STAFF PAPER

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Paper topic	Time Value of Money		

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Purpose of the paper

1. Based on the feedback on the 2011 Exposure Draft *Revenue from Contracts with Customers*, this paper considers:

   (a) when an entity should adjust the promised amount of consideration to account for the time value of money, and

   (b) clarifications related to the application of the time value of money requirements.

Summary of recommendations

2. The staff recommend that the Boards affirm the proposal in the 2011 ED that an entity should adjust the amount of promised consideration to reflect the time value of money. In addition, the staff recommend the Boards clarify and refine the principles as follows:

   (a) narrow the application of the proposals to require an entity to adjust the promised amount of consideration to reflect the time value of money when:

      (i) the primary purpose of the payment terms is to provide financing (to either the customer or the entity); *and*

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(ii) that financing component is significant to the contract.

(b) clarify in the revenue standard that an entity need not reflect the effects of time value of money for goods or services paid for in advance when the "transfer of those goods or services to the customer is at the discretion of the customer" (paragraph BC144);

(c) retain the practical expedient to exempt entities from adjusting for financing when the timing between payment and performance will be one year or less, and clarify its application to contracts with a term of greater than one year; and

(d) clarify that the proposals do not preclude interest income from being presented as revenue.

3. Appendix A summarizes how the proposals in the 2011 ED may change as a result of these staff recommendations.

Structure of the paper

4. This paper is organized into the following sections:

(a) Background of the proposals in the 2011 ED (paragraphs 5 – 8)

(b) Feedback on the 2011 ED (paragraphs 9 – 11)

(c) When to account for the time value of money (paragraphs 12 –40)

(d) The practical expedient (paragraphs 41 –48)

(e) Other clarifications (paragraphs 49 – 53)

(f) Appendix A: Suggested changes

Background of the proposals in the 2011 ED

5. In determining the transaction price, the proposals in the 2011 Exposure Draft would require an entity to adjust the promised amount of consideration to reflect the time value of money if a contract has a financing component that is significant

to the contract. A contract has a financing component when “the promised amount of consideration differs from the cash selling price of the promised goods or services” (paragraph 58 of the 2011 ED). The objective of these proposals is to reflect what the selling price would have been if the customer had paid cash for the promised goods or services at the point they are transferred to the customer.

6. Paragraph 59 of the 2011 ED states that “in assessing whether a financing component is significant to a contract, an entity shall consider various factors including, but not limited to, the following:

   (a) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services;

   (b) whether the amount of consideration would differ substantially if the customer paid in cash promptly in accordance with typical credit terms in the industry and jurisdiction; and

   (c) the interest rate in the contract and prevailing interest rates in the relevant market.”

7. The discount rate that should be used to make an adjustment to the promised amount of consideration (that is, when the financing component is significant) is the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. An entity may be able to determine the discount rate by identifying the rate that discounts the nominal amount of the promised consideration to the cash selling price of the good or service (paragraph 61 of the 2011 ED). The resulting interest expense or interest income should be presented separately from revenue in the statement of comprehensive income (paragraph 62 of the 2011 ED).

8. To ease the application of the proposals, paragraph 60 of the 2011 ED states that “as a practical expedient, an entity need not adjust the promised amount of consideration to reflect the time value of money if the entity expects at contract inception that the period between payment by the customer of all or substantially

all of the promised consideration and the transfer of the promised goods or services to the customer will be one year or less."

Feedback on the 2011 ED

9. The Boards did not specifically invite comment on their revised proposals for reflecting the time value of money in the determination of the transaction price. However, many respondents commented on various aspects of this topic. Of those who responded, a small number did not think that the revenue standard should include requirements to adjust the promised amount of consideration for the effects of the time value of money. Those respondents suggested that the costs and complexity of accounting for the effects of the time value of money would outweigh the benefit to users. This is because, in their view, the proposals require adjustments to contracts which users do not view as financing arrangements and therefore the adjustments may be difficult to explain to users. Respondents in the telecommunications industry also emphasized that complying with the proposals on the time value of money would be extremely complex, and a further difficulty for them in applying the allocation model as set out in the 2011 ED.

