

IFRS in Focus Joint Meeting on Revenue (October 2014)

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This IFRS in Focus summarises the October meeting of the IASB and FASB joint revenue transition resource group (TRG).

Introduction

The purpose of the TRG is not to issue guidance but instead to seek feedback on potential issues related to the implementation of IFRS 15 *Revenue From Contracts With Customers* (the “new revenue standard”). By analysing and discussing potential implementation issues, the TRG will help the boards determine whether they need to take additional action, such as providing clarification or issuing other guidance. The TRG comprises financial statement preparers, auditors, and users from “a wide spectrum of industries, geographical locations and public and private organisations” and board members of the IASB and FASB attend the TRG’s meetings. Representatives from the SEC, PCAOB, IOSCO and AICPA are also invited to observe the meetings.

See the IASB’s [website](#) for more information about the TRG, including [meeting materials](#) further describing the topics discussed below.

Topic 1 – Customer options for additional goods and services and non-refundable up-front fees

Background

In practice, a customer may often be given the option – either as part of an entity’s marketing efforts or through a current sales contract – of receiving additional future goods or services at a discount. Examples of such options include contract renewal options, sales incentives, customer awards or credits, and other discounts.

The new revenue standard’s core principle is that an entity recognises revenue for expected consideration from a customer in exchange for the transfer of promised goods or services. Accordingly, an entity must evaluate whether options for future goods or services are performance obligations under a current contract with a customer. That is, if the option provides the customer with a material right, the customer is effectively paying for a future good or service in advance by purchasing goods or services under the contract (see paragraphs 26 and B40 of IFRS 15). As a result, consideration received for the current contract will be recognised when the future goods or services are transferred to the customer.

In addition, an entity’s evaluation of whether an option provides a customer with a material right affects when revenue is recognised for non-refundable up-front fees. If an option provides a customer with a material right, non-refundable up-front fees received for the contract are included in the transaction price and allocated to the performance obligations (see paragraph B42 of IFRS 15).

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

Questions have arisen regarding the application of this guidance to (1) loyalty programmes in which customers accumulate points that may be used for future goods or services, (2) certain types of discount vouchers, (3) certain renewal options, and (4) contracts that include a customer's payment of a non-refundable up-front fee and renewal options. In particular, views differ on whether an entity's evaluation of an option (to determine whether it represents a material right) should:

- take into account only the current transaction or past and expected transactions as well; and
- include an assessment of only quantitative factors or both quantitative and qualitative factors.

Summary

TRG members generally agreed that in determining whether an option for future goods or services was a material right, an entity should (1) consider factors outside the current transaction (e.g. the current class of customer – see paragraphs 10 and B40 of IFRS 15) and (2) assess both quantitative and qualitative factors. Further, TRG members noted that an entity should also evaluate incentives and programmes to understand whether they were customer options designed to influence customer behaviour because this could be an indicator that an option was a material right.

In addition, some TRG members expressed concerns about the examples in the new revenue standard. Board members noted that the quantitative examples were not meant to establish thresholds but to illustrate how the related guidance would be applied. It was also acknowledged that an entity would need to exercise significant judgement in assessing whether an option was a material right.

Regarding certain offers, such as “buy three and get one free”, TRG members noted that the quantities involved are less important than the fact that an entity would be “giving away” future sales in such cases. While not determinative, such an indicator may lead an entity to conclude that a customer option was a material right.

TRG members also discussed loyalty programmes that had an accumulation feature. Some TRG members noted the belief that, through the presence of an accumulation feature in a loyalty programme, the entity gave its customers a material right. Others, however, indicated that the accumulation feature was not a determinative factor that would automatically lead an entity to conclude that it granted its customers a material right. Rather, these TRG members noted that if an accumulation feature was present, an entity would be required to evaluate the programme.

Because TRG members generally agreed about the issues discussed, one Board member summarised the discussion by noting that the guidance seemed operational and that no additional clarifications appeared to be necessary.

Topic 2 – Presentation of contract assets and contract liabilities

Background

The new revenue standard introduces the terms “contract asset” and “contract liability” and provides guidance on their presentation in the balance sheet. Although certain types of assets and liabilities result from revenue arrangements under existing GAAP, questions have arisen regarding how contract assets and contract liabilities should be presented under the new revenue standard. These questions include the following.

