STAFF PAPER

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Project	**FASB/IASB Joint Transition Resource Group for Revenue Recognition**
Paper topic	Significant Financing Components

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Purpose

1. Some stakeholders have informed the staff that there questions on the guidance 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'), regarding significant financing components. The implementation questions relate to the following topics:

   (a) Application of the factor in paragraph 606-10-32-17(c) [62(c)][1] in determining when the difference between promised consideration and cash selling price is not related to a significant financing component

   (b) Application of the guidance in scenarios in which the promised consideration is equal to the cash selling price

   (c) Whether the standard precludes accounting for financing components that are not significant

[1] IFRS 15 references are included in "[XX]" throughout this paper.

(d) Determining whether or not the practical expedient can be applied in scenarios in which there is a single payment stream for multiple performance obligations

(e) Calculation of interest in arrangements with a significant financing component

(f) Application of the significant financing guidance when a contract with a customer includes multiple performance obligations.

2. At the January 26, 2015 TRG meeting, a preliminary discussion was held on some of these topics (TRG Agenda Ref No. 20). That discussion was based on the submission received by the staff. TRG members indicated that the issues should be brought back for further discussion at a TRG meeting. Accordingly, this memo provides analysis beyond the stakeholder submission that was previously provided to TRG members.

Background

3. The core principle of the new revenue standard is that an entity should 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* in exchange for those goods or services (emphasis added). In Step 3 of the model in the new revenue standard, an entity determines the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services in the contract to a customer (excluding amounts collected on behalf of third parties). In determining the transaction price, an entity considers the effects of various items (for example, variable consideration and the *existence of a significant financing component*). The new revenue standard includes guidance (as well as discussion in the Basis for Conclusions) about when a significant financing component exists and how to account for significant financing components. The questions in this paper relate to that guidance.

4. The new revenue standard includes the following guidance about when a significant financing component exists in a contract within the scope of this guidance[2] (note: Examples 26-30 in the standard illustrate the application of the guidance in these paragraphs, but are not included in this paper):

> **606-10-32-15 [60]** In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.
>
> **606-10-32-16 [61]** The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer (that is, the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

[2] In addition to applying to contracts with customers, the significant financing component guidance also applies to transactions in the scope of Subtopic 610-20-Gains and Losses from the Derecognition of Nonfinancial Assets and disposals of items of PPE, intangible assets and investment property under IAS 16, IAS 38 and IAS 40.

a. The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services

b. The combined effect of both of the following:

1. The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services

2. The prevailing interest rates in the relevant market.

606-10-32-17 [62] Notwithstanding the assessment in paragraph 606-10-32-16, a contract with a customer would not have a significant financing component if any of the following factors exist:

a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.

b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty).

c. The difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 606-10-32-16) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.

> **606-10-32-18 [63]** As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

5. Existing U.S. GAAP and IFRS include guidance about accounting for the time value of money in a revenue transaction. However, the guidance in the new revenue standard includes more guidance on the topic than existing standards, and in particular because it applies to advance payments as well as payments in arrears, the guidance represents a change from existing U.S. GAAP and general practice under IFRS.

6. IAS 18 *Revenue* states that if the arrangement "effectively constitutes a financing transaction", the fair value of the consideration must be determined by discounting all future receipts using an imputed rate of interest. Similarly in U.S. GAAP, if products are sold on extended payment terms, and collection is reasonably assured, Subtopic 835-30, Imputation of Interest (which includes the guidance formerly in Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables*), requires that the receivable and the revenue be recognized at the present value of the payments, and a portion of the payments be attributed to interest income.

7. The following two paragraphs in the new revenue standard (as well as Examples 28 and 29) provide guidance on how to account for a significant financing component:

> **606-10-32-19 [64]** To meet the objective in paragraph 606-10-32-16 when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the

credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

606-10-32-20 [65] An entity shall present the effects of financing (interest income [interest revenue] or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income (statement of activities). Interest income [interest revenue] or interest expense is recognized only to the extent that a contract asset (or receivable) or a contract liability is recognized in accounting for a contract with a customer.

