Revenue, Section 3400 — Background Information and Basis for Conclusions

Foreword

In December 2019, 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.

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INTRODUCTION

1 This document summarizes considerations that were deemed significant by the members of the AcSB in reaching their conclusions in developing amendments to REVENUE, Section 3400. This document sets out the reasons the Board undertook the project to develop this material, the process of research and deliberation, the key decisions made, and the principal reasons for adopting the positions taken and rejecting others. Individual Board members gave some factors greater weight than other ones.

2 Nothing in this document is to be taken as overriding the requirements of the Handbook. However, the discussion may help readers understand how the AcSB reached its conclusions in developing the Sections and the Board's intent with respect to interpretation and application of the amendments.

BACKGROUND

3 Stakeholders have informed the AcSB through various outreach activities that entities applying Section 3400 need more guidance on the accounting for revenue. These stakeholders have frequently pointed to other sources of guidance, such

as the superseded Emerging Issues Committee Abstracts related to revenue and U.S. GAAP in effect pre-2018 (e.g., for software industry guidance). In addition, stakeholders have noted an increasing need to reconsider adding this guidance into Section 3400 now that the revenue standards in IFRS® Standards and U.S. GAAP in effect post-2018 moved away from a risk-and-rewards model to a control-based model for revenue recognition.

4 The AcSB did not intend for stakeholders to move away from the previous guidance as the principles embedded in Section 3400 were thought at the time of transition to Accounting Standards for Private Enterprises to be sufficient. However, as practice has evolved, the Board has observed that additional guidance in Section 3400 is needed.

5 In 2015, the AcSB consulted with its stakeholders about its relative priorities for Part II of the CPA Canada Handbook – Accounting. Stakeholders applying Section 3400 identified revenue as an area of concern. Specifically, they identified a lack of guidance in this Section resulting in a need to:

(a) refer to guidance in the pre-changeover standards in Part V of the Handbook such as the Abstracts (e.g., non-refundable fees and multiple-element arrangements); and

(b) refer to guidance in other jurisdictions, such as the revenue guidance in IFRS Standards and U.S. GAAP in effect pre-2018.

6 To better understand stakeholders' concerns, the AcSB conducted a survey targeting stakeholders applying Section 3400 in Part II, directly and via the not-for-profit standards in Part III. For an overview of the key results, see In Brief – Results of Stakeholder Survey on Section 3400.

7 In May 2019, the AcSB issued its Exposure Draft, "Revenue." In developing the Exposure Draft, the Board considered the feedback from the survey, and the advice of its Private Enterprise Advisory Committee (Advisory Committee).

8 The amendments to Section 3400 provide additional guidance on the following topics:

(a) percentage of completion method;

(b) multiple-element arrangements;

(c) reporting revenue gross or net;

(d) bill and hold arrangements; and

(e) upfront non-refundable fees / payments.

9 The AcSB considered the following in deciding which topics to include in the scope of these amendments:

(a) the pervasiveness of the issue;

(b) comments provided by survey respondents; and

(c) the availability of existing guidance, specifically revenue guidance in superseded Abstracts in the pre-changeover standards in Part V of the Handbook and IFRS Standards and U.S. GAAP in effect pre-2018.

10 In response to the Exposure Draft, some respondents raised concerns related to guidance or topics in Section 3400 that are outside of the scope of the amendments. The AcSB acknowledges that there may be other areas where changes to Section 3400 may be needed; however, the Board decided not to broaden the scope of the project at this time to address stakeholder concerns related to the key topics raised in the survey in a timely manner. The Board will consider these comments in potential future projects for improvements to Section 3400.

11 In developing the amendments, the AcSB:

(a) decided to retain the risk-and-rewards model and the principles-based approach currently used in Section 3400 and to provide explanatory guidance on the existing principles, supplemented by illustrative examples;

(b) considered how to leverage the revenue guidance from:

  (i) various superseded sources of guidance, (i.e., the Abstracts in the pre-changeover standards in Part V of the Handbook);

  (ii) IFRS Standards in effect pre-2018, (i.e., IAS 11, *Construction Contracts* and IAS 18 *Revenue*);

  (iii) U.S. GAAP in effect pre-2018; and

(c) considered the feedback from its Advisory Committee and survey respondents on the guidance currently used most often by enterprises.

