

# IFRS in Focus

## Joint Meeting on Revenue (July 2014)

### Contents

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#### Introduction

**Topic 1 – Determining whether an entity offering internet-related intangible goods and service arrangements is a principal or an agent**

**Topic 2 – Determining whether certain amounts billed to customers should be presented as revenue or a reduction of costs**

**Topic 3 – Sales-based and usage-based royalties in contracts with licenses and goods or services other than licenses**

**Topic 4 – Inclusion of renewal periods for impairment testing of capitalised contract costs**

#### Next Steps

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This IFRS in Focus summarises the July 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 – Determining whether an entity offering internet-related intangible goods and service arrangements is a principal or an agent**

##### Background

Intangible goods and service arrangements – commonly called “virtual” goods and services – continue to be offered on the Internet through social networking websites and mobile application stores. Transactions involving virtual goods and services (including online games (e.g. through hosted applications), website advertising space, e-tickets or vouchers and electronic gift cards) typically share certain characteristics, such as (1) there is often an intermediary that is party to the transaction, (2) the end customer will receive a nonphysical item, and (3) the originator of the virtual goods or services receives cash that is “net of an amount retained by the intermediary”. In such transactions, it is therefore difficult to determine the customer and the amount of revenue that the originator should record as a result of providing the virtual good or service (i.e. whether the originator should record a gross or net amount as revenue because it is the principal or agent in the transaction).

Under the new revenue standard, the determination of whether an entity is a principal or agent depends on the nature of the entity’s promise to a customer and who controls the promised good or service before it is transferred to the customer. (Paragraphs B34–B38 of IFRS 15 indicate that an entity is a principal to the transaction if its promise is “a performance obligation to provide the specified goods or services”, but that the entity is an agent if the nature of its promise is to arrange for another party to provide the specified goods or services. In addition, the guidance lists certain indicators of when an entity is an agent.)

For more information please see the following websites:

[www.iasplus.com](http://www.iasplus.com)

[www.deloitte.com](http://www.deloitte.com)

Because of the nonphysical nature of the arrangements, there are inconsistent views on:

- how control would be assessed with respect to the originator and intermediary, including the impact on the principal-agent assessment when an originator has no knowledge of the amount an intermediary charged a customer for virtual goods or services;
- the order of steps for determining whether an entity is a principal or agent. For example, it is unclear whether the agency indicators are intended to help an entity initially assess who controls the goods or services or whether the entity would apply the indicators only after it cannot readily determine who controls the goods or services;
- how to apply the agency indicators to the originator and intermediary (e.g. if certain indicators apply to both the originator and intermediary); and
- whether certain indicators either are more important or should be discounted (e.g. whether inventory risk would be applicable in arrangements involving virtual goods or services).

In addition, the new revenue guidance requires that the total consideration in a contract with a customer be allocated to each of the entity's performance obligations under the contract, including discounts.

Questions have arisen regarding whether discounts should be allocated to all performance obligations and whether consideration should be allocated on a gross or net basis if the entity is a principal for certain performance obligations but an agent for others.

### Summary

TRG members acknowledged that there were similar issues under current GAAP and that the indicators in the new revenue standard were similar to those in current GAAP. However, members noted that the control principle in the new revenue standard complicated principal-agent assessments. They remarked that since transactions involving virtual goods and services were often executed in milliseconds, and control of the intangible asset (often a right) was instantaneous, determining control and the customer may not be obvious.

To illustrate some of the difficulties, two TRG members offered examples. One described a situation in which a wholesale club sold a restaurant gift card for a future meal at a specified price to a customer of the wholesale club. The other described the use of advertising exchanges for Internet advertising. The TRG's and boards' discussions centred primarily on identifying (1) the customer, (2) the order of the steps for determining control and applying the agency indicators, and (3) the relative weight of the agency indicators (e.g. inventory risk, payment risk and determining the primary obligor).

Certain board members noted that perhaps too much emphasis was being placed on identifying the customer instead of on the nature of the contract and the promises made. Participants also noted that the accounting could vary depending on the order in which entities performed the steps of the assessment.