606-10-32-20[3] In accounting for the effects of the time value of money, an entity also shall consider the subsequent measurement guidance in Subtopic 835-30, specifically the guidance in paragraphs 835-30-45-1A through 45-3 on presentation of the discount and premium in the financial statements and the guidance in paragraphs 835-30-55-2 through 55-3 on the application of the interest method.

[3] The guidance is included in Topic 606, but is not included in IFRS 15.

Question 1 – How should the factor in paragraph 606-10-32-17(c) [62(c)] be applied in determining when the difference between promised consideration and cash selling price is not related to a significant financing component?

8. The Boards included a list of factors in the new revenue standard to indicate when a significant financing component might not exist. Implementation questions have arisen about the factor in paragraph 606-10-32-17(c) [62(c)], which is included in the background section above.

9. The question posed in the submission received by the staff relates to how "broadly" this factor should be applied. The stakeholder submission includes the following two views:

   (a) *View A* – Paragraph 606-10-32-17(c) [62(c)] should not be applied broadly. If the timing of payment differs from the timing of the transfer of goods and services to the customer (and the amount of interest income or expense would be significant), a significant financing component likely exists (that is, a presumption of such that can be overcome for a truly valid reason).

   (b) *View B* – Paragraph 606-10-32-17(c) [62(c)] was intended to be applied broadly (especially in arrangements that include advance payments). Entities should determine if the payment terms were intended (or implied) to be used as a financing component (that is, it was considered in determining the amount of consideration) and, if so, determine whether the financing component is significant. If not, entities would generally look to the intent of the payment terms (for example, as retainer fees, to avoid periodic billings, for customer convenience, normal business practice, perceived value by customer, etc.) as other than financing.

10. The question arises, in part, due to the interaction of the guidance in paragraphs 606-10-32-15 [60] and 606-10-32-16 [61]. Paragraph 606-10-32-15 [60] explains the principle is to *adjust the promised amount of consideration for the time value of money if the customer or entity receive a significant benefit of financing the transfer of goods or services to the customer*. The objective when adjusting the promised amount of consideration for a significant financing component in

paragraph 606-10-32-16 [61] is to recognize revenue for the goods and services at an amount that reflects what the cash selling price would be without the significant financing component that the entity already concluded exists based on applying the new revenue standard. It is important to note that the objective of measuring a significant financing component should not be interpreted as the principle for evaluating *whether or not* a significant financing component exists. Rather, it is the objective an entity should apply when adjusting the transaction price because it has concluded there is a significant financing component under the new revenue standard.

11. View A implies that there is a presumption (although that presumption might be overcome) that if the cash selling price varies from promised consideration (or there is a long time frame between transfer of the goods and payment), then a significant financing component exists. If read in isolation, some stakeholders might come to this conclusion after reading paragraph 606-10-32-15 [60] due to the use of the term "time value of money" in that paragraph when describing the principle. However, when reading the totality of the guidance on significant financing components, including the Basis for Conclusions, it seems clear that View A is not what was intended by the Boards. That is, the standard does not include a presumption and requires the use of judgment in the assessment. Paragraph BC231 discusses some of the Boards' considerations.

> **BC231** The Boards considered whether the guidance for identifying a financing component should be based only on whether payment is due either significantly before, or significantly after, the transfer of goods or services to the customer. However, a number of respondents explained that this might have required an entity to adjust for the time value of money when the parties did not contemplate a financing arrangement as part of the negotiated terms of the contract. Those respondents explained that, in some cases, although there is a significant period of time between the transfer of the goods or services and the payment, the reason for that timing difference is not related to a

> financing arrangement between the entity and the customer. The Boards agreed with those respondents and clarified their intention by specifying in paragraph 606-10-32-15 [60] that **an entity should adjust for financing only if the timing of payments specified in the contract provides the customer or the entity with a significant benefit of financing. (emphasis added)**

12. Paragraph BC230 provides some further guidance on this topic. This paragraph highlights that an entity should consider whether the payment terms of the contract provide the benefit of financing to the customer or entity (and which is significant at the contract level). It is noting that there may be other reasons than providing financing and reasons why the consideration is not remitted at the time the performance obligations are satisfied. An entity will need to apply judgment to determine whether the payment terms are providing finance or are for another reason. Paragraph 606-10-32-17(c) [62(c)] contain some language about the difference being proportional to the reason for the difference.