10. A few respondents also suggested that the Boards should remove the requirements on the time value of money from the revenue standard and undertake a project that more comprehensively evaluates the effects of time value of money on contracts with customers, including the assets and liabilities related to both revenue and purchase contracts.

11. Most other respondents acknowledged the theoretical basis for accounting for the effects of the time value of money in contracts with customers, however, they raised questions regarding:

    (a) when to account for the time value of money;

    (b) when to apply the practical expedient and clarification of how it should be applied in some cases; and

(c) other clarifications related to the application of the time value of money.

When to account for the time value of money

Feedback

12. Although a few respondents suggested the Boards remove the requirements for time value of money from the revenue standard and some suggested the Boards undertake a comprehensive project to consider the effects of time value of money more holistically, the staff recommend the Boards confirm the inclusion of the requirements to account for time value of money in the revenue standard. This is because the reasons presented in paragraph BC145 for accounting for the effects of time value of money are still valid, specifically:
    (a) Entities are not indifferent to the timing of cash flows in a contract and reflecting the time value of money portrays an important feature of a contract.
    (b) Not recognising the financing component could misrepresent the profit of a contract.
    (c) Contracts with explicitly identified financing components would be accounted for consistently with contracts in which the financing component is implicit in the contract price.
13. In addition, users mostly support the proposals to account for time value of money when the contract includes a financing component (although they acknowledge that the proposals may require an adjustment for time value of money for too many contracts – discussed further below). Furthermore, the staff observe that the IASB has asked the IFRS Interpretations Committee to consider developing an interpretation of IFRSs that would create symmetry by requiring customers to also adjust for the time value of money on prepayments of long-term supply contracts (discussed further below).
14. A number of other respondents also agreed that it was appropriate to adjust for time value of money in some circumstances and acknowledged the improvements

in the 2011 ED (specifically the indicators in paragraph 59) that provide additional guidance for when an entity would be required to adjust the transaction price for the effects of the time value of money. However, many of those respondents explained that they thought the proposals were still too broad and would require an adjustment for financing on too many transactions. Those respondents, as well as some users, explained that they thought it would be inappropriate to adjust for financing when the payment terms were agreed for reasons other than financing. This is because although the deferred or advance payment terms provide either the customer or the entity with the implicit financing, that benefit is generally expected to be a consequence of the primary reason for the entity and the customer agreeing to those payment terms. This may occur, for example, when an entity and customer agree payment terms to:

(a) reflect the credit history of the customer;

(b) establish a fixed price for the purchase of raw materials;

(c) reflect the timing of the entity’s payments to suppliers;

(d) provide security for timing of delivery or future production; or

(e) provide the customer with assurance that the entity will satisfactorily complete their obligations under the contract.

15. In addition to their overall concern about the broad application of the time value of money proposals, many respondents raised specific concerns about the requirement to account for the effects of financing when the customer has paid in advance (ie prepayment) and the exclusion of timing of payments to suppliers in the determination of when a financing component is significant.

Advance Payments

16. A number of respondents disagreed with the requirement to adjust the promised amount of consideration for the effects of financing when the customer provides payment in advance. (This was consistent with the feedback on the 2010 ED.) Many explain that this is because the effects of financing on advance payments would result in a higher amount of revenue being recognised than cash received

which, to them, is counter-intuitive. A few respondents also explained that this result may be exacerbated if a higher discount rate is used, because it may result in higher revenue being recognised by the entity. However the staff observe that the discount rate would reflect a rate that the entity would have obtained had they obtained financing from a third-party, and in those cases, the resulting adjustment to the promised amount of consideration would represent the cash selling price the entity would require to be compensated for its additional cost of financing.

