IFRS FASB FINANCIAL ACCOUNTING STANDARDS BOARD

STAFF PAPER

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Project	FASB/IASB Joint Transition Resource Group for Revenue Recognition		
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Background and purpose

1. IFRS 15 *Revenue from Contracts with Customers* and Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers* (collectively referred to as the 'new revenue standard') provide guidance on identifying the contract to be accounted for (Step 1 of the revenue model – identify the contract with the customer).

2. A *contract* is defined in the new revenue standard as 'an agreement between two or more parties that creates enforceable rights and obligations.' Existence of a contract, which means that there are enforceable rights and obligations, is a precondition for revenue recognition under the new revenue standard.

3. Some stakeholders have raised questions about how termination clauses in a contract are evaluated in determining the duration of the contract. The duration of the contract can affect the amount of revenue recognised each period. This paper includes a summary of the potential implementation issue that stakeholders have reported to the staff.

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Accounting guidance

4. Paragraphs 11 and 12 [606-10-25-3 and 25-4] provide guidance on when a contract exists when applying the new revenue standard:[1]

    11 Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply this Standard to the duration of the contract (ie the contractual period) *in which the parties to the contract have present enforceable rights and obligations*. [Emphasis added.]

    12 For the purpose of applying this Standard, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract *without compensating the other party* (or parties)… [Emphasis added.]

5. The Basis for Conclusions explains:

    BC50 The boards decided that IFRS 15 [ASU 2014-09] should not apply to wholly unperformed contracts if each party to the contract has the unilateral enforceable right to terminate the contract *without penalty*. Those contracts would not affect an entity's financial position or performance until either party performs. In contrast, there could be an effect on an entity's financial position and performance if only one party could terminate a wholly unperformed contract *without penalty*… [Emphasis added.]

6. Basis for Conclusions paragraph BC391 also discusses the effect of termination (or cancellation) provisions in determining the contract term under the new revenue standard. This paragraph states the following:

    BC391. A renewal option gives a customer the right to acquire additional goods or services of the same type as

[1] Paragraph references within '[XX]' are from the FASB *Accounting Standards Codification*.

> those supplied under an existing contract. This type of option could be described as a renewal option within a relatively short contract (for example, a one-year contract with an option to renew that contract for a further year at the end of the first and second years) *or a cancellation option within a longer contract (for example, a three-year contract that allows the customer to discontinue the contract at the end of each year)*. A renewal option could be viewed similarly to other options to provide additional goods or services. In other words, the renewal option could be a performance obligation in the contract if it provides the customer with a material right that it otherwise could not obtain without entering into that contract. [Emphasis added.]

Potential implementation issue

How should termination clauses be evaluated in determining the duration of a contract (that is, the contractual period)?

7. Some stakeholders have asked whether the contractual period should be restricted to reflect the expected termination date if each party to the contract has a unilateral enforceable right to terminate the contract. Below are some considerations about how stakeholders think that termination clauses should be considered.

8. In determining the contractual period in which the parties have present enforceable rights and obligations, paragraph 11 [606-10-25-3] does not explicitly explain how termination penalties should be considered. However, some stakeholders have asserted that the guidance in paragraphs 11 and 12 [606-10-25-3 and 25-4], together with the explanation in BC50, suggests that a contract *exists* if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract only *by compensating the other party*. Accordingly, those stakeholders think that a contract *continues to exist* during the specified contractual period even if each party to the contract has the unilateral enforceable right to terminate the contract at any time during the specified contractual period

by compensating the other party. This is because enforceable rights and obligations exist throughout the contractual period, evidenced by the fact that compensation would be required to terminate the contract. In other words, on termination, parties to the contract waive those enforceable rights and avoid their obligations by paying compensation.

9. Some stakeholders also point to paragraph 49 [606-10-32-4] that, in the context of determining the transaction price, states that the entity should assume the contract will *not* be cancelled. However, BC186 makes clear that paragraph 49 applies in the context of having already identified the contract with the customer.

10. It should be noted that the guidance in paragraphs 11 and 12 [606-10-25-3 and 25-4] refers to whether the termination requires *compensating the other party*. Some stakeholders have shared a narrow interpretation of this guidance, asserting that the guidance refers only to termination penalties. Other stakeholders take a broader view that compensating the other party is any amount related to something other than payments due as a result of goods delivered or services transferred up to the termination date and, therefore, that it is not restricted only to payments explicitly characterized as termination penalties.

