.e., questions regarding how a material right would be evaluated for customer options for additional goods and services; presentation of contract assets and liabilities; and contract enforceability and termination clauses).

4. Preview of future TRG issues

The staff asked for initial feedback on several questions that may be added to the agenda for the next TRG meeting on 30 March 2015. The staff also encouraged stakeholders to submit issues for discussion to the TRG and review those that have already been submitted on the websites of the IASB or FASB.

4.1 Material rights

- Would an entity account for the exercise of a material right as a continuation of the original contract, a contract modification or variable consideration?
- When assessing materiality, would an entity compare an upfront non-refundable fee to the fee for the enforceable contract period or to the cumulative service fee expected over the estimated customer life?
- Would a material right also create a significant financing component (i.e., has the customer, in effect, paid the entity in advance for future goods and services)?

TRG members generally agreed that the first two questions need to be discussed because diversity in practice is likely. TRG members believe that the answer to the third question will likely depend on the facts and circumstances of the arrangement. As a result, the TRG may not be able to provide much insight

4.2 Consideration payable to a customer

- Should entities apply the requirements for consideration payable to a customer at the contract level or, more broadly, to the entire 'customer relationship'?
- Are the requirements only applicable to customers in the distribution chain or are they also applicable to any customer of an entity's customer (e.g., when an agent in a transaction provides incentives directly to a principal's customer)?

- If the payments to a customer exceed consideration received from that customer, how would an entity present this ‘negative revenue’?

TRG members generally agreed that the first two questions need to be discussed. Some members suggested additional application guidance on negative revenue would be helpful, but others said that they expect this issue to arise infrequently.

4.3 Significant financing components

- IFRS 15 indicates that a significant financing component does not exist if a difference between the promised consideration and the cash selling price is for reasons other than the provision of finance. How broadly should this be applied?
- Would an interest-free financing arrangement contain a significant financing component?
- How would an entity calculate the time value of money if the consideration is received upfront, but revenue is recognised over multiple years?

TRG members agreed that all three questions merit further discussion.

Appendix - TRG consensus issues

Identifying promised goods or services	
In applying IFRS 15, an entity must identify the promised goods and services within the contract and determine which of those goods and services are distinct (i.e., performance obligations).	
Questions raised	***General consensus***
Will the new standard require the identification of promised goods or services that are not identified as deliverables today?	Generally, no. Entities may not disregard items that they deem to be perfunctory or inconsequential. However, entities would consider materiality in determining whether items are promised goods or services. For example, telecommunications entities may have to allocate consideration to the 'free' handsets that they provide. Likewise, automobile manufacturers may have to allocate consideration to 'free' maintenance that may be considered a marketing incentive under current practice.
Are there any changes that could be made to the standard if it was, in fact, the Boards' intent not to identify significant numbers of new promised goods or services?	Many TRG members favour an update to the standard's Basis for Conclusions, but do not believe that the wording in IFRS 15 needs to be changed. Specifically, some members commented that the 'perfunctory or inconsequential' language in the Basis for Conclusions[2] could be deleted to avoid confusion over the Boards' expectations. At a joint Board meeting in February 2015, the Boards will consider whether any changes should be made when they discuss the requirements for determining whether goods or services are distinct within the context of a contract. Any actions that the Boards take at the February 2015 meeting could affect both general consensuses of the TRG on identifying promised goods or services.

Incremental costs to obtain a contract	
Under IFRS 15, the incremental cost of obtaining a contract (e.g., sales commissions) will be recognised as an asset if the entity expects to recover it.	
Questions raised	***General consensus***
When and how much would an entity capitalise when commissions are paid on renewal contracts? How would an entity amortise such an asset and evaluate if it is commensurate? Should commissions earned on contract modifications that are not treated as separate contracts be capitalised? If commissions are contingent on future events, can they be considered incremental? Can commissions that are subject to claw backs and/or achieving cumulative thresholds be capitalised? Should fringe benefits on commission payments be included in the capitalised amounts?	Instead of focusing on the detailed questions in the staff paper, TRG members discussed the underlying principle for capitalising costs under the standard. TRG members noted that it is the applicable liabilities standard that determines when to recognise contract costs that may be eligible for capitalisation under IFRS 15. TRG members agreed that IFRS 15 is not expected to change the requirements on recognition of liabilities under current IFRS. Therefore, entities would first refer to the applicable liability standard to determine when they are required to recognise a liability for certain costs. Entities would then refer to IFRS 15 to determine whether the related costs would need to be capitalised. TRG members generally agreed that no changes to IFRS 15 are necessary. They also agreed that certain aspects of the

