STAFF PAPER

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Project	FASB/IASB Joint Transition Resource Group for Revenue Recognition
Paper topic	Impairment testing of capitalised contract costs

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Purpose

1. The purpose of this paper is to discuss the implementation of some specific paragraphs in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, and IFRS 15 *Revenue from Contracts with Customers* (collectively referred to as the "new revenue standard") that provide guidance on impairment testing of the asset recognised from the incremental costs of obtaining a contract or costs incurred in fulfilling a contract with a customer (the 'capitalised contract costs').

2. The implementation issue particularly relates to the interaction between paragraph 102 [340-40-35-4] and paragraph 101(a) [340-40-35-3(a)]. These paragraphs require an entity, for the purposes of impairment testing, to determine the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates using the principles for determining the transaction price.

Background

3. Paragraph 99 [340-40-35-1] states that (emphasis added):

> An asset recognised in accordance with paragraph 91 [340-40-25-1] or 95 [340-40-25-5] shall be amortised on a

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> systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. *The asset may relate to goods or services to be transferred under a specific anticipated contract* (as described in paragraph 95(a) [340-40-25-5(a)]).

4. Paragraph 101 [340-40-35-3] states that (emphasis added):

> An entity shall recognise an impairment loss in profit or loss to the extent that the carrying amount of an asset recognised in accordance with paragraph 91 [340-40-25-1] or 95 [340-40-25-5] exceeds:
>
> (a) *the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates*; less
>
> (b) the costs that relate directly to providing those goods or services and that have not been recognised as expenses (see paragraph 97 [340-40-25-7]).

5. The requirements in paragraphs 99 [340-40-35-1] and 101 [340-40-35-3] are consistent in that an entity, for the purposes of amortisation or impairment testing, not only considers the goods or services that will be transferred to the customer as promised in accordance with the existing contract but also the goods or services that will be transferred under a specific anticipated contract (for example, goods or services to be provided on renewal or extension of the contract) if the asset also relates to those goods or services to be transferred under the specific anticipated contract. In other words, an entity considers the total period over which it expects to receive the economic benefits relating to the asset both for the purpose of determining the amortisation period and for estimation of cash flows for the purpose of impairment testing.

6. Paragraph 102 [340-40-35-4] states that (emphasis added):

> For the purposes of applying paragraph 101 [340-40-35-3] to determine the amount of consideration that an entity expects to receive, *an entity shall use the principles for determining the transaction price* (except for the

> requirements in paragraphs 56–58 [606-10-32-11 through 32-13] on constraining estimates of variable consideration) and adjust that amount to reflect the effects of the customer's credit risk.

7. The guidance on determining the transaction price is provided in paragraphs 47–49 [606-10-32-2 through 32-4]. Paragraph 49 [606-10-32-4] states that for the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract *and that the contract will not be cancelled, renewed or modified* (emphasis added). Accordingly, for contracts that contain extension or renewal options (either explicitly in the contract or as a matter of business practice) and that are expected to be extended or renewed, the entity will not consider extensions or renewals when determining the transaction price.

Potential implementation issue

8. The implementation question arises because paragraph 102 [340-40-35-4] read with paragraph 49 [606-10-32-4] could be interpreted as overriding the requirements in paragraph 101 [340-40-35-3]. In other words, the implementation issue arises from the use of the principles for determining the transaction price to ascertain the cash flows that the entity expects to receive in exchange for the goods or services to which the asset relates, especially the question of whether or not the consideration expected to be received during renewal or extension periods should be considered in the impairment analysis. The staff are aware of two views.

View 1 based on the application of paragraph 49 [606-10-32-4] —renewals and extensions may not be considered for impairment test

9. Under this view, paragraph 102 [340-40-35-4] read with paragraph 49 [606-10-32-4] could be considered as restricting an entity from assuming extension or renewal of the contract for the purposes of computing the future cash flows for impairment testing. This is because paragraph 49 [606-10-32-4] prohibits an entity from assuming contract renewals or modifications in determining the

transaction price. Accordingly, in using the principles for determining the transaction price when ascertaining the cash flows for impairment testing, the entity would not include the cash flows from anticipated renewal or extension periods for the purposes of paragraph 101(a) [340-40-35-3(a)]. Consequently, an entity may have to immediately impair the asset to the extent the capitalised contract costs exceed the consideration that the entity expects to receive during the initial contract period.

View 2 based on principles in paragraphs 99 [340-40-35-1] and 101 [340-40-35-3] —renewals and extensions may be considered for impairment test

10. As explained earlier in this paper, paragraphs 99 [340-40-35-1] and 101 [340-40-35-3] define the boundary of the period to be considered by an entity for amortisation and the impairment testing of the capitalised contract costs. This period essentially represents the period over which the entity expects to realise the economic benefits in the form of consideration from the transfer of goods and services to which the asset relates. The entity may determine that the asset relates to the goods and services to be transferred to the customer during the existing contract and / or specific anticipated contract. This is consistent with paragraph 95(a) [340-40-25-5(a)] which requires an entity to capitalise costs to fulfil a contract that directly relate to a contract or to an anticipated contract that the entity can specifically identify.

11. Under this view, the requirement in paragraph 102 [340-40-35-4] to use the principles for determining the transaction price is read as providing guidance only for the purpose of projecting the cash flows that the entity expects to receive in exchange for the goods or services to which the capitalised contract costs relate. Therefore, when determining the remaining amount of consideration that the entity expects to receive in exchange for the goods or services as required by paragraph 101(a) [340-40-35-3(a)], the entity will consider the cash flows that it expects to receive during contract extensions or renewals if the asset also relates to the goods or services that the entity expects to transfer during the extension or renewal periods.

12. Although paragraph 102 [340-40-35-4] requires an entity to use the principles for determining the transaction price for estimating the future cash flows for

impairment testing, paragraph BC310 in the Basis for Conclusions states that the objective for measuring and recognising impairments of capitalised contract costs is different from the measurement objective of revenue. The impairment objective is to determine whether the carrying amount of the capitalised contract costs is recoverable. Under this view, to meet the overall objective of impairment, an entity would consider the economic benefits from anticipated contract extensions or renewals if the asset relates to the goods and services that will be transferred during those extension or renewal periods.

13. Further, Example 37 (paragraphs IE192–IE196) of the Illustrative Examples to IFRS 15 [Example 2 of the Illustrations in Subtopic 340-40 (paragraphs 340-40-55-5 through 55-9)] illustrates that the period of amortisation could be longer than the stated term of the contract. The facts of the Example are that an entity enters into a service contract to manage a customer's information technology data centre for five years and the contract is renewable for subsequent one-year periods. The average customer term is seven years and the entity amortises the capitalised contract costs over seven years because it expects to receive the economic benefits over the seven year term, which includes the two anticipated one-year renewal periods. In the Example, under this view, the entity is most likely to evaluate impairment based on the cash flows over the seven year period instead of five years.

Questions for TRG Members

1. What are your views about the potential implementation issue included in this paper?
2. Are you aware of other interpretations for the issue not included in this paper?
3. Are there any related potential interpretation issues not included in this paper?