Revenue, Section 3400 – Background Information and Basis for Conclusions

Foreword

In May 2024, the Accounting Standards Board (AcSB) amended REVENUE, Section 3400 in Part II of the CPA Canada Handbook – Accounting. The AcSB has approved for publication the contents of this document setting out its rationale for these amendments.

Background Information and Basis for Conclusions documents are sources of generally accepted accounting principles, as described in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100 in Part II of the Handbook. These documents are intended to help readers understand how the AcSB reached its conclusions, but they do not include explanations of requirements or guidance on the application of the relevant Section or Accounting Guideline.

INTRODUCTION

1 This document summarizes considerations that the AcSB deemed significant in reaching its conclusions to amend Section 3400 in Part II of the CPA Canada Handbook – Accounting. This document sets out the reasons the Board undertook to develop the amendments, the process of research and deliberation, the key decisions made and the principal reasons for adopting the positions taken and rejecting others.

BACKGROUND

2 In July 2022, the AcSB issued the Exposure Draft, "Revenue – Upfront Non-refundable Fees or Payments," proposing to defer the effective date of amendments to Section 3400 related to upfront non-refundable fees or payments. The proposed new effective date was for fiscal years beginning on or after January 1, 2025, with earlier application permitted. After receiving positive feedback on the Exposure Draft, the Board issued the amendments into the Handbook on November 15, 2022. The purpose of this deferral was to give the Board more time to research concerns raised around implementing the amendments.

3 In paragraph 21 of the Exposure Draft, the AcSB proposed that its research and any potential standard setting should focus on entities that charge non-refundable initiation and life-membership fees. This includes for-profit entities applying Part II of the Handbook and not-for-profit organizations (NFPOs) applying Part III. The Board also noted that entities collecting certain types of upfront non-refundable fees, including fees related to the issuance of software

licenses, have benefited from the added application guidance. The Board proposed that these types of arrangements should be excluded from its research, and that any amendments to the requirements or guidance should not impact these entities. Respondents to the Exposure Draft agreed with the Board's proposed scope of research and standard-setting activities.

OPTIONS CONSIDERED

Exception for NFPOs based on the criteria in Emerging Issues Committee Abstract of Issues Discussed (EIC) 105, *Revenue Recognition of Non-refundable Initiation fees in Not-for-Profit Organizations*

4 The AcSB considered providing an exception solely for NFPOs, to allow them to recognize certain non-refundable initiation and life-membership fees immediately in revenue. If the Board were to implement this solution, it noted that any exception would need to be clearly limited to NFPOs.

5 The AcSB noted that this form of exception would not apply consistently to transactions with similar characteristics. For example, for-profit golf clubs operate in a similar manner to member-benefit golf clubs. However, their financial statements would be presented differently due to the exception being applicable only to member-benefit golf clubs. In addition, this guidance would no longer apply to member-benefit organizations if the preface were to scope these entities into Part II of the Handbook instead of Part III.

6 Therefore, the AcSB did not propose this solution because it would result in accounting for the same transaction differently purely based on which Section of the Handbook an entity is scoped into. This has the potential to change when the Board completes work on the Evaluating the Preface project.

Exception for all non-refundable initiation and life-membership fees based on the criteria in EIC-105

7 This solution is similar to the one in paragraphs 4-6, except that it would apply broadly to both for-profit and not-for-profit entities collecting non-refundable initiation and life-membership fees. The AcSB analyzed this potential solution because it heard that for-profit and not-for-profit clubs normally have similar operations to one another. Therefore, the Board considered whether they should arrive at similar accounting outcomes for similar transactions.

8 The AcSB received feedback that most for-profit clubs defer and amortize initiation fees into revenue over time. This is because EIC-105, when it was effective, never applied to for-profit entities. Therefore, for-profit entities used the core revenue recognition guidance to conclude that upfront fees should be deferred and amortized into revenue over time. As a result, if the Board provides an exception for all non-refundable initiation and life-membership fees, for-profit clubs will experience a change in practice. This will likely not result in information that is useful to their users given they have an established understanding of the deferred revenues.