17. Other respondents explained that they thought advance payments should be excluded from the requirements to account for the effects of financing because often the advance payment is provided for a reason other than financing. One commentator observed:

> In long-term contracting, advance payments are often collected to protect the financial interest of the contractor or reserve production capacity for the supplier rather than as a vehicle for financing the satisfaction of the underlying obligations. We believe a model that reflects these advance payments as financing transactions would be misleading to investors as it would not represent the intent of the transaction. (CL#125 The Boeing Company)

18. Some respondents explained that if the Boards did not exclude all advance payments from the requirements to account for financing, the Boards should at least specify some advance payments that would be excluded. Those respondents requested the Boards elevate to the standard the circumstances outlined in paragraph BC144 and exclude from the time value of money requirements contracts that include goods or services that are paid for in advance whereby "the transfer of those goods or services to the customer is at the discretion of the customer" (eg prepaid phone cards and loyalty points). Those respondents also requested the Boards exclude other advance payments where the purpose of the payments is not for financing (eg deposits).

19. One respondent also suggested the Boards exclude specific payments made both in advance and in arrears that arise for reasons other than financing as follows:

    (a) Payments to provide security or indemnity for one party to a contract (eg security deposits, retainages on contracts, performance guarantees, etc.)

    (b) Payments to secure capacity or fund production costs on construction or long-term production contracts

    (c) Payments to lock-in price on resources and raw materials

    (d) Payments to transfer certain types of risks (eg extended warranty and product maintenance contracts)

    (e) Payments to secure availability of services (eg prepaid club memberships, prepaid seasonal tickets, etc)

    (f) Payments to provide a sales incentive other than through the use of financing (eg rebates, volume discounts, customer loyalty points, etc)

Payments to suppliers

20. Many respondents also observed that the indicators in paragraph 59 of the 2011 ED ignore a critical piece of the equation for determining whether there is a financing arrangement by ignoring the timing of payments to suppliers. Some respondents thought that the timing of payments to suppliers should be an indicator of when a financing component is significant. This is because their current practice of accounting for contracts in which revenue is recognized over time is to only account for the effects of financing when there is a significant or material difference in the timing between payments from customers and payments to suppliers.

21. Others thought that the Boards should also require an adjustment for the effects of the time value of money on other assets and liabilities that arise from the costs related to the contract. Those respondents disagreed with the mismatch that results from accounting for the effects of financing on revenue but ignoring the effects on the corresponding assets and liabilities. One respondent explained:

> We do not believe the broader implications of introducing time value into the revenue accounting model have been considered by the Boards. Business models where implicit financing is inherent in contracts with customers generally have similar arrangements with suppliers and collaborative partners. An accounting model that discounts only revenues could significantly distort the financial results of these businesses. It is imperative that the Boards address time value holistically. (CL#4A Aerospace Industries Association of America)

Narrowing the application of the time value of money

22. As a solution to concerns about the broad application of the requirements to account for the effects of financing, many respondents suggested the Boards narrow the application of the proposals. Some suggested excluding advance payments from the requirements to adjust for financing, in particular because existing US GAAP does not require an adjustment for financing on advance payments and practice in IFRS is mixed. Some also suggested the Boards include the timing of payments to suppliers in the determination of whether a financing component is significant.

23. Other respondents suggest narrowing the application of the proposals to require an adjustment for financing on only those contracts where the purpose of the negotiated payment terms was to provide financing. To narrow the application in this way, those respondents request the Boards incorporate into the standard the notion in paragraph BC147 that suggest that a financing component is only accounted for when the primary purpose of the payment terms is to provide financing. One respondent explained:

> While we acknowledge that the Board appears to contemplate the intent of the parties to a contract in paragraph BC147 of the ED by recognizing that there may be instances where timing of payment is driven primarily by something other than financing, we believe this concept

> should be given more prominence in the proposed standard. (CL#49 Raytheon Company)

24. For reference, paragraph BC147 states:

> ...in some circumstances, a payment in advance or arrears in accordance with the typical payment terms of an industry or jurisdiction may have a primary purpose other than financing. For example, a customer may retain or withhold an amount of consideration that is payable only on successful completion of the contract or on achievement of a specified milestone. The purpose of such payment terms may be primarily to provide the customer with assurance that the entity will satisfactorily complete their obligations under the contract, rather than to provide financing to the customer. Consequently, the effects of the time value of money may not be significant in those circumstances.

