STAFF PAPER

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Project	**Revenue Recognition**		
Paper topic	Constraint on estimates of variable consideration		
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Purpose

1. This paper considers possible improvements to the constraint on estimates of variable consideration based on the Boards' September 2013 request for the staff to evaluate:

   (a) An alternative approach that refocuses the objective of the constraint on the quality of an entity's estimate and whether or not the entity should reassess that estimate;

   (b) Whether to provide more specificity about the level of confidence to be used in the application of the constraint; and

   (c) Whether to reinstate specific guidance that would address the accounting for a usage-based royalty on licenses of intellectual property.

Staff recommendation

2. The staff recommend the Boards articulate the objective of the constraint and the level of confidence as follows:

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> Include the amount of variable consideration in the transaction price only if it is probable [IFRS: highly probable] that a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal (paragraph 56.1 of Appendix A of this paper).

3. With regards to the questions on reassessment and sales-based royalties the staff recommend that the Boards adopt Alternative 1 in Appendix A. That is:

   (a) Require an entity to update the transaction price at each reporting date (paragraph 56.4 in Alternative 1 in Appendix A).

   (b) Include an exception that would preclude an entity from including in the transaction price an estimate of sales or usage-based royalties from licenses of intellectual property until the customer's subsequent sales or usage occur (paragraph 56.5 in Appendix A).

Structure of the paper

4. This paper is organized as follows:

   (a) Objective of the constraint and confidence level (paragraphs 5 – 30)

   (b) Reassessment and sales-based royalties (paragraphs 31 – 50)

   (c) Appendices

      (i) Appendix A – Drafting alternatives

      (ii) Appendix B – Illustrative examples

Objective of the constraint and confidence level

Background

5. In the November 2012 joint Board meeting, the Boards tentatively decided that an entity should include an amount of variable consideration in the transaction price only if the entity expects that a subsequent change in the estimate of the amount

of variable consideration would not result in a significant revenue reversal. A significant revenue reversal would occur if a subsequent change in the estimate of the variable consideration would result in a significant downward adjustment to the amount of cumulative revenue recognized from that contract with that customer. An entity should reassess this objective as subsequent facts and circumstances change. In July 2013, the Boards tentatively decided to specify that for all contracts an entity should include a minimum amount of variable consideration in the estimate of the transaction price, when including that amount would not result in a significant revenue reversal.

6. Feedback from some auditors and preparers in the drafting process suggested that the objective places too much emphasis on the possibility of a downward adjustment. They commented that any reversal–regardless of how infrequent–would come under intense scrutiny from auditors and regulators. The objective could therefore result in preparers being overly conservative in their estimates such that revenue recognition would not reflect the entity's performance under the contract but would be unduly delayed. Some also commented that they thought the objective should instead focus on the quality of the entity's estimate.

7. Preparers and auditors also indicated that the word 'expect' was unclear to them, and requested more precision around the level of confidence necessary for an entity to assert that the objective of the constraint can be met. Many also observed that when considered in light of the objective of 'would not result in a significant revenue reversal', the guidance might result in an entity applying a level of confidence closer to virtually certain. Although the term was not broadly accepted,[1] many liked that the 2011 ED provided more guidance by specifying that the cumulative amount of revenue an entity recognizes should be limited to the amount to which the entity is **reasonably assured** to be entitled.

[1] Many respondents to the 2011 ED explained that the term 'reasonably assured' caused confusion. This is because the term is used elsewhere in IFRSs, U.S. GAAP and auditing requirements, and the meaning of the term in those other requirements is often different than the qualitative assessment the Boards intended in the 2011 ED. Respondents to the 2011 ED suggested that the Boards either re-draft the section to avoid the use of any term or select another term that is not used elsewhere in accounting or auditing requirements.

8. In the September 2013 joint Board meeting, the Boards requested the staff to evaluate two alternatives for articulating the objective of the constraint. Those alternatives were articulated in the September 2013 Agenda Paper 7A/174A as follows:

   (a) *Significant revenue reversal*—An entity should include an amount of variable consideration in the transaction price only if the entity expects that a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal. (Included as Alternative 2B in the September 2013 Agenda Paper 7A/174A. This was also the objective that was included in the external review draft.)

   (b) *Predictive amount* —An entity should include an amount of variable consideration in the transaction price only if that estimate is predictive of the amount of consideration to which the entity expects to ultimately be entitled. (Included as Alternative 2C in the September 2013 Agenda Paper 7A/174A.)

9. In addition, the Boards also asked the staff to evaluate whether it was appropriate to specify a level of confidence in the objective of the constraint.

Significant revenue reversal – Including a level of confidence

10. As explained above in paragraphs 6 and 7, some of the feedback on the objective of "the entity expects that…would not result in a significant revenue reversal" was that the notion of "expects" was unclear to them. In addition, many suggested that without greater clarity around the level of confidence necessary for an entity to assert that the objective of the constraint can be met, regulators may interpret this assessment as closer to virtually certain while others may presume the assessment could be closer to "more likely than not" or another less significant level.