- What is the appropriate unit of account? Some believe that, because of the title of each term, presentation is determined at the contract level. However, others think that the unit of account should be at the level of performance obligations within contracts.
- For individual contracts with both contract assets and contract liabilities, should contract assets and contract liabilities be presented on a gross or net basis?
- For entities that have combined revenue contracts with a customer (because they have met the criteria in IFRS 15 to do so), should contract assets and contract liabilities be presented on a separate or combined basis?
- May an entity offset other assets and liabilities against contract assets and contract liabilities? If so, should an entity apply the guidance in existing accounting literature (i.e. IAS 1 *Presentation of Financial Statements* and IAS 32 *Financial Instruments: Presentation*)?

Summary

TRG members generally agreed that:

- the contract, and not individual performance obligations, is the appropriate unit of account for presenting contract assets and contract liabilities;
- contract assets or contract liabilities are presented for each contract on a net basis; and
- for contracts that meet the criteria for combination under the new revenue standard, a contract asset or contract liability would be presented for the combined contract.

One board member noted that netting of contract assets and contract liabilities reflected an entity's net position for the remaining rights and obligations under the contract and therefore this was different from offsetting. Further, TRG members generally agreed that entities should look to existing guidance to determine whether they had the right of offset.

Certain board members indicated that the related guidance in the new revenue standard seemed operational and that further clarification was not necessary.

Topic 3 – Determining the nature of a license of intellectual property

Background

As with the requirement for entities to identify other performance obligations in revenue contracts with customers, the new revenue standard requires entities to evaluate whether licenses of intellectual property (IP) represent separate performance obligations.

The new revenue standard includes implementation guidance that addresses an entity's promise to grant a license of its IP (see paragraphs B52 – B62 of IFRS 15). Accordingly, if a license is distinct from other promised goods or services, an entity would need to assess the nature of the license and determine whether the license grants the customer a right to use or a right to access the entity's IP.

Under a "right-to-use" license, the licensor's ongoing activities are not expected to significantly affect the IP. Therefore, a right-to-use license gives a customer the right to use the entity's IP as it exists at the point in time at which the license is granted (and control is transferred at a point in time). Conversely, a "right-to-access" license gives a customer the right to access the entity's IP as it exists throughout the license period (and control is transferred over time) because the licensor's ongoing activities are expected to significantly affect the IP (see paragraph B58 of IFRS 15).

Because of the impact that a licensor's ongoing activities have on the determination of whether an IP license is a right-to-use or right-to-access license, questions have arisen regarding how entities should evaluate such ongoing activities. These questions include the following.

- For a license of IP that is not a separate performance obligation, does an entity need to determine the nature of the license as a right to access the entity's IP or a right to use the entity's IP (i.e. determine whether the license is satisfied over time or at a point in time)? (Issue 1 in TRG Agenda Paper 8)
- For the nature of a license to be a right to access the entity's IP as it exists throughout the license period, (a) do the contractual or expected activities of the licensor have to change the form and/or functionality of the underlying IP (i.e. the license is either 'static' or 'dynamic') or (b) do significant changes in the value of the IP alone constitute a change to the IP? (Issue 2 in TRG Agenda Paper 8)
- If a customer is not required to use the most recent version of the underlying IP, do the licensor's activities directly expose the customer to positive or negative effects of the IP to which the customer has rights? (Issue 2a in TRG Agenda Paper 8)
- Are activities that transfer a good or service that is not separable from the license of IP considered in determining the nature of the license? (Issue 2b in TRG Agenda Paper 8)
- Can restrictions in a contract for a license of IP affect the determination of whether that contract contains one or multiple licenses when applying Step 2 (identify performance obligations) of the new revenue standard? (Issue 3 in TRG Agenda Paper 8)

Summary

TRG members noted that a "distinct" license would be a separate performance obligation and that an entity would apply the license-specific implementation guidance in the new revenue standard in such cases. However, TRG members stated that the standard was unclear on how to treat a license when it was not distinct and instead would be bundled with non-license elements in a combined performance obligation.

Further, TRG members noted that paragraph BC407 in the Basis for Conclusions of the new revenue standard discussed licenses in the context of a combined performance obligation. While paragraph BC407 used the terms "primary" and "dominant," many of the TRG's observations focused on the term "dominant". TRG members noted that paragraph BC407 indicated that when a license of IP was a dominant component in a combined performance obligation, an entity would apply the license-specific implementation guidance to assess the nature of the license and determine whether the combined performance obligation was satisfied over time or at a point in time.

