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IFRS

New on the Horizon: Clarifications to IFRS 15

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Contents

A clearer view of IFRS 15

The IASB has published proposals clarifying four key areas of the new revenue standard that are of significant interest to users and preparers of financial statements.

When the IASB and FASB published their new joint standard on revenue recognition[1], we said that the real work was just beginning – and so it has proved. The new standard has been the subject of intense scrutiny and interpretative focus, years before it becomes effective. This reflects the importance of revenue as a financial reporting metric across industries, and the scale of the implementation effort that many companies face.

The Boards have responded by deferring the effective date of the new standard to 2018 – and by proposing clarifications to certain key requirements.

The IASB has published a single exposure draft (ED) of its proposals to IFRS 15, and is proposing to amend the standard in four key areas: licensing, principal vs agent, identifying performance obligations and transition. It expects to make no additional changes to the standard until the planned post-implementation review (expected in 2020–21).

The FASB has adopted a different approach, and is in the process of publishing a series of shorter EDs. Taken together, the FASB EDs will address all of the areas in which the IASB proposes to amend the standard, although the FASB is proposing to make more extensive changes.

This publication provides an overview of the IASB's proposals and explains the key differences with the FASB proposals.

The IASB has asked for comments on its proposals by 28 October 2015. We hope you find this publication helpful as you assess the potential impact of the proposed changes on your business, and how to respond to the IASB.

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1. IFRS 15 and FASB ASC Topic 606 *Revenue from Contracts with Customers*.

1 The story so far…

In May 2014, the IASB and the FASB (the Boards) published their new joint standard on revenue recognition – IFRS 15/ASC Topic 606 *Revenue from Contracts with Customers* (the new standard). This replaces most of the guidance on revenue recognition that currently exists under IFRS and US GAAP. At the same time, the Boards formed the joint Transition Resource Group for Revenue Recognition (TRG).

About the TRG

The TRG's primary purposes are to:

- solicit, analyse and discuss stakeholder issues arising from implementation of the new standard;
- inform the Boards about those implementation issues, which will help them determine what, if any, action will be needed to address them; and
- provide a forum for stakeholders to learn about the new standard from others involved with implementation.

The TRG advises the Boards and does not have standard-setting authority. Its members include financial statement preparers, auditors and users with knowledge and experience of revenue recognition under US GAAP and/or IFRS from various industries and geographies. Two KPMG partners are members.

The TRG's discussions so far

Since its formation, the TRG has met five times, and a sixth meeting is scheduled for November 2015. The Boards have not yet scheduled any further TRG meetings. The agenda and papers of the TRG meetings are publicly available and all meetings are held in public.

The TRG discussion on most issues considered to date has indicated that stakeholders should be able to understand and apply the new standard without further guidance. However, in some cases the discussion has identified the potential for diversity in practice to arise.

How is the IASB issuing its proposals?

The ED contains the IASB's proposals to address potential issues of diversity in practice. The IASB envisages that these proposals will be the only changes it will make to IFRS 15 before the planned post-implementation review of the standard.

How is the FASB issuing its proposals?

The FASB is in the process of proposing its own amendments to Topic 606. In contrast to the IASB approach of issuing a single ED, the FASB is issuing a series of EDs, each of which addresses several topics.

The FASB proposals cover all of the issues listed above, although in a number of areas the detailed proposals are different to those of the IASB. We highlight the differences between the IASB and FASB proposals in Sections 3–6.

The FASB is also proposing a number of additional changes, which we discuss in Section 7.

2 Key proposals

<table>
<tr><th>Topic</th><th>What's the issue?</th><th>What's the IASB proposing?</th><th>Section</th></tr>
<tr><td rowspan="2">Licences</td><td>Should licence revenue be recognised at a point in time or over time?</td><td>Amendments and new examples to clarify the application of the existing criteria for assessing whether licence revenue is recognised at a point in time or over time.</td><td rowspan="2">Section 3</td></tr>
<tr><td>When does the exception for sales- and usage-based royalties apply?</td><td>Amendments to clarify that the exception (allowing revenue recognition as the sales or usage occur) applies whenever the licence is the predominant item to which the royalty relates, and that a single royalty stream should not be split for accounting purposes.</td></tr>
<tr><td>Principal vs agent</td><td>The control principle – how should a company assess whether it is a principal or an agent?</td><td>Amendments and new examples to clarify that:
companies should identify the nature of the specified good or service provided;
the assessment is based on the control principle – i.e. whether the company controls the good or service provided to the customer;
the indicators inform, but do not over-ride, the principle; and
there is no absolute hierarchy to the indicators – the relevance of an indicator is based on the facts and circumstances of each case.
New examples addressing more complex scenarios – i.e. sales of virtual or intangible goods – would also be added under the proposals.</td><td>Section 4</td></tr>
<tr><td>Identifying performance obligations</td><td>When is a promised good or service 'distinct within the context of the contract'?</td><td>New examples, and clarifications to existing ones, to illustrate how the separation guidance would be applied – i.e. whether goods or services promised in a contract are accounted for as a bundle or individually.</td><td>Section 5</td></tr>
<tr><td rowspan="2">Transition</td><td rowspan="2">Should further practical expedients be added to the transition options?</td><td>A new practical expedient for contracts that are modified before the date of initial application.</td><td rowspan="2">Section 6</td></tr>
<tr><td>A new practical expedient permitting companies not to apply the new standard to contracts completed under legacy GAAP when applying the new standard retrospectively.</td></tr>
</table>