12 As part of its research program, the AcSB will continue to examine the need for further improvements to Section 3400, including an assessment of retaining the current risk-and-rewards model.

13 The AcSB received 11 comment letters and heard from 12 stakeholders at roundtables from across Canada.

APPLICABILITY TO NOT-FOR-PROFIT ORGANIZATIONS

14 CONTRIBUTIONS – REVENUE RECOGNITION, Section 4410 in Part III of the Handbook states that not-for-profit organizations (NFPOs) apply Section 3400 for guidance on the recognition of revenue arising from the sales of services or goods. Accordingly, while developing the amendments, the AcSB gave updates on the project to its Not-for-Profit Advisory Committee and gave members opportunities to highlight any specific considerations for NFPOs applying these amendments.

EFFECTS ANALYSIS

15 Stakeholder feedback indicated that there was diversity in the application of the principles in Section 3400 due to the current lack of guidance. Survey results suggested that some enterprises refer to other sources for guidance. Accordingly, the AcSB acknowledges that providing additional guidance may result in a change in practice for some enterprises.

16 As noted above, the AcSB sought to limit the effects of the amendments, by considering the guidance that is currently used in practice when deciding what sources to look to for each of the areas addressed by these amendments.

17 Based on feedback from its Advisory Committee and as the guidance is substantially consistent with guidance provided in the superseded Abstracts, the AcSB expects that there will be minimal costs associated with the amendments relating to the following areas:

(a) reporting revenue gross or net;

(b) bill and hold arrangements; and

(c) upfront non-refundable fees / payments.

18 The AcSB acknowledges that there may be additional costs associated with applying the amendments relating to the percentage of completion method. Based on its Advisory Committee's feedback, these costs may include:

(a) obtaining and tracking the information necessary, depending on the measure used to determine the degree of completion; and

(b) retaining experts, such as engineers or architects.

19 In addition, the AcSB understands that additional costs may be incurred on transition to the amendments relating to multiple-element arrangements, as the information necessary may not be readily available.

20 The AcSB acknowledges that stakeholders would bear these additional costs, therefore, it has tried to minimize these costs by providing transitional relief.

21 In accordance with FINANCIAL STATEMENT CONCEPTS, paragraph 1000.13, in developing accounting standards, the AcSB weighs the anticipated costs and benefits of its proposals in general terms to assess whether they are justified on cost / benefit grounds. Having considered the effects of the proposals, the Board thinks that the amendments will result in improvements to the financial reporting of enterprises.

DEVELOPMENT OF THE AMENDMENTS

22 Throughout the development of the amendments, the AcSB followed its due process. This process included:

(a) ongoing input from its Advisory Committee;

(b) issuance in May 2019 of the Exposure Draft, "Revenue"; and

(c) analysis and consideration of feedback received through written responses to the Exposure Draft and from roundtable participants.

23 The AcSB also asked the Advisory Committee members to perform a fatal-flaw review of the final amendments to ensure the guidance is:

(a) clear in reflecting the Board's intent; and

(b) written in a manner that is consistent with other guidance in Part II of the Handbook.

24 The AcSB received 11 written responses to the Exposure Draft from preparers, joint working groups, a user and public accounting firms. The Board reminds stakeholders that as part of its due process related to Part II of the Handbook, it makes available a public file of materials relating to completed projects, which includes response letters received unless confidentiality is requested.

25 Respondents, including roundtable participants, supported the AcSB's proposals in the Exposure Draft. However, respondents provided additional comments suggesting changes to some of the proposals. The specific issues addressed in this project, including the comments received on the Exposure Draft and any changes made in response to those comments, are highlighted in the subsequent sections.