11. The staff think that a specified level of confidence would provide the clarity that the preparers and auditors are requesting. The analysis an entity would undertake would still be largely qualitative and would require the entity to use the factors in

paragraph 56.2 (Appendix A) to evaluate whether the specified target could be met. That is, the staff would not expect entities to prepare a quantitative analysis each time they assess the likelihood of whether a significant revenue reversal could occur.

12. Feedback has indicated that the term 'probable' is widely used and understood in practice in the U.S. and is defined in U.S. GAAP as, "The future event or events are likely to occur" (ASC Topic 450, *Contingencies*). However, the term 'probable' is applied slightly differently in practice by entities applying IFRS. This is because the term 'probable' is defined in IFRS as "more likely than not" (IFRS 5 *Non-current Assets Held for Sale and Discontinue Operations*, and also IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*). Therefore, to achieve the same meaning in IFRS as U.S. GAAP, the IASB would need to use the term 'highly probable', in cases where the FASB uses 'probable'. The staff note that there is precedence for this approach in IFRS 5 where the IASB used the term 'highly probable' to achieve the same meaning as 'probable' in U.S. GAAP (as described in paragraph BC81 of IFRS 5).

13. The staff considered other terms (for example, confident, highly confident, sufficiently confident) to specify the level of confidence intended in the constraint. However, the staff rejected those terms because they would not narrow the range of interpretations unless the Boards provided more precise guidance in the standard or the Basis for Conclusions.

14. Preparers from long-term contracting industries have expressed concern that a more specific level of confidence may inappropriately restrict revenue. They are not currently required to support a specified level of confidence in their estimates because current U.S. GAAP presumes they can make reasonably dependable estimates. As a result, some have requested the Boards re-articulate the objective of the constraint to focus on the quality of the estimates. However, the staff think a confidence level in the new revenue standard could benefit preparers because when a significant revenue reversal subsequently occurs, the preparers could more easily support their original assertion that a significant revenue reversal was not probable/highly probable. In addition, using a more generally understood term to

specify the level of confidence would limit the likelihood that it could be interpreted in different ways by different people, such as regulators.

15. If the Boards decide not to specify a confidence level, the staff would retain the notion of "expect." That is, an entity would include variable consideration in the transaction price only if it expects that a subsequent change in the estimate of variable consideration would not result in a significant revenue reversal.

Including a minimum amount

16. An objective of 'significant revenue reversal' inherently means that a minimum amount of revenue could be recognized to meet the objective. Therefore, some may prepare their estimates of variable consideration to be sufficiently conservative in order to meet the objective of the constraint.

17. However, the staff think that precluding entities from including some, but not all, of the variable consideration in the transaction price may inappropriately prevent revenue recognition in situations where there are multiple sources of variability with varying degrees of uncertainty. For example, a long-term contractor has five unrelated incentive fees in a contract with a single performance obligation. The contractor estimates variable consideration in accordance with paragraph 55 (the most likely amount—see Appendix A) and includes an amount for all five of the incentive fees. However, the contractor observes that there is significant uncertainty related to one of the incentive fees and therefore the contractor determines that it cannot conclude that it will be probable/highly probable that a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal (that is, the objective of the constraint cannot be met). A strict prohibition on including some, but not all, of the variable consideration would result in none of the incentive fees being included in the transaction price. Precluding an entity from including some, but not all, of the variable consideration in the transaction price would be a significant change in practice for the long term constructors and as a result the staff do not think that it would be appropriate. The staff acknowledge that including specific language in the drafting (see paragraph 56.3 in Appendix A) may result in other entities also

recognizing a minimum amount at the time of satisfying a performance obligation, for example for entities that sell through a distribution channel. However, the staff think that recognizing revenue would be appropriate in these cases if the entity can meet the objective in the constraint (that is, because it is not probable that there will be a significant revenue reversal) for some, but not all, of the estimate of variable consideration to appropriately depict performance.

'Predictive amount' and other alternatives considered

18. The alternative of including an estimate if that amount was 'predictive' of the amount to which the entity ultimately be entitled (outlined in the September 2013 as Alternative 2C) tried to focus the objective of the constraint on determining whether the estimate will actually occur (that is, the entity will be entitled to that amount). Because that objective focused an outcome, it also included a qualitative level of confidence to help an entity assess what the likelihood of that outcome occurring. This level of confidence was described in the September 2013 paper as 'sufficient confidence', however it could also be replaced with a term such as 'probable' or 'highly probable' as described above. This is because each of those terms provide a target to assess the likelihood of an outcome occurring.

