STAFF PAPER

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Project	**FASB-IASB Joint Transition Resource Group for Revenue Recognition**
Paper topic	Variable Consideration

CONTACT(S)	Philip Hood	prhood@fasb.org	+1 203 956 5386
	Mary Mazzella	msmazzella@fasb.org	+1 203 956 3434
	Scott Muir	samuir@fasb.org	+1 203 956 3478
	Raghava Tirumala	rtirumala@ifrs.org	+44 207 246 6953

Purpose

1. This paper addresses two questions that stakeholders have raised regarding the guidance on variable consideration 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").

2. The staff plans to ask the members of the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG) for their views on each of the topics included in this paper.

Background

3. In Step 3 of the new revenue standard, an entity must consider the terms of the contract and its customary business practices to determine the transaction price. In determining the transaction price, an entity is required to consider variable consideration and constraints on estimates of variable consideration. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.

4. Paragraph 606-10-32-5 [50] states that if the consideration in a contract includes variable consideration, the entity is required to estimate the amount of variable consideration to which it is entitled to in exchange for transferring the promised good or service to the customer. Paragraphs 606-10-32-11[64] through 32-12 [65] provide guidance on constraining estimates of variable consideration. The transaction price includes an entity's estimate of variable consideration only to the extent that it is probable [highly probable] that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. Additionally, the new revenue standard provides a list of factors to consider when evaluating whether the revenue reversal is probable [highly probable].

5. This paper addresses two questions related to variable consideration and the constraint. Those questions relate to the following:
   (a) When an entity should recognize consideration payable to a customer
   (b) Whether the constraint on variable consideration should be applied at the contract level or the performance obligation level.

6. The guidance on variable consideration encompasses many different types of transactions that occur in contracts with customers. While this paper is not intended to address all of the questions on variable consideration, the staff would be interested in hearing if TRG members have other questions in this area of the new revenue standard.

Question 1: When Should an Entity Recognize Consideration Payable to a Customer?

7. Some stakeholders have questioned when an entity should recognize consideration payable to a customer, which occurs in Step 3 (Determine the Transaction Price) of the new revenue standard. The question arises due to the interaction of the guidance on constraining variable consideration and the guidance on consideration payable to the customer.

8. Paragraph 606-10-32-27 [72] provides the following guidance on the timing of recognizing consideration payable to a customer:

> Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognize the reduction of revenue when (or as) the later of either of the following events occurs:
>
> a. The entity recognizes revenue for the transfer of the related goods or services to the customer.
>
> b. The entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

9. Paragraph 606-10-32-25 [70] provides the following guidance on recognizing consideration payable to a customer that is variable:

> If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 606-10-32-5 through 32-13.

10. Paragraph 606-10-32-6 [51] provides the following guidance on what constitutes variable consideration:

> 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 also can vary if an entity's entitlement to the consideration is contingent on the occurrence or nonoccurrence 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.

11. The question on consideration payable to a customer in the new revenue standard is related to situations in which an entity promises to pay consideration to a customer *after* it recognizes revenue for the transfer of goods or services to the customer. This is because some stakeholders assert that the variable consideration guidance would require recognition of the consideration payable to a customer (that is, a reduction of revenue) when revenue is recognized; whereas, the guidance on consideration payable to the customer might indicate that a later date is acceptable. Consider the following example:

> An entity that manufactures consumer goods enters into a contract to sell a new product to a customer (a retail store chain) on December 15th. Before delivering any of the new products to the retail store chain, the entity's marketing department assesses whether the entity should offer CU1-off coupons in newspapers to encourage consumers to buy the new product. The entity will reimburse the retail store chain for any coupons that are redeemed. The entity has not historically entered into similar coupon offerings in the past.
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> The entity delivers the new consumer goods (1,000 units at CU10/unit) to the retail store chain on December 28th. Assume for this example, that the customer has no right to return the products. On December 31st, the entity decides to make the coupon offering. On January 2nd, the entity communicates to its customer that it will reimburse the retail store chain on March 30th for any coupons redeemed by the retail store's customers. Assume the entity prepares its financial statements based on a calendar year end.

12. Some stakeholders assert that the entity should include an estimate of the consideration it expects to pay the retail store chain when it recognizes revenue on December 28th for the products delivered to the customer. Other stakeholders assert that the entity should wait until either January 2nd (when the entity promises the consideration) or March 30th (when the entity pays the consideration) to recognize the consideration payable to the customer.

13. The specific facts and circumstances of the arrangement will impact the entity's conclusion about whether the CU1,000 of consideration payable to a customer (1,000 units x CU1/unit rebate, for simplicity, ignore the effects of potential breakage) should be recognized on December 28th (the date revenue is recognized), January 2nd (the date the entity promises to pay the consideration to its customer),

or some date in between. In this example, the staff does not think March 30th would be an acceptable date to recognize the consideration payable to the customer. If the entity waited until March 30th to recognize the reduction in revenue, the CU1,000 reduction in revenue would not be recognized until after it recognizes revenue *and* after it makes a promise to pay the customer.