Staff analysis

25. The staff acknowledge the concerns about advance payments; however the staff think that it would not be appropriate to address these concerns by excluding all advance payments from the requirements to account for the effects of financing. This is because, as the Boards previously explained in paragraph BC150 "ignoring the time value of money effects of advance payments could substantially skew the amount and pattern of profit recognition if the advance payment is large and occurs well in advance of the transfer of the goods or services to the customer".

26. The staff also think that the Boards should not consider (in the revenue project) the effects of time value of money on other assets and liabilities related to revenue contracts, such as those arising from purchase contracts. Those contracts are outside the scope of the revenue proposals. In addition, the staff think the Boards should not include the timing of payments to suppliers as an indicator of when a financing component is significant because it will add complexity and it will be difficult to define which payments should be included in the calculation.

27. As explained above, the staff observe that, for IFRS preparers, concerns related to the discounting of assets and purchase contracts may be alleviated by an interpretation that intends to require purchasers to adjust for the time value of money when a purchaser makes a prepayments in a long-term supply contract. The staff note that the IFRS Interpretations Committee will wait until the Boards finalise the proposals related to the time value of money in the revenue project before developing the interpretation.

28. In the staff's view, the concerns about advance payments, the timing of payments to suppliers and the overall concern that the proposals are too broad can be addressed by narrowing the application of the proposals. This will mean that entities will be required to adjust for financing on a smaller population of contracts. Narrowing the application will also address some of the concerns about the complexity of applying the proposals (discussed below).

29. The staff suggest that the Boards could narrow the application of the proposals by requiring entities to only adjust for financing on transactions where the purpose of the payment terms is to provide financing to either the customer or the entity (ie the seller). This narrow application would be consistent with the existing requirements in IAS 18 *Revenue* that requires consideration to be adjusted "when the arrangement effectively constitutes a financing" (paragraph 11 of IAS 18). The narrow application would also be broadly consistent with the intent of paragraphs 835-30-15-1 through 15-4 in *FASB Accounting Standards Codification*® Topic 835, *Interest*, which exclude a number of explicit situations where the purpose of the payment terms may not be financing (eg security deposits, retentions and payments from the customer for acquisition of resources and raw materials). In addition, this narrow application appears to also be consistent with the guidance provided by the IASB to the IFRS Interpretations Committee in developing the interpretation to adjust for financing on prepayments for long term supply contracts. Specifically, the IASB has indicated that the Interpretations Committee should consider requiring adjustments only when the prepayments represent financing transactions. Furthermore, the IASB explained to the Interpretations Committee that it would not be appropriate to accrete

interest on premiums paid for the purposes of securing supply or for fixing prices (IASB Update February 2012).

30. To operationalize this proposal, the staff suggest incorporating the notion of the 'primary purpose of financing' from paragraph BC147. Payment terms in the contract would have the primary purpose of financing when financing is explicit in the contract or implicit in the payment terms. Indicators that the payment terms have the primary purpose of financing may be:

(a) the contract states that that the customer or the entity are providing or receiving financing.

(b) the customer is offered differential pricing based on the timing of payment for goods or services relative to the delivery of those goods or services. In other words, the differing prices offered to the customer for the same goods or services indicates that financing is provided to the entity or to the customer, depending on when the amount is paid and the goods or services are delivered.

(c) the amount of consideration differs depending on the timing of the payments.

31. Consider the following examples:

Example 1 – Cable service:

A customer signs a three year, non-cancellable subscription agreement for monthly cable service. The customer purchases the box from a third-party and is provided with the following options to pay for the service:

(a) pay CU15 per month;

(b) pay CU250 at the beginning of the contract term and CU7.50 per month; or

(c) pay CU500 at the beginning of the contract term, with no additional monthly payments.

The differential pricing in options (b) and (c) indicate that the contractual payment terms have the primary purpose of providing the entity with financing. (The staff note that in option (a), there is no financing component because

CU15 reflects the cash selling price at the point they are transferred to the customer.)

