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IASB proposes clarifications to IFRS 15

Why are the amendments being proposed?

The amendments proposed in the ED are being made in response to feedback received by the IASB | FASB Joint Transition Resource Group for Revenue Recognition (TRG), which was formed to address potential issues associated with the implementation of IFRS 15 and the U.S. GAAP equivalent, ASU Topic 606.

What are the changes proposed by the ED?

Identifying performance obligations

IFRS 15 requires entities to identify distinct goods or services as performance obligations. A good or service is distinct if (1) "the customer can benefit from [it] on its own or together with other resources that are readily available to the customer" and (2) "the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract." The IASB received requests from stakeholders to provide additional guidance on the second criterion.

The IASB is proposing to add some new illustrative examples, and to amend some of the existing illustrative examples accompanying IFRS 15 to demonstrate the application of the guidance to several different industries and fact patterns.

In the proposed Basis for Conclusions, the IASB notes that in evaluating whether the entity's promise to transfer a good or service is separately identifiable from other promises in the contract, an entity should consider the relationship between the various goods or services within the contract in the context of the process of fulfilling the contract. That is, an entity should consider the level of integration, interrelation or interdependence among promises to transfer goods or services and not merely evaluate whether one item, by its nature, depends on the other (i.e. whether two items have a functional relationship). Instead, an entity should evaluate whether there is a transformative relationship between the two items in the process of fulfilling the contract.

Observations

The FASB's proposed ASU reframes the separation criteria to focus on a bundle of goods or services. The boards believe that the decisions in this area are the same except for "minor" wording differences, and as a result, divergence is not expected.

Principal versus agent considerations

IFRS 15 requires an entity to evaluate whether it is a principal or an agent on the basis of whether it controls a promised good or service before it transfers the good or service to the customer; paragraph B37 of the Standard includes various indicators that an entity is acting as agent. However, stakeholders have questioned (1) how to determine the unit of account (i.e., whether it should be at the contract level or performance obligation level), (2) whether the related indicators in paragraph B37 are intended to assist in a single evaluation of control or represent an additional evaluation, and (3) how certain indicators are related to IFRS 15's general control principle.

In response, the IASB proposes to make the following amendments to the Standard:

Clarify that an entity should apply principal versus agent guidance to each distinct good or service (or distinct bundle of goods or services).

Describe situations in which an entity that is a principal can control a service that is to be performed by a third party for the entity's customer. This amendment is intended to explain how "inventory risk" can apply to services.

Update the indicators in paragraph B37 of IFRS 15 by: Adding guidance to explain how each indicator supports the assessment of control.

Reframing the indicators to indicate when an entity is a principal rather than when an entity is an agent.

Removing the indicator relating to the form of the consideration as this indicator would not be helpful in assessing whether an entity is a principal.

Clarifying that (1) the purpose of the indicators is to help an entity assess whether it controls the specified good or service (i.e., whether it acts as the principal) and (2) certain indicators may be more or less persuasive for different contracts.

Add two examples and revise some of the existing illustrative examples in IFRS 15 to better illustrate the application of the principal versus agent guidance.

Licensing application guidance

Determining the nature of the entity's promise in granting a licence of intellectual property

IFRS 15 contains application guidance on an entity's promise to grant a licence of its intellectual property ("IP") and requires entities to determine whether the licence grants customers a right to use the underlying IP (which would result in point in time revenue recognition) or a right to access the IP (which would result in revenue recognition over time). This determination hinges on whether the licensor's ongoing activities are expected to significantly affect the underlying IP.

The IASB proposes to clarify that the assessment of whether the entity's activities change the IP to which the customer has rights is based on whether those activities affect the IP's ability to provide benefit to the customer (i.e. the 'utility' of the IP), and in some cases the utility will be derived from the form or functionality of the IP to which the customer has rights, and in other cases, from the value of that IP. If the IP has significant stand-alone functionality (i.e. the entity's activities do not significantly affect the functionality of the IP), the licence would be a right to use IP, and revenue would be recognised at a point in time.

Observations

The FASB has proposed an alternative approach. The proposed ASU would revise the guidance in Topic 606 to distinguish between two types of licences (1) functional IP (i.e. software, drug formulas, completed media content) and (2) symbolic IP (i.e. brands, team or trade names and franchise rights), which are classified according to whether the underlying IP has significant stand-alone functionality. Functional IP would represent a right to use the IP and would be recognised at a point in time (unless there is a requirement to update the IP, in which case it would be accounted for as a right to access and would be recognised over time), whereas symbolic IP would represent a right to access and would be recognised over time. Under this approach, some licences of symbolic IP could be classified as a right to access IP, even though there is no expectation that the entity will undertake activities after making the IP available to the customer; however, this is expected to be rare, and accordingly, the different approaches are only expected to result in different outcomes in relatively few cases.