19. The intention in expressing the objective in this way was to try to find a principled approach to address the concerns related to sales and usage-based royalties that seemed to arise from the requirement to include a minimum amount in the transaction price. However, the concern is also related to the requirement to reassess the transaction price and both issues are discussed further below.

20. Initial feedback on an objective that focuses on the 'predictive amount' was that it was too restrictive, as it seemed to limit estimates further than a 'significant revenue reversal' notion. This is because it would restrict an entity from including an estimate in the transaction price if there was a chance of any upward adjustments, even if the entity was certain to be entitled to that amount.

21. To address these concerns, the staff tried to re-articulate the objective and included a more widely understood confidence level as follows:

> If an amount of consideration to which an entity expects to be entitled is variable, the entity shall include the amount of variable consideration estimated in accordance with paragraph 55 in the transaction price only if it is probable [IFRS: highly probable] that the estimate will not be significantly different from the amount to which it will be entitled for the goods or services transferred to date.

22. The staff circulated the re-articulated objective with a targeted group of preparers and auditors. Those participants provided similar feedback as to that provided on the 'predictive' objective—that is, by focusing on a specific outcome (that is, the estimate will not be significantly different from the amount to which the entity will be entitled) and the likelihood of that occurring (that is, probable/highly probable), the re-articulated objective also restricted the entity's ability to estimate. In addition, some explained that this concern was further exacerbated by including the notion of probable/highly probable. Some also explained that this significant restriction would result in a change in practice for those in industries with a long history of recognizing revenue based on estimates.

23. In light of these concerns, the staff determined that neither approach of articulating the constraint as a 'predictive amount' or 'not significantly different' would be appropriate. This is because they would inappropriately restrict estimates and furthermore, they would not address the feedback received in the drafting process.

24. After rejecting both approaches, the staff considered another alternative for articulating the objective of the constraint. This objective is closer to that proposed in the 2010 and 2011 EDs which focused on an entity's ability to make a reasonable estimate and the quality of that estimate. That alternative is as follows:

> If an amount of consideration to which an entity expects to be entitled is variable, an entity shall include some or all of the variable consideration estimated in accordance with

> paragraph 55 in the transaction price only if the variable consideration can be reasonably estimated. The variable consideration can be reasonably estimated only if all of the following criteria are met:
>
> (a) The entity has experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities).
>
> (b) The entity's experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled to in exchange for the goods or services transferred to date.

25. This approach refocuses the objective of the constraint onto the quality of the entity's estimates and the process for building that estimate, instead of focusing the objective on achieving a particular outcome (and the likelihood of that estimate occurring).

26. The staff acknowledge that this alternative has some clear merit and would respond to some of the feedback received in the drafting process. In addition, the notions of 'reasonable estimates' and 'reliable estimates' exist in current guidance including ASC Subtopic 605-15 on products (formerly FAS 48), ASC Subtopic 605-35 on construction-type and production-type contracts (formerly SOP 81-1) and IAS 11 *Construction Contracts.*

27. However, by refocusing the objective on the quality of the estimate instead of an outcome, the objective would not address the feedback received on the 2010 and the 2011 ED's where respondents requested greater clarity about the application of the constraint. In addition, the staff observe that if the Boards wanted to provide that clarity through a level of confidence, a term like 'probable' or 'highly probable' would be incompatible with an objective that focuses on the quality of the estimate rather than an outcome. Therefore, the Boards would need to consider another term such as 'confident', however as explained in paragraph 13 above, such a term is not currently defined in U.S. GAAP or IFRS and therefore may not

provide enough clarity for an entity, unless the Boards were to develop additional guidance.

Staff recommendation

28. The staff observe that two of the alternatives outlined above that focused on the likelihood of outcomes occurring (that is, 'predictive' and 'not significantly different') were not viable because they seemed to inappropriately restrict an entity's ability to estimate. In addition, the staff observe that the third alternative of 'reasonable estimates' (similar to the 2010 and 2011 ED), while less restrictive, would not seem to respond adequately to the feedback received on those exposure drafts that requested greater clarity on the application of the constraint. Therefore, the only reasonable alternative seems to be articulating the constraint with the notion of no 'significant revenue reversal' (see paragraph 56.1 in Appendix A).

29. The staff also observe that by including a level of confidence in the objective of the constraint of 'significant revenue reversal', the Boards would be responding to much of the feedback where participants were requesting greater clarity about when the objective of the constraint might be met.

30. Therefore, the staff recommend the Boards articulate the objective as outlined in paragraph 56.1 of Appendix A (that is, no significant revenue reversal) and include a level of confidence of 'probable' (U.S. GAAP) / 'highly probable' (IFRS) for the following reasons:

    (a) The objective is consistent with the majority of users' feedback that indicated that the objective of the constraint should be to limit revenue recognition when there is a risk of downward adjustment.

    (b) A defined confidence level of probable / highly probable would be understandable and operational for preparers, auditors, and regulators because it is used today. As a result, it may not be subject to widely varying interpretations.