3 Licensing

The IASB is proposing amendments and new examples to clarify whether revenue from a licence is recognised at a point in time or over time, and when to apply the exception that applies to sales- and usage-based royalties.

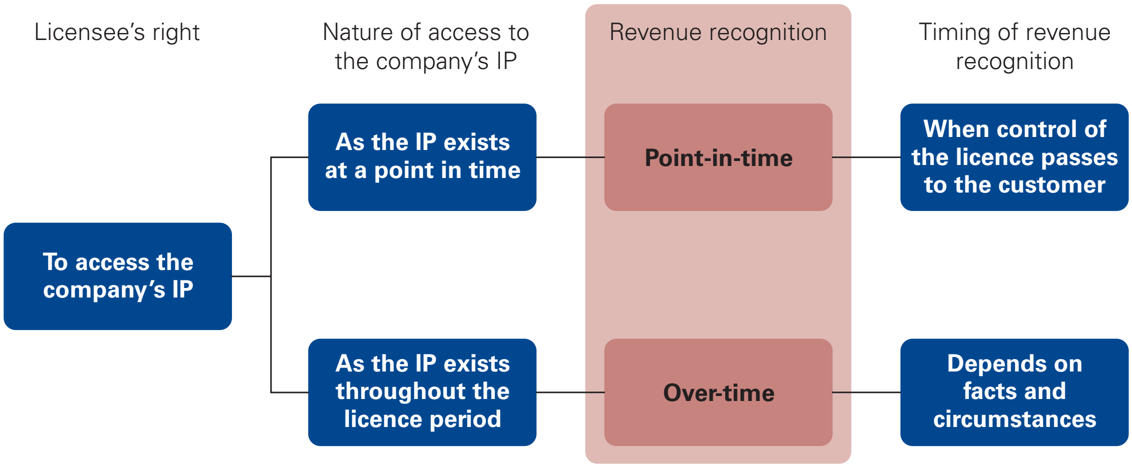
3.1 Point-in-time vs over-time recognition

3.1.1 What's the issue?

What's the current guidance in IFRS 15?

The new standard provides implementation guidance on whether the consideration for a distinct licence of intellectual property (IP) is recognised as revenue at a point in time or over time.

As shown below, the licensee recognises revenue based on its right to access the company's IP, either as it exists at a point in time, or as it exists throughout the licence period.



To determine whether a licence represents a right to access the company's IP, a company considers – among other things – whether it continues to be involved with the IP, and undertakes activities that significantly affect the IP to which the customer has rights.

What practical considerations have been identified?

Stakeholders have raised questions about what activities a company could undertake that significantly affect the IP.

The TRG considered that it was clear that a licence would be significantly affected by activities that result in changes in its:

- form – i.e. design; or
- functionality – i.e. the ability to process a transaction, perform a function or task, or – in the case of media content – be played or broadcast.

However, the TRG noted that it was not clear whether a company's activities that changed or maintained the value – but not the form or functionality – of the licence were relevant in assessing whether revenue was recognised at a point in time or over time. This was a potentially significant practice issue for a number of types of licence.

Consider the following example. A film studio transfers a licence to show a completed film to a customer, and the studio plans to undertake significant marketing activities that will affect box-office receipts. The marketing activities will not change the functionality of the IP (the film), but they may affect its value. Should the studio consider the marketing activities when assessing when to recognise revenue from the licence?

3.1.2 What's the IASB proposing?

The IASB is proposing to amend the application guidance on licensing and to add new examples. The amendments aim to clarify that a company's activities can also significantly affect the IP when the customer's ability to obtain benefits from the IP is substantially derived from, or dependent upon, the activities.

When classifying a licence, a company would focus on whether its ongoing activities affect the licence's form or functionality, or whether the customer's ability to obtain benefit from the licence depends on the activities.

Recognition timing	Rationale	Examples
At a point in time	Revenue is recognised at a point in time – i.e. up-front – because the IP's functionality exists as soon as it is created.	Films Drug formulas Software
Over time	Revenue is recognised over time because the IP's design and functionality change over time, or because the customer's ability to obtain benefits from the IP is substantially derived from, or dependent on, the company's activities.	Brand names Franchise rights Logos and team names

Observations

Increased clarity on when to recognise revenue

The proposals clarify when revenue from a licence of IP should be recognised over time or at a point in time. As such, they could minimise potential diversity in practice based on the current guidance in the new standard. For example, in the film example above, the studio would recognise revenue at a point in time because the IP's functionality exists as soon as the film is created.