Some TRG members noted that entities would not be precluded from using the license-specific implementation guidance when a license was part of a combined performance obligation but that it may not always be clear when an entity would apply such guidance. Further, regarding the guidance in paragraph BC407, some TRG members believed that entities may need additional guidance on situations in which the license component was part of a bundled performance obligation (i.e. not distinct) and was less than dominant. For example, one TRG member suggested that the new revenue standard could include a framework that noted the following:

- if a license is distinct or a dominant component of a bundled performance obligation, an entity would apply the license-specific implementation guidance;
- if a license is unimportant or insignificant, an entity would not consider the license-specific implementation guidance; and
- if a license is less than dominant but more than insignificant, an entity would need to consider the license, along with other elements in the combined performance obligation, to determine the pattern of recognition (the framework could include examples of factors for entities to consider).

Further, TRG and board members noted that the boards may need to perform additional tasks, including (1) moving the guidance in paragraph BC407 to the new revenue standard and (2) creating additional guidance on application of the terms “dominant” and “insignificant”.

Much of the TRG’s debate centred on Issue 2 (see above), which focused on the nature of the licensor’s ongoing activities to determine whether a customer has a right-to-use or right-to-access license. In particular, the TRG discussed three views regarding the nature and extent of activities that would be construed as “significant changes” in accordance with paragraph B58 of IFRS 15, causing an entity to conclude that a license was a right-to-access license:

- Interpretation A: changes are limited to those that affect the form or functionality of the IP – that is, activities that affect the value of the IP would not be considered;
- Interpretation B: only the value of the IP needs to be affected; these changes may or may not result from changes in the form or functionality of the IP; and
- Interpretation C: changes are similar to those in Interpretation B; however, “significant” is viewed as a high threshold.

While some TRG members noted that they understood how entities could hold the views expressed in Interpretation A, most TRG members acknowledged that they believed the boards generally supported Interpretation B or perhaps Interpretation C. However, they also acknowledged that Interpretations B and C would be challenging to implement and that entities would need to exercise significant judgement in evaluating activities that significantly changed the value of IP. TRG members discussed an example in which a media company licensed two movies to a streaming service. Except for the movies subject to the arrangement, the licenses were identical. In the example, one movie was a popular movie that was part of a series and the other movie was relatively unknown. Because the media company was likely to engage in promotional activities for the popular movie (e.g. because it may be planning a sequel) but few or no promotional activities for the other movie, different conclusions may be reached about the licenses. Although the licenses were identical licenses with the same customer, the activities may be viewed as significantly affecting the value of one license but not that of the other. As a result, one license may be a right-to-access license (satisfied over time) and the other a right-to-use license (satisfied at a point in time). One board member summarised the discussion by noting that the debate demonstrated how people could read the words in the new revenue standard and come to different conclusions.

The TRG also presented additional issues (Issues 2a and 2b in TRG Agenda Paper 8) that focused on the effects of a licensor’s ongoing activities on the evaluation of whether a license was a right-to-use or right-to-access license. However, because TRG members did not comment on Issues 2a and 2b, one board member summarised the discussion by stating that the new revenue standard appeared to provide sufficient guidance on such situations.

The TRG also discussed the impact of contractual restrictions on the determination of the number of licenses (i.e. performance obligations) in a contract (Issue 3 above) – for example, a media license that gave a content provider the right to air content but only at specified times over a contract period (e.g. the airing of a holiday movie once a year in December for four years). Some TRG members expressed a view that it would be difficult to reach a conclusion on Issue 3 in isolation (i.e. without generally considering other aspects of the model and resolving Issue 2, which was discussed above).

Topic 4 – Determining whether goods or services are “distinct in the context of the contract”

Background

The new revenue standard requires entities to assess the goods or services promised in a contract with a customer and to identify as a performance obligation each promise to transfer either (1) a good or service (or bundle of goods or services) that is distinct or (2) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. Under the new guidance, a good or service is “distinct” if it is (1) capable of being distinct and (2) “distinct within the context of the contract” (i.e. separately identifiable). Paragraph 29 of IFRS 15 provides the following factors indicating that an entity’s promise to transfer a good or service is separately identifiable (this is not an exhaustive list):

- a. the entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted;
- b. the good or service does not significantly modify or customise another good or service promised in the contract; and
- c. the good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or services.

Questions have arisen regarding how entities should assess whether a good or service is “distinct within the context of the contract”. Specifically, views differ on whether the existence of one or more of the following affects this assessment:

- a customised design;
- a complex design;
- an entity’s learning curve to produce the goods or services;
- the customer’s motivation for purchasing the goods or services;
- contractual restrictions preventing another party from performing services related to the goods included in the contract (e.g. installation); and/or
- one good or service is not functional without another good or service promised in the contract.

Summary

Much of the TRG’s discussion focused on whether “distinct in the context of the contract” should include the view of the customer and, if so, to what extent.