    (c) A defined confidence level of probable / highly probable is consistent with the Boards' stated intention at the November 2012 joint board

meeting that the level of confidence would need to be relatively high for an entity to recognize variable consideration.

Reassessment and sales-based royalties

31. The external review draft required an entity to assess the constraint when control transfers and at each subsequent reporting date (referred to as 'reassessment' in this paper). This requirement, combined with the requirement to recognize a minimum amount of variable consideration (Boards' tentative decision in July 2013), resulted in a requirement for an entity to recognize revenue differently for licenses of intellectual property with a sales or usage-based royalty than what was proposed in the 2011 ED. This is because the 2011 ED included a specific requirement for the pattern of revenue recognition for licenses of intellectual property with consideration that varies on the basis of the customer's subsequent sales of a good or service, for example a sales-based royalty (this requirement was in paragraph 85 of the 2011 ED).

32. Some entities have questioned whether it is appropriate to reassess the constraint because it may result in a piecemeal recognition of revenue as uncertainties are resolved for some of the consideration that does not correspond with the entity's performance (that is, the transfer of control). Although this may occur in a number of situations, the clearest example occurs in a license that provides a right (that is, a performance obligation satisfied at a point in time) where the promised consideration is a sales-based royalty for a number of years:

> An entity licenses its intellectual property (IP) for a 10-year period in England. The entity will receive a percentage of the customer's sales as consideration (that is, a sales-based royalty). There are no other performance obligations in the contract. The entity concludes that the license provides a right, which results in a performance obligation satisfied at a point in time.
>
> The entity has experience in licensing the IP in similar countries and markets. The entity estimates the total amount of consideration it expects to be entitled to over the 10 years will be CU500,000. Some of that amount might be subject to significant revenue reversal, however, at the time of satisfying its performance obligation, the entity does not expect

the amount of revenue to be less than CU100,000. Consequently, the entity would recognize CU100,000 when it satisfies its performance obligation.

At the end of year 1, based on sales to date, the entity revises its estimate of the amount of consideration that will not be subject to revenue reversal to be CU175,000. Consequently, the entity would recognize an additional CU75,000 of revenue at the end of year 1. This process of revising the estimates would continue for the 10-year period and therefore may result in a revenue recognition pattern as follows:

Year 1: CU100,000

Year 2: CU 75,000

Year 3: CU 60,000

Years 4-9: CU265,000

Year 10: NIL (assuming that at the end of Year 9 the entity accurately estimates the total amount of consideration)

The particular point to note is that revenues recognized in Years 2-9 convey no information about the entity's performance and relate entirely to updates in the entity's estimate of the transaction price—essentially, the revenue represents a series of 'true-ups'.

33. Because of the concern demonstrated in the example above, at the September 2013 joint Board meeting, the Boards requested that the staff evaluate whether an entity should reassess its estimate of variable consideration. In addition, the Boards asked the staff to evaluate whether to reinstate specific guidance from the 2011 ED that would address the accounting for a sales or usage-based royalty on licenses of intellectual property. In the staff's view, these decisions are clearly linked.

34. The staff think that reassessment should be required in most cases. This is because preventing an entity from reassessing variable consideration, particularly when the performance obligation is satisfied over time, may preclude the entity from appropriately depicting its performance. However, as described above, reassessment in some transactions, particularly licenses of intellectual property, when coupled with an objective that may drive to minimums, may result in revenue recognition in periods that do not relate to the entity's performance.

35. Appendix A outlines two alternatives for reassessment. Both alternatives try to address the concerns related to the revenue recognition pattern that may result for a license of intellectual property with a sales or usage-based royalty. However they achieve the requirement in slightly different ways:

    (a) Alternative 1 – This alternative requires an entity to update the transaction price at each reporting date (paragraph 56.4 in Alternative 1 in Appendix A). In addition, consistent with the 2011 ED, this alternative includes an exception that would preclude an entity from including in the transaction price an estimate of sales or usage-based royalties from licenses of intellectual property until the customer's subsequent sales or usage occur (paragraph 56.5 in Appendix A).

    (b) Alternative 2 – This alternative requires an entity to determine whether to include an estimate in the transaction price when (or as) control of the goods or services transfers to the customer (paragraph 56.4 in Alternative 2 in Appendix A). This means that, broadly, there may be different outcomes for performance obligations satisfied over time and performance obligations satisfied at a point in time. This is because an entity would continue to assess whether to include an estimate in the transaction price as performance occurs for a performance obligation satisfied over time. However, for a performance obligations satisfied at a point in time, if the entity cannot include an estimate when control transfers, the entity would not reassess variable consideration. Instead, the entity would include the variable consideration only when (or as) the uncertainty is resolved (that is, when the consideration is no longer variable). This alternative would also include implementation guidance for licenses that clarifies that when the license provides a right (that is, is a performance obligation satisfied at a point in time) and the estimate fails the constraint when control transfers, the entity should recognize revenue when the uncertainty related to the variable consideration is resolved (for example, when the customer's subsequent sales occur).