3.2 Sales- or usage-based royalties

3.2.1 What's the issue?

What's the current guidance in IFRS 15?

The new standard includes an exception to the general requirements for variable consideration for sales- or usage-based royalties that are attributable to a licence of IP.

Under this exception, a company recognises revenue at the later of:

- when the subsequent sale or usage occurs; or
- when the performance obligation to which the royalty has been allocated – wholly or in part – has been satisfied (or partially satisfied).

This consideration model is simpler than the general requirements for variable consideration. Under the general requirements, a company estimates variable consideration and includes the estimated amount in revenue. The estimated variable consideration is only included to the extent that it is highly probable that a significant revenue reversal will not subsequently occur when the uncertainty over the variable amount is resolved.

Sales- and usage-based royalties are common in a number of sectors – e.g. media, technology and pharmaceuticals. Constituents in those sectors generally welcomed the inclusion of the exception in the new standard.

What practical considerations have been identified?

Questions have arisen over when the exception can be applied. The questions have focused on scenarios in which a licence of IP is provided along with other goods or services in a contract – e.g. broadcasting licences with promotional activities.

The TRG considered that it is unclear whether a single royalty should be split into two portions with differing accounting treatment – with the royalties exception applied to one portion and the general variable consideration guidance applied to the remainder.

3.2.2 What's the IASB proposing?

The IASB is proposing to amend the new standard to state that the royalties exception applies when:

- the royalty relates only to a licence of IP; or
- the licence is the predominant item to which the royalty relates.

The IASB is proposing to clarify that a company should not split a royalty into a portion that *is* subject to the exception and a portion that *is not*. This means that under the proposals the royalty would either be:

- wholly covered by the royalties exception; or
- wholly covered by the general guidance on variable consideration.

Example

Applying the royalties exception

Film distributor D licenses Cinema operator C the right to show Film F for six weeks. D has agreed to provide memorabilia to C for display at its cinemas and to sponsor local radio advertisements. In exchange, D will receive a portion of C's ticket sales for Film F as a royalty.

In this example, D concludes that there is significantly more value to C from the licence than from the promotional activities, and therefore the licence to show Film F is the predominant component to which the sales-based royalty relates.

D therefore applies the exception to the entire sales- and usage-based royalty and is precluded from making an up-front estimate of the expected royalty amount. Therefore, D cannot include a portion of that estimate in revenue at the date on which it transfers the film rights.

Observations

Resolving stakeholder concerns

The clarifications would avoid the complexity that would arise for preparers and users if a royalty were allocated to more than one promised good or service. They are therefore consistent with the Boards' original rationale for the exception: to simplify the accounting for royalties generally.

The proposals would:

- address the issues raised by stakeholders;
- promote consistency in application; and
- ease implementation of the new standard.

However, the approach could give rise to a loss at the date on which control of the goods or services is transferred. This is because costs associated with the goods or services would be recognised as an expense at that date, but revenue would not be recognised until the sales or usage occurs.

Judgement required to assess when a licence is 'predominant'

The IASB is not proposing any new guidance on the definition of 'predominant'. The proposals require companies to use judgement to determine whether a licence of IP is predominant when it is bundled with other goods or services.

However, stakeholders have already identified two significantly different interpretations of 'predominant'.

- Under one interpretation, the exception would apply when the licence represented a large proportion of the bundle by value or utility – i.e. 'predominant' means 'major part' or 'substantially all', or similar.
- Under another interpretation, the exception would apply when the licence is the biggest single item in the bundle – i.e. 'predominant' means 'largest single item'.

These different interpretations could result in differences in practice whenever there are three or more items in a bundle.

3.3 What's the FASB proposing?

3.3.1 Point-in-time vs over-time recognition

Different from the IASB's approach, the FASB's proposals aim to distinguish the attributes of a licence that would qualify it for recognition over time. The new guidance proposes to classify intellectual property into two categories, as follows.

Type of IP	Typical revenue recognition timing	Features	Examples
Functional	**Point-in-time**	• The IP derives a substantial portion of its utility from its stand-alone functionality. • Ongoing activities are not part of an integrated promise to the customer in granting a licence. • The licence is satisfied at a point in time.	• Software • Biological compounds • Drug formulas • Media content – e.g. films, television shows, music.
Symbolic	**Over-time**	• The IP does not have significant stand-alone functionality. • The company's promise is to both: – grant the customer rights to use and benefit from the company's IP; and – generally continue to support and maintain the IP. • The licence is satisfied over time.	• Brands • Team names • Logos • Franchise rights

3.3.2 Sales- or usage-based royalties

The FASB is pursuing the same approach as the IASB to clarify how the royalties exception should be applied.