Example 2 – construction contract:

A customer signs a contract with a constructor to build an aircraft that will take 24 months to build.

Scenario A: Performance obligation satisfied at a point in time

The contractor must make on-going payments to its suppliers and unless the customer pays in advance of performance, the contractor would be required to borrow money from a bank. Therefore the contractor requires the customer to pay CU75,000 monthly for 24 months (total amount of payments = CU1,800,000). If the customer does not want to pay monthly, the constructor will require payment of CU2,000,000 on delivery.

When the customer pays monthly, the primary purpose of the payment terms is to provide financing to the contractor. The CU2,000,000 represents the cash selling price because the aircraft transfers to the customer only upon delivery.

Scenario B: Performance obligation satisfied over time

The performance obligation is satisfied over time and thus the customer controls the work-in-progress. As in Scenario A, the contractor must make on-going payments to its suppliers and unless the customer pays as the work is completed, the contractor would be required to borrow money from a bank. Therefore the contractor requires the customer to pay CU75,000 monthly for 24 months (total amount of payments = CU1,800,000). If the customer does not want to pay monthly, the constructor will require payment of CU2,000,000 at the end of 24 months.

The monthly payments represent the cash selling price, because the work-in-progress transfers over time. (Although there may be some timing differences between payment and performance, the staff expect that they are likely immaterial.) If the customer pays at the end of 24 months, the primary purpose of the payment terms is to provide financing *to the customer*, who obtains control of the work-in-progress over time.

32. In these cases, when the payment terms provide financing to either the customer or the entity, the staff think it would be necessary to adjust for financing to reflect "what the cash selling price would have been if the customer had paid cash for the promised goods or services at the point that they are transferred to the customer" (paragraph 58 of the 2011 ED).

33. Narrowing the application of the proposal to only reflect the time value of money on contracts where the primary purpose of the payment terms is to provide financing to the customer or the entity would mean that payments such as deposits or retentions that provide security for the customer and the entity would not be adjusted for financing. In those cases, absent other factors, the staff think that it is not necessary to adjust the promised amount of the consideration because the 'cash sales price' will be unchanged based on the amounts of the prepayment or retention.

34. The staff observe that some may disagree with the proposal to narrow the application of the requirements to adjust for financing only when the primary purpose of the payment terms is financing. This is because they think that it creates subjectivity into the assessment of when to adjust for financing. Furthermore, some may think that a timing difference between payment and performance will always provide some form of financing that should be reflected in the transaction price, regardless of whether that was the intention of the parties.

35. However narrowing the proposals would have the benefit of easing the application of an area of the 2011 ED that many thought was too complex and where they thought the costs of applying the proposals outweighed the benefits. Furthermore, it would capture only those contracts where financing is clearly an important part of the contract that should be accounted for to properly portray the profit on a contract and ensure consistency with contracts that offer explicit and separate financings. In outreach and comment letters, many users acknowledged that accounting for the effects of financing is important, however they thought the effects of financing should be recognised only when the arrangement represents a financing arrangement:

> We agree with the concept of recognizing the effects of the time value of money; however, we believe its application should be more limited than currently proposed.
>
> We understand the conceptual underpinning of the proposal, but suggest financing elements be separately recognized only when they are a clear element of the contractual agreement. (CL#275 Standard and Poor's)

36. The staff acknowledge that since many of the concerns relate to advance payments, the Boards could consider narrowing the application by requiring an entity to account for the effects of time value of money on advance payments only when the advance payments have a primary purpose of financing. This proposal would ensure that deferred payments (when significant) are always adjusted for financing. However, without a specific exclusion for retention payments (which are deferred payments), this alternative would require an adjustment for financing on retentions in the construction industry, which the staff understand would result in a change in current practice for most preparers. Furthermore, this would create a difference between the accounting for payments in advance and payments in arrears and may add to the complexity of the proposals.

