Applying IFRS

TRG addresses more revenue implementation issues

November 2015

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What you need to know

- TRG members discussed four implementation issues and reached general agreement on several topics.
- TRG members expressed diverse views on certain implementation issues related to restrictions and renewals of licences of intellectual property. It is unclear whether or how the Boards will address these issues.
- While no meetings are currently scheduled in 2016, the TRG may meet again if stakeholders continue to have broad implementation issues that they would like the TRG to address.

Overview

At its November 2015 meeting, the Joint Transition Resource Group for Revenue Recognition (TRG) discussed four implementation issues that stakeholders have raised in relation to the new revenue recognition standards[1] jointly developed by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards). The Boards are using the TRG discussions to help them determine whether more application guidance is needed and to educate constituents.

TRG members expressed diverse views on issues related to the new application guidance on licences of intellectual property (IP), specifically the requirements for restrictions and renewals of licences. It is unclear whether or how the Boards will address these issues. The Boards are both working on amendments to the licences application guidance in their respective standards, and it is possible that they will address these issues in those amendments.

TRG members expressed diverse views on the accounting for renewals and restrictions of licences of IP.

TRG members generally agreed on issues relating to customer options for additional goods and services, the accounting for pre-production activities and whether fixed-odds wagering contracts for gambling entities are within the scope of the new revenue standards. These views are summarised in the appendix to this publication. While the views of the TRG members are non-authoritative, they represent the latest thinking on each topic, and entities should consider them as they continue to implement the new revenue standards.

1. Accounting for renewals and restrictions in licences of IP

TRG members discussed the accounting for renewals of right-to-use licences (i.e., licences for which the related revenue is recognised at a point in time) and how to consider licence restrictions (e.g., restrictions of time, geographical region or use) that are included in an original contract or added through a contract modification. TRG members generally agreed that the standards do not clearly explain how an entity would consider licence restrictions or whether time-based restrictions would be considered differently from other restrictions.

TRG members primarily discussed two examples described in the paper that the Boards' staffs prepared for the meeting. The first involved the renewal of a right-to-use licence (for which revenue was recognised at a point in time). On 1 August 20X0, Licensor and Customer entered into a three-year software licence to begin on 1 January 20X1 and end on 31 December 20X3. On 30 June 20X3, the licence was renewed and extended for an additional three years (i.e., 1 January 20X4 through to 31 December 20X6). In the example, the licence was a separate performance obligation.

[1] IFRS 15 *Revenue from Contracts with Customers* and ASU 2014-09, *Revenue from Contracts with Customers* (largely codified in ASC 606).

The conclusion in the staff paper was that Licensor would recognise revenue for the renewal when it is finalised by the parties (i.e., 30 June 20X3), primarily because no additional performance would be required of Licensor. That is, because the existing rights are extended and no new rights would be transferred to Customer, the renewal is just a change to an attribute of the licence that Customer already controls. Customer is not being granted a second, distinct licence that would delay revenue recognition for the it until the start of the renewal term (i.e., 1 January 20X4).

The second example involved a right-to-use licence that contained 'staggered rights' (i.e., additional rights that the customer obtains over the contract period). In this example, Licensor granted Customer the right to use its patent (to manufacture a product that it would sell) for a seven-year period, beginning on 1 January 20X1. For the first two years, Customer could only sell the product in Europe. Starting in year three, Customer could also sell the product in Japan.

The conclusion in the staff paper was that Customer was granted two distinct licences because the right to sell the product in Japan was distinct from the right to sell the product in Europe. This staff paper began with an analysis of Step 2 of the model (i.e., identifying performance obligations) and concluded that Licensor would determine that the contract included two performance obligations. Under this view, Licensor would allocate the transaction price to each performance obligation. Furthermore, Licensor would not recognise revenue for the second performance obligation for the rights in Japan until those rights were available to Customer.

Some TRG members struggled with the distinction that the staff paper seemed to draw between the time-based restriction in the first example and the geographical restriction in the second example. They noted that the new application guidance says that an entity should disregard "restrictions of time, geographical region or use"[2] when determining the accounting treatment for a licence of IP because these restrictions only define the attributes of a promised licence. However, from the conclusions in the staff paper, it appeared that a time-based restriction would be ignored in the first example, but the geographical restriction in the second example would lead to the identification of a second performance obligation. Other TRG members agreed with the conclusions in the staff paper for the two examples. Those members noted that the rights available to the customer were constant in the first example (and it was only the period in which those rights could be used that changed), but the rights granted in the second example differed from the rights granted later in the contract than at contract inception. However, they did acknowledge that these conclusions may potentially conflict with the application guidance on licence restrictions in the standards.