3.3.3 Licences that are not distinct (FASB only)

The FASB is proposing a limited amendment to clarify that a company should consider the nature of a licence even when the licence is not distinct.

Specifically, when a licence of IP is not distinct from other goods or services in a contract, the proposals state that it may be necessary to assess the nature of the licence to determine whether the performance obligation is satisfied at a point in time or over time.

For example, if a licence is bundled with goods or services that are provided over a period shorter than the licence term, then a company would consider the nature and term of the licence when determining the pattern for revenue recognition of the bundled arrangement.

3.3.4 Contractual restrictions (FASB only)

The FASB is also proposing to clarify that contractual restrictions in a licence are attributes of the licence and do not affect the company's identification of its promises in the contract.

For example, a customer may license a film for a three-year period but be restricted to showing it only on a specified public holiday in each of those three years. The restrictions define the scope of the broadcasting licence, rather than changing the number of promises in the contract. Therefore, the contract in this example includes only a single licence rather than multiple licences.

Observations

Different approaches to licence classification – but only limited scope for different outcomes

The two Boards favour different approaches to licence classification. The IASB approach plans to change fewer words in the new standard, and to expand on the existing guidance.

The FASB approach proposes to introduce new classification terminology, and represents a broader re-articulation of the intended approach.

Each Board believes that its proposal remains true to the principles of the new standard – and both believe that there should not be significant differences in practice between IFRS and US GAAP in most cases if their separate proposals are enacted.

The Boards, nevertheless, acknowledged that differences may arise in the unique circumstance that a company is not expected to undertake significant activities after a licence is granted but the licence relates to symbolic intellectual property.

For example, the logo for an historical sports team that is no longer active may be licensed – e.g. for a film. But the licensor – having not been active as a sports team for many years – is not undertaking activities that change the form or functionality of the underlying IP, or that affect the customer's ability to obtain benefit from the licence. In this case, the IASB approach may result in point-in-time revenue recognition and the FASB approach in over-time revenue recognition.

IASB concludes that FASB's additional clarifications are unnecessary

The IASB has concluded that additional guidance is not required for licences that are not distinct and for licences with contractual restrictions.

It believes that in these circumstances there is sufficient guidance in the new standard for a company to determine an appropriate accounting approach. The basis for conclusions to IFRS 15 highlights the existing guidance that the IASB considers relevant, and how a company might apply it.

4 Principal vs agent

The IASB's proposals and new examples clarify that a company's role as principal or agent in a transaction depends on the control principle – i.e. whether the company controls a good or service before it is transferred to the customer.

4.1 Clarifying the control principle

4.1.1 What's the issue?

What's the current guidance in IFRS 15?

Under the new standard, if more than one party is involved in providing goods or services to a customer, then the company assesses whether it is acting as principal or agent in the transaction as follows.

Who provides the goods or services?	Principal or agent?	What is the basis for revenue recognition?
The company	Principal	The gross consideration amount is recognised as revenue.
Another party	Agent	Revenue is recognised on a net basis.

The new standard's guidance on how to make this assessment includes an overall principle, indicators and illustrative examples. The overall requirement to assess whether a company is acting as principal or agent relies on the control framework under the new standard rather than the risks-and-rewards framework under current IFRS and US GAAP.

What practical considerations have been identified?

Questions have arisen about how the control principle in the implementation guidance interacts with the agency indicators, including the following.

1. What is the unit of account for the control assessment?
2. What is the relationship between the control principle and the indicators? (Specifically, should the control principle be applied independently of the indicators – e.g. based on how control is evaluated elsewhere in the revenue standard – or are the agency indicators part of the control assessment?)
3. Are some indicators more important than others, particularly when they contradict each other?
4. How would the guidance apply to sales of virtual or intangible goods – e.g. a software developer selling its app through another party's website?

4.1.2 What's the IASB proposing?

The IASB is proposing to amend the application guidance on principal vs agent considerations and to add new examples, to clarify how a company assesses whether it is acting as principal or agent.

The IASB decided to retain the control principle as the basis for determining whether a company is acting as principal or agent. To make this clearer, the IASB is proposing four amendments to the new standard in response to the questions raised.

1. What is the unit of account for the principal vs agent assessment?

Under the proposals, a company would identify the nature of the specified good or service – i.e. the underlying good or service provided to the customer. A specified good or service is:

- a distinct good or service, including the right to an underlying good or service to be provided by another party – e.g. an airline ticket; or
- a distinct bundle of goods or services.

2. What is the relationship between the control principle and the indicators?

The proposals reaffirm that the control principle is the basis for the assessment – i.e. a company is a principal when it controls the specified good or service before it is transferred to the customer. The indicators inform, but do not over-ride, the principle.

