# IFRS 9 and IFRS 15: Scope Interactions

## Extract, IFRS® Discussion Group Report on the Meeting – January 10, 2018

The first step of the new model for revenue recognition requires that an entity determine if a contract exists and whether the contract is with a customer. IFRS 15 *Revenue from Contracts with Customers* applies to all contracts with customers, except for contracts that are within the scope of other standards, such as leases, insurance, and financial instruments.

An entity needs to consider all other potentially relevant accounting literature before concluding that the arrangement is within the scope of the revenue standard. If another standard only applies to a portion of the contract, the entity would need to separate the contract.

There are other interactions between the revenue standard and other standards as well. For example, IFRS 15 deals with the initial recognition of accounts receivable from revenue transactions. Subsequent to initial recognition, IFRS 9 *Financial Instruments* applies to accounts receivable.

The following fact patterns examine the interaction between IFRS 9 and IFRS 15. Specifically:

(a) credit losses, price concessions and discounts;

(b) commodity sales agreements in which the pricing is based on the future commodity prices; and

(c) disclosure of contract assets.

### *Fact Pattern 1*

Entity A recognizes a number of adjustments to accounts receivable balances subsequent to invoicing for goods once control has been transferred. These adjustments include price concessions, volume discounts and credit losses.

### ***Issue 1: Is the following analysis appropriate in determining whether the adjustment is accounted for under IFRS 9 or IFRS 15?***

### *Analysis*

The nature of the underlying adjustment should be assessed to determine whether the adjustment is accounted for under IFRS 9 or IFRS 15. An entity should consider the definition of credit loss under IFRS 9 and the definition of variable consideration under IFRS 15 in making this assessment. For example, paragraph 51 of IFRS 15 states, in part, that “[a]n amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items.”

The nature of the underlying adjustment would be determined based on the relevant facts and circumstances. For some entities, this may be an area of significant management judgment.

### *The Group's Discussion*

Group members agreed with the analysis, emphasizing that the nature of the adjustment is relevant, as opposed to how the adjustment is labelled in the invoice. For example, price concessions can vary in nature. If the price concession was provided because of unanticipated credit issues with the customer, such an adjustment would be within the scope of IFRS 9. If, instead, the price concession was provided as a new feature of the contract, the question becomes whether there is a contract modification, which would then be within the scope of IFRS 15.

One Group member noted that Illustrative Example 40 of IFRS 15 is helpful in explaining the scope considerations. The accounts receivable balance is within the scope of IFRS 9 because it represents the entity's unconditional right to consideration. However, the volume discount is recognized as a contract liability because it is a separate unit of account from the entity's unconditional right to consideration. The volume discount is subject to variability, which is considered variable consideration within the scope of IFRS 15. If the entity did not account for the volume discount separately, the entire receivable would fail the solely payments of principal and interest test in IFRS 9 and be measured at fair value through profit or loss.

Another Group member commented that in practice, it is not unusual for an entity to bundle multiple adjustments and settle them together with a customer (e.g., settling historical price concession claims together with making a modification to the customer contract). Entities need to deconstruct the settlement to determine which amounts are within the scope of IFRS 9 or IFRS 15, taking materiality into consideration.

### *Fact Pattern 2*

A mining entity enters into a contract to sell 1,000 tons of Commodity X to a customer on December 1, 20X7. The final price will be based on the Official Metal Exchange commodity price three months from the date of delivery.

Delivery takes place on December 30, 20X7 and control of Commodity X is transferred to the customer on that date. Final invoicing will take place on March 31, 20X8.

The entity has a December 31 year-end. The three-month forward Commodity X price on December 30 is $6,500 per tonne. On March 31, 20X8, the Commodity X price amounts to $6,750 per tonne. These contracts are frequently referred to as provisional pricing arrangements.

## ***Issue 2: Does the provisional pricing arrangement represent a sales contract with an embedded derivative within the accounts receivable, or variable consideration?***

### *View 2A – The provisional pricing arrangement represents a sales contract with an embedded derivative within the accounts receivable.*

Proponents of this view think that at contract inception (i.e., December 1, 20X7), the provisional pricing arrangement represents an embedded derivative in the host sales contract. Revenue will be recognized on December 31, 20X7, the date when control of the commodity is transferred to the customer and the performance obligation is satisfied in accordance with IFRS 15.