IDENTIFYING UNITS OF ACCOUNT

26 In its Exposure Draft, the AcSB proposed guidance on identifying units of account in the multiple-element arrangements section. Additionally, the Exposure Draft included guidance on combining and segmenting service and long-term contracts in the percentage of completion method section. Respondents to the Exposure Draft commented that the way the proposals were placed in the Exposure Draft was difficult to follow. They highlighted that it was unclear whether the Board intended for there to be an interrelationship between the two sections of guidance. For example, it was unclear whether the guidance on combining and segmenting contracts was meant to apply only to service and long-term contracts or whether the guidance would apply to other types of revenue arrangements.

27 The AcSB agreed with stakeholders and, therefore, decided to provide guidance on identifying the units of account and combining and segmenting contracts in a separate section in the appendix to Section 3400. The Board also decided to include decision trees to assist stakeholders in navigating Section 3400.

MULTIPLE-ELEMENT ARRANGEMENTS

28 Stakeholder feedback relating to multiple-element arrangements included:

(a) understanding the concept of "acts of performance" and whether or not they are significant; and

(b) determining how to allocate revenue to multiple elements.

29 As an initial step, the AcSB considered the guidance in EIC-175, *Multiple Deliverable Arrangements*. Its Advisory Committee advised that elements of that guidance were considered too complex and would be difficult to apply. Specifically, the concept of vendor specific objective evidence (VSOE) used to determine the allocation of revenue to the separate elements was thought to be onerous. Instead, the Advisory Committee recommended that guidance from IFRS 15 *Revenue from Contracts with Customers*, be considered. The Advisory Committee advised, and the Board agreed, that this selected guidance from IFRS 15 would not conflict with the principles in Section 3400 and would be a more practical solution to the current lack of guidance in this regard.

30 The guidance indicates that an enterprise evaluates all deliverables in an arrangement to determine whether they represent separate units of account. The AcSB noted that, while EIC-175 required that this evaluation be performed at the inception of the arrangement and as each item in the arrangement is delivered, IFRS 15 only required that this evaluation be performed at the inception of the arrangement. Accordingly, the Board decided that the guidance should not be more onerous than IFRS 15 and that the evaluation should only be performed at the inception of the arrangement. Respondents agreed with the Board's proposal, but some suggested the evaluation should also be performed when there are significant modifications to the arrangement.

31 Respondents also suggested that additional guidance be provided for the accounting for contract modifications. These respondents thought that this guidance should be provided for contracts with multiple elements as well as for all other revenue arrangements. The AcSB notes that contract modifications are not within the scope of the amendments; therefore, the Board decided not to include additional guidance for contract modifications with these amendments.

32 The proposals provided examples of two methods that may be used to estimate the stand-alone selling of a good or service when such a stand-alone selling price is not directly observable: adjusted market approach and expected cost-plus margin approach. Respondents to the Exposure Draft observed that there may be situations where the two methods provided in the guidance may not work to estimate the stand-alone selling price and recommended that the residual approach be included in the guidance. In developing the Exposure Draft, the AcSB considered whether to also include the residual approach as an example of a method to use when estimating the stand-alone selling price of a good or service. The Advisory Committee recommended, and the Board agreed, not to include the residual approach as this method may be too complex to apply. The Board also notes that the two methods included in the guidance are intended to be examples of methods that may be used and that depending on the circumstances, other methods may also be appropriate. Accordingly, the Board decided not to include additional examples of methods that may be used.

PERCENTAGE OF COMPLETION METHOD

33 The AcSB understands that percentage of completion accounting is a complex area; one where there is diversity in practice. This is also an area in which limited guidance was provided under pre-changeover GAAP.

34 Areas of concern that stakeholders, including survey respondents, raised included:

(a) when to recognize revenue;

(b) determining the percentage of completion;

(c) determining when contracts should be combined or segmented;

(d) determining which costs to include or exclude;

(e) how to account for contract costs; and

(f) how to account for expected contract losses.

35 Users also identified percentage of completion accounting as an area of concern. Users noted that when financing arrangements have failed, improper application of the percentage of completion method resulted in users being unable to identify the risk of failure before it occurred.