Staff recommendation

37. The staff recommend that the Boards narrow the application of the proposals related to the time value of money to require an adjustment for financing when the primary purpose of the payment terms is to provide financing to either the customer or the entity (ie the seller). This approach would:

(a) Achieve the objective of recognising revenue "at an amount that reflects what the cash selling price would have been if the customer had paid cash for the promised goods or services at the point that they are transferred to the customer" (paragraph 58 of the 2011 ED).

(b) Ease the application of the proposals by limiting the number of contracts that may be adjusted for financing.

(c) Avoid accounting for the effects of the time value of money when the resulting information may not be useful (ie because neither party to the arrangement nor the users of the financial statements thinks that the contract contains a financing arrangment).

(d) Limits the number of accounting mismatches in the income statement.

38. The staff also recommend retaining the principle of requiring an adjustment for a financing component only when it is significant, with the indicators provided in paragraph 59 of the 2011 ED. This is because the staff think it is helpful to retain the notion of significance that was added in response to feedback on the 2010 ED and also because many respondents appreciated the addition of these indicators. However the staff suggest the Boards incorporate some of the discussion from paragraph BC146 that explains that the notion of significance was added to ensure that entities would not be required to account for financings that are not material at the individual contract level but may be material for a portfolio of contracts.

39. In addition, the staff recommend clarifying in the revenue standard that an entity need not reflect the effects of time value of money for goods or services paid for in advance when "the transfer of those goods or services to the customer is at the discretion of the customer" (paragraph BC144). This may include, for example, prepaid phone cards and loyalty points.

40. The staff note that in making this recommendation they have rejected the following options:

(a) Retaining the proposals in the 2011 ED (that is because this approach would not adequately address the concerns of respondents that the proposals are too broad and may provide results that are not useful to users).

(b) Exclude advance payments from the requirements to adjust for the effects of time value of money (for the reasons outlined in paragraph 25).

(c) Consider the effects of time value of money on other assets and liabilities related to revenue contracts with customers, such as those arising from purchase contracts (for the reasons outlined in paragraph 26).

(d) Narrowing the application by requiring an entity to account for the effects of time value of money on advance payments only when the advance payments have a primary purpose of financing (for the reasons outlined in paragraph 36).

Questions 1, 2 and 3:

1. Do the Boards agree with the staff recommendation to confirm the inclusion of the requirements to adjust for the effects of the time value of money in the final revenue standard?

2. Do the Boards agree with the staff recommendation that an entity would be required to adjust the consideration to reflect the time value of money when:

(a) the primary purpose of the payment terms in the contract is to provide financing, and

(b) when that financing component is significant?

Indicators that the payment terms have the primary purpose of financing:
(i) the contract states that that the customer or the entity are providing or receiving financing.
(ii) the customer is offered differential pricing based on the timing of payment for goods or services relative to the delivery of those goods or services.
(iii) the amount of consideration differs depending on the timing of the payments.

3. Do the Boards agree with the staff recommendation to clarify in the revenue standard that an entity need not reflect the effects of time value of money for goods or services paid for in advance when "the transfer of those goods or services to the customer is at the discretion of the customer" (paragraph BC144)?

The practical expedient

41. The Boards added a practical expedient in paragraph 60 to simplify compliance with the proposals in response to feedback, but also because they observed that

"some existing standards require an entity to recognise the effects of financing only if the time period exceeds a specified period, often one year" (paragraph BC148). The practical expedient does not require an adjustment for the time value of money if the timing between payment and performance is one year or less.

Including a practical expedient

42. Many respondents (primarily preparers) appreciated the addition of the practical expedient to the 2011 ED and agreed that it would simplify compliance. However, other constituent groups (most notably, standard setters and professional bodies) expressed concerns that the practical expedient is arbitrary, and they thought it would be inappropriate for the practical expedient to apply to contracts in high-inflation economies.

43. Those who were concerned about the practical expedient being a bright line suggested that the Boards remove the practical expedient, or indicate that it cannot be applied by entities in high-inflationary economies. In addition, a few suggested that the Boards could include the practical expedient as an indicator of when an entity has a financing component that is significant to a contract to ensure that those entities in high-inflationary economies adjust for the effects of financing in both long and short-term contracts.