14. Paragraph 606-10-32-43 [88] states that changes in the transaction price for satisfied performance obligations (such as, in the example above, the transferred products) shall be recognized as revenue, or as a reduction in revenue, in the period in which the transaction price changes. Therefore, beginning on the date the entity considers offering the coupons, the entity should consider whether there is a change in the transaction price (that is, has the amount of consideration to which the entity expects to be entitled for transferring the products changed).

15. Simply having the *thought of*, or having some initial preliminary discussions about, a potential coupon offering does not necessarily result in a change to the transaction price. However, the entity might no longer reasonably expect to be entitled to CU10,000 for the 1,000 products even before the January 2nd date upon which it promises the consideration to the customer (for example, on December 31st the entity committed to the coupon program). Therefore, the date at which the transaction price changes will be a matter of judgment.

16. If the products are delivered on December 28th and the entity recognized CU10,000 as revenue, and the entity subsequently concludes there is a change in the transaction price downward to CU9,000, then that CU1,000 should be recognized as a reduction to revenue in the period in which it determines that the transaction price has changed.

17. In the example above, the entity provides the customer with a CU1-off coupon, which is a form of variable consideration. Paragraph 606-10-32-6 [51] describes consideration payable to a customer as a type of variable consideration. The entity would consider the guidance on variable consideration and the guidance on consideration payable to customer. That is, the two concepts are related and an entity does not only look to one or the other.

18. The guidance indicates an entity would estimate the consideration it expects to pay the retail store chain and include that amount in the transaction price (Step 3). Because the transaction price includes variable consideration, the entity would follow the guidance in Step 3 on constraining estimates of variable consideration.

19. The entity also would consider whether an implicit promise for the coupon has been made prior to making the formal promise. The guidance in paragraph 606-10-32-25(b) [70(b)] states that a promise of consideration to a customer might be implied by an entity's customary business practices. Therefore, in many cases the promise to pay consideration may occur at a point before the formal offer is made.

20. Regardless of whether an entity was following the guidance on variable consideration or consideration payable to the customer (including consideration of the guidance on changes in transaction price), the recognition of the sales incentive (the coupon) would result in a reversal of revenue. That reversal of revenue should be made at the *earlier* of the date that there is a change in the transaction price in accordance with paragraph 606-10-32-25 [70] or the date at which the consideration payable to a customer is promised in accordance with paragraph 606-10-32-27 [72].

21. As described in paragraph 606-10-05-3[IN8], the core principle of the standard is to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. If the entity never expects to be entitled to that consideration, it would not be appropriate to recognize the reduction of revenue at a later date. Further, the notion of the constraint on variable consideration is that revenue should not be recognized if it is probable [highly probable] of significant reversal. In this example, a delay in recognizing the effect of the coupon might result in a significant reversal of revenue which would be in conflict with the constraint principle.

Question 2: Should the Constraint on Variable Consideration Be Applied at the Contract Level or the Performance Obligation Level?

22. Some stakeholders have questioned whether the constraint on variable consideration should be applied at the performance obligation level or the contract level. This

question might be particularly pertinent in scenarios in which variable consideration is not allocated proportionately to all performance obligations in a contract, or when one performance obligation is fixed and the other is variable.

23. Consider the following example:

> An entity enters into a contract with a customer to provide it with equipment and a consulting service. The purpose of the consulting service is to improve the customer's manufacturing process. The equipment and the consulting service are separate performance obligations. The stated price for the equipment is fixed at CU10 million. The contract does not include stated, fixed consideration for the consulting service, but if the customer's manufacturing costs decrease by 5% over a one-year period, the entity will receive CU50,000 for the consulting service.
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> The standalone selling prices of the equipment and consulting service are determined to be CU10 million and CU 50,000, respectively. The entity allocates the potential performance-based fee entirely to the consulting service performance obligation based on the criteria in paragraph 606-10-32-40 [85]. Because the equipment is not expected to have any positive or negative effect on the customer's manufacturing costs, the entity concludes that the variable payment terms relates specifically to the entity's consulting service and allocating the consideration in this manner is consistent with the overall transaction price allocation objective.

24. In the fact pattern above, the entity concludes that CU50,000 is the most likely amount of consideration to which it expects to be entitled using the most likely method. The entity also concludes it is not probable [highly probable] that it will earn the performance-based fee. However, despite the fact that the entity concludes that it is not probable [highly probable] it will earn the fee, the entity also has to evaluate whether inclusion of the amount in the transaction price may result in a *significant* revenue reversal. Paragraph 606-10-32-12 [57] specifies that an entity must consider *both* the likelihood <u>and</u> the magnitude of a potential revenue reversal in determining whether the constraint on variable consideration applies.

25. Some stakeholders have questioned whether the significance/magnitude determination is based on an assessment of the potential reversal of revenue against (a) the transaction price allocated to the related performance obligation (in this case,

CU50,000) or (b) the total transaction price for the contract (CU10.05 million). Those stakeholders assert that an entity may come to a different conclusion about whether or not variable consideration must be constrained depending on which approach it follows. For example, some stakeholders assert that the entity would include the CU50,000 in the transaction price (that is, it would not be constrained) because it is not significant to the entire contract transaction price, including the variable consideration, of CU10.05 million. Other stakeholders assert that the CU50,000 should be constrained because any reversal would represent a 100% reversal on revenue recognized related to that performance obligation.