36 The AcSB noted that the superseded Abstracts contained limited guidance relating to the percentage of completion method. Accordingly, these Abstracts could not be referred to for additional guidance. The Board also understood from survey respondents and its Advisory Committee that enterprises often refer to the guidance in pre-2018 U.S. GAAP. Accordingly, the Board looked to Accounting Standards Codification (ASC) 605 as a reference for the additional guidance.

37 In particular, the AcSB has provided additional guidance relating to the areas that stakeholders noted. For example, the Board has provided guidance on determining the degree of completion of a contract using either input or output measures. In that regard, while it understands that enterprises generally use input measures to determine the degree of completion, the Board thought it would be helpful to also provide guidance on the use of output measures for those enterprises that determine that output measures relate as directly as possible to the nature of the contract.

38 The AcSB provided guidance on the costs to include in measuring the degree of completion based on the ratio of incurred to total estimated costs. The Board proposed that when using this method, only those costs that reflect work performed be included in the costs incurred to date and that some of the costs incurred be disregarded. An example of such costs was the costs of uninstalled materials not specifically produced or fabricated for the project. While respondents to the Exposure Draft generally agreed with the Board's proposals, one respondent noted that excluding these uninstalled

materials is contradictory to what is seen in practice and recommended that uninstalled materials be eligible for inclusion in the costs to determine the degree of completion. Users noted that from their perspective, it is appropriate to include such costs to determine the degree of completion. The Board considered this feedback and thinks as many enterprises are including such costs, and users agree with the inclusion of such costs, the cost imposed on enterprises to exclude the costs of uninstalled materials would outweigh the benefits. Therefore, the Board decided to allow costs of uninstalled materials that have been delivered to the job site to be included in the costs to determine the degree of completion.

39 The AcSB has also proposed guidance on alternative approaches to computing income earned for a period under the percentage of completion method. The Board notes that the proposed alternatives are examples of approaches and not meant to be an all-inclusive list of alternatives. Enterprises should use judgment to determine which approach is most appropriate in their circumstances. While respondents to the Exposure Draft supported the alternative approaches, some noted that Alternative B is not frequently used in practice. These respondents recommended that the Board provide an illustrative example for Alternative B. The Board agrees and therefore provided an illustrative example for Alternative B.

40 The AcSB considered whether to include guidance relating to the accounting for expected contract losses. The Board noted that the notion of onerous contracts is not included in Part II of the Handbook. However, the Board understands that expected contract losses are generally recognized in current practice. Therefore, the Board has decided to provide guidance on the accounting for expected contract losses.

41 One respondent to the Exposure Draft suggested that the AcSB state explicitly that using the percentage of completion method or the completed contract method is not a policy choice. The Board discussed whether guidance was needed to clarify that the completed contract method can only be used in limited circumstances. The Board thinks the guidance in paragraph 3400.18 is clear that using the completed contract method is not a policy choice. As such, additional guidance was not considered necessary on this issue.

UPFRONT NON-REFUNDABLE FEES / PAYMENTS

42 Stakeholder feedback regarding upfront non-refundable fees / payments primarily related to determining when to recognize revenue in respect of these fees / payments.

43 The guidance in this area has been obtained from EIC-141, *Revenue Recognition*, as the AcSB understands from its Advisory Committee and survey respondents that this is the guidance that enterprises generally refer to in current practice.

44 The AcSB also noted that upon applying this guidance, depending on other terms of the agreements that might exist, the accounting for upfront fees associated with licenses that have a set term may differ from the accounting for upfront fees associated with perpetual licenses. Specifically, upfront fees associated with term licenses are generally recognized as revenue over the term, whereas upfront fees associated with a perpetual license are generally recognized as revenue when received or receivable. The Board considered the expectations of the buyer and the notion proposed in paragraph 3400.A45 that revenue is deferred, unless the upfront fee is in exchange for products delivered or services performed that have utility to the buyer separate and independent of the other elements in the arrangement. Exposure Draft respondents generally agreed with the Board's proposals and agreed that the accounting for upfront non-refundable fees or payments should be tied to the expectations of the buyer and the general revenue recognition criteria of when performance obligations are met.