13. The staff further note that paragraph 606-10-32-16 [61] deemphasized "the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services" as compared to exposure drafts of the new revenue standard as a direct response to feedback from stakeholders on those previous exposure drafts. Stakeholders commented that, as drafted, the proposed guidance appeared to create the presumption embodied by View A.

14. Further, the Boards included the factors in 606-10-32-17 [62] to clarify the circumstances in which a contract does not provide the entity or the customer with a significant benefit of financing. The Basis for Conclusions includes the following discussion of the factor included in paragraph 606-10-32-17(c)[62(c)]:

> **BC233**…The difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of financing to either the customer or the entity. In some

> circumstances, a payment in advance or in arrears in accordance with the typical payment terms of an industry or jurisdiction may have a primary purpose other than financing. For example, a customer may retain or withhold some consideration that is payable only on successful completion of the contract or on achievement of a specified milestone. Alternatively, the customer might be required to pay some consideration up front to secure a future supply of limited goods or services. The primary purpose of those payment terms may be to provide the customer with assurance that the entity will complete its obligations satisfactorily under the contract, rather than to provide financing to the customer or the entity respectively.

15. View B implies that it was the Boards' intention for paragraph 606-10-32-17(c) [62(c)] to be applied broadly and that it should capture all or most advance payments. In other words, View B implies that an advance payment generally would not contain a significant financing component.

16. The staff note that the Basis for Conclusions specifically discusses why the Boards did not provide an exemption for advance payments.

> **BC238. The Boards decided not to exempt an entity from accounting for the effects of a significant financing component for advance payments.** This is because ignoring the effects of advance payments could substantially skew the amount and pattern of profit recognition if the advance payment is significant and the primary purpose of that payment is to provide financing to the entity. Consider the example in which an entity requires a customer to pay in advance for a long-term construction contract because the entity requires financing to obtain materials for the contract. If the entity did not require the customer to pay in advance, the entity would need to obtain the financing from a third party and, consequently, would

> charge the customer a relatively higher amount to cover the finance costs incurred. However, in either scenario the goods or services transferred to the customer are the same; it is only the party providing the financing to the entity that changes. Consequently, the entity's revenue should be consistent regardless of whether it receives the significant financing benefit from the customer or from a third party. (emphasis added)

17. Further, the standard includes two examples on advance payments. In Example 29, the entity concludes there is a significant financing component due to the different payment options available to the customer and length of time between the advance payment from the customer and the transfer of control. In example 30, the entity concludes that there is not a significant financing component because the timing difference relates to a reason other than financing.

18. The new revenue standard is clear that advance payments are not excluded from the scope of the guidance on significant financing component. However, the Boards readily acknowledged that there may be valid non-financing reasons for an advance payment. In those cases, an entity should establish why that feature of the arrangement is not providing a significant financing benefit, but is instead there for a different and substantive business purpose. As previously noted, in addition to having a reason other than financing, paragraph 606-10-32-17 (c) [62(c)] requires the difference between the promised consideration and cash selling price of the good or service to be proportional to the reason for the difference.

19. In the staff's view, determining whether a contract with a customer includes a significant financing component is a matter of judgment, both in determining whether a financing component exists and, if so, in determining the significance of the benefit that the financing component provides to the customer or the entity. The staff think the interpretations expressed in View A and View B are opposite ends of the spectrum of how one might interpret the guidance, such that the Boards' intent may be best characterized as something in between. The guidance outlined above seems to make clear that the Boards think some contracts provide a significant benefit of financing, but that differences (a) between the timing of

payment and the transfer to the goods or services and (b) between the stated price and the cash selling price of a good or service are not *necessarily* indicative of a significant financing component. It is important that entities analyze all of the facts of circumstances in the arrangement in applying the guidance on significant financing components to determine if one exists. It is clear that judgment will be required in this area of the new revenue standard.

