STAFF PAPER

January 26, 2015

Project	**FASB/IASB Joint Transition Resource Group for Revenue Recognition**
Paper topic	Consideration Payable to a Customer

CONTACT(S)	Mary Mazzella	msmazzella@fasb.org	+1 203 956 3434
	Kristin Floyd	knfloyd@fasb.org	+1 203 956 5384
	Stuart Leadill	sleadill@ifrs.org	+44 207 246 6410

The following implementation questions and potential interpretations were submitted to the TRG by a stakeholder.

Background

1. Topic 606 [IFRS 15], *Revenue from Contracts with Customers* (the standard), provides guidance on accounting for cash amounts that an entity pays, or expects to pay, to the customer. Such amounts are a reduction of the transaction price, and therefore revenue, unless the payment is in exchange for a distinct good or service and the payment does not exceed fair value of that good or service. Several questions have arisen related to the implementation of this guidance, as outlined below.

Potential Implementation Issues

Issue 1: Are entities required to apply the guidance on consideration payable to a customer at the contract level or more broadly to the entire "customer relationship"?

2. The standard does not explicitly state whether the guidance on consideration payable to a customer should be applied at the contract level (that is, only to individual contracts or contracts that are required to be combined) or more broadly to the entire "customer relationship." The guidance in the standard is generally applied at the contract level, as specified in paragraph 606-10-10-4 [IFRS 15 paragraph 4]. However, in the basis of conclusions (BC257), the boards note that: "The amount of consideration received from a customer for goods or services, and the amount of any

consideration paid to that customer for goods or services, could be linked even if they are separate events." This could be interpreted to suggest that consideration payable to a customer could be linked to the customer relationship even if the payment is not within the same contract (and the contracts are not required to be combined).

3. The guidance on consideration payable to a customer is similar to current U.S. GAAP guidance in Subtopic 605-50, *Customer Payments and Incentives*. Current U.S. GAAP guidance is generally applied broadly to the entire "customer relationship." This is generally viewed as "anti-abuse" guidance and can result in uneconomic outcomes in some fact patterns. For example, an entity could be required to record a payment to a vendor as a reduction of revenue because of an unrelated customer relationship with that vendor in a different line of business at the entity. This could occur because the entity is unable to demonstrate that the payment represents the fair value of the identifiable benefit it receives from the vendor. Similar issues could arise under Topic 606 [IFRS 15] if an entity is required to apply the guidance broadly to the customer relationship, since paragraph 606-10-32-26 [IFRS 15 paragraph71] requires an entity to determine the fair value of the good or service received from the customer.
4. Potential interpretations of the guidance include the following:
   a. *Interpretation A:* Entities must consider all consideration paid or payable to a customer and assess whether such amounts are paid for a distinct good or service and if so, whether the amounts exceed fair value of that good or service.
   b. *Interpretation B:* Entities are only required to apply the guidance on consideration payable to a customer to amounts paid within the same contract or contracts that must be combined pursuant to the guidance on combination of contracts.

Interpretation A

5. Supporters of Interpretation A believe that entities must apply the guidance on consideration payable broadly to the entire "customer relationship," based on the discussion in the basis for conclusions, particularly BC257. Supporters of this interpretation believe the intent of the guidance is similar to existing U.S. GAAP and therefore, the accounting results should be similar.

Interpretation B

6. Supporters of Interpretation B believe the guidance on consideration payable to a customer is only applicable to amounts paid within the same contract or contracts that must be combined pursuant to paragraph 606-10-25-9 [IFRS 15 paragraph 17]. Supporters of this interpretation assert that the boards provided guidance on when contracts must be combined to capture transactions that are economically linked. Therefore, it is not necessary to look to the broader "customer relationship" to identify when payments made to a customer should reduce revenue. This is also consistent with the general principle that the guidance in the standard is applied to an individual contract.
7. Supporters of Interpretation B acknowledge that payments to a customer may not always occur at or near the same time as a related contract. However, agreements to make payments to a customer could represent a modification to a contract. For example, a manufacturer could enter into a multi-year contract to sell a product to a retailer and, at a later point in time, offer to make a payment to the retailer to secure a more prominent display space in the retailer's store. While the offer to make the payment does not directly modify the terms of the existing contract, the commercial substance of the arrangement is that the transaction price has changed and therefore, the payment would be accounted for as a modification.