However, some indicated that different conclusions would not be troubling because they would be made on the basis of promises, which varied. In addition, while some acknowledged that ascribing relative weights to the indicators may promote consistency, others noted that entities should use judgement and base the amount of weight they gave to indicators on the facts and circumstances of their transactions.

TRG and board members generally agreed that it may be impractical for entities that were originators to try to estimate a gross amount (i.e. the amount for which an intermediary was selling a virtual good or service) when the originator did not have such information.

## Topic 2 – Determining whether certain amounts billed to customers should be presented as revenue or a reduction of costs

### Background

The core principle of the new revenue standard is that "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" (see paragraph IN7 of IFRS 15). However, paragraph 47 of IFRS 15 states that the transaction price should exclude "amounts collected on behalf of third parties" (e.g. some sales taxes).

It may be unclear whether amounts billed to an entity's customer (e.g. shipping and handling fees, out-of-pocket expenses, taxes and other assessments remitted to governmental authorities) are collected on behalf of third parties. Consequently, there are inconsistent views on whether such amounts should be presented as revenue or as reductions of costs in accordance with the new revenue standard. Some stakeholders have asserted that entities should determine presentation on the basis of the principal-agent guidance in the new revenue standard (i.e. to determine whether the entity is merely a conduit).

However, other stakeholders have pointed out that amounts billed to customers for shipping and handling would result in presentation as revenue because an entity incurs these amounts to fulfil its promise to the customer and, in the case of taxes, to satisfy its obligation to the tax authority.

### Summary

Discussion centred primarily on taxes and shipping and handling costs. One TRG member noted that the new revenue standard's definition of transaction price was clear and that an entity would therefore record amounts gross unless the entity (1) arranges shipping on behalf of the customer in accordance with the customer's specifications or (2) the tax was levied on the customer. In each case, the entity was only responsible for collecting and remitting fees to third parties. TRG members acknowledged that an entity would most likely need to assess whether it was acting as a principal or an agent to determine how to present amounts billed and collected on behalf of third parties.

In discussing other costs, TRG members observed that when an entity acted as a "pass-through", amounts would be recognised on a net basis as if the entity were an agent if, for example, (1) the customer chose and contracted directly with the shipper but the entity collected the shipping fee or (2) goods or services were insured by third parties and the entity was collecting the insurance fee. However, TRG members also discussed situations in which shipping was offered as an incentive (e.g. free or discounted shipping terms), which had become more prevalent in e-commerce transactions, or in which entities were responsible for shipping (i.e. shipping was included in the entity's pricing of a good or service). In such instances, determining whether to recognise amounts as revenue on a gross or net basis was less clear.

Regarding taxes, TRG members noted that the new revenue standard would require entities to evaluate every type of tax (e.g. sales, income, excise) in every tax jurisdiction (i.e. in every local, state and federal jurisdiction in each country in which the entity had contracts with customers). Many questioned whether such an exercise was practical or whether it was intended by the boards.

Certain board members believed that no additional guidance was needed. One remarked that entities should determine whether under the new revenue model the entity had a separate performance obligation (to which consideration would need to be allocated) and assess the nature of the promise (i.e. to perform or arrange as a principal or an agent, respectively).

## Topic 3 – Sales-based and usage-based royalties in contracts with licenses and goods or services other than licenses

### Background

The new revenue standard includes guidance that specifically addresses sales- or usage-based royalties promised in exchange for licenses of intellectual property (IP) – often referred to as the "royalty constraint" (see paragraph B63 of IFRS 15). For such arrangements, entities are required to record revenue when (1) the subsequent sale or usage occurs or (2) the related performance obligation has been fully or partially satisfied. Otherwise, entities would need to estimate the amount of variable consideration to include in the transaction price (which would not be subject to significant revenue reversal) and reassess it (see paragraphs 56 – 59 of IFRS 15). Questions have arisen regarding how the royalty constraint would apply when an IP license is offered with other goods or services in a contract (e.g. software licenses with post-contract customer support, franchise licenses with training services, biotechnology and pharmaceutical licenses sold with research and development services or a promise to manufacture a drug for the customer).

Views differ on whether the royalty constraint should apply to circumstances in which a royalty is (1) related to both a distinct license and non-license goods or services that are distinct from the license and (2) combined with other non-license goods or services in the contract (i.e. it is not distinct). In addition, certain stakeholders have questioned whether the royalty constraint may partially apply to a sales- or usage-based royalty.