20. The Boards included a number of items for an entity to consider when making judgments about whether a significant financing component exists in a contract. Those considerations include the criteria in paragraph 606-10-32-16 [61], the factors in paragraph 606-10-32-17 [62], and several illustrative examples (Examples 26, 27, 28 (Case A), 28 (Case B), 29, and 30).

21. In addition, to reduce the cost and complexity of applying the guidance on significant financing components, the Boards decided to include a practical expedient in the guidance. Paragraph 606-10-32-18 [63] states that an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects that the period between when the entity transfers a promised good or service and when the customer pays for that promised good or service will be one year or less. The staff think this practical expedient should substantially reduce the population of contracts for which an entity would be required to evaluate whether or not a significant financing component exists (that is, because most contracts would be eligible for the practical expedient, an entity would not be required to make judgmental evaluations about whether there is an implied financing element).

22. The Boards could have removed judgment in this area by not requiring any consideration of whether a significant financing component exists. Such a decision would have been a significant difference compared with existing U.S. GAAP and IFRS for (a) revenue and (b) many other areas. The Boards also could have removed judgment by always requiring a financing component to be accounted for whenever there is a difference between the timing of payments in comparison to performance. However, such a decision would have been inconsistent with the feedback the Boards received from stakeholders about circumstances in which the difference is unrelated to financing and likely would

result in more cost and complexity than permitting an entity to apply judgment in determining when a contract includes the significant benefit of financing to one of the parties.

Question 2 – If the promised consideration is equal to the cash selling price, does a financing component exist?

23. The standard includes the following objective for adjusting the promised amount of consideration for a significant financing component :

> **606-10-32-16 [61]** The objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognize revenue at an amount that reflects the **price that a customer would have paid for the promised goods or services if the customer had paid cash** for those goods or services when (or as) they transfer to the customer (that is, the cash selling price). An entity shall consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:
>
> a. **The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services**
>
> b. The combined effect of both of the following:
>
> > 1. The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services
> >
> > 2. The prevailing interest rates in the relevant market.
>
> [Emphasis added]

24. Some stakeholders have questioned whether this guidance implies that there is never a significant financing component when there is not a difference between the amount of promised consideration and the cash selling price. In certain industries, it may be common for the promised consideration and cash selling price to be equal. Consider the following examples.

> **Example 1:** A customer can purchase a piece of equipment for CU1,200 and then will be eligible to purchase service for the equipment for CU100 each month under a month-to-month service contract. However, the customer could choose to pay zero for the equipment on day one and have the option to sign a note to pay the CU1,200 over a 24 month period without an additional charge for interest and still pay CU100 each month for service.
>
> **Example 2:** A furniture retailer offers a promotion for a CU2,000 dining set. Customers have the option to obtain 0% financing for 3 years as part of this special promotion or to pay the entire amount at the time of purchase.

25. In the examples above, the list price of the goods is equal to the promised consideration in the contract. However, it is important to note that the list price might not always equal the cash selling price and a contract might have an implied interest rate that is different from a stated interest rate. For example, if a customer offers to pay cash upfront when the entity is offering "free" financing, the customer might be able to pay less than the list price. That is, the true cash selling price might be (in fact, may be likely to be) less than the list price. This notion is consistent in concept with the guidance in paragraph 606-10-32-32 [77], which states that a contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the standalone selling price of that good or service.

26. In the examples above, if the list price, the cash selling price, and the promised consideration are all equal, the respective entities should not automatically assume that there is no significant financing component. The difference, if any, between the amount of promised consideration and the cash selling price is <u>a</u> *consideration* (that is, it is one of two factors in paragraph 606-10-32-16 [61], not the *only* consideration), not a presumption, in determining whether a significant financing component exists. The guidance in paragraph 606-10-32-16 [61] further specifies

that an entity should consider *all* relevant facts and circumstances. Accordingly, this one fact, that the cash selling price is equal to the selling price in the contract, would not be the totality of the assessment. However, if the list price, the cash selling price, and the promised consideration are all, in fact, equal (including after careful consideration of whether the list price is the cash selling price), that might indicate that the contract does not include a significant financing component.

27. It also may be possible that in these type of scenarios (that is, zero implied interest) that a financing component exists but that it may not be significant. Entities will need to apply judgment in determining whether or not the financing component is significant or not.