In addition, the IASB is proposing to clarify how the control principle applies to services. A company that is a principal:

- controls a right to a service to be performed by a third party; and
- can direct the third party in performing the service.

For example, a company may enter into a maintenance services contract with a customer and engage a third party to perform those services under the company's direction.

3. Are some indicators more important than others?

The proposals change the focus of the indicators to indicate when a company is a *principal*, rather than when a company is an *agent*.

Although the proposals do not provide guidance on how to weight the indicators, they do clarify that certain indicators may be more or less persuasive based on facts and circumstances. The list of indicators is not intended to be exhaustive.

Some examples are also amended to illustrate how the indicators should be used to support the evaluation of control.

4. How would the guidance apply to sales of virtual or intangible goods?

The proposals include adding a new example to address complex scenarios where the assessment relates to virtual or intangible goods – e.g. when a company operates a virtual marketplace that connects end customers and third-party sellers.

Observations

Clearer direction on an inherently judgemental area

The proposals on principal vs agent considerations respond to concerns that the current guidance could result in diversity in practice, with reasonable people reaching different conclusions for the same fact patterns.

The proposal to clarify that a company is first required to identify the nature of the specified good or service could help companies that provide goods together with services to identify the unit of account. For example, internet advertising intermediaries often bundle their services by buying advertising space for advertisers and providing various other services.

However, the assessment of whether a company is acting as principal or agent will remain inherently judgemental.

4.2 What's the FASB proposing?

4.2.1 Similar amendments to the IASB

The FASB is proposing similar amendments on principal vs agent considerations, but with two differences in associated areas.

Firstly, the FASB has proposed a practical expedient for sales taxes that the IASB has rejected – see 7.1.

Secondly, the IASB and FASB have different views on what a company should do if it concludes that it is a principal but does not know the amount that its agent has charged the customer. Although neither Board proposes to amend the authoritative sections of the new standard, both Boards discuss the issue in the basis for conclusions to their respective EDs.

- The IASB believes that a company should generally make an estimate of the amount paid by the customer and include this estimate in revenue.
- The FASB believes that a company should generally include only the amount received from the agent in revenue.

5 Identifying performance obligations

The IASB is proposing new examples to identify whether goods or services promised in a contract are accounted for as a bundle or individually. These proposals address a core part of the new revenue recognition model that will impact many companies.

5.1 Applying the indicators

5.1.1 What's the issue?

What's the current guidance in IFRS 15?

At contract inception, a company evaluates which goods or services (or bundles of goods or services) in the contract are distinct and therefore constitute performance obligations.

A good or service (or bundle) is distinct when both of the following criteria are met.

Criterion		What this means
1	**The good or service is capable of being distinct.**	The customer can benefit from the good or service on its own, or together with other readily available resources.
2	**The good or service is distinct within the context of the contract.**	The company's promise to transfer the good or service is separately identifiable from other promises in the contract.

The new standard includes indicators that help a company assess whether Criterion 2 has been met – i.e. the good or service is distinct within the context of the contract.

What practical considerations have been identified?

One of the indicators for Criterion 2 is that the good or service is not "highly dependent on, or highly inter-related with, other goods or services promised in the contract". There have been difficulties understanding exactly what this means in practice.

For example, if a machine requires installation at a customer's premises, then promises to transfer the machine and to install it could be considered to be two performance obligations.

However, some stakeholders believe that the two promises are not distinct within the context of the contract because:

- the machine would not function without being installed; and/or
- the installation services are dependent on successfully transferring the equipment.

5.1.2 What's the IASB proposing?

The IASB is not proposing any amendments to these requirements; rather, it aims to clarify how to apply them, by adding new examples and clarifying the existing ones.

The new examples highlight that to combine goods or services in a contract there needs to be a transformative relationship between them in fulfilling the contract – i.e. a combined output. Examples of scenarios where goods or services in a contract may be separately identifiable or represent a single performance obligation include the following.

Separate or combined?	Example contract	Reason
Separately identifiable	Off-the-shelf software and an optional installation service	The software and installation service do not transform each other.
	Off-the-shelf software with a contractual installation service	The software and installation service do not transform each other regardless of the contractual restriction.
	A piece of equipment and the ongoing purchase of consumables	They can be both delivered without the other. The equipment does not transform the consumables it uses, and vice versa.
Single performance obligation	Building a hospital	Each good and service transforms the other into a combined output – i.e. the hospital.
	A customised piece of software and an installation service to integrate it with the customer's existing systems	The installation service helps to transform the custom software by integrating it with the customer's existing systems, and therefore fulfilling the contract.
	Multiple units of a complex and specialised device – the company is responsible for the manufacture, testing and logistics of delivering all of the devices to the customer	The company has promised to provide the customer with a production process to deliver an agreed number of devices. Therefore the company is transforming all of the inputs into a combined output.