BILL AND HOLD ARRANGEMENTS

45 Stakeholder feedback relating to bill and hold arrangements included:

(a) determining whether revenue should be recognized or deferred when there is a bill and hold arrangement with the customer; and

(b) understanding whether significant risks and rewards of ownership have been transferred to the buyer.

46 EIC-141 was used for the guidance in this area. The AcSB understands from its Advisory Committee and survey respondents that this is the guidance that enterprises generally refer to in current practice.

47 The AcSB noted that one of the criteria in EIC-141 specified that there must be a "fixed" schedule for delivery of the goods. The Board thought that this criterion was too prescriptive. It thought that there may be circumstances where there may be a schedule for delivery of the goods, but that a schedule is not necessarily established with fixed dates. Accordingly, the Board decided to amend the criterion in paragraph 3400.A43(d) to remove reference to "fixed" and specify that there must be a schedule of delivery that is reasonable and consistent with the buyer's purpose.

48 In the developing the Exposure Draft, the AcSB considered whether the criterion in paragraph 3400.A43(c) should include the requirement that the buyer must have a substantial business purpose for ordering the goods on a bill and hold basis. Some respondents disagreed with this criterion. These respondents thought including the requirement would place undue burden on the enterprise to obtain the buyer's reasoning for the request and to assess whether the buyer have a substantial business purpose for the request.

49 The AcSB discussed this feedback and thinks that revenue from bill and hold arrangements should only be recognized in limited circumstances. Therefore, the Board decided that the criterion in paragraph 3400.A43(c) should be retained in the final amendments.

REPORTING REVENUE GROSS OR NET

50 Stakeholder feedback relating to reporting revenue gross or net included:

(a) understanding which enterprise bears the risk; and

(b) when to perform the assessment to determine whether revenue should be reported gross or net.

51 EIC-123, *Reporting Revenue Gross as a Principal versus Net as an Agent*, was used for the guidance. The AcSB understands from its Advisory Committee and survey respondents that this is the guidance that enterprises generally refer to in current practice.

52 In considering the criteria for reporting revenue gross or net, and in developing the illustrative examples, the AcSB noted that the criteria proposed are intended to be indicators. In addition, in a particular circumstance, indicators for reporting revenue gross and net might exist. The Board expects that an enterprise should use judgment to determine which of the criteria have more weighting in their circumstances when arriving at its conclusion.

DISCLOSURE

53 The AcSB received feedback from various users that when an enterprise has long-term contracts accounted for using the percentage of completion method, users often seek additional information from the enterprise relating to those contracts. The additional information gives them a better understanding of these contracts and the risks associated with them.

54 In addition, survey respondents indicated that additional disclosures in the area would be helpful. They would provide the user with information about how the percentage of completion was determined and to distinguish between inventory work in progress and unbilled revenue.

55 To develop the disclosure requirements, the AcSB considered the disclosure requirements in IAS 11. The disclosure requirements in IAS 11 provide sufficient information to meet the needs identified by users while not being too onerous to apply, particularly since the disclosure requirements are to be applied on an aggregate basis, and not to each individual contract.

56 One respondent to the Exposure Draft recommended that the disclosures for contracts accounted for using the percentage of completion method that are in progress at the end of reporting period be provided by individual contract and not in aggregate. The respondent also thought that disclosures should be provided relating to contracts completed during the reporting period. The AcSB discussed this feedback and thinks that it would be too onerous for enterprises to provide such detailed disclosure. The Board therefore concluded that the disclosure requirements should remain as proposed. However, the Board encourages enterprises to provide more detailed disclosure when such disclosure will be useful for the users of the enterprise's financial statements.

TRANSITION

57 In the absence of specific transitional provisions, ACCOUNTING CHANGES, Section 1506, requires amendments to be applied retrospectively, except if impracticable. The AcSB thinks retrospective application of the guidance relating to percentage of completion method and multiple-element arrangements could be difficult for enterprises because the information necessary to apply the amendments retrospectively may not be available. In addition, user members of the Advisory Committee noted that their primary concern is with the ongoing accounting in these areas, rather than requiring retrospective restatement.