11. Considering the guidance outlined above, some stakeholders think that an entity could reach the following conclusions:

    (a) If a contract can be terminated by each party at any time without compensating the other party for the termination (that is, other than paying amounts due as a result of goods or services transferred up to the termination date), the duration of the contract does not extend beyond the goods or services already transferred. This is the case whether or not the contract has a specified contract period. Some stakeholders think this scenario is the intent behind the discussion in paragraph BC391 because the right to cancel the contract is no different than a right to renew the contract. Whether it is a right to cancel the contract or a right to renew the contract, a party to the contract must elect to do, or not do, something (to renew the contract or not to cancel the contract).

> *Example 1*
>
> An entity enters into a service contract with a customer under which the entity continues to provide services until the contract is terminated. Each party can terminate the contract without compensating the other party for the termination (that is, there is no termination penalty).
>
> The duration of the contract does not extend beyond the services already provided.

(b) If each party can terminate the contract without compensating the other party and the termination right can be exercised only after a specified minimum period, the duration of the contract is up to the point at which the contract can be terminated.

> *Example 2*
>
> An entity enters into a contract with a customer to supply services for two years. Each party can terminate the contract at any time after fifteen months from the start of the contract without compensating the other party for the termination.
>
> The duration of the contract is fifteen months.

(c) In Examples 1 and 2, any right to consideration at the point at which the contract is terminated would be unconditional (that is, a receivable). In other words, the right to consideration would not be conditional upon any future performance. If a contract can be terminated by either party by compensating the other party, the duration of the contract is either the specified contractual period or the period up to the point at which the contract can be terminated without compensating the other party.

> *Example 3*
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> An entity enters into a contract with a customer to provide services for two years. Either party can terminate the contract by compensating the other party.
>
> The duration of the contract is the specified contractual period of two years.
>
> *Example 4*
>
> An entity enters into a contract with a customer to supply services for five years. The entity earns a fixed fee each quarter and, if specified performance

metrics are met, the entity will be entitled to a performance bonus at the end of the five-year service period (which will be paid at that time). Either party can terminate the contract at any time after two years; however, if the contract is terminated, the customer must pay a fee equivalent to the performance bonus it would otherwise only pay at the end of the contract.

The duration of the contract is five years. If the contract is terminated, the customer must make a payment that it would otherwise not have to make until the end of the contract term and the payment is based on conditions that might have changed over the full term of the contract. This indicates that at contract inception enforceable rights and obligations exist beyond the first two years.

(d) If the entity has a past practice of not enforcing the collection of a termination penalty to which it is contractually entitled, some stakeholders have asked whether the past practice affects the assessment of the contract term.

Example 5

An entity enters into a contract to provide services for 24 months. Either party can terminate the contract by compensating the other party. The entity has a past practice of allowing customers to terminate the contract at the end of 12 months without enforcing collection of the termination penalty.

In this case, whether the contractual period is 24 months or 12 months depends on whether the past practice is considered by law (which may vary by jurisdiction) to restrict the parties' enforceable rights and obligations. The entity's past practice of allowing customers to terminate the contract at the end of month 12 without enforcing collection of the termination penalty affects the contract term in this example *only* if that practice changes the parties' legally enforceable rights and obligations. If that past practice does not change the parties' legally enforceable rights and obligations, then the contract term is the stated term of 24 months.

12. Stakeholders note that when an entity concludes that the contractual term is less than the stated term because of a termination clause, the following are some of the possible consequences:

(a) In contracts containing multiple performance obligations, allocation of the transaction price may be significantly affected for a contract with a specified term of two years that is determined to be of one year duration

(because of a termination clause) compared with the two-year duration (if the termination clause were not considered).

(b) The termination penalty, if any, would be considered part of the transaction price. The termination penalty may be variable, in which case the guidance on variable consideration, including the constraint, would be applied.

(c) The periods covered by the termination provisions would be assessed in the same manner as renewal options (that is, whether the renewal options provide the customer a material right).

Question for TRG members
Do you think that the new revenue standard can be applied consistently in determining the duration of the contract in each of the above examples?