Transition relief

9 The application guidance on upfront fees introduced into Section 3400 applies fully retrospectively. Therefore, entities that did not previously defer revenues could now have large, deferred revenue balances, which will require explanation to their users if the entities are required to apply the existing guidance. The AcSB considered whether providing transition relief in the form of prospective application of the guidance could be an alternative.

10 The AcSB heard that deferring and amortizing revenues for initiation fees and other similar transactions better represents the pattern in which these revenues are earned. However, the sudden change in recognition policy and added cost of calculating the deferred revenues from many years prior may not meet the cost/benefit threshold. Therefore, by allowing for prospective application, entities could slowly accumulate a deferred revenue balance onto their balance sheet instead of immediately presenting a large liability to represent the unearned revenue from their entire active member base. That is because entities would only recognize deferred revenue for contracts entered into after the effective date of the amendments. If the Board were to implement this solution, it would need to consider whether prospective application would be a requirement or a choice upon transition.

11 The AcSB noted that allowing for prospective application of the guidance might result in a lack of comparability between balance sheets of for-profit and NFPOs until most of their membership bases turn over (i.e., when revenue from upfront fees is deferred and amortized for most of the clubs' members). In the case of a private golf club, this might take multiple decades. However, the income statement would be more comparable from one year to the next as all entities would be consistently deferring initiation fees from new members.

12 The AcSB thought this was a viable option that would result in consistency in practice for similar transactions. However, given that it would result in a lack of balance sheet comparability for an extended period, the Board decided not to proceed with this option.

Defer effective date until completion of the Evaluating the Preface project

13 Since the AcSB is contemplating changes to the Preface of the Handbook, one possible solution is to indefinitely defer the effective date of the guidance on upfront non-refundable fees or payments until this strategic research project is complete. This way, the Board can propose solutions that will be compatible with the updated version of the Preface. There is precedent for this type of indefinite deferral in other standards.

14 The benefit of this option is that no immediate change in practice would be required for any entities. Therefore, entities that were previously deferring and amortizing will continue to do so while those that recognized revenues upfront for initiation fees could also continue this practice. In addition, any entities that early adopted the amendments can continue to apply those amendments as the application guidance will remain in the Handbook.

Withdraw the guidance on accounting for upfront non-refundable fees or payments

15 The AcSB considered withdrawing the guidance completely instead of delaying the effective date. Both options would allow the Board to propose solutions compatible with an updated version of the Preface.

16 In determining whether to delay the effective date or withdraw the guidance, the AcSB considered why the amendments were issued in the first place. Before the Board issued the amendments in December 2019, many entities were asking for more guidance on how to account for upfront non-refundable fees or payments. This fee structure is typical for entities issuing software-licensing agreements. With the lack of guidance in Section 3400, entities referred to the superseded guidance in EIC-141, *Revenue Recognition*, on how to account for these types of arrangements. By adding this guidance from EIC-141 to the Handbook, it was formalized as authoritative. For these types of entities, the amendments were beneficial and supported their accounting policy for upfront non-refundable fees or payments. By keeping the guidance in the standard, it will continue to support the accounting policies of entities who initially asked for it. Therefore, the Board decided not to proceed with this option.

Disclosure requirement for entities recognizing upfront non-refundable fees in revenue upfront

17 The AcSB also considered whether a disclosure that specifies the amount of upfront non-refundable fees recognized in revenue would provide decision useful information without requiring entities to change their revenue recognition policy. The Board's Private Enterprise Advisory Committee and Not-for-Profit Advisory Committee indicated that this disclosure would not be onerous to prepare since information on initiation fees recognized in revenue upfront is readily available.

18 The AcSB noted that the amendments to paragraphs 3400.A45 -.A48 were issued to reduce diversity in the accounting for upfront non-refundable fees or payments. If the Board were to indefinitely defer the effective date of these amendments, diversity in practice might continue. The Board thinks that this disclosure requirement will provide useful information to financial statement users.