44. Including the practical expedient as an indicator of when a contract is significant would significantly lessen the relief provided by the practical expedient. This is because an entity would still need to assess *all* short term contracts against the indicators in paragraph 59 and would need to prove that their contract's financing component is not significant. This appears to be contrary to the Boards' objective of simplifying compliance with the revenue standard (as explained in paragraph BC148). In addition, although the Boards acknowledge that the practical expedient creates circumstances with arbitrary outcomes (involving both short-term contracts and contracts with high implicit interest rates), making the practical expedient an indicator of when a financing component is significant seems unnecessary because "the effect on the pattern of profit recognition should be limited" (paragraph BC148).

45. However, the staff acknowledge that while a practical expedient can ease the application of proposals, it does not mean that entities who wish to adjust for the effects of the time value of money (because for example they operate in a high-inflationary economy) are precluded from doing so. Therefore the staff recommend the Boards affirm their decision to include a practical expedient in the proposals.

Applying the practical expedient

46. While some were concerned with the inclusion of the practical expedient, other respondents requested additional clarification on how to apply the practical expedient. Specifically, some thought it was unclear whether the practical expedient exempted only contracts with a term of less than one year, or whether the practical expedient should also apply to situations whereby the contract term is greater than one year but the period between the transfer of a goods or service to the customer and payment by the customer for that good or service is less than one year. Consider for example a three year magazine subscription that is paid annually, at the beginning of each year.

47. Others were confused aboutt how to assess the timing difference between payment and performance when the contract included multiple performance obligations or performance obligations satisfied over time:

> The application of the time lag practical expedient in paragraph 60 of the ED (e.g., assessing the time lag between delivery of the related good / service and cash payment) should be made at the individual performance obligation delivery level rather than for the entire contract as a whole. For example, assume a customer enters into a three year forward commodity contract which is billed monthly based on volumes delivered in the prior month. If the commodity is delivered in September and payment is due in October, this arrangement would not be viewed as containing a financing element since the goods are delivered and cash is collected for the delivered goods

> within 30 days. In assessing whether or not a financing exists in a contract with multiple performance obligations created by delivery of the same product(s) at multiple points over time, it is not relevant that all goods are not delivered until the end of the three year period. Rather, the assessment would be made based on the delivery of each individual performance obligation as compared to the cash payment for each delivery. (CL#70 American Gas Association)

48. The practical expedient was meant to provide relief for those contracts where the timing between payment and performance was less than one year. As explained above, this was to simplify the application of the proposals, but also because the effects of the time value of money would likely not be material in most contracts where timing between performance and payment for that performance was less than one year. The practical expedient would be applied to contracts where the contract term is less than one year (and payment and performance occur within that year), but it will also apply to contracts that have a term of greater than one year, but payment and performance occur within one year. Consider the example provided by the American Gas Association in the comment letter summarised above: payment and performance (delivery of gas) occurs within 30 days. Or the example of a monthly magazine subscription for three years that is paid for annually (ie at the beginning of each year). In both cases, the timing between payment and performance occurs within one year and thus these contracts should be excluded from the requirements to adjust for the time value of money by applying the practical expedient. The staff think that these concerns can be addressed and clarified in drafting.

Question 4:
Do the Boards agree with the staff recommendations to: (a) retain the practical expedient in the TVM proposals; and

(b) clarify the application of the practical expedient to contracts where the term may be greater than one year, however the timing difference between payment and performance is one year or less?

Other clarifications

49. Many respondents also raised questions about the application of the proposals to adjust for the effects of financing (ie how to account for the time value of money). A number of those respondents raised broad concerns that they thought that, even with the additional guidance provided in the 2011 ED, the proposals related to the time value of money were complex to apply. As a result, many requested additional guidance or clarification of some of the principles, as well as additional and more complex examples.