Observations

Addressing a key application issue

Of all of the proposals in the IASB and FASB EDs, those on identifying performance obligations are likely to be of interest to the largest number of companies. This is because identifying performance obligations is a key step in applying the new revenue standard – it determines the unit of account for revenue recognition.

Appropriate understanding of the examples

Introducing additional examples to accompany the new standard may help explain how the Boards intend the separation guidance to be applied. However, it is important that financial statement preparers read the fact patterns in the examples carefully and apply the guidance as appropriate.

5.2 What's the FASB proposing?

5.2.1 An extensive rewrite of the 'separately identifiable' test

The FASB is proposing the following amendments to clarify the guidance on what makes a promised good or service distinct within the context of the contract.

Proposal	What this means
To provide additional explanation of what 'separately identifiable' means	The FASB is proposing to add explanatory language to better articulate the objective when considering whether promised goods and/or services are separately identifiable – namely to determine whether the nature of the company's promise to the customer is primarily to transfer: • each of those separate goods and/or services; or • a combined item (or items) comprising each of those goods and/or services as an input.
To clarify the factors for determining what is distinct in the context of the contract	The factors would be amended to more closely relate to the 'separately identifiable' test. They would also refer to the goods and services in the contract as a bundle. This would focus the analysis on circumstances where goods or services significantly affect each other.
To provide additional examples	The additional examples would demonstrate how the FASB intends the separation guidance to be applied.

5.2.2 Immaterial goods and services can be ignored

The FASB is proposing to clarify that a company would evaluate materiality at the contract level when determining whether a good or service promised in a contract should be identified as a performance obligation – i.e. a company is not required to identify goods or services to be transferred to the customer that are immaterial in the context of the contract.

Some FASB members believed that this would be:

- consistent with the objective of identifying the nature of the company's performance obligations; and
- consistent with the way materiality is assessed when evaluating whether a material right exists and whether a significant financing component exists.

Some expressed concern about over-riding the concept of materiality at the financial statement level. However, the FASB ultimately concluded that the clarification should be made to reduce the costs and complexities of identifying promises that are considered to be insignificant.

5.2.3 Practical expedient for shipping and handling

The FASB is proposing a new practical expedient under which a company would be allowed to choose to account for shipping and handling either as a fulfilment cost or as a promised service when transfer of control over the goods occurs before the company ships the goods.

Observations

Differences in approach

The FASB is proposing more extensive and more detailed changes than the IASB. Besides redrafting the principle and corresponding indicators on the 'separately identifiable test', the FASB is proposing new amendments on materiality and shipping and handling services.

The Boards' proposals would result in non-converged language between the IFRS and US GAAP versions of the new standard, with a risk of unintended outcomes.

Furthermore, different outcomes could arise under IFRS and US GAAP if companies reporting under IFRS identify shipping and handling as a promised service but companies reporting under US GAAP elect to treat the same services as a fulfilment cost.

6 Transition

The IASB is proposing additional practical expedients to reduce the complexity of applying the new standard to contracts that pre-date its initial application.

6.1 Additional practical expedients

6.1.1 What's the issue?

What's the current guidance in IFRS 15?

Companies can transition to the new standard using one of two methods.

<table>
<tr><th>Method</th><th>How it works</th></tr>
<tr><td>Retrospective method (with optional practical expedients)</td><td>Restate contracts at the start of the earliest presented comparative period.

A company that follows the retrospective method can elect to apply any or all of the following practical expedients.

<table>
<tr><th>Practical expedient</th><th>What it allows a company to do</th></tr>
<tr><td>1</td><td>It can choose not to restate contracts that begin and end in the same annual period.</td></tr>
<tr><td>2</td><td>For completed contracts with variable consideration, it can use the transaction price at the date of completion rather than estimating the variable consideration.</td></tr>
<tr><td>3</td><td>In comparative periods, it can choose not to disclose the amount of the transaction price allocated to the remaining performance obligations.</td></tr>
</table>

A company needs to consider all contracts with customers, except those covered by any practical expedients it has elected.</td></tr>
<tr><td>Cumulative effect method</td><td>A company may choose not to restate comparatives, and instead adopt the new standard with effect from the date of initial application, adjusting retained earnings at that date.</td></tr>
</table>

What practical considerations have been identified?

Stakeholders have expressed concerns that transition to the new standard would continue to be challenging, despite the alternative methods and existing practical expedients.

For example, some have highlighted that transition may be especially burdensome for companies entering into long-term contracts that have been frequently modified before the date of initial application – e.g. outsourcing contracts that include many deliverables and may run for 10 years or longer. This is because the company would be required to analyse each contract, identify all modifications over its lifetime, and apply the new standard to each modification.

6.1.2 What's the IASB proposing?

The IASB is proposing to add two new practical expedients to reduce the complexity of applying the new standard for the first time.