TRG members discussed how to evaluate the existence of a customised design, a complex design, or a learning curve (to produce goods promised in a contract) in the determination of performance obligations under the new revenue standard. TRG members generally agreed that the existence of these factors was not individually determinative in the assessment of whether there was a single performance obligation. Further, TRG members indicated that it was better to consider these factors collectively rather than individually. Some TRG members believed that the entity should consider what items the customer had been promised and whether the promised items would be integrated in some way. For example, many TRG members agreed that an entity would need to evaluate the impact of design services it performed in determining the performance obligations under a contract (e.g. if the customer obtained control of the rights to the manufacturing process developed by the entity).

The TRG also discussed how the entity’s knowledge of its customer’s intended use for the goods or services would affect the determination of whether the goods or services were highly interrelated. Many TRG members expressed the view that an entity should consider whether the goods or services could fulfil their intended purpose on a stand-alone basis or whether they were inseparable because they affected the customer’s ability to use the combined output that it had contracted for. One board member gave an example in which an entity promised to provide an airport with all seven of the standard x-ray machines the airport needed to have a functional security system. TRG members generally agreed that each x-ray machine would represent a distinct performance obligation because each machine did not rely on the other machines in the contract to perform its intended function. The board member contrasted this example with one in which a homebuilder promised to provide its customer with a house consisting of four walls and a roof. TRG members generally agreed that the four walls and the roof would not be separate performance obligations because, while they could potentially have benefit on their own, within the context of the contract, the customer did not contract for the walls and roof but for an integrated structure.

In addition, TRG members discussed whether a contractual restriction that prohibited a customer from using another entity to perform installation services related to a good promised in the same contract affected the identification of performance obligations. Multiple TRG members indicated that it was difficult to apply the guidance on whether the service of installing the good was “highly dependent on, or highly interrelated with,” the good being installed. One board member acknowledged that stakeholders appeared to be struggling with this concept in situations in which the good and the installation service would have been distinct if they were the sole item promised in a contract. The board member acknowledged that the boards would have to contemplate how they could make the guidance on whether a good or service was separately identifiable more operational.

Topic 5 – Evaluating the duration of a contract with termination clauses

Background

The new revenue standard defines a contract as “an agreement between two or more parties that creates enforceable rights and obligations”. Accordingly, the parties to a contract must have enforceable rights and obligations for revenue to be recognised under the new guidance. The new revenue standard also indicates that a contract does not exist if each party to the contract has the unilateral enforceable right to terminate the wholly unperformed contract without compensating the other party (or parties). Because the new revenue standard does not provide explicit guidance on how to consider termination penalties, questions have arisen regarding how an entity should evaluate termination clauses in determining the contractual period (i.e. the duration) of a contract.

Some stakeholders believe that an entity could reach the following conclusions by applying the guidance in the new revenue standard:

- if each party can terminate a contract at any time without compensating the other party for the termination (in addition to the amount due for goods and services already transferred), the contract period would end at the point in time at which such goods or services were transferred;
- if each party can terminate the contract without compensating the other party and the termination right can be exercised only after a specified minimum period, the duration of the contract is up to the point at which the contract can be terminated;
- if either party can terminate a contract by compensating the other party, the duration of the contract is either the specified contractual period or the period up to the point at which the contract can be terminated without compensating the other party; and
- if the entity has a past practice of not enforcing the collection of a termination penalty to which it is contractually entitled, the duration is only affected if that practice changes the parties’ legally enforceable rights and obligations.

An entity that concludes that the contractual term of a contract is less than the contract’s stated term would have to (1) reassess the allocation of the transaction price, (2) include the termination penalty in the transaction price (subject to the constraint on variable consideration, if appropriate), and (3) assess whether the termination provisions provide the customer with a material right (similarly to how the entity would assess renewal options in a contract).

Summary

One TRG member noted that certain stakeholders had found it difficult to apply the guidance in the new revenue standard when determining the duration of a contract with termination clauses. For example, the TRG discussed certain contracts in the automotive, telecommunications, and investment management industries for which stakeholders believed differing interpretations of the guidance could result in differences when the guidance was applied in similar circumstances. However, many TRG members indicated that the guidance in the new standard was operational. Consequently, many board members noted that additional clarification did not appear necessary for these issues.

Next Steps

As intended, no conclusions were reached at the meeting. The boards and their staffs will consider the feedback from the meeting to determine whether to provide additional guidance or clarification and, if so, what it should be.

The TRG’s next meeting is scheduled for 26 January 2015.

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