Issue 2: The guidance refers to payments made to a customer or "to other parties that purchase the entity's goods or service from the customer." Is this guidance meant to apply only to customers in the distribution chain or more broadly to any customer of an entity's customer?

8. The guidance on consideration payable to a customer refers also to payments made "to other parties that purchase the entity's goods or services from the customer." BC255 refers to payments an entity makes to "its customers or to its customer's customer (for example, an entity may sell a product to a dealer or distributor and subsequently pay amounts to or provide a cash incentive to a customer of that dealer or distributor)." Questions have arisen as to whether the scope of the guidance applies only to payments to customers in the distribution chain or whether "customer's customer" should be interpreted more broadly.

9. For example, an entity that is acting as an agent typically views the principal in the arrangement as its customer. The agent may make incentive payments to parties that purchase the principal's good or service. In many cases, these incentives are not part of the contract with the principal, or a promise made explicitly or implicitly to the principal; although, the principal may be aware of the incentive program. The agent makes incentive payments to the principal's customer, such as providing coupons or cash rebates, to increase the volume of transactions on which it earns its agency fee. These parties are not purchasing the agent's goods or services (that is, the principal's customer is not in the distribution chain).
10. Potential interpretations of the guidance include the following:
    a. *Interpretation A:* The guidance refers explicitly to "parties that purchase the entity's goods or services from the customer" and therefore, only applies to entities in the distribution chain.
    b. *Interpretation B:* The guidance should be applied more broadly to any customer of an entity's customer, including a "customer's customer" that is not purchasing the entity's goods or services (that is, a party that is not in the distribution chain).

Interpretation A

11. Supporters of Interpretation A believe the guidance in paragraph 606-10-32-25 [IFRS 15 paragraph 70] is explicit that the guidance on consideration payable to a customer applies only to customers in the distribution chain (refer to Appendix A for an illustration of the difference between a distribution chain relationship and a principal/agent relationship). In the basis for conclusions, the boards use the phrase "customer's customer"; however, this appears to simply be shorthand for an end consumer of an entity's goods or services. This is further supported by BC255, which provides a customer of a distributor as an example of a "customer's customer." Supporters of Interpretation A believe the reference to "customer's customer" in the basis for conclusions does not modify the guidance in paragraph 606-10-32-25 [IFRS 15 paragraph 70], which explicitly refers to customers in the distribution chain.

12. Current U.S. GAAP refers explicitly to the distribution chain in Section 605-50-20, as follows: "Customer includes any purchaser of the vendor's products at any point

along the distribution chain, regardless of whether the purchaser acquires the vendor's products directly or indirectly (for example, from a distributor) from the vendor. For example, a vendor may sell its products to a distributor who in turn resells the products to a retailer. The retailer in that example is a customer of the vendor." However, there is diversity in practice under current U.S. GAAP regarding who is viewed as the "customer" in certain arrangements.

13. Under this interpretation, payments to a party that is not in the distribution chain are not within the scope of Topic 606 [IFRS 15] and are therefore recognized as an expense, similar to other marketing costs. This approach reflects the fact that the payment is not part of the contract with the entity's customer (or any party purchasing the entity's goods or services) and is not a promise made explicitly or implicitly to the customer. An example is an agent providing a cash incentive (such as a coupon) to a principal's customer that is not contemplated in the contract with the principal or explicitly or implicitly promised to the principal. Such payments are a marketing expense similar to other costs incurred to third parties to increase sales of a good or service.
14. Opponents of Interpretation A believe a payment to a "customer's customer" is directly tied to the revenue transaction and therefore, payments to any customer of a customer (whether or not in the distribution chain) should reduce revenue. Opponents believe the guidance on consideration payable to a customer was intended to be applied more broadly based on the reference to "customer's customer" in the basis of conclusions.