36. The Boards included paragraph 85 in the 2011 ED in response to concerns raised on the 2010 ED about the pattern of revenue recognition that would result from applying the general constraint to licenses of intellectual property with sales-based royalties. Paragraph 85 stated that notwithstanding the general requirements of the constraint, if an entity licenses intellectual property to a customer and the customer promises to pay an additional amount of consideration that varies on the basis of the customer's subsequent sales of a good or service (for example, a sales-based royalty), the entity is not reasonably assured to be entitled to the additional amount of consideration until the uncertainty is resolved (that is, when the customer's subsequent sales occur).

37. Paragraph 85 precluded an entity from estimating variable consideration. Therefore, for licenses in which an entity *could* estimate the sales-based royalties with sufficient confidence (for example, a license of a mature, approved drug), the entity would not recognize the revenue when control transfers.

38. The primary advantage of Alternative 1 is to clearly resolve the previous concerns raised about the revenue recognition pattern for sales and usage-based royalties on sales of intellectual property. That is because when an entity transfers control of a license at a point in time, the entity would not be required to estimate variable consideration and revise the estimate at each reporting date throughout the term of the license. This would respond to the feedback where entities noted that they are concerned about revenue recognition patterns similar to those presented in paragraph 32 above that do not provide users of their financial statements with useful information about their performance. The specific requirement would also be helpful for entities that transfer licenses over time because it would provide them with clarity about how to measure their progress and best depict their performance, which many think should be the customer's subsequent sales or usage of their intellectual property. However, one disadvantage of Alternative 1 is that it would not result in any revenue being recognized at the time of transfer for licenses in which an entity *could* estimate the sales-based royalties with sufficient confidence (for example, a license of a mature, approved drug).

39. Another disadvantage of Alternative 1 is that it may result in different outcomes for similar transactions depending on whether the good or service is determined to be a license of intellectual property. The terms 'license' and 'intellectual property' are not defined in U.S. GAAP or IFRS and will not be defined in the proposed revenue standard. In most cases, it may be clear what is a license and what is intellectual property, however, in others it may not. The staff have not received significant questioning about what constitutes a license of intellectual property, however, some have questioned whether it could become a practice issue in the future.

40. The staff observe that in the feedback on the 2011 ED, the Boards received questions about why an exception was made for licenses of intellectual property for applying the constraint and for reassessment. However, there was a significant amount of support amongst preparers and users for the outcomes that paragraph 85 produced. Even those that criticize the lack of conceptual merit acknowledge that it would be operational. Most would prefer the operationality of a limited exception to the continual reassessment over the extended period of a license term.

41. Some of the disadvantages of Alternative 1 are resolved by Alternative 2. This is because Alternative 2 would require an entity to assess the constraint when (or as) control of the goods or services transfers to the customer. For performance obligations satisfied at a point in time, if the entity concludes it does not meet the objective of the constraint, the entity would not reassess variable consideration. Instead, the entity would include the variable consideration only when (or as) the uncertainty is resolved. For example, the uncertainty associated with monthly sales-based royalties would be resolved each month as the customer's sales occur. A distinction between performance obligations satisfied over time from those satisfied at a point in time is that in a performance obligation satisfied over time, it is likely the entity's performance – rather than outside factors – provides new, relevant information allowing the estimate to pass the constraint.

42. An advantage Alternative 2 is that it would eliminate the need to have an exception for licenses of intellectual property. However, it would only provide a

similar outcome for licenses that transfer at a point in time if the entity does not conclude that it should book a minimum amount in accordance with the objective of the constraint. This is because if the entity determined it could book a minimum amount, the entity would be required to reassess the constraint at each reporting period, which would result in the revenue recognition pattern in paragraph 32 above.

43. However an advantage of Alternative 2 is the outcome that it would provide to an entity that sells goods to distributors (provided they are not required to record a minimum amount). It would allow the entity to consider the quality of the evidence available when control transfers. If the entity cannot assert that it is probable / highly probable that there will not be a significant revenue reversal when control transfers, it would essentially default to 'sell-through' accounting. This would provide practical relief to preparers that cannot pass the constraint when control transfers and do not want to continually reassess for the reasons described above.

44. A disadvantage of Alternative 2 is that it puts pressure on the initial constraint evaluation, in particular as it relates to minimums. This is because including a minimum amount would require an entity to reassess its estimates in Alternative 2, which would not achieve the outcomes requested by both users and preparers. In addition, some reviewers have explained that the lack of clarity over whether they are required to estimate sales or usage-based royalties on intellectual property significantly reduces the practical relief of Alternative 2.