Question 3 – Does the standard preclude accounting for financing components that are not significant?

28. The standard requires accounting for "significant" financing components. Some stakeholders have questioned whether it would be acceptable to account for financing components that are not significant.

29. The staff understand that the genesis of this question has to do with the fact that the assessment of the significance of the financing component is based on an evaluation of the contract. That is, an entity might deem the financing to not be significant at the contract level, but might prefer to account for it if it is material at the entity level (although the standard does not require an entity level assessment of materiality in this area). Additionally, an entity may have a portfolio of contracts that include financing components for which some are significant and others are insignificant. In this scenario, it would likely be less burdensome to implement the standard if the entity accounts for the financing component across all contracts in its portfolio instead of having to apply two methods of accounting (that is, apply financing component accounting to some and not to others). The Boards' rationale for placing the significance assessment at the contract level is described in the Basis for Conclusions as follows

> **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. As described in this Basis paragraph, the rationale for assessing significance at the contract level was to reduce the burden for entities. That is, it was for practical reasons rather than conceptual reasons. The staff is not aware of any guidance in the standard that would preclude an entity from deciding to account for a financing component that is not significant.

Question 4 – How should entities determine if the practical expedient can be applied in scenarios in which there is a single payment stream for multiple performance obligations?

31. The new revenue standard permits an entity to use the following practical expedient in applying the guidance on significant financing component:

> **606-10-32-18 [63]** As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

32. The staff has received implementation questions about scenarios in which the cash payment may not be directly tied to a particular good or service in a contract. Consider the following example:

> An entity offers a 24 month contract to customers which include the delivery of a device at contract inception and related services over 24 months. The entity concludes that the device and services are each distinct. The promised amount of consideration (combined amount for device and services) is CU2,400 payable in 24 monthly installments of CU100. Assume the transaction price is allocated to the device (CU500) and services (CU1,900 [CU79 per month]).
>
> For purposes of this example, assume that the arrangement includes a significant financing component as the question to be answered only relates to whether the practical expedient can be applied. For purposes of the analysis, this example does not include the calculation of the amount that would be attributed to interest income.

33. In determining the period between when the entity transfers a promised good or service and when the customer pays for that good or service, the question arises as to whether the entity should consider the full monthly consideration received as a payment of the first good or service delivered (that is, follow a first-in-first-out approach) or whether the entity should proportionately allocate the monthly consideration promised in the contract between the equipment and the services.

34. Assume that the entity transfers the device first and recognizes revenue for CU500. Each month the entity transfers the services and recognizes revenue for CU79. The two alternatives for determining whether the practical expedient applies are illustrated as follows

View A:

- The entity allocates consideration to the first item delivered (the device). Therefore, the device will be "paid" (that is, in relation to the allocation of the transaction price) in full after 5 months (CU100/month for 5 months) and the entity concludes that the period between delivery of the device and receipt of the consideration is less than one year.

- The entity notes that any given month of service will be settled in less than 12 months under this approach. For example, services delivered in month 1 will be fully paid in month 6, services delivered in month 2 will be fully paid in month 7, etc.
- The entity therefore applies the practical expedient not to adjust the consideration promised in the contract for the effects of a significant financing component as the entity concludes that the period between transfer of any good or service in the contract and when the customer pays for that good or service is one year or less.

View B:

- The entity proportionally allocates the monthly consideration to the device and the services. Each month, CU79 of the cash is allocated to service and CU21 cash is allocated to the device.
- The amount related to the service receivable is fully settled at the end of each month. The entity will, however, receive the full amount outstanding on the handset only over 24 months (CU21/month for 24 months). The entity concludes that the period between delivery of the device and receipt of the consideration relating to the device to be more than one year. Therefore, the entity would be required to consider whether there is a significant financing component in the contract.
- The staff note that the fact that the practical expedient would not apply does not mean there is necessarily a significant financing component in the contract (that is, the entity would need to consider the guidance in paragraphs 606-10-32-15 [60] through 32-17 [62] to make that determination).