It is unclear whether or how the Boards will clarify the licences application guidance as a result of this discussion. Both Boards are working on amendments to the licences application guidance in their respective standards and it is possible that they may address these questions in the amendments.

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[2] IFRS 15.B62(a)

2. Update on previous TRG issues

The Boards are addressing several issues that TRG members previously discussed without reaching general agreement. In July 2015, the IASB issued a comprehensive exposure draft of proposed amendments, including amendments on identifying performance obligations, licences of IP, principal versus agent considerations and transition. The IASB plans to discuss comments on the exposure draft in the coming months and expects to hold a joint meeting with the FASB in December 2015 on comments they have received on their converged principal versus agent proposed amendments. The IASB expects to complete its redeliberations on these proposed amendments by early 2016.

The FASB has proposed amendments to its revenue standard on topics that include identifying performance obligations, licences of IP, principal versus agent considerations, transition, collectability, non-cash consideration and presentation of sales and other similar taxes. The FASB voted in October 2015 to amend its standard on the first two topics and plans to issue the final amendments by the end of 2015. The FASB plans to discuss comments on its other proposals in the coming months.

3. What's next

While no TRG meetings are currently scheduled in 2016, the TRG may meet again if stakeholders continue to have broad implementation questions they would like the TRG to address.

Appendix – TRG items of general agreement

<table>
<tr><th colspan="2">Customer options for additional goods and services</th></tr>
<tr><td colspan="2">The standards specify that, when an entity grants a customer the option to acquire additional goods or services (e.g., future sales incentives, loyalty programmes, renewal options), the option is a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market).[3]</td></tr>
<tr><td>Questions raised</td><td>General agreement</td></tr>
<tr><td>How should an entity distinguish between a contract that contains an option to purchase additional goods and services and a contract that includes variable consideration based on a variable quantity (e.g., a usage-based fee)?</td><td>TRG members generally agreed that this determination requires judgement and consideration of the facts and circumstances. They also generally agreed that the staff paper on this question provides a framework that will help entities to make this determination.

The staff paper explained that the first step for the entity in determining whether a contract includes optional purchases or variable consideration is to determine the nature of the entity's promise in providing services to the customer and the rights and obligations of each party. With a customer option, the vendor is not obligated to provide additional goods and services until the customer exercises the option. In contrast, in a contract that includes variable consideration (rather than a customer option), the vendor is presently obligated to transfer all goods and services requested by the customer.

The staff paper contains the following example of a contract that includes a customer option (rather than variable consideration): Entity B enters into a contract to provide 100 widgets to Customer Y at CU10 per widget. Each widget is a distinct good transferred at a point in time. The contract also gives Customer Y the right to purchase additional widgets at the stand-alone selling price of CU10 per widget. Therefore, the quantity that may be purchased by Customer Y is variable.

The staff paper concludes that, while the quantity of widgets that may be purchased is variable, the transaction price for the existing contract is fixed at CU1,000 [100 widgets x CU10/widget]. That is, the transaction price only includes the consideration for the 100 widgets specified in the contract. Any exercise of an option for additional widgets would be accounted for as a separate contract (because there is no material right, given the pricing of the option at the stand-alone selling price of the widget). While Entity B may be required to deliver additional widgets in the future, Entity B is not legally obligated to provide the additional widgets until Customer Y exercises the option.</td></tr>
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[3] IFRS 15.B40

	Examples described in the staff paper of contracts that may include variable consideration (rather than a customer option) included certain information technology outsourcing and transaction processing contracts. Under these types of contracts, the vendor provides continuous delivery of a service over the contract term.
How should an entity account for a customer's option to purchase or use additional copies of software?	As part of their discussion on licences, TRG members considered examples of vendors that enter into multi-year software arrangements with customers for a fixed fee of CU300,000 for up to 500 users. The customers pay CU400 for each additional user. In some fact patterns, the customers may be able to replicate the software without the assistance of the vendor. In other fact patterns, the customers must request additional access codes from the vendor. TRG members generally agreed that the entity would have to determine whether the contract is for a single licence or for multiple licences and that this determination requires judgement and consideration of the facts and circumstances. TRG members also generally agreed that an entity would have to perform a similar analysis as that discussed above in order to determine whether the additional software usage represents an option to purchase additional goods and services or variable consideration based on a variable quantity (e.g., a usage-based fee). In addition, they generally agreed that the accounting should not depend on whether the customer needs the vendor's assistance to receive the additional software licences. If the customer's ability to add users is treated as a customer option, the vendor would have to determine at contract inception whether the option represents a material right. If it is a material right, the vendor would allocate a portion of the transaction price to that material right. If the option is not a material right, the vendor would not account for the additional purchases until they occur. If the customer's ability to add users is considered variable consideration (because it represents additional usage of the software that the customer already controls and, therefore, additional consideration), revenue would be recognised when (or as) the additional purchases occur.
Do all contracts with a stand-ready element include a single performance obligation that is satisfied over time?	TRG members generally agreed that not all contracts with a stand-ready element necessarily include a single performance obligation satisfied over time. As an example, an entity may be required to stand ready to produce a part for a customer under a master supply arrangement (MSA). If the nature of the promise was a service of standing ready, the contract would be accounted for as a single performance obligation satisfied over time. In that situation, the entity may be required to estimate the number of