[2] IFRS 15.BC90

What is the pattern of amortisation for a contract cost asset that relates to multiple performance obligations that are satisfied over disparate periods of time?	recognition of costs will require entities to apply significant judgement to determine the appropriate accounting treatment. For example, judgement would be needed to assess items, such as, the amortisation pattern for a contract cost asset that relates to multiple performance obligations that are satisfied over different periods of time.
Stand-ready obligations	
IFRS 15 states that a contract may include "a service of standing ready to provide goods or services (e.g., unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides".[3]	
Questions raised	***General consensus***
What is the nature of the promise in a 'typical' stand-ready obligation?	TRG members generally agreed that the promise in a stand-ready obligation is the assurance that the customer will have access to the good or service, not the delivery of the underlying good or service. A staff member indicated the staff do not believe that the Boards intended to change current practice for determining when software/technology transactions include specified upgrade rights (i.e., a separate performance obligation) or unspecified upgrade rights (i.e., a stand-ready obligation).
How would an entity measure progress toward satisfaction of a stand-ready obligation that is satisfied over time?	TRG members agreed that an entity could not default to a straight-line revenue attribution model. However, TRG members generally agreed that if an entity expects the customer to receive and consume the benefits of its promise throughout the contract period, a time-based measure of progress (e.g., straight-line) would be appropriate. A staff member indicated that this may often be the case for unspecified upgrade rights. TRG members generally agreed that rateable recognition may not be appropriate if the benefits are not spread evenly over the contract period (e.g., an annual snow removal contract that provides more benefit in winter).
Collectability	
Under IFRS 15, collectability refers to the customer's ability and intent to pay the amount of consideration to which the entity expects to be entitled. The Boards concluded that assessing a customer's credit risk is an important part of determining whether a contract, as defined by the standard, exists.	
Questions raised	***General consensus***
How would an entity assess collectability for a portfolio of contracts?	TRG members agreed that if an entity has determined it is probable that a customer will pay amounts owed under a contract, but the entity has historical experience that it will not collect consideration from some customers within a portfolio of contracts, it would be appropriate for the entity to record revenue for the contract in full and separately evaluate the corresponding contract asset or receivable for impairment. Some TRG members cautioned that the analysis to determine whether to recognise a bad debt expense for a

[3] IFRS 15.26(e)

	contract in the same period in which revenue is recognised (instead of reducing revenue for an anticipated price concession) will require judgement.
When would an entity reassess collectability?	IFRS 15 requires an entity to evaluate at contract inception (and when significant facts and circumstances change) whether it is probable that it will collect the consideration to which it expects to be entitled (i.e., the transaction price, not the stated contract price). TRG members agreed that entities would need to exercise judgement to determine whether changes in the facts and circumstances require a reassessment of collectability. Judgement would also be needed to determine whether changes in the facts and circumstances are significant enough to indicate that a contract under the standard no longer exists.
How would an entity assess whether a contract includes a price concession?	The Boards have indicated that an entity's belief that it will receive partial payment for performance may be sufficient evidence that an arrangement meets the definition of a contract (and that the expected shortfall of consideration is more akin to a price concession). TRG members agreed that entities will need to exercise judgement. They also acknowledged that it may be difficult in some cases to distinguish between price concessions, impairment and a lack of sufficient commercial substance to be considered a contract under the standard.

Variable consideration

Entities will be required to constrain the amount of variable consideration included in the estimated transaction price. That is, entities will have to conclude that it is highly probable that a significant revenue reversal will not occur in future periods before any such amounts are included in the transaction price.

Questions raised	***General consensus***
Would the constraint on variable consideration be applied at the contract or performance obligation level?	TRG members agreed that the constraint would be applied at the contract level and not at the performance obligation level. That is, the significance assessment of the potential for a revenue reversal would consider the total transaction price for the contract (not the portion of transaction price allocated to a performance obligation).

Islamic Financing Transactions

Islamic financial institutions (IFI) enter into Sharia-compliant instruments and transactions. Instead of earning interest on loans, these transactions involve real assets (e.g., vehicles) on which the IFI can earn a premium to compensate them for the deferred payment terms. Typically, for the IFI, the transaction would involve a cash purchase of the underlying asset; legal possession even if only for a short time; and an immediate sale on deferred payment terms. The financial instruments created by these transactions are within the scope of IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement*) and IAS 32 *Financial Instruments: Presentation*.

Questions raised	*General consensus*
Before being reported under IFRS 9 (or IAS 39), are deferred-payment transactions that are part of Sharia-compliant instruments and transactions within the scope of IFRS 15?	TRG members agreed that Sharia-compliant instruments and transactions may be outside the scope of the standard, however the analysis would depend on the specific facts and circumstances and may require significant judgement as contracts often differ within and between jurisdictions.

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