45. Initial feedback received from auditors and preparers has shown very little support for Alternative 2. Most said that reassessment is important and should not be precluded in situations other than licenses of intellectual property. In addition, the distinction of reassessment based on when a performance obligation is satisfied has caused confusion when it was included in earlier drafting and many have suggested that they will have difficulty in applying this requirement to contracts that include both performance obligations satisfied over time and at a point in time. Furthermore it places greater pressure on the determination as to whether a performance obligation is satisfied over time or at a point in time, which may be a

factor in a repetitive delivery contract (for example, a series of distinct goods or services) and in licenses.

46. However, Alternative 1 will significantly relieve the tension around requiring an entity to determine whether a license transfers over time or at a point in time. This is because Alternative 1 would require revenue from a sales or usage-based royalty to be recognized as those sales or usage occurs, regardless of whether the license transfer at a point in time or over time.

Should the scope of the paragraph 56.5 in Alternative 1 be expanded?

47. In the December 2012 Agenda Paper 7D/165D the Boards considered whether to expand the scope of the requirement now included in paragraph 56.5 in Alternative 1 in Appendix A. Specifically, the Boards considered expanding the scope to include all consideration that may be contingent on a customer's actions. The Boards did not decide to include that paragraph at that meeting and so the question was not answered. However, the staff do not think that it would be appropriate to expand the scope of paragraph 56.5 because it may lead to unintended consequences. In addition, the staff think that an expanded scope would unnecessarily restrict an entity from estimating variable consideration in cases where the consideration may be contingent on a customer's actions and yet the entity can meet the objective of the constraint (for example, contracts where the customer has a right of return). As a result, it may not appropriately depict performance in those contracts, which may also be exacerbated by the recognition of costs when the entity performs. Furthermore, including an exception in the paragraph for rights of return would increase the complexity of the paragraph.

48. In addition, the staff think that a license of intellectual property (for example, music, brand, franchise, software, biotech) often has characteristics that are different than those of a tangible good that supports limiting the paragraph to only licenses of intellectual property. For example:

(a) A license term may extend over several years

(b) The entity does not incur significant costs to transfer a license because it is generally an intangible asset

(c) The fair value of a license may be difficult to determine because of its unique nature.

Staff recommendation

49. The staff recommend that the Boards adopt Alternative 1. That is:

    (a) Require an entity to update the transaction price at each reporting date (paragraph 56.4 in Alternative 1 in Appendix A).

    (b) Include an exception that would preclude an entity from including in the transaction price an estimate of sales or usage-based royalties from licenses of intellectual property until the customer's subsequent sales or usage occur (paragraph 56.5 in Appendix A).

50. This is because Alternative 1 provides clear guidance for recognizing revenue for licenses of intellectual property with a sales or usage-based royalty. In addition, the requirement would provide practical relief for the entities applying the constraint and the requirement to reassess. Furthermore, the outcomes from applying the exception in paragraph 56.5 of Appendix A was preferred by both users and by preparers. In addition, Alternative 1 would take significant pressure off the requirement to include some, but not all, of the variable consideration that passes the constraint and it would relieve the tension in licenses of determining whether the promise to transfer a license is a performance obligation satisfied at a point in time or over time.

Other clarifications

51. During the drafting process a number of reviewers indicated they were concerned that the constraint required an entity to complete a two-step process of making an estimate using paragraph 55 (see Appendix A) and then applying the constraint to that estimate. Practically, the staff think that many preparers will not go through the two-step process. Rather, the preparers will have the probable / highly probable threshold in mind when they are preparing their estimate of variable

consideration and will therefore meet the objective of the constraint. Nonetheless, the staff think this concern can be fixed in drafting by emphasizing in the basis that the Boards did not expect an entity to strictly apply a two-step process and practically may be able to meet the objective of the constraint with the estimates made in accordance with paragraph 55 (see Appendix A).

Question 1: Objective of the constraint

Do the Boards agree with the objective of the constraint and the level of confidence as outlined in paragraph 56.1 of Appendix A and as follows:

"Include the amount of variable consideration in the transaction price only if it is probable [IFRS: highly probable] that a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal."

Question 2: Reassessment and sales-based royalties

Do the Boards agree with the staff recommendation of Alternative 1 in Appendix A, that is:

(a) Require an entity to update the transaction price at each reporting date (paragraph 56.4 in Alternative 1 in Appendix A).

(b) Include an exception that would preclude an entity from including in the transaction price an estimate of sales or usage-based royalties from licenses of intellectual property until the customer's subsequent sales or usage occur (paragraph 56.5 in Appendix A)?

Appendix A – Drafting alternatives

Variable Consideration

53. If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

53.1. The amount of consideration to which an entity will be entitled can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. The promised consideration also can vary if the entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For example, the amount of consideration promised in a fixed-price contract would be variable if the contract included a right of return.