Practical expedient	Contracts affected	Proposal	What it means
4	**Modified contracts**	A company would be allowed to use hindsight when assessing the effect of modifications on a contract.	This expedient would allow a company to assess the contract based on the terms and conditions in place at the transition date and ignore the accounting for modifications that occurred between contract inception and the start of the earliest period presented. However, it would not exempt the company from applying other aspects of the requirements to a contract – e.g. identifying the performance obligations in the contract.
5	**Completed contracts**	When using the retrospective method, a company could elect to not restate contracts completed before the start of the earliest presented comparative period.	This expedient would essentially allow a company to apply the cumulative effect method from the start of the earliest presented comparative period.

Observations

A trade-off between cost and comparability

Modified contracts

Practical expedient 4 would provide welcome relief for companies with large numbers of contracts that are frequently modified, and for those with complex long-term contracts. However, it would not provide full relief, because companies would still be required to:

- identify all of the performance obligations in the contract, whether satisfied or unsatisfied, at the modification date; and
- obtain historical data to allocate the transaction price at that date.

Completed contracts

When a company applies the retrospective method, Practical expedient 5 would afford relief extending beyond contracts that merely include modifications before the date of transition. In particular, it would provide relief for companies that may be required to identify goods or services as a performance obligation under the new standard that were previously treated as expense items – e.g. after-sales services provided to a customer's customer.

Both practical expedients reduce comparability

While both of the additional practical expedients would provide relief on transition, they would also reduce comparability – e.g. between similar contracts entered into by the same company before and after the date of initial application. This could affect trend data until all contracts that were open at the date of initial application are completed, which may be many years away for some companies. Therefore, companies would need to carefully weigh the benefit of reduced costs on transition against the downside of reduced comparability.

More focus on the subsequent accounting for completed contracts

Allowing Practical expedient 5 to be elected under the retrospective approach would expand the number of contracts for which a company would need to consider the post-completion date accounting.

Under the existing requirements, a completed contract is one in which the goods or services identified in the contract under legacy GAAP have been delivered. In some cases, not all of the revenue is recognised at the date on which the goods or services are delivered – e.g. a royalty arrangement or sale with right of return. In these cases, a question has arisen as to how a company should account for changes to the amount of revenue recognised up to the date at which the expedient has been applied. The IASB discussed this issue further in September 2015, and decided not to make any changes to IFRS 15 in this area. However, as part of its discussions the IASB noted that an entity would continue to apply legacy revenue accounting requirements to any changes in the amount of revenue recognised for a completed contract after the date at which the expedient had been applied.

By contrast, the FASB has decided to propose to clarify that the definition of a completed contract is a contract for which all (or substantially all) of the revenue was recognised under legacy revenue accounting requirements. In addition, it will propose to amend the cumulative effect method to permit an entity to use that method for all contracts at the date of initial application of the new standard – i.e. it could be applied to both completed and incomplete contracts.

6.2 What's the FASB proposing?

6.2.1 Different dates for the modified contracts expedient

Consistent with the IASB, the FASB has decided to propose a new practical expedient that would allow a company to use hindsight when accounting for contract modifications. While the practical expedient is the same as that proposed by the IASB, it would be applied at a different date depending on the transition approach.

When would a company apply the practical expedient?		
Transition method	**IASB approach**	**FASB approach**
Retrospective method	At the beginning of the earliest period presented	At the beginning of the earliest period presented
Cumulative effect method		At the beginning of the current period

6.2.2 No completed contract expedient under the retrospective approach

In contrast to the IASB, the FASB has decided not to propose making the completed contracts practical expedient available to companies that follow the retrospective method, due to concerns about reduced comparability.

6.2.3 Disclosure exemption

The FASB has also agreed to propose that a company electing the retrospective transition approach would not be required to disclose the impacts of adopting the new standard on the current period. Without this change, a company would be required to account for contracts under both the new standard and current US GAAP in the period of adoption. This proposed change would align the US GAAP version of the standard with the IFRS version.

7 FASB-only proposals

The FASB is issuing additional clarifications in three areas: sales taxes, collectibility and non-cash consideration.

7.1 Sales taxes

7.1.1 What's the issue?

Under the new standard, the transaction price – and therefore revenue – excludes amounts collected on behalf of third parties – e.g. some sales taxes. A company assesses sales taxes on a case-by-case basis to determine whether it should present them:

- gross – i.e. include them in revenue and expenses; or
- net – i.e. exclude them from revenue.

The requirement to assess each tax collected from a customer and remitted to a government body is similar to current IFRS. However, it differs from current US GAAP, which includes a practical expedient permitting a company to make an accounting policy election to present these sales either gross or net. The US GAAP election covers sales taxes, use taxes, value-added taxes and some excise taxes.