26. The new revenue standard provides the following guidance relevant to determining the magnitude of a potential revenue reversal:

> **606-10-32-11 [56]** An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 606-10-32-8 [53] only to the extent that it is **probable [highly probable]** that a significant reversal in the amount of cumulative **revenue** recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.
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> **606-10-32-12 [57]** In assessing whether it is probable [highly probable] that a significant reversal in the amount of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and the magnitude of the revenue reversal.

27. In addition, the Basis for Conclusions includes some excerpts relevant to this discussion. Based on discussions with stakeholders, it appears that the question outlined in the above paragraph has been raised principally as a result of the following paragraphs (emphasis added).

> BC216. The guidance for constraining estimates of variable consideration requires an entity to assess whether a significant revenue reversal would not occur for the amount of cumulative revenue recognized for a satisfied

> (or partially satisfied) **performance obligation**. This is because **the Boards did not intend for an entity to inappropriately recognize revenue by offsetting the risk of a future revenue reversal for a satisfied (or partially satisfied) performance obligation against expected revenue from future performance**.
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> BC217. The guidance for constraining estimates of variable consideration also requires an entity to assess the magnitude of a significant revenue reversal for both variable consideration and fixed consideration. For example, if the consideration for a single performance obligation included a fixed amount and a variable amount, the entity would assess the magnitude of a possible revenue reversal of the variable amount relative to the total consideration (that is, variable and fixed consideration). This is because **the objective of constraining estimates of variable consideration is focused on a possible revenue reversal of the amount of cumulative revenue recognized for a performance obligation, rather than on a reversal of only the variable consideration allocated to that performance obligation**.

28. Also relevant to this issue, the Boards provided the following reasoning for including the constraint in the new revenue standard (emphasis added):

> BC206…The majority of users of financial statements that were consulted indicated that the most relevant measure for revenue in a reporting period would be one that will not result in a **significant** reversal in a subsequent period. This is because an amount that would not reverse in the future would help users of financial statements better predict future revenues of an entity. Therefore, the Boards decided that the focus for constraining revenue should be on possible downward adjustments (that is, revenue reversals), rather than on all revenue adjustments (that is,

> both downward and upward adjustments). Specifically, the Boards decided that an entity should include some or all of an estimate of variable consideration in the transaction price only to the extent it is probable [highly probable] that a **significant** revenue reversal will not occur.

29. While the paragraphs above from the Basis for Conclusions and the absence of explicit guidance on the level at which the magnitude of a potential revenue reversal is determined in the standard explains why the question has been raised, *the unit of account for determining the transaction price (Step 3 of the model) is the contract*, not the performance obligation. The staff note that while the unit of account is not explicitly stated with respect to application of the constraint, a contract unit of account is explicitly noted elsewhere within the Basis for Conclusions discussion about Step 3 of the model. BC234, which relates to identifying a significant financing component in a contract, states:

> BC234. The Boards also observed that for many contracts, an entity will not need to adjust the promised amount of customer consideration because the effects of the financing component will not materially change the amount of revenue that should be recognized in relation to a contract with a customer. In other words, for those contracts, the financing component will not be significant. During their redeliberations, **the Boards clarified that an entity should only consider the significance of a financing component at a contract level** rather than consider whether the financing is material at a portfolio level. The Boards decided that it would have been unduly burdensome to require an entity to account for a financing component if the effects of the financing component were not material to the individual contract, but the combined effects for a portfolio of similar contracts were material to the entity as a whole.

30. The Boards' reasoning with respect to identifying significant financing components explains why an entity should consider significance at the contract level rather than

the performance obligation level. Additionally, the practical expedient on applying the new revenue standard (paragraph 606-10-10-4 [4]) to a portfolio of contracts would permit an entity to evaluate application of the constraint to a portfolio of contracts with similar characteristics (for example, similar variable fee structures) so long as the effects on the financial statements would not differ materially from applying this guidance to the individual contracts. The staff thinks an entity *might* conclude, for example, that it does not need to evaluate each of its variable consideration arrangements such as the one included in the example above, if the potential cumulative effect of a revenue reversal in all of those contracts would not be material.

31. Determining the magnitude of a potential revenue reversal, and application of the overall constraint, should not be confused with the core requirement for determining the transaction price. That is, the core principle of the new revenue standard is to recognize revenue to depict the transfer of promised goods or services to customers in an amount (that is, the transaction price) that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. If the entity does not expect to be entitled to CU50,000 (for example, it concludes the most likely amount to which it will be entitled is CU0, rather than CU50,000) it would not include that amount in the transaction price regardless of whether or not a reversal of that amount would be significant. That is, the CU50,000 performance-based fee would be excluded from the transaction price before the entity even assesses whether to apply the constraint on variable consideration.

Questions for the TRG Members

1. What are your views about applying the guidance on variable consideration addressed in this paper?
2. Are there any related potential interpretation questions that are not included in this paper?