STAFF PAPER

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IASB Meeting

Project	**Revenue from Contracts with Customers**		
Paper topic	Constraining estimates of variable consideration when the consideration varies based on a future market price		

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Purpose of this paper

1. Some stakeholders have asked whether the requirement in IFRS 15 *Revenue from Contracts with Customers* to constrain estimates of variable consideration must be applied to variability arising solely from changes in market prices such as a commodity price.

2. The purpose of this paper is to:

   (a) consider whether the requirement in paragraphs 56–58 in IFRS 15 ('the variable consideration constraint') must be applied to consideration that varies based on a future market price; and

   (b) ask the IASB if it agrees with the staff's analysis.

3. The paper is structured as follows:

   (a) background and issue description;

   (b) staff analysis and conclusions; and

   (c) question for the IASB.

Background and issue description

4. If the consideration promised in a contract includes a variable amount, paragraph 50 of IFRS 15 requires an entity to estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer. Paragraph 51 of IFRS 15 describes types of variable consideration that may occur in a contract with customer.

> An amount of consideration can vary because of *discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items*. The promised consideration can also vary if *an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event*. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone. [emphasis added]

5. Paragraph 56 of IFRS 15 requires an entity to include in the transaction price some or all of an amount of estimated variable consideration only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved. The objective of this variable consideration constraint is to reduce the risk of subsequent reversals of revenue, but not to eliminate the use of estimates. As explained in paragraph BC206 of the Basis for Conclusions on IFRS 15, the IASB considered the feedback from users of financial statements, a majority of whom indicated that the most relevant measure for revenue in a reporting period would be one that will not reverse in a subsequent period. That is because an amount that would not reverse in the future would help users of financial statements better predict future revenues of an entity.

6. The type of circumstances that the IASB considered when developing the requirements relating to variable consideration in IFRS 15, and that were envisaged in

the drafting of paragraph 51 of IFRS 15, capture scenarios in which the uncertainty is related to future events that might affect the amount of consideration to which the entity will be entitled. These include, for example, uncertainty related to an entity's performance (a performance-based incentive bonus), quality of the promised goods or services (eg a machine performing as promised or meeting particular specifications), possible actions by customers or third parties (eg returns or volume discounts). The staff think that it is clear that the variable consideration constraint applies to these types of cases.

7. However, in some cases the consideration is variable even after the entity has satisfied its performance obligation and no other event needs to occur before the entity is entitled to the consideration or that consideration is due. The staff think such cases could arise if the amount of consideration varies based on a future market price. An example is a provisionally priced commodity contract. Consider the following example.

> An entity enters into a contract with a customer on 30 September 20X0 to deliver Commodity on 1 January 20X1 (which is when the performance obligation is satisfied). Payment is due on 30 June 20X1 based on the spot price of Commodity on that date.[1]

8. In this example, stakeholders have asked how the entity should determine the transaction price when it delivers Commodity, specifically whether the entity must apply the variable consideration constraint to the variability arising from changes in the market price of Commodity from the delivery date until the payment date. If the entity is required to apply the variable consideration constraint, it must include in the transaction price an estimated amount of variable consideration only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty is subsequently resolved. Consequently, from the delivery date until the payment date, the entity would need to determine the transaction price based on its expectations of the future market price of

[1] The entity has determined that the contract is not within the scope of IFRS 9 *Financial Instruments* in its entirety (eg the contract is an 'own use' contract as described in paragraph 2.4 of IFRS 9).

Commodity that is not subject to a significant reversal; ie the price that is highly probable that Commodity will not fall below before payment date.

9. Some stakeholders think that it is challenging to apply the variable consideration guidance in these circumstances. They have also expressed concern about the resulting financial reporting if the variable consideration constraint is applied in these circumstances and questioned whether the revenue reported in the periods from the delivery date to the payment date would be meaningful.

10. They think that it would be challenging for the entity to estimate the future market price that is not subject to a significant reversal, especially if the market price of Commodity has been volatile. For example, some have argued that in order to avoid a subsequent significant reversal in this example, the entity would not be able to recognise any revenue at all or would be able to recognise only a small amount of revenue until payment is received.

11. They also think that such a result would not provide useful information to the users of financial statements. For instance, because of the challenges noted in the preceding paragraph, the financial information that would result from applying the variable consideration constraint would be unlikely to provide a faithful depiction of the value of the entity's performance and its entitlement to consideration. Furthermore, that financial information would be less comparable across reporting entities compared to using market price information because, for example, entities would have different views about the price that Commodity will not fall below.

12. Consequently, they think that the income statement at each reporting date should reflect the market's expectations for the future price without the overlay of the variable consideration constraint.

Staff analysis and conclusions

13. In this paper we are not analysing or giving our opinion on (a) whether an entity is required to assess a contract with a customer for embedded derivatives; *or* (b) if an

entity performs such an assessment, whether the requirements for separation in IFRS 9 are met.

14. However we acknowledge that in the Commodity example above, if the entity concludes that it must assess the contract for embedded derivatives and that the variability associated with the market price of Commodity must be accounted for separately as a derivative in accordance with IFRS 9, then the question of applying the variable consideration constraint in IFRS 15 becomes irrelevant. That is because there is no other variability to be accounted for under IFRS 15; ie the ‘host’ revenue contract that remains within the scope of IFRS 15 would not have any variability (the variability is in the separated derivative).