Stakeholders, especially in the US, raised concerns about practical difficulties in determining the classification of taxes across multiple jurisdictions. For example, in the US, tax arrangements can differ from state to state and in local jurisdictions.

7.1.2 What's the FASB proposing?

The FASB is proposing a practical expedient that would allow a company to present sales taxes on a net basis. It would have the same scope as the policy election available under current US GAAP. If a company did not elect to apply the practical expedient, it would apply the new standard on a jurisdiction-by-jurisdiction basis.

The IASB decided that no standard-setting was needed on this issue because the new standard is clear that sales taxes are excluded from the transaction price if they are collected on behalf of the tax authorities. Judgement would be required to determine how to present each sales tax.

Observations

Reinstating an existing GAAP difference

The FASB proposal would reinstate an existing difference between IFRS and US GAAP that the new standard sought to eliminate. This would reduce the comparability of financial statements under IFRS and US GAAP, and within US GAAP to the extent that different companies adopt different approaches. Users would have to rely on additional disclosures to make meaningful comparisons between affected companies.

The FASB staff noted that under current US GAAP, companies within a given sector tend to select the same approach, so it is possible that current sector-by-sector preferences would be carried forward. This would be contrary to one of the key aims of the new standard, which was to reduce sector-specific accounting.

7.2 Collectibility

7.2.1 What's the issue?

The new standard's revenue recognition model applies only to contracts that pass the 'contract existence' criteria in Step 1 of the model (identifying the contract). These criteria include assessing whether it is probable that the customer will pay the consideration to which the company expects to be entitled – i.e. the 'collectibility criterion'. If a contract fails the collectibility criterion, a company does not recognise revenue until the criterion is met, or unless certain other conditions are met – e.g. the contract has been terminated.

Stakeholders raised a number of concerns about applying the collectibility guidance, including:

- how to apply the collectibility criterion; and
- how to determine when the contract has been terminated.

7.2.2 What's the FASB proposing?

To help companies apply the collectibility guidance, the FASB has decided to issue proposals that would:

- clarify that the objective of the collectibility threshold is to assess an entity's exposure to credit risk for the goods and services that will be transferred to the customer; and
- add a criterion to the alternate recognition model stating that an entity should recognise revenue for non-refundable consideration received when the entity:
  - has transferred control of the goods or services; and
  - has stopped transferring additional goods or services.

The IASB has decided not to propose any amendments to the collectibility requirements because it believes that sufficient guidance already exists.

7.3 Non-cash consideration

7.3.1 What's the issue?

Under the new standard, non-cash consideration is included in the transaction price and is measured at fair value, unless this cannot be reliably measured. If the fair value of non-cash consideration varies only because of its form, then it is not variable consideration.

Stakeholders have raised questions about the date at which the fair value of non-cash consideration should be determined. They have also questioned how the variable consideration guidance should be applied to contracts that include non-cash consideration, specifically when the fair value of non-cash consideration varies due to its form and also for other reasons.

7.3.2 What's the FASB proposing?

The FASB decided to propose that non-cash consideration be measured at contract inception. The illustrative example in the new standard would also be updated to reflect the proposal. Using contract inception as the measurement date is generally consistent with the measurement of the transaction price when it consists of cash consideration.

The FASB also decided to propose a clarification to the new standard, making it clear that the constraint guidance applies to variability caused by factors other than the form of the consideration.

The IASB decided not to amend the non-cash consideration guidance, because it does not expect significant diversity on applying the new standard.

Observations

Greater consistency, but split approach may be required

The FASB proposals on the measurement date would increase consistent application of the new standard under US GAAP.

The FASB proposals on variable consideration would also promote consistent application under US GAAP. However, the FASB's chosen approach may be difficult to apply in some cases, as it requires a company to split movements in the fair value of non-cash consideration between those related to the form of the consideration and those arising for other reasons.

The IASB's decision not to provide guidance leaves open the possibility that companies reporting under IFRS may seek to follow the FASB's approach; however, they may instead prefer a simpler approach that avoids allocating changes in fair value to different causes other than those required by the FASB's approach.

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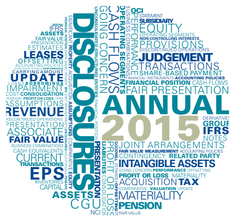

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About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

Content

Our *New on the Horizon* publications are prepared on the release of a new proposed IFRS, or proposed amendment(s) to the requirements of existing IFRSs, or a discussion paper. They include a discussion of the key elements of the new proposals/ discussion points and highlight areas that may result in a change of practice.

This edition of *New on the Horizon* considers the requirements of the IASB's exposure draft on proposed clarifications to IFRS 15 issued in July 2015.

The text of this publication refers to the exposure draft and to selected other current IFRSs in issue at 31 August 2015.

Further analysis and interpretation will be needed for a company to consider the potential impact of the proposals in light of the company's own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group and these observations may change.

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