50. If the Boards decide to narrow the application as described above, the staff think that many of these concerns about complexity will be reduced because the revised proposals would require an adjustment for financing only on a subset of the contracts captured by the 2011 ED. However, the staff think that many respondents may still request additional illustrative examples, because in their view, the example in paragraph IG66/IE8 does not go far enough to provide application guidance for entities with complex contracts such as long-term contracts or contracts with separate performance obligations whereby goods or services are transferred at various points in time and the timing and amount of cash inflows from the customer does not correspond with the transfer of those goods or services. Those respondents requested additional examples to include some or all of the following elements:

    (a) multiple performance obligations;

    (b) performance obligations satisfied over time that span multiple periods; and

    (c) differing payment streams (including variable consideration).

51. The staff observe that this is not the only area where constituents have requested additional and more complex examples. However, the staff note that more

complex examples are not always productive, because the facts of the example may be interpreted as prescriptive guidance. Furthermore, the complexity of the example often obscures the principle that the example is trying to demonstrate. The staff believe the conclusions the Boards will make in Question 1 and 2 may influence the direction in which the examples are drafted. Therefore, the staff plan to wait to consider whether additional examples are necessary until these substantive decisions are made.

52. In addition to the request for additional illustrative examples, some respondents also questioned whether the language in paragraph 62 that indicates that the effects of financing are to be presented separately from revenue (as interest expense or interest income) means that the interest income could not be presented as part of revenue. This was a particular concern for Islamic banks and other banks because they regularly enter into financing transactions and thus for them, interest income represents a main source of income arising from ordinary activities. These respondents explained that currently they present interest income as part of revenue (as permitted by paragraph 11 of IAS 18) and were concerned that if they were required to present this income outside of revenue it would not reflect the activities of the institution.

Staff recommendation

53. The staff think that the Boards did not intend to prevent an entity from presenting interest income as part of revenue if it was part of its ordinary activities. Therefore the staff recommend that the Boards clarify that the proposals do not preclude interest income from being presented as revenue.

Question 5:
Do the Boards agree with the staff recommendation to clarify that the proposals do not preclude interest income from being presented as revenue?

Appendix A: Suggested changes

A1. The following table lists the proposed requirements from the 2011 ED that relate to the time value of money and identifies which of those proposals might change as a result of the staff recommendations in this paper.

Proposals from the 2011 Exposure Draft	Suggested changes
58 In determining the transaction price, an entity shall adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is significant to the contract. The objective when adjusting the promised amount of consideration to reflect the time value of money is for an entity to recognize revenue at an amount that reflects what the cash selling price would have been if the customer had paid cash for the promised goods or services at the point that they are transferred to the customer. If the promised amount of consideration differs from the cash selling price of the promised goods or services, then the contract also has a financing component (that is, interest either to or from the customer) that may be significant to the contract.	The staff recommend a change in paragraphs 37 through 40 of this paper. Specifically, the staff recommend that an entity will adjust the promised amount of consideration to reflect the time value of money when the primary purpose of the contract payment terms is to provide financing. The staff also recommend retaining the requirement that the financing component must also be significant (see below).
59 In assessing whether a financing component is significant to a contract, an entity shall consider various factors including, but not limited to, the following: (a) The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services (b) Whether the amount of consideration would differ substantially if the customer paid in cash promptly in accordance with typical credit terms in the industry and jurisdiction (c) The interest rate in the contract and prevailing interest rates in the relevant market.	No material change to this paragraph.

60	As a practical expedient, an entity need not adjust the promised amount of consideration to reflect the time value of money if the entity expects at contract inception that the period between payment by the customer of all or substantially all of the promised consideration and the transfer or the promised goods or services to the customer will be one year or less.	No material change to this paragraph. The staff recommend some clarifications in paragraph 48.
61	To adjust the promised amount of consideration to reflect the time value of money, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract as well as any collateral or security provided by the customer or the entity, which might include assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the cash selling price of the good or service. After contract inception, an entity shall not update the discount rate for changes in circumstances or interest rates.	No material change to this paragraph.
62	An entity shall present the effects of financing separately from revenue (as interest expense or interest income) in the statement of comprehensive income.	The staff recommend a clarification in paragraph 53.