PROPOSED SOLUTION

19 The AcSB issued an Exposure Draft in November 2023 proposing to indefinitely defer the effective date of the amendments, with early application permitted, until the Evaluating the Preface project is complete. The Board also proposed a new disclosure requirement for upfront non-refundable fees or payments recognized in revenue when the enterprise recognizes the fee or payment in revenue upon entering into an arrangement.

20 Since it proposed to defer the effective date, while still providing entities with the option to early adopt, the AcSB thinks that no entities will be required to change practice in the near term. Entities that were previously deferring and amortizing can continue to do so while those that recognized revenues upfront for initiation fees will also continue this practice with additional disclosure. In addition, any entities that early adopted the amendments can continue to apply those amendments as the application guidance will remain in the standard. The Board thinks that the new disclosure requirement will provide useful information to financial statement users while there is still diversity in practice.

21 Most Exposure Draft respondents agreed with the Board's proposal to indefinitely defer the effective date of the amendments, with early application permitted, until the Evaluating the Preface project is complete.

22 Some respondents raised concerns that indefinitely deferring the effective date might create diversity in the accounting for upfront non-refundable fees among for-profit entities because they think this will encourage some for-profit entities to recognize revenue upfront when deferral is more appropriate. The AcSB noted that this concern was not raised while it was developing the Exposure Draft. The Board only heard that some for-profit and not-for-profit entities are accounting for upfront non-refundable fees differently because EIC-105, when it was effective, never applied to for-profit entities. The Board noted that it is aware that diversity in the accounting for upfront non-refundable fees will continue while the effective date is deferred. The new disclosure requirement is intended to provide useful information to financial statement users while there is still diversity in practice. Therefore, this concern was considered by the Board when it developed the proposals. Additionally, any entity considering a change in accounting policy must demonstrate that such a change results in the financial statements providing reliable and more relevant information to meet the requirements in ACCOUNTING CHANGES, paragraph 1506.06(b). The Board thinks that proving the switch from deferral to upfront revenue recognition meets this requirement might be challenging for entities. Therefore, the Board thinks this concern may only affect entities adopting accounting standards for private enterprises (ASPE) for the first time or those for when these transactions are new, and an accounting policy was not previously established.

23 Some Exposure Draft respondents thought that the AcSB should clarify how potential changes to the Preface of the Handbook might impact the application of these requirements to both for-profit and not-for-profit entities. The Evaluating the Preface project is in its research phase, and it remains uncertain what, if any, changes to the Preface will be made. However, that project could affect which entities are directed to Part II and Part III of the Handbook. Therefore, the Board is deferring the effective date of the upfront non-refundable fee amendments until the Evaluating the Preface project concludes to avoid unnecessary changes in accounting practice.

24 Exposure Draft respondents unanimously agreed with the proposed disclosure requirement if the AcSB decides to proceed with indefinitely deferring the effective date. One respondent suggested that new paragraph 3400.35A should clarify that this disclosure is required for revenue recognized "during the period." However, the Board decided not to proceed with adding the words "during the period" to the disclosure requirement. After discussing this proposal with its

advisory committees, the Board thinks that adding the words "during the period" might distract from the notion of revenue recognized upon entering into the arrangement – that is, upfront. The Board noted that arrangements when the entity collects an upfront non-refundable fee but recognizes revenue over time (e.g., a multi-year warranty that is paid for entirely upfront) are not intended to be within the scope of this disclosure requirement. The disclosure requirement is only intended to scope in upfront non-refundable fees that an entity recognizes in revenue upon entering into the arrangement (e.g., an initiation fee at a private golf club).

EFFECTIVE DATE AND TRANSITION

25 The AcSB issued the amendments into Part II of the Handbook on May 1, 2024, while continuing to allow early adoption of the added application guidance on accounting for upfront non-refundable fees or payments. The Board heard that the proposed disclosure requirement should not be onerous for entities to prepare, so this amendment is effective for fiscal years beginning on or after January 1, 2025.