[53.2 – 54 Intentionally excluded]

55. An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

a. The expected value. The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
b. The most likely amount. The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

56. An entity shall consistently apply one method of estimating the amount of variable consideration in accordance with paragraph 55. In addition, an entity shall consider all the information (historical, current, and forecasted) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration typically would be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for promised goods or services.

56.1. An entity shall include the amount of variable consideration estimated in accordance with paragraph 55 in the transaction price only if it is probable [IFRS:

highly probable] that, based on the assessment of factors in paragraph 56.2, a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal. A significant revenue reversal would occur if a subsequent change in the estimate of the variable consideration would result in a significant downward adjustment on the amount of cumulative revenue recognized from that contract with that customer.

56.2. An entity shall use judgment and consider all facts and circumstances when assessing whether it is probable [IFRS: highly probable] that a subsequent change in an estimate of variable consideration would not result in a significant revenue reversal. This assessment considers both the likelihood of a downward adjustment in the estimate of variable consideration and the magnitude of the possible revenue reversal when the uncertainty related to the variable consideration has been resolved. Factors that indicate that including an estimate of variable consideration in the transaction price could result in a significant revenue reversal include, but are not limited to, the following:

a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors include volatility in a market, the judgment or actions of third parties (for example, the consideration promised by a customer in exchange for a license varies based on the customer's subsequent sales of a good or service), weather conditions, and a high risk of obsolescence of the promised good or service.
b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
c. The entity's experience (or other evidence) with similar types of contracts is limited or that experience (or other evidence) has limited predictive value.
d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
e. The contract has a large number and broad range of possible consideration amounts.

56.3. If an entity expects that including some, but not all, of the estimated amount of variable consideration (that is, a minimum amount) in the transaction price would not result in a significant revenue reversal, the entity shall include that amount (and subsequent changes to that amount) in the estimate of the transaction price.

Reassessment and sales-based royalties		
Reassessment Alternative 1	***Reassessment Alternative 2 (with IGXX below)***	***Key Elements of Alternative 1 and Alternative 2***
56.4. An entity shall update the estimated transaction price at each reporting date to represent faithfully the circumstances present at the reporting date and the changes in circumstances during the reporting period. An entity shall account for changes in the transaction price in accordance with paragraphs 77 – 80.	56.4. An entity shall assess whether or not to include variable consideration in the transaction price when (or as) control of the goods or services transfers to the customer. As a result, for performance obligations satisfied at a point in time, if the entity concludes it cannot an estimate of variable consideration in the transaction price in accordance with paragraph 56.1, then the entity shall not reassess variable consideration after the performance obligation has been satisfied. Rather, the consideration should be included in the transaction price when it is no longer variable. For all other performance obligations, an entity shall update the estimated transaction price at each reporting date to represent faithfully the circumstances present at the reporting date and the changes in circumstances during the reporting period.	Reassessment Alternative 1 requires reassessment at each reporting date. It is supplemented by 56.5 which is similar to paragraph 85 in the 2011 ED. Licenses of intellectual property with sales-based royalties would not estimate variable consideration. Rather, they would not include the variable consideration until the uncertainty is resolved (the customer's sales occur) Reassessment Alternative 2 precludes reassessment after a performance obligation satisfied at a point in time has been satisfied. An entity would assess the constraint when control transfers. If the constraint is not passed, an entity would not include the variable consideration until the uncertainty is resolved (for example, the customer's sales occur each month or the return period expires)
56.5. If a portion of the consideration to which the entity is entitled is variable and a portion is fixed (for example, a guaranteed minimum amount), the	56.5. An entity shall account for changes in the transaction price in accordance with paragraphs 77–80.	For example, a fixed minimum is included in the transaction price A sales-based royalty is variable consideration until the customer's sales occur. Each

entity shall include the portion that is fixed in the transaction price. The entity shall consider whether to include the variable portion in accordance with paragraphs 53 – 56.3.		month, a portion of the variable consideration becomes fixed
56.6. Notwithstanding the requirements in paragraphs 56.1 – 56.5, if an entity licenses intellectual property in which the consideration is in the form of a sales or usage-based royalty, the entity shall include that consideration in the transaction price only when the subsequent sales or usage occur.	[Not used]	This is similar to paragraph 85 in the 2011 ED Applies only to licenses of intellectual property with sales or usage-based royalties Precludes an entity from estimating variable consideration for the sales-based royalty Sales-based royalties would be included in the transaction price only when they are no longer variable (that is, as the customer's sales occur)

[Not used]	IGXX. If a license provides a customer with a right to use the entity's intellectual property (thus the license transfers at a point in time) and consideration varies on the basis of the customer's subsequent sales or usage of a good or service (for example, a sales-based royalty), the entity may not be able to reasonably estimate the amount to which the entity will be entitled for the goods or services transferred to date. In those cases, the entity shall recognize revenue when the uncertainty related to the variable consideration is resolved (for example, when the customer's subsequent sales occur).	Implementation guidance for licensors to make it clear that if they fail the constraint when control transfers, the sales-based royalties cannot be included in the transaction price until the uncertainty is resolved

Appendix B – Illustrative examples

Example 1—Book Sales with a Right of Return (Sell-In / Sell-Through)

On January 1, an entity delivers 500 copies of a new book to a customer (a distributor) for $50,000 ($100 per book) and control of the books transfers to the customer at that time. Payment of the $50,000 is received by the entity on January 1, and the entity agrees that the customer can return any unsold copies of the book within 12 months.