35. Because the service is to be used over a two year period and the payments are also over a two year period, View A would not appropriately reflect the economics of the arrangement. Further, the substance of the transaction is that the customer is financing the purchase of a device and is not financing the service. The staff think View B more appropriately represents the intent of the standard and the economics of the transaction. Accordingly, in the staff's view, View B is the appropriate method to apply when determining whether the practical expedient in paragraph 606-10-32-18 [63] applies in this example. The example provided and

the mechanics used by the staff to arrive at the amounts in View B are fairly simple. An entity would need to apply judgement in determining if the practical expedient applies, especially in fact patterns that are substantially more complex than the example above.

Question 5 – How should an entity calculate the adjustment of revenue in arrangements that contain a significant financing component?

36. While the new revenue standard requires accounting for a significant financing component apart from revenue, the standard does not include explicit guidance on how to calculate the interest income/expense. However, the standard includes guidance on estimating the discount rate and some examples (examples 26 and 29 are included later in this paper). Example 29 includes the calculation of interest expense in an advanced payment scenario. Some stakeholders have raised a question as to how to perform the calculations.

37. The guidance on determining the discount rate in the standard is as follows:

> **606-10-32-19 [64]** To meet the objective in paragraph 606-10-32-16 [61] when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

38. The standard also includes guidance on the presentation of the financing component in the income statement as follows:

> **606-10-32-20 [65]** An entity shall present the effects of financing (interest income [interest revenue] or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income (statement of activities). Interest income [revenue] or interest expense is recognized only to the extent that a contract asset (or receivable) or a contract liability is recognized in accounting for a contract with a customer.
>
> **606-10-32-20[4]** In accounting for the effects of the time value of money, an entity also shall consider the subsequent measurement guidance in Subtopic 835-30, specifically the guidance in paragraphs 835-30-45-1A through 45-3 on presentation of the discount and premium in the financial statements and the guidance in paragraphs 835-30-55-2 through 55-3 on the application of the interest method.

39. Further the new revenue standard includes some illustrations of how to apply the guidance:

> **Example 26:** The contract includes an implicit interest rate of 10 percent (that is, the interest rate that over 24 months discounts the promised consideration of $121 to the cash selling price of $100). The entity evaluates the rate and concludes that it is commensurate with the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. The following journal entries illustrate how the entity accounts for this contract in accordance with paragraphs 606-10-55-22 through 55-29 [B20-B27]:
>
> a. When the product is transferred to the customer, in accordance with paragraph 606-10-55-23 [B21].
>
> Asset for right to recover product to be returned $80 (a)
>
> Inventory $80

[4] The guidance is included in Topic 606, but is not included in IFRS 15.

(a) This Example does not consider expected costs to recover the asset.

b. During the three-month right of return period, no interest is recognized in accordance with paragraph 606-10-32-20 [65] because no contract asset or receivable has been recognized.

c. When the right of return lapses (the product is not returned).

Receivable $100 (b)

Revenue $100

Cost of sales $80

Asset for product to be returned $80

(b) The receivable recognized would be measured in accordance with Topic 310 on receivables. This Example does not consider the impairment accounting for the receivable. [The receivable recognized would be measured in accordance with IFRS 9.This example assumes there is no material difference between the fair value of the receivable at contract inception and the fair value of the receivable when it is recognised at the time the right of return lapses. In addition, this example does not consider the impairment accounting for the receivable.]

Until the entity receives the cash payment from the customer, interest income would be recognized consistently with the subsequent measurement guidance in Subtopic 835-30 on imputation of interest. The entity would accrete the receivable up to $121 from the time the right of return lapses until customer payment. [Until the entity receives the cash payment from the customer, interest revenue would be recognised in accordance with IFRS 9. In determining the effective interest rate in accordance with IFRS 9, the entity would consider the remaining contractual term.]

Example 29:

An entity enters into a contract with a customer to sell an asset. Control of the asset will transfer to the customer in two years (that is, the performance obligation will be satisfied at a point in time). The contract includes 2 alternative payment options: payment of $5,000 in 2 years when the customer obtains control of the asset or payment of $4,000 when the contract is signed. The customer elects to pay $4,000 when the contract is signed.

The entity concludes that the contract contains a significant financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market.