15. Nonetheless, even if the entity concludes that the contract is entirely within the scope of IFRS 15, ie the entity does not separately account for an embedded derivative, we think that an entity could reasonably conclude that the variability arising solely from changes in the market price of Commodity would not be subject to the variable consideration constraint in IFRS 15. That is because a receivable would exist at the delivery date and the entity would be required to account for that receivable in accordance with IFRS 9.

16. Paragraph 108 of IFRS 15 states that:

> A receivable is an entity’s right to consideration that is unconditional. A right to consideration is unconditional if *only the passage of time is required before payment of that consideration is due*. For example, an entity would recognise a receivable if it has a present right to payment even though that amount may be subject to refund in the future. An entity shall account for a receivable in accordance with IFRS 9… [emphasis added]

17. This description of a receivable in IFRS 15 implies that if *something else* must happen before the payment of consideration is due, then the right is not unconditional.

18. In the Commodity example, *nothing else* (ie no future event) needs to happen before payment of the consideration is due. The existence of a price in the future requires no

event to occur and depends solely on the passage of time. Changes in the price of Commodity do not affect the entity's right to consideration, even though the amount that the entity receives is known only on the payment date. In other words, there is no uncertainty with regards to the entity's **entitlement** to the consideration. The entity's right to consideration is therefore unconditional as understood by IFRS 15 and the entity would recognise a receivable when it delivers Commodity on 1 January 20X1. Paragraph 108 of IFRS 15 requires that a receivable is accounted for in accordance with IFRS 9, and thus the variable consideration constraint would not apply to the variability arising from changes in the market price of Commodity after 1 January 20X1. Instead those changes would be measured in accordance with IFRS 9.

19. We think that our conclusion in paragraph 18 is consistent with the IASB's rationale for the requirements for variable consideration in paragraph 51 of IFRS 15 (which is reproduced in paragraph 4 of this paper). In other words, we think that variability arising solely from changes in market prices is different from the types of variability that the IASB considered when it developed the variable consideration constraint. That is because the variability considered by the IASB—and set out in paragraph 51 of IFRS 15—relates to an entity's performance (a performance-based incentive bonus), quality of the promised goods or services (eg a machine performing as promised or meeting particular specifications), possible actions by customers or third parties (eg returns or volume discounts)—not variability arising solely from changes in market prices. In addition, paragraph 51 of IFRS 15 states that 'the promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event'. As set out above, the future market price of a commodity does not affect the entity's entitlement to the consideration but instead affects only the amount of consideration.

20. Moreover, we think our conclusion is consistent with other requirements in IFRS 15.

(a) **Non-cash consideration**—For contracts in which a customer promises consideration in a form other than cash, the entity must measure the non-cash consideration (or promise of non-cash consideration) at fair value.

Paragraph 68 of IFRS 15 states that the fair value of the non-cash consideration may vary because of the form of the consideration (eg a change in the price of a share to which an entity is entitled to receive from a customer). If the fair value of the non-cash consideration varies *for reasons other than only the form of the consideration* (eg the entity's performance), the entity must apply the variable consideration constraint in paragraphs 56–58 of IFRS 15. Hence, changes in the fair value of non-cash consideration arising from only the form of the consideration are not constrained. Paragraph BC252 of the Basis for Conclusions on IFRS 15 explains that decision[2] and suggests that if an entity is entitled to a variable number of shares of a customer depending upon the quality of its services, the entity would constrain the estimate of the *number* of shares to which it expects to be entitled but it would not constrain changes in the share *price*. We think this outcome is consistent with our conclusion that variability arising solely from changes in the market price of Commodity would not be subject to the variable consideration constraint in IFRS 15.

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[2] Paragraph BC252 of IFRS 15 states that:

The boards decided that it would be most appropriate to apply the requirements for constraining estimates of variable consideration to the same types of variability regardless of whether the amount that will be received will be in the form of cash or non-cash consideration. *Consequently, the boards decided to constrain variability in the estimate of the fair value of the non-cash consideration if that variability relates to changes in the fair value for reasons other than the form of the consideration (ie for reasons other than changes in the price of the non-cash consideration)*. For example, if an entity is entitled to a performance bonus that is payable in the form of non-cash consideration, the entity would apply the requirements for constraining estimates of variable consideration to the uncertainty of whether the entity will receive the bonus, because that uncertainty is related to something other than the form of the consideration (ie the entity's performance)… [emphasis added]

(b) **Contracts denominated in a foreign currency**—Similarly, for contracts in which the consideration is denominated in foreign currency, variability in the consideration arising from changes in the foreign currency exchange rates is accounted for in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*.[3] In other words, the variable consideration requirements in IFRS 15 do not apply because the amount of consideration in the foreign currency is fixed. Similarly to the point about non-cash consideration in the preceding paragraph, this highlights that not all variability in the amount of consideration to which the entity will be entitled is subject to the variable consideration constraint in IFRS 15.

Question for the IASB

Does the IASB agree with the staff's analysis and conclusion that variability arising solely from changes in a market price would not be subject to the variable consideration constraint in IFRS 15?

[3] During its discussions leading to the development of Draft IFRIC Interpretation *Foreign Currency Transactions and Advance Consideration*, the IFRS Interpretations Committee agreed with the staff analysis in Appendix C of Agenda Paper 5 of the January 2015 meeting and Agenda Paper 2 of the March 2015 meeting. In those papers, the staff concluded that variable consideration requirements in IFRS 15 do not apply to variability in value that is only due to movements in foreign exchange rates because exchange rate movements do not alter the amount of the foreign currency consideration to which the entity is entitled under the contract.