The embedded derivative relates to the accounts receivable, which is recognized and measured based on IFRS 9. The embedded derivative would typically cause the receivable to fail the “solely payments of principal and interest” test under IFRS 9; meaning the receivable would need to be measured at fair value through profit or loss.

Under this view, the presentation of changes in the fair value of the receivable between the initial recognition date and final payment will also be affected. The change in fair value relating to the receivable would not represent revenue from contracts with customers for purposes of disclosure under IFRS 15. However, it may be appropriate to present as other revenue, or a similar description.

*View 2B – The provisional pricing arrangement represents variable consideration.*

Proponents of this view think that the provisional pricing arrangement constitutes variable consideration to be accounted for in accordance with IFRS 15 and not a financial asset within the scope of IFRS 9.

The mining entity would need to apply judgment in: (i) estimating the variable sales price at December 31, 20X7; and (ii) determining whether the estimate meets the “highly probable” test regarding the likelihood of significant reversal. Judgment is also required to identify the point at which the variable consideration becomes unconditional and is therefore considered a financial asset within the scope of IFRS 9.

Under this view, the variable consideration recognized would be included in the IFRS 15 disclosures.

*The Group’s Discussion*

Group members supported that the provisional pricing arrangement in the fact pattern represents a sales contract with price variability that is not variable consideration because the final price is indexed to the Official Metal Exchange commodity price (View 2A). There is no uncertainty regarding the entity’s entitlement to the consideration, as the performance obligation has been satisfied. Therefore, there is no variability to account for under IFRS 15.

The Group also discussed a more complicated situation in which the quantity can vary. For example, an entity has fulfilled its performance obligation to deliver gold, but the actual number of ounces of gold delivered is not known until the refinement process is complete in addition to containing provisional pricing.

If the adjustment to the quantity delivered is viewed as confirming the actual quantity delivered, the adjustment should be treated as a true-up to the revenue initially recognized and the receivable amount. However, if the quantity adjustment resulted from more than just a confirmation process and the adjustment is not regarded as variable consideration, the entity may have an embedded derivative within the accounts receivable. In this case, the accounting is the same as View 2A. Since the arrangement contains a host that is a financial asset within the scope of IFRS 9, the entire arrangement including the embedded derivatives related to quantity and provisional pricing, would be assessed for classification under IFRS 9. The embedded derivatives would cause the receivable to fail the solely payments of principal and interest test and, therefore, the asset as a whole would be measured at fair value through profit or loss.

However, if the adjustment to the quantity delivered is considered variable consideration, the entity would have a contract asset with an embedded derivative. The contract asset is within the scope of IFRS 15 and not a financial asset within the scope of IFRS 9. Therefore, the embedded derivative for provisional pricing is separated from the contract asset and measured at fair value through profit or loss.

*Fact Pattern 3*

IFRS 15 contains certain disclosure requirements relating to contract assets. IFRS 7 *Financial Instruments: Disclosures* contains several disclosure requirements relating to financial assets.

### *Issue 3: Does a contract asset meet the definition of a financial asset such that IFRS 7 disclosures would be applicable?*

*Analysis*

IFRS 15 requires that contract assets be assessed for impairment based on the provisions in IFRS 9. This requirement does not mean that a contract asset meets the definition of a financial asset and is subject to the IFRS 7 disclosure requirements.

This view is also consistent with the Basis for Conclusions on IFRS 15, in which the IASB specifically addressed possible contradictions between the scope provisions of IFRS 9 and IFRS 15. Paragraph BC63 in the Basis for Conclusions on IFRS 15 states, in part, the following:

> "The IASB noted that the requirements in paragraph 5 of IFRS 15 (together with paragraph 2(k) of IAS 39 *Financial Instruments: Recognition and Measurement*, which is a consequential amendment to IAS 39 added by IFRS 15) are clear that when a contract asset is within the scope of IFRS 15, it is not within the scope of IFRS 9."

*The Group's Discussion*

Group members agreed with the analysis above.

Overall, the Group's discussion of the three fact patterns raises awareness about the different factors to consider when analyzing whether a contract, or a portion of the contract, is within the scope of IFRS 9 or IFRS 15. No further action was recommended to the AcSB.

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