The interest rate implicit in the transaction is 11.8 percent, which is the interest rate necessary to make the 2 alternative payment options economically equivalent. However, the entity determines that, in accordance with paragraph 606-10-32-19 [64], the rate that should be used in adjusting the promised consideration is 6 percent, which is the entity's incremental borrowing rate.

The following journal entries illustrate how the entity would account for the significant financing component.

a. Recognize a contract liability for the $4,000 payment received at contract inception.

Cash $4,000

Contract liability $4,000

b. During the 2 years from contract inception until the transfer of the asset, the entity adjusts the promised amount of consideration (in accordance with paragraph 606-10-32-20 [65]) and accretes the contract liability by recognizing interest on $4,000 at 6 percent for 2 years.

Interest expense $494 (a)

Contract liability $494

(a) $494 = $4,000 contract liability × (6 percent interest per year for 2 years)

c. Recognize revenue for the transfer of the asset.

Contract liability $4,494

Revenue $4,494

40. Because the standard does not provide guidance on subsequent accounting, entities should refer to respective U.S. GAAP (Subtopic 835-30) and IFRS (IFRS 9 *Financial Instruments*) to determine the appropriate accounting.

41. Subtopic 835-30 provides guidance on subsequent measurement in situations in which imputation of interest is required. The guidance requires the use of the interest method. That is, with respect to a note for which the imputation of interest is required, the difference between the present value and the face amount shall be

treated as discount or premium and amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period. The guidance allows for other methods of amortization to be used if the results obtained are not materially different from those that would result from the interest method. Although the guidance in Subtopic 835-30 provides guidance when there are extended payment terms to the customer, a similar calculation methodology would be applied to advance payments from a customer. Chapter 5 of IFRS 9 sets out the measurement requirements for financial instruments and, in particular, includes guidance on calculating interest revenue using the effective interest method.

Question 6 – How should the significant financing guidance be applied when there are multiple performance obligations?

42. The examples in the new revenue standard about the significant financing component guidance include scenarios in which there is a single performance obligation. Stakeholders have raised questions about how to apply the guidance when there are multiple performance obligations. Specifically, the key question stakeholders have raised is whether an adjustment for a significant financing component should ever be attributed to only one or some of the performance obligations in the contract, rather than to *all* of the performance obligations in the contract.

43. Identifying and accounting for significant financing components is part of determining the transaction price (that is, it is part of Step 3 of the revenue model). The transaction price is defined in paragraph 606-10-32-2 [47] as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services. That is, when determining the transaction price, the effect of financing would be excluded because the financing component (interest expense or interest income) is in exchange for financing, rather than for the exchange of promised goods or services and is a separate component of the contract apart from the revenue generation for goods and service.

44. After determining the total transaction price for the contract, the entity would allocate the transaction price to performance obligations in Step 4. For example, if the consideration in a contract is CU100 and an entity determines that the interest component (significant benefit received by the customer) is CU10, then the transaction price is CU90. The standard requires allocation of the transaction price to the performance obligations in the contract on a relative standalone selling price basis in most cases. However, the standard also requires allocation of a bundled discount and allocation of variable consideration on a basis other than relative standalone selling price when specified criteria in the paragraphs referenced above are met.

45. The staff thinks it would be reasonable to attribute a significant financing component to one or more, but not all, of the performance obligations, by analogy to the allocation of variable consideration or allocation of a discount guidance. That is, it might be possible to determine that a significant financing component relates specifically to one (or some) of the performance obligations in the contract. Attribution of a financing component to one (or some) of the performance obligations will require the use of judgment. Attributing the effect of the significant financing component entirely to one (or some) performance obligations might produce an allocation result that is *more* consistent with the overall allocation objective in paragraph 606-10-32-28 [73]:

> The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

Question for the TRG Members

1. For each of the questions above about significant financing components, the staff has provided in this paper the applicable guidance in the new revenue standard, including the Basis for Conclusions and related examples. The staff also has observed where judgment will be necessary, similar to existing GAAP and IFRS. Are there other considerations not included in the staff's analysis that might be helpful to stakeholders' understanding of how to apply the new revenue standard?