Interpretation B

15. Supporters of Interpretation B believe the guidance on consideration payable to a customer should be applied more broadly to any customer of an entity's customer. They believe the references to customers in the distribution chain in paragraph C 606-10-32-25 [IFRS 15 paragraph 70] and BC255 are only examples of a "customer's customer." Supporters of Interpretation B point to paragraph BC92, which discusses the concepts of making a promise to a "customer's customer" and does not put limitations on who could be considered a "customer's customer."

16. Supporters of this interpretation believe that payments to a “customer’s customer” (including parties not in the distribution chain) are usually directly linked to the revenue transaction. That is, the entity is making the payment to increase its revenue. For example, an agent making a payment to a principal’s customer typically intends to increase the volume of transactions on which it earns its agency fee. Additionally, both the principal and the principal’s customer are usually aware of the agent’s involvement in the transaction. Thus, the payment should reduce the agent’s revenue from the arrangement.
17. Some supporters of Interpretation B view the principal’s customer as a customer of both the agent and the principal. They view the role of an agent as an intermediary between the principal and the end consumer and observe that the agent is providing its agency service to both the principal and the end consumer. As a result, they would view payments made by the agent to the end consumer as payments directly to a customer.
18. Opponents of Interpretation B assert that there are many costs that are directly linked to a revenue transaction (for example, sales commissions); however, these costs are not recorded as a reduction of revenue. Opponents believe payments that should reduce revenue should be limited to payments to parties purchasing the entity’s goods or services (direct customers or customers in the distribution chain), consistent with the guidance in paragraph 606-10-32-25 [IFRS 15 paragraph 70].
19. Opponents of Interpretation B also note that the principal typically accounts for the price paid by the end consumer as revenue and the agency fee it pays to an agent as a selling expense. Interpretation B suggests that the principal should record an amount of revenue and agency fee adjusted for cash incentives; however, the principal may not be aware of the amount of an incentive paid to a specific customer.

Issue 3: Timing of recognizing consideration payable to a customer that is anticipated, but not yet promised, to the customer[1]

20. The guidance on consideration payable to a customer states that such amounts should be recognized as a reduction of revenue the later of when the related sales are recognized or the entity pays or promises to pay such consideration. The guidance

[1] Refer toTRG Agenda Ref No. 14, Variable Consideration, for further details on this issue.

states that the promise to pay could be "implied by the entity's customary business practices."

21. This guidance could be viewed as inconsistent with guidance on variable consideration. The description of variable consideration is broad and includes price concessions, refunds, incentives, and other payments to a customer. Such amounts must be estimated and reduce the transaction price if "the customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract" <u>or</u> "other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer." (paragraph 606-10-32-7 [IFRS 15 paragraph 52]).
22. The variable consideration guidance could be viewed as a "lower bar" as compared to the guidance on consideration payable to a customer in paragraph 606-10-32-25 [IFRS 15 paragraph 70]. That is, the variable consideration guidance would require an entity to estimate amounts and reduce transaction price before the entity "promises to pay" the consideration in some fact patterns. An example is a situation in which an entity intends to provide a rebate, but does not have a customary business practice of doing so.
23. Question: Is the variable consideration guidance inconsistent with the guidance on consideration payable to a customer? If so, which guidance should apply to incentive programs and other types of payments that could be viewed as both variable consideration and consideration payable to a customer?

