IFRS 15: Significant Financing Component

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The new revenue model in IFRS 15 *Revenue from Contracts with Customers* requires an entity to estimate the transaction price in a contract, which includes considering whether there is a significant financing component.

Paragraph 60 of IFRS 15 states, in part, the following:

> "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."

However, when there is a change in the anticipated timing of the delivery of the goods or services, there is ambiguity around the subsequent accounting for the significant financing component.

An entity would also need to consider guidance in paragraph 18 of IFRS 15 to determine whether there has been a contract modification. It may be a matter of judgment to assess whether a change in timing of delivery is considered a change in the scope or price of a contract.

Fact Pattern

- An entity sells a large piece of equipment to a customer, to be delivered in two years, for $10,000. The customer is required to pay the full amount upfront.
- The entity recognizes a contract liability when it receives the cash. The entity identifies that there is one performance obligation: the sale of the equipment, which is satisfied at a point in time upon delivery to the customer's premises.
- The entity has considered the guidance in paragraphs 60 to 65 of IFRS 15 and has concluded that the contract contains a significant financing component because of the length of time between when the customer pays for the equipment and when the entity transfers control of the equipment to the customer.
- The entity concludes 5 per cent is an appropriate annual rate of interest for the two years, and adjusts the promised amount of consideration to accrete the contract liability by 5 per cent over the two-year period. Interest expense is recognized to reflect the financing received through the customer's advance payment. The total transaction price of $11,025 ($10,000 x 1.05^2) is recognized as revenue when the equipment is delivered and $1,025 is recognized as financing expense over the two-year period.
- Six months after contract inception, the customer is facing delays in its project and asks to postpone the delivery date of the equipment by 12 months. There is no change to the consideration paid by the customer as a result of the extension of the contract duration.

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- Paragraph 18 of IFRS 15 defines a contract modification as “a change in scope or price (or both) of a contract that is approved by the parties to the contract.” In this fact pattern, the entity concludes that no contract modification exists, because neither the scope nor the price in the contract have been changed. The overall price in the contract remains $10,000 (equal to the cash received), although the allocation of that price between the financing component and the transaction price to be recognized as revenue may change.

Issue 1: Assuming that the change in timing of delivery is not considered a contract modification under IFRS 15, how should the significant financing component be accounted for?

View 1A – The entity should not adjust the discount rate and should continue to recognize interest expense over the extended delivery period. This results in a change to the transaction price and the amount of revenue recognized upon delivery.

Paragraph 64 of IFRS 15 states, in part, that “[a]fter 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).”

Proponents of this view note that the same discount rate of 5 per cent should be applied to calculate the financing component. This means the contract liability would be accreted up to $11,576, which would then be recognized as revenue when the equipment is delivered. The cumulative interest expense recognized over three years would be $1,576.

View 1B – The entity should recognize revenue to reflect the cash price for the delivery of goods or services. Therefore, the discount rate should be adjusted to maintain a constant financing component and transaction price.

Paragraph 61 of IFRS 15 states, in part, that:

> “[t]he objective when adjusting the promised amount of consideration for a significant financing component is for an entity to recognise 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 (ie the cash selling price).”

Proponents of this view note that the amount of the financing component and transaction price should remain the same as at inception such that the amount of revenue recognized reflects the cash price. Therefore, the discount rate should be adjusted to spread the interest expense over the extended period. In extreme circumstances when delivery is delayed for a significant period of time, application of View 1A could lead to a significant gross up between revenue and financing expense.

The Group’s Discussion

Group members expressed diverse views on this issue.

Some Group members noted that the entity should not adjust the discount rate because of the guidance in paragraph 64 of IFRS 15 (View 1A). Some Group members also noted that the entity has received an additional benefit of financing from holding the advance payment for another 12 months.

Other Group members focused on the objective stated in paragraph 61 of IFRS 15 that indicates the entity should recognize revenue to reflect the cash selling price (View 1B). One way of looking at paragraph 61 of IFRS 15 is that the transaction price would not be revised for the effect of the change in the expected period between payment and performance. Instead, the entity would revise the period over which it recognizes the difference between the transaction price and promised consideration as interest expense.

One Group member observed that there is no guidance in IFRS 15 for changes in transaction price relating to the significant financing component. The absence of guidance could suggest that the standard intended for maintaining a constant financing component and transaction price when there is no contract modification. Another Group member questioned whether there is economic benefit to the entity as a result of the customer's delay. If the entity finished producing the equipment, the cash received upfront would have been used such that there is no additional financing benefit derived from the customer's delay.

A concern was raised about changing the transaction price when an entity determined that there is no significant financing component at inception, but subsequently a significant financing component arises because of the delay in timing of delivery. A Group member noted that this situation may be addressed by the practical expedient described in paragraph 63 of IFRS 15. The practical expedient allows entities not to recognize a significant financing component at contract inception if the period between when the entity transfers the good or service and when the customer makes the payment is 12 months or less. This Group member's view is that once an entity determines that no significant financing component exists at inception, this determination would not change over the life of the contract unless there is a contract modification.

Issue 2: If, instead, the change in timing of delivery is in conjunction with a contract modification under IFRS 15, how should the significant financing component be accounted for?

Paragraph 20 of IFRS 15 is applicable when the scope of the contract increases because of the addition of promised goods or services that are distinct, and there is a concurrent change in the price of the contract that reflects the entity's stand-alone selling prices for the additional promised goods or services. In such a circumstance, the modification is accounted for as a separate contract. In this case, the financing component for the original contract would not be affected by the contract modification.

Paragraph 21 of IFRS 15 is applicable for contract modifications not accounted for as a separate contract in accordance with paragraph 20 of IFRS 15. The accounting differs based on whether the remaining goods or services are:

- distinct from those transferred on or before the date of contract modification (i.e., a paragraph 21(a) modification); or
- not distinct such that there is only a single performance obligation that is partially satisfied as at the date of contract modification (i.e., a paragraph 21(b) modification).

Issue 2(a): How should the significant financing component in a paragraph 21(a) modification be accounted for?

For the fact pattern above, the remaining goods or services to be transferred are considered distinct because there has not been any transfer prior to the change in timing of delivery.

A paragraph 21(a) modification is accounted for as if it were a termination of the existing contract and the creation of a new contract. The consideration for the new contract is the sum of:

(i) the consideration promised by the customer under the original contract that was included in the estimate of the original transaction price not yet recognized in revenue; and

(ii) the consideration promised as part of the contract modification.

Based on how the consideration is calculated above, it could be viewed that the financing component in the original transaction price is unchanged and an additional financing component should be determined, potentially based on a new discount rate.

Issue 2(b): How should the significant financing component in a paragraph 21(b) modification be accounted for?

A paragraph 21(b) modification is accounted for as if it were part of the existing contract. The effect that the contract modification has on the transaction price, and on the entity's progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue at the date of modification (i.e., adjustment to revenue is made on a cumulative catch-up basis).

This accounting could be viewed to suggest that because the retrospective effect of the modification is accounted for on a cumulative catch-up basis, the discount rate applicable to the financing component should be reset. A new discount rate and financing component should be determined, taking into account the modifications to the contract.

The Group's Discussion

Group members agreed with the analysis presented above for Issue 2, which includes Issues 2(a) and 2(b).

The Group discussed whether a recommendation for action is needed to the AcSB on Issue 1 given the diverse views expressed and how this issue might exist in large scale projects (e.g., construction, mining and aerospace). The Group thought it would be premature to raise this issue and suggested monitoring to understand how significant financing components are being accounted for in order to determine if a future action is needed.

(For a full understanding of the discussions and views expressed, listen to the audio clip).