The consideration is variable because the entity's entitlement to the consideration is contingent upon whether the customer exercises its rights to return any of the books.

Based on projections in the entity's business plans, which incorporated information from market studies about prior sales of books by similar authors and by other authors in the same genre, it is probable [IFRS: highly probable] that the number of books returned will not exceed 100 in the 12-month period.

When considering the indicators in paragraph [56.2], the entity determines that it is probable [IFRS: highly probable] that recognizing revenue of $40,000 (in other words, assuming 100 books are returned) would not result in a significant revenue reversal.

Consequently, the entity recognizes revenue of $40,000 at January 1. The entity reassesses this estimate at each reporting date until the uncertainty is resolved in accordance with paragraphs [56.3 and 56.4].

Example 2—Management Fees Subject to Constraint

On January 1, an entity enters into a contract with a client to provide asset management services for 5 years. The entity will receive a performance-based incentive fee of 20 percent of the fund's return in excess of the return of an observable market index as measured at the end of the 5-year period. This fee is variable consideration as described in paragraph [53.1].

In considering the indicators in paragraph [56.2], the entity determines that its experience with similar contracts is of little predictive value in determining the future performance of the market because the amount of incentive consideration is highly susceptible to factors outside of the entity's influence, that is, volatility in the observable market index as compared to the return of the fund. In addition, the incentive fee has a large number and broad range of possible consideration amounts.

When considering the indicators in paragraph [56.2], the entity determines that it is not probable [IFRS: highly probable] that a subsequent change in the estimate of variable consideration would not result in a significant revenue reversal.

Consequently, the entity includes no estimate of the incentive fee in the transaction price at contract inception. Although the entity reassesses this estimate at each reporting period in which the uncertainty is not yet resolved, due to the nature of the uncertainty (market index), it is not probable [IFRS: highly probable] at any time over the 5-year period that including an amount would not result in a significant revenue reversal. The entity recognizes the incentive fee as revenue at the end of the 5-year period when the uncertainty relating to the incentive fee is resolved.

Example 3—Construction Contract with Variable Consideration Where the Estimate Fails the Constraint at Contract Inception

An entity enters into a contract with a customer to provide a service of building a customized asset. The service represents a performance obligation that is satisfied over time. The contractual price of the service is made up of a fixed amount of $1 million and a performance bonus that can range from $100,000 to $750,000. The performance bonus is based on the degree to which the customized asset achieves several milestones on completion. The entity has not built this type of asset in the past and consequently does not have experience with similar types of contracts.

The entity does not have experience providing similar services. Based on the internal budgeting that was used during the bid and proposal process for the construction services, the entity identified a wide range of possible outcomes for the performance bonus, however, the entity determines that it is probable [IFRS: highly probable] that the performance bonus will not be lower than $100,000.

When considering the indicators in paragraph [56.2], the entity determines that it is probable [IFRS: highly probable] that including the amount of $100,000 of variable consideration in the transaction price would not result in a significant revenue reversal.

Consequently, the entity includes $1,100,000 (the fixed amount of $1 million and the variable portion of $100,000) in the transaction price. The entity reassesses this estimate at each reporting date until the uncertainty is resolved.

Example 4—Sales-Based Royalty on License of Intellectual Property

An entity licenses its intellectual property (IP) for a 10-year period. The entity will receive a percentage of the customer's sales as consideration (that is, a sales-based royalty). There are no other performance obligations in the contract. The entity concludes that the license represents a right to use its underlying intellectual property which results in a performance obligation satisfied at a point in time.

At the outset of the license agreement, the entity estimates variable consideration over the 10-year period to be $1.5 million, but there is a wide range of realistically possible royalty receipts and the amount is highly susceptible to many factors outside the entity's influence.

Reassessment Alternative 1 – exception for licenses of intellectual property

The entity includes the consideration in the transaction price only when the customer's subsequent sales occur and recognizes revenue as the amounts become due from the customer.

<u>Reassessment Alternative 2 – no reassessment for a performance obligation satisfied at a point in time</u>

The entity determines that it cannot meet the objective of the constraint when the performance obligation is satisfied. Since the performance obligation was satisfied at a point in time, the entity concludes that it does not need to reassess and can recognize revenue as the customer's subsequent sales occur.