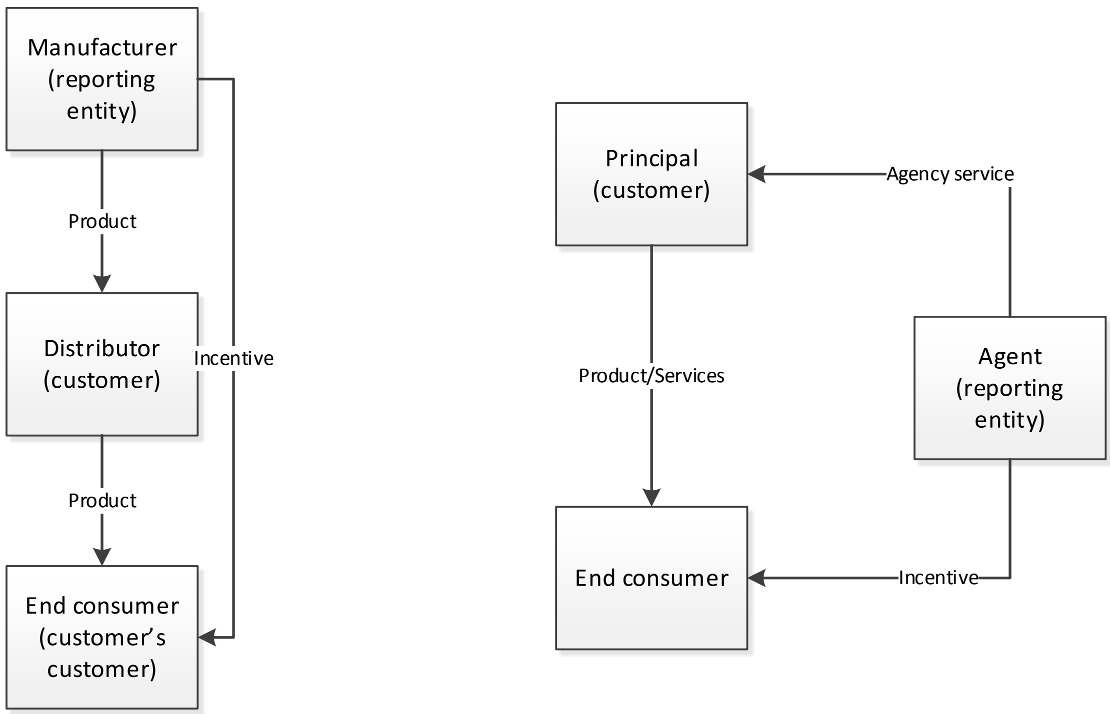
Issue 4: "Negative revenue" resulting from consideration payable to a customer

24. In some fact patterns, payments to a customer could exceed consideration from a customer resulting in "negative revenue." The determination of whether a payment results in negative revenue depends on the resolution of Issue 1 above; that is, whether the assessment is done in relation to a specific contract or more broadly based on the customer relationship.
25. If negative revenue is determined on an overall customer relationship basis, one view is that entities should present negative revenue as performance obligations are satisfied. An alternative view is that entities should reduce cumulative customer

revenue to zero and reclassify the remaining negative revenues as expense in the period such determination is made.

26. If negative revenue is determined based on a specific contract, potential views are (a) entities should present negative revenue as performance obligations are satisfied or (b) entities should reclassify negative revenue as expense in the period determined. The latter would not result in negative revenues on a specific customer contract. If determined on a specific contract basis, there would likely be far fewer instances of negative revenue given payments to a customer won't be linked to a specific revenue contract in many, if not most, cases.
27. Current U.S. GAAP guidance (paragraphs 605-50-45-6 through 46-11) includes specific guidance for instances where recording customer payments as a reduction of revenue results in negative revenue. In these situations, the cumulative shortfall is reclassified as an expense if the vendor can demonstrate that the reduction in revenue results in negative revenue for a specific customer on a cumulative basis. The standard does not currently address the accounting for "negative revenue."
28. Question: Should "negative revenue" be reclassified to expense and if so, in what circumstances?

Appendix A – Illustration of the difference between a distribution chain relationship and a principal/agent relationship



Appendix B – Relevant Guidance

606-10-10-4 (IFRS 15 - paragraph 4) This guidance specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply this guidance to a portfolio of contracts (or **performance obligations**) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

Combination of Contracts

606-10-25-9 (IFRS 15 – Paragraph 17) An entity shall combine two or more **contracts** entered into at or near the same time with the same **customer** (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:

a. The contracts are negotiated as a package with a single commercial objective.

b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single **performance obligation** in accordance with paragraphs 606-10-25-14 through 25-22.

Variable Consideration

606-10-32-5 7 (IFRS 15 – Paragraph 50) 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**.