58 Therefore, the AcSB thinks it is important to provide enterprises with relief on transition. Accordingly, the Board has decided to provide enterprises with the following transitional relief:

(a) an enterprise would not be required to make retrospective adjustments for long-term contracts accounted for using the percentage of completion method that are completed during the fiscal year in which the amendments are first applied or during the immediately preceding fiscal year; and

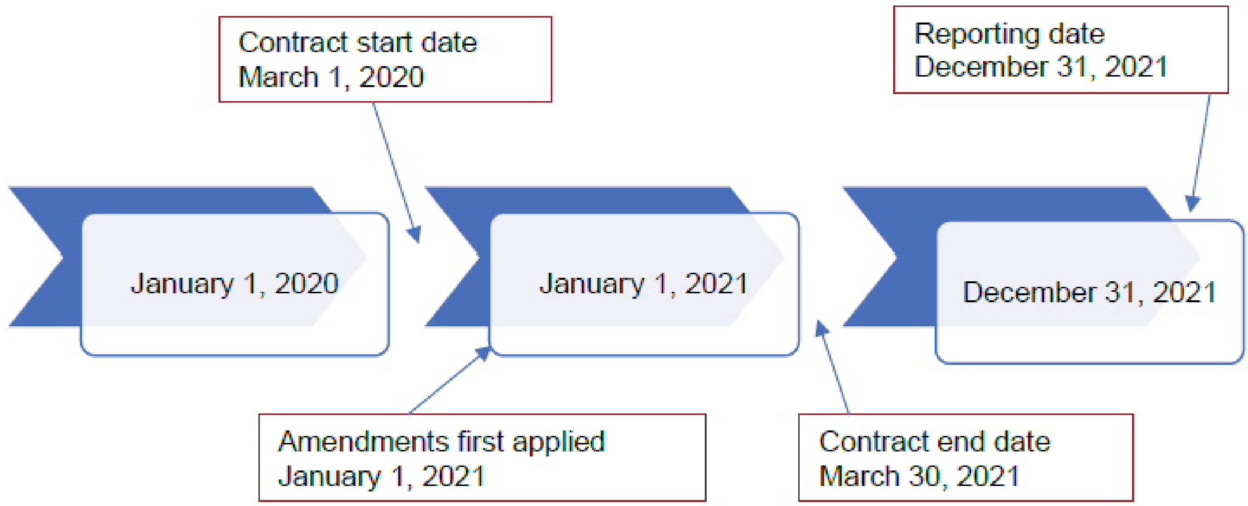
(b) an enterprise would not be required to make retrospective adjustments for multiple-element arrangements when all deliverables have been delivered by the fiscal year in which the amendments are first applied or during the immediately preceding fiscal year.

59 Respondents to the Exposure Draft generally agreed with the AcSB's proposals with regards to transition. Some respondents thought that the overall transition to the amendments would be simplified by allowing transition relief for all five topics. The Board deliberated this feedback and concluded that the amount of effort and cost needed to obtain the information to apply the amendments retrospectively for the topics for which transition relief is not provided does not outweigh the benefit of retrospective application. Therefore, the Board decided not to provide transition provisions for all five topics.