	purchases to be made throughout the contract term and continually update the transaction price and its allocation among the transferred goods and services. However, TRG members generally agreed that the nature of the promise in this example is the delivery of the parts, rather than a service of standing ready. When the customer submits a purchase order under the MSA, it is contracting for a specific number of distinct goods and creates new performance obligations for the entity.
How should an entity evaluate the contract term when *only the customer* has the right to cancel the contract without cause and how do termination penalties affect this analysis? The Boards noted in the Basis for Conclusions of their respective standards that a cancellation option or termination right is akin to a renewal option. That is, such contract provisions could be a performance obligation in the contract if they provide the customer with a material right.[4]	TRG members generally agreed that a substantive termination penalty payable by a customer to the entity is evidence of enforceable rights and obligations of both parties throughout the period covered by the termination penalty. This is consistent with the general agreement the TRG reached in October 2014 that, when each party has the unilateral enforceable right to terminate the contract (at any time during a specified period) by compensating the other party, enforceable rights and obligations exist throughout the stated contractual term of the contract (or to the date when a termination payment would not be due). That is, members of the TRG do not view a customer-only right to terminate as sufficient to warrant a different conclusion. For example, consider a four-year service contract in which the customer has the right to cancel without cause at the end of each year, but for which the customer would incur a termination penalty that decreases each year (and is determined to be substantive). TRG members generally agreed that such an arrangement would be treated as a four-year contract. TRG members also generally agreed with the conclusion in the staff paper that customer cancellation rights would be treated as a customer option when there are no (or non-substantive) contractual penalties that compensate the other party upon cancellation and when the customer has the unilateral right to terminate the contract for reasons other than cause or contingent events outside the customer's control. However, TRG members observed that the determination of whether a termination penalty is substantive, and what are the enforceable rights and obligations under a contract, will require judgement and consideration of the facts and circumstances.

[4] IFRS 15.BC391

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<td>When, if ever, should an entity consider the goods or services underlying a customer option as a separate performance obligation when there are no contractual penalties (e.g., termination fees, monetary penalties for not meeting contractual minimums)?</td>
<td>TRG members generally agreed that, even if an entity may believe that it is virtually certain that a customer will exercise its option for additional goods and services, an entity would not identify the additional goods and services underlying the option as promised goods or services (or performance obligations) if there are no contractual penalties. Only the option would be assessed to determine whether it represents a material right to be accounted for as a performance obligation. As a result, consideration that would be received in return for optional goods or services is not included in the transaction price at contract inception.

The staff paper contained an example of a contract in which an entity sells equipment and consumables and both are determined to be distinct goods that are recognised at a point in time. The stand-alone selling price of the equipment and each consumable is CU10,000 and CU100, respectively. The equipment costs CU8,000 and each consumable costs CU60. The entity sells the equipment for CU6,000 (i.e., at a 40% discount on its stand-alone selling price) with a customer option to purchase each consumable for CU100 (i.e., equal to its stand-alone selling price). There are no contractual minimums, but the entity estimates the customer will purchase 200 parts over the next two years. This is an exclusive contract in which the customer cannot purchase the consumables from any other vendors during the contract term.

TRG members generally agreed that the consumables underlying each option would not be considered a part of the contract. Furthermore, the option does not represent a material right because it is priced at the stand-alone selling price for the consumable. Accordingly, the transaction price is CU6,000 and it is entirely attributable to the equipment. This would result in a loss for the entity of CU2,000 when it transfers control of the equipment to the customer.</td>
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<tr>
<td colspan="2">Pre-production activities</td>
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<td colspan="2">Some stakeholders have raised questions about how to account for pre-production activities. For example, some long-term supply arrangements require an entity to perform upfront engineering and design services to create new, or adapt existing, technology to the needs of a customer. The pre-production activity is often a pre-requisite to delivering any units under a production contract.