606-10-32-6 7 (IFRS 15 – Paragraph 51) 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.

606-10-32-7 (IFRS 15 – Paragraph 52) The variability relating to the consideration promised by a customer may be explicitly stated in the contract. In addition to the terms of the contract, the promised consideration is variable if either of the following circumstances exists:

a. The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry, or customer this offer may be referred to as a discount, rebate, refund, or credit.

b. Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

Consideration Payable to a Customer

606-10-32-25 (IFRS 15 – Paragraph 70) Consideration payable to a **customer** includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). An entity shall account for consideration payable to a customer as a reduction of the **transaction price** and, therefore, of **revenue** unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 606-10-25-18 through 25-22) that the customer transfers to the entity. 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.

606-10-32-26 (IFRS 15 – Paragraph 71) If consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity shall account for such an excess as a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it shall account for all of the consideration payable to the customer as a reduction of the transaction price.

606-10-32-27 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.

BC92. The Boards observed that it was important to clarify that granting a right to goods or services to be provided in the future, such as when an entity makes a promise to provide goods or services to its customer's customer, would give rise to performance obligations for the entity. Those types of promises exist in distribution networks in various industries but are particularly common in the automotive industry. For example, when a manufacturer sells a motor vehicle to its customer (a dealer), the manufacturer also may promise to provide additional goods or services (such as maintenance) to the dealer's customer. Topic 606 requires an entity to identify all of the promises—both explicit and implicit—that are made to the customer as part of the contract with that customer. Consequently, a promise of a good or service (such as maintenance) that the customer can pass on to its customer would be a performance obligation if the promise could be identified (explicitly or implicitly) in the contract with the customer. However, the Boards noted that some promised goods or services might not represent performance obligations if those promises did not exist (explicitly or implicitly) at the time that the parties agreed to the contract.

Consideration Payable to a Customer (Paragraphs 606-10-32-25 through 32-27)

BC255. In some cases, an entity pays consideration to one of its customers or to its customer's customer (for example, an entity may sell a product to a dealer or distributor and subsequently pay a customer of that dealer or distributor). That consideration might be in the form of a payment in exchange for goods or services received from the customer, a discount or refund for goods or services provided to the customer, or a combination of both.

BC256. To help an entity distinguish between those types of payments, the Boards decided that the only circumstance in which an entity should account for any good or service received in the same way as for other purchases from suppliers is if the good or service is distinct. Previous guidance in U.S. GAAP on the consideration that a vendor gives to a customer used the term *identifiable benefit*, which was described as a good or service that is "sufficiently separable from the recipient's purchase of the vendor's products such that the vendor could have entered into an exchange transaction with a party other than a purchaser of its products or services in order to receive that benefit." The Boards concluded that the principle in Topic 606 for assessing whether a good or service is distinct is similar to the previous guidance in U.S. GAAP.

BC257. The amount of consideration received from a customer for goods or services, and the amount of any consideration paid to that customer for goods or services, could be linked even if they are separate events. For instance, a customer may pay more for goods or services from an entity than it otherwise would have paid if it was not receiving a payment from the entity. Consequently, the Boards decided that to depict revenue faithfully in those cases, any amount accounted for as a payment to the customer for goods or services received should be limited to the fair value of those goods or services, with any amount in excess of the fair value being recognized as a reduction of the transaction price.

BC258. If the payment of consideration is accounted for as a reduction of the transaction price, an entity would recognize less revenue when it satisfies the related performance obligation(s). However, in some cases, an entity promises to pay consideration to a customer only after it has satisfied its performance obligations and, therefore, after it has recognized revenue. When this is the case, a reduction in revenue should be recognized immediately. Accordingly, the Boards clarified that the reduction of revenue is recognized at the later of when the entity transfers the goods or services to the customer and when the entity promises to pay the consideration. By using the phrase *promises to pay*, the Boards clarified that an entity should reflect in the transaction price payments to customers that are conditional on future events (for example, a promise to pay a customer that is conditional on the customer making a specified number of purchases would be reflected in the transaction price when the entity makes the promise).