Sales-Based and Usage-Based Royalties

IFRS 15 contains specific guidance on sales-based and usage-based royalties promised in exchange for licences of IP, often referred to as the "royalties constraint". In such arrangements, entities must recognise revenue at the later of 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 apply the general constraint guidance to estimate the amount of variable consideration to include in the transaction price (i.e. the amount of variable consideration that would not be subject to significant revenue reversal) and reassess it.

In response to questions raised by stakeholders regarding the application of the royalties constraint when a licence is bundled with other goods or services in a contract, the IASB proposes to add guidance to clarify that the royalties constraint guidance would be applied either (1) when the royalty relates only to a licence of IP or (2) when a licence of IP is the predominant item to which the royalty relates. The proposed amendments reject the notion of splitting royalties, indicating that doing so would be complex and may not result in useful information to users of financial statements.

Observations

Entities would still need to use judgement to determine whether a licence of IP – when "bundled" with other goods or services (for example, the licence is not a distinct performance obligation) – is the predominant item to which the royalty is related. However, the change would permit broader application of the royalties constraint and would eliminate the potential need to apply variable consideration and royalty guidance to different portions of a single royalty.

Practical expedients upon transition – contract modifications and completed contracts

Contract modifications

The IASB proposes to add a practical expedient to IFRS 15 permitting entities to use hindsight in determining contract modifications for transition purposes. A new term, "contract modification adjustment date" (CMAD) would be added to the Standard and defined as the beginning of the earliest year presented upon initial adoption of the Standard.

Entities electing this practical expedient would be permitted to use hindsight to account for all modifications from contract inception through to the CMAD (i.e., to determine the transaction price) and allocate the transaction price to all satisfied and unsatisfied performance obligations on the basis of historical stand-alone prices. Consequently, while an entity would need to assemble and analyse information to understand contract modifications throughout the term of a contract, it would not be required to recalculate the effect of such modifications sequentially as they occur. Instead, the entity would use hindsight with respect to the modifications as of the CMAD to perform a single analysis to determine the resulting transaction price, the satisfied and unsatisfied performance obligations, and the allocation of the transaction price to the performance obligations.

Completed contracts

The IASB also proposes to give entities the option to apply another practical expedient when using the full retrospective transition approach. Under this expedient, entities would, for transition purposes, be permitted to exclude the evaluation of any contract that was completed in accordance with current IFRSs as of the CMAD. The purpose of this practical expedient is to reduce the population of contracts to which an entity would need to apply IFRS 15 to, in order to reduce the effort and cost of initial application.

Observations

Based on the FASB's tentative decision at the boards' joint meeting on 18 March 2015, the FASB is not expected to propose a practical expedient for completed contracts. Entities reporting under U.S. GAAP would need to evaluate completed contracts when using a full retrospective transition approach. The IASB's proposal to allow the exclusion of completed contracts under the full retrospective transition approach is consistent with IFRS 1 (which has no equivalent under U.S. GAAP).

FASB activities

On 12 May 2015 the FASB issued a proposed ASU that would amend certain aspects of the guidance on identifying performance obligations and the implementation guidance on licensing. The FASB is expected to issue further proposed ASUs in Q3 2015 that include amendments to the guidance on collectability, measuring non-cash consideration, the presentation of sales taxes, and principal versus agent (reporting revenue gross versus net).

The IASB concluded that it was not necessary to propose any amendments with respect to collectability, measuring non-cash consideration, and the presentation of sales taxes.

When would the proposed amendments apply?

The ED does not include an effective date for the proposed amendments. However, if finalised, earlier adoption is proposed to be permitted.

The IASB expects to complete its redeliberations by the end of 2015, with the objective of finalising the proposed amendments in sufficient time to set an effective date that aligns with the revised effective date of IFRS 15 (1 January 2018).

The proposed amendments would be applied retrospectively, so entities would apply the amendments as if they had been included in IFRS 15 at the date of initial application. For entities that adopt both IFRS 15 and the amendments at the same time, any effect of applying the amendments would be reflected in the effects of initially applying IFRS 15; however, entities that adopt the amendments after the date of initial application of IFRS 15 would need to restate the effects of initially applying IFRS 15 for any effects of initially applying the amendments.

The comment period for the ED ends on 28 October 2015.

Observations

The IASB acknowledges that further implementation issues could arise; however, it is expected that given entities, auditors and others have had fourteen months to identify implementation issues, no substantive issues are expected, and the IASB expects that it is unlikely that any such issues would result in standard setting before the post-implementation review of IFRS 15 is undertaken. Further, acknowledging that further amendments would have more of a disruptive than helpful effect on the implementation process, the IASB is reluctant to propose any further amendments until after the post-implementation review.