### Summary

TRG members discussed whether the royalty constraint could be applied to a contract that contained multiple performance obligations, at least one of which was to provide a distinct license of IP. One TRG member provided an example in which a media entertainment company entered into a contract with a movie theatre to provide (1) a license to show a feature-length film for a limited time and (2) a minimum amount of local advertising for the film in exchange for a royalty equal to 50 percent of the theatre's ticket sales from the film. The TRG member referred to Example 60, "Access to Intellectual Property", in the new revenue standard and indicated that it was unclear whether the royalty constraint in the example would apply to (1) only the performance obligation to provide the license to show the film, (2) both the license and advertising, or (3) neither.

As noted in the meeting materials, TRG members generally expressed one of the three following views.

- View A – A sales- or usage-based royalty is promised in exchange for a license of intellectual property whenever that royalty relates to a license, regardless of (i) whether the royalty also relates to another non-license good or service or (ii) whether the license is a separate performance obligation (that is, not combined for accounting purposes with a non-license good or service).
- View B – A sales- or usage-based royalty is promised in exchange for a license of intellectual property only when that royalty relates solely to a license and that license is a separate performance obligation (that is, it is not combined for accounting purposes with a non-license good or service).
- View C – A sales- or usage-based royalty is promised in exchange for a license of intellectual property when the royalty relates (i) solely to a license of intellectual property, or (ii) the royalty relates to a license and one or more other non-license goods or services, but the license is the primary or dominant component to which the royalty relates.

The TRG also discussed whether the royalty constraint could be applied to a contract in which an entity promised to deliver a tangible product that incorporated a license of IP that was not distinct (e.g. a copier that included proprietary software) in exchange for a usage-based fee. A board member expressed his belief that a sales- or usage-based fee arrangement would only be considered a royalty (i.e. potentially considered for the exception) if it was contingent on (1) the sale of the IP to the intermediary's customer or (2) the usage of the IP by the intermediary's customer.

Members of the boards also discussed the definition of key terms such as "royalty", "license" and "intellectual property" and acknowledged that users may want further clarification about the boundaries within which the royalty constraint would apply – especially because it was meant to be applied on an exception basis.

#### **Topic 4 – Inclusion of renewal periods for impairment testing of capitalised contract costs**

##### **Background**

The new revenue standard requires entities to capitalise (1) incremental costs of obtaining a revenue contract and (2) costs of fulfilling a revenue contract (if certain criteria are met) and test such assets for impairment. Under the new guidance, an impairment exists when the carrying amount of the contract asset exceeds "the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates" less associated costs that have not yet been recognised (see paragraphs 91–104 of IFRS 15 for guidance on cost capitalisation and impairment).

To test contract assets for impairment, an entity must consider the total period over which it expects to receive an economic benefit from the contract asset. Accordingly, to estimate the amount of remaining consideration that it expects to receive, the entity would also need to consider goods or services under a specific anticipated contract (i.e. including renewals). However, the impairment guidance appears to contradict itself because it also indicates that entities should apply the principles used to determine the transaction price when calculating the "amount of consideration that an entity expects to receive" (see paragraph 102 of IFRS 15). The determination of the transaction price would exclude renewals (see paragraph 49 of IFRS 15).

##### **Summary**

Many TRG members expressed the view that when testing a contract asset for impairment, an entity would consider the economic benefits from anticipated contract extensions or renewals if the asset related to the goods and services that would be transferred during those extension or renewal periods. No TRG member or board member presented an alternate view. Consequently, many board members believed that the topic required no additional clarification.

##### **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. Board members did not indicate the timing of any communications summarising the meeting or describing actions they intend to take. A TRG member asked whether the public would be informed of issues submitted for consideration by the boards and the TRG, including submissions that would not be further contemplated in TRG meetings. Board members agreed that greater transparency should be a goal in the TRG's process and indicated that they would further consider how best to achieve it.

The TRG's next meeting was held on 31 October 2014. The related IFRS in Focus can be found on [www.iasplus.com](http://www.iasplus.com)

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