60 The following examples illustrate how the transitional provisions would be applied:

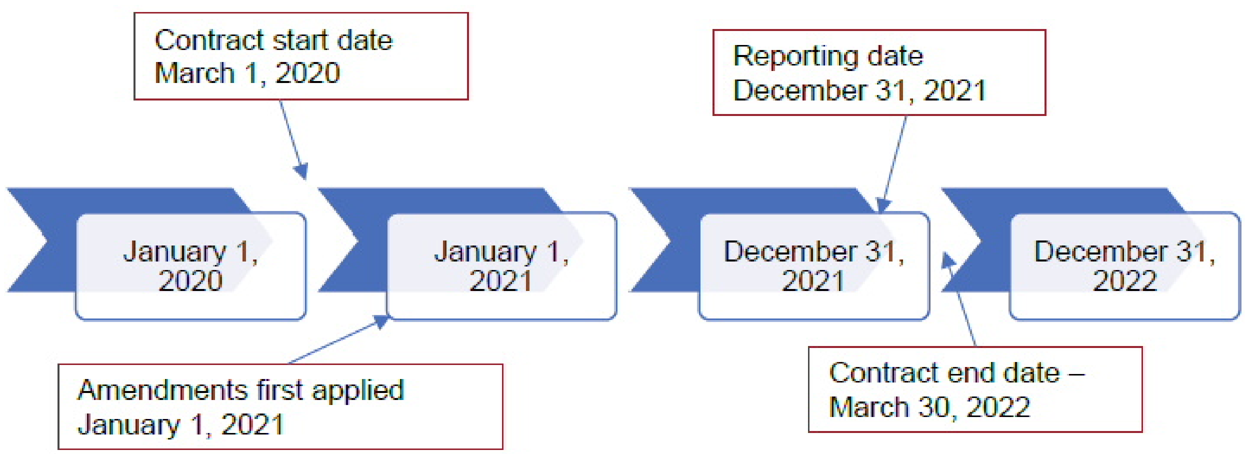
Example 1

- Contract accounted for using the percentage of completion method was completed during the fiscal year the amendments were first applied.
- In this scenario, no restatement required, irrespective of whether enterprise chooses to apply amendments in accordance with paragraph 3400.39 (a) or (b).



Example 2

- Contract accounted for using the percentage of completion method was completed in the fiscal year after the amendments were first applied.
- In this scenario, restatement is required. The enterprise will be required to restate the opening retained earnings as at January 1, 2021, in accordance with paragraph 3400.39 (b).



EFFECTIVE DATE

61 Respondents to the Exposure Draft agreed with the AcSB's view that the effective date, being fiscal years beginning on or after January 1, 2021, would allow sufficient time for preparers to implement the changes, and to educate users on the amendments. The Board acknowledges that this effective date deviates from its usual approach of setting the effective dates for Part II of the Handbook on a two-year cycle. However, the Board thinks this deviation is appropriate given the transitional provisions, and that the guidance resolves the stakeholders' issues in a timely way.

61A In August 2020 the AcSB deferred the effective date of these amendments by one year to alleviate pressure for stakeholders as they navigate challenges and uncertainty created by the COVID-19 pandemic. The amendments are now effective for annual financial statements beginning on or after January 1, 2022. Earlier application is permitted and therefore, the deferral of the effective date does not prohibit stakeholders from applying the amendments in an earlier fiscal year.

CONSEQUENTIAL AMENDMENTS

62 The amendments will affect other Sections. The rationale for some of the more significant amendments are described throughout the Basis as well as below.

FIRST-TIME ADOPTION, Section 1500, and FIRST-TIME ADOPTION BY NOT-FOR-PROFIT ORGANIZATIONS, Section 1501 in Part III

63 The AcSB decided to allow a first-time adopter to not make retrospective adjustments for service and long-term contracts accounted for using the percentage of completion method that are completed during the fiscal year in which the amendments are first applied or during the immediately preceding fiscal year. Similarly, first-time adopters will not be

required to make retrospective adjustments for multiple-element arrangements when all deliverables have been delivered by the fiscal year in which the amendments are first applied or during the immediately preceding fiscal year.

EXPOSURE FOR COMMENT

64 After resolving the issues arising from the exposure draft process, the AcSB considered, as part of its due process, whether the revisions to the proposals should be exposed for comment.

65 The revisions have been highlighted in the relevant sections throughout the Basis for Conclusions. These revisions consist of changes and clarifications to reduce complexity, based on feedback received from stakeholders. Other than the changes and clarifications already highlighted in the Basis for Conclusions, only minor drafting changes were made. Therefore, the AcSB decided that there was no need for re-exposure.