In Step 2 of the new model, an entity must identify the promised goods or services within a customer contract and determine which of those goods and services are performance obligations. However, the new standards specify that performance obligations do not include activities that an entity must undertake to fulfil a contract unless those activities transfer a good or service to the customer.[5] In addition, IFRS 15 and ASC 340-40, Other Assets and Deferred Costs – Contracts with Customers contain requirements on the accounting treatment for costs an entity incurs to obtain and fulfil a contract.</td>
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[5] IFRS 15.25

Questions raised	*General agreement*
How should an entity assess whether pre-production activities are a promised good or service?	TRG members generally agreed that the determination of whether pre-production activities are a promised good or service or fulfilment activities will require judgement and consideration of the facts and circumstances. TRG members generally agreed that if an entity is having difficulty determining whether a pre-production activity is a promised good or service in a contract, the entity should consider whether control of that good or service ever transfers to the customer. For example, if an entity is performing engineering and development services as part of developing a new product for a customer and the customer will own the resulting IP (e.g., patents), the entity would likely conclude that it is transferring control of the IP and that the activities are a promised good or service in the contract. However, TRG members noted that assessing whether control transfers in such arrangements may be challenging. In some arrangements, legal title of the good or service created from the pre-production activity is transferred to the customer. However, TRG members generally agreed that an entity would have to consider all indicators of control transfer under the new standards and that the transfer of legal title is not a presumptive indicator. If a pre-production activity is determined to be a promised good or service, an entity will allocate a portion of the transaction price to that good or service (as a single performance obligation or as part of a combined performance obligation that includes the pre-production activities along with other goods and services). If the pre-production activities are included in a performance obligation satisfied over time, they would be considered when measuring progress toward satisfaction of that performance obligation.
How should an entity account for pre-production costs that currently are accounted under ASC 340-10, *Other Assets and Deferred Costs*? *(This topic was only raised in a US GAAP context)*	The FASB's new revenue standard did not amend the requirements in ASC 340-10 on pre-production costs related to long-term supply arrangements. TRG members meeting in Norwalk, Connecticut, generally agreed that an entity reporting under US GAAP that is appropriately following the requirements in ASC 340-10 today would continue to do so after implementation of the FASB's new revenue standard. However, several TRG members queried whether the requirements in ASC 340-10 should be deleted because they appear unnecessary and potentially inconsistent with the revenue and cost requirements in ASC 606 and ASC 340-40, respectively. TRG members meeting in London did not discuss this issue because the question was only raised in relation to existing US GAAP.

Will pre-production costs for contracts that were previously within the scope of ASC 605-35, *Revenue Recognition – Construction-Type and Production-Type Contracts*, be within the scope of the cost guidance in ASC 340-10 or ASC 340-40? *(This topic was only raised in a US GAAP context)*	The contract cost requirements in ASC 605-35 will be superseded by the FASB's new revenue standard. TRG members meeting in Norwalk generally agreed that an entity reporting under US GAAP that is appropriately accounting for contract costs under ASC 605-35 today would account for those contract costs under ASC 340-40 after adopting the FASB's new revenue standard. TRG members meeting in London did not discuss this issue because the question was only raised in relation to existing US GAAP.
Gambling entities – fixed-odds wagering contracts *(This topic was raised in a US GAAP context)*	
Under IFRS, consistent with a July 2007 IFRS Interpretations Committee agenda decision, wagers that meet the definition of a derivative are within the scope of IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement*. Those that do not meet the definition of a derivative would be within the scope of IFRS 15. Today, US GAAP gambling entities account for earnings from fixed-odds wagering contracts as gambling revenue under ASC 924-605, *Entertainment — Casinos — Revenue Recognition*. These industry-specific requirements will be superseded by ASC 606. In fixed-odds wagering contracts, the pay-out for wagers placed on gambling activities (e.g., table games, slot machines, sports betting) is known at the time the wager is placed. US GAAP stakeholders have questioned whether these contracts are within the scope of the FASB's new revenue standard or whether they could meet the definition of a derivative and be in the scope of ASC 815, *Derivatives and Hedging*.	
Question raised	***General agreement***
Are fixed-odds wagering contracts within the scope of the FASB's new revenue standard?	TRG members meeting in Norwalk generally agreed that it was not clear whether fixed-odds wagering contracts should be in the scope of the FASB's new revenue standard or ASC 815. ASC 606 scopes in all contracts with customers unless the contracts are within the scope of other requirements, such as ASC 815. TRG members agreed that it was possible that fixed–odds wagering contracts would meet the definition of a derivative under ASC 815 and, therefore, be scoped out of ASC 606. If the FASB believes that these contracts should be considered as revenue arrangements and should be accounted for under ASC 606 once the industry-specific standard is superseded, TRG members meeting in Norwalk recommended that a clarification be codified within US GAAP. TRG members meeting in London did not discuss this issue because the question was raised in relation to existing US GAAP only.

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