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Clarity in financial reporting

Trail Commissions – impact of AASB 9 Financial Instruments & AASB 15 Revenue from Contracts with Customers

CONTENTS

Talking points

- When an entity adopts AASB 15, trail commission receivables will be accounted for as contract assets under AASB 15 until such time that the right to consideration is considered to be unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. At the point where the right to consideration is considered to be unconditional, trail commission receivables are accounted for as financial assets under AASB 139 or AASB 9
- If an entity early adopts AASB 9 (without early adopting AASB 15), trail commission receivables will be measured at fair value through profit or loss on transition to IFRS 9 as they will fail the contractual cash flow characteristic test. Subsequently, a different measurement basis will be applied when AASB 15 is adopted. Consequently, it is advisable to early adopt AASB 15 together with AASB 9 where trail commission receivables are material.
- Accounting for trail commission payables is not affected by the adoption of AASB 15. These will continue to be accounted for at amortised cost under AASB 9
- If an entity early adopts AASB 9 (without early adopting AASB 15), it is not advisable to elect the fair value option for the measurement of trail commission payables to address the accounting mismatch between trail commission receivables and payables.

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Background

Internationally there is some diversity in the accounting for trail commission receivables and payables. In Australia, entities typically accrue for trail commission revenue or expense upfront and account for the corresponding receivable or payable as a financial instrument measured at amortised cost under AASB 139 Financial Instruments: Recognition and Measurement. For the purpose of this discussion, we are focusing on the accounting consequences of transitioning to AASB 15 and AASB 9 for those entities that can demonstrate reliable measurement and account for the revenue or expense upfront with a corresponding trail commission payable or receivable under AASB 139. The effective date of both AASB 9 and AASB 15 are for financial years beginning 1 January 2018 with early application permitted.

Example

Broker X introduces various customers to Bank A. If the customers purchase mortgages from Bank A as a result of Broker X's introduction, Bank A compensates Broker X with a trail commission. The terms of the trail commission are such that, for as long as a customer (each in their individual right) is locked into the mortgage contract with Bank A, Bank A will pay Broker X $100 per month per customer. However, Broker X's right to trail commissions ceases when a customer ceases to be a customer of Bank A (for example when a customer pre-pays or refinances the mortgage with another financial institution). Broker X has no ongoing relationship with Bank A or the customer other than the right to receive the trail commissions.

Impact of adopting AASB 15 on trail commission receivables

Presentation

AASB 15 contains specific guidance to determine when a right to consideration is considered a financial asset under AASB 139. Paragraph 108 of IFRS 15 states: "A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due…"

This specifies when a right to consideration is considered a contract asset under AASB 15 versus when it is considered a financial asset under AASB 139. When AASB 15 is adopted by Broker X, the trail commission receivable will initially be accounted for under IFRS 15 as a contract asset under paragraph 108. This is because Broker X's right to consideration is not unconditional as it is contingent on customers remaining with Bank A.

In other words, Broker X's right to consideration is considered to be conditional (i.e. not a receivable under AASB 139 or AASB 9) because it is not only the passage of time that is required before payment of the consideration is due.

Measurement

Under AASB 15, trail commission is considered to be variable consideration. This is because Broker X's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event (i.e. the customer maintaining its relationship with Bank A). In accordance with paragraph 53 of AASB 15 an entity should estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

The expected value – the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

The most likely amount – the most likely amount is the single most likely amount in a range of possible consideration amounts (i.e. the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes.

Typically the measurement of a trail commission will require an analysis of more than only two possible outcomes with regard to the term over which cash flows could be expected. Consequently, an expected value approach would be the more appropriate method to estimate the consideration under AASB 15.

An entity should include variable consideration only to the extent that it is highly probable that a significant reversal of the amount recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

At the end of each reporting period, an entity shall update the estimated transaction price to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period.

Impact of early adopting AASB 9 (without early adopting AASB 15) on trail commission receivables

Assuming the business model test is met under AASB 9, trail commission receivables would have to meet the contractual cash flow characteristics test under AASB 9 in order to apply amortised cost accounting. To do so, the conditions in paragraphs 4.1.2(b) and 4.1.2A(b) of AASB 9 require an entity to determine whether the asset's contractual cash flows are solely payments of principal and interest (SPPI) on the principal amount outstanding. Paragraphs B4.1.7A to B4.1.9 of AASB 9 explain what constitutes a cash flow that is SPPI. In short, it is cash flows that are consistent with basic lending arrangements. Therefore, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that are unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are SPPI. IFRS 9 also makes it clear that an originated or purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form.

The contingency inherent in a trail commission receivable will result in it not meeting SPPI. This is because the amount and timing of the cash flows are entirely contingent on the customer maintaining a business relationship with a supplier. Consequently, trail commission receivables would be required to be measured at fair value through profit or loss under AASB 9.

Trail commission receivables are just a series of cash flows, with no repayment of 'principal'. In other words, if the contingency is likened to a pre-payment feature it means that an entity will not have a principal repaid with any accrued interest. Instead, the cash flows will simply stop when the contingency is triggered. Therefore, the cash flows outstanding are not consistent with basic lending arrangements. Another way to look at the payments would be to view each trail commission payment like an interest rate strip. However, each payment is contingent on the customer not refinancing or pre-paying the borrowed amount (the mortgage in the example above).

When AASB 15 is adopted, the trail commission receivable will cease to be a financial instrument and will be accounted for as a contract asset under AASB 15 (for the reasons stated above). Under AASB 15, entities will apply the variable consideration guidance to measure the trail commission contract asset as opposed to the fair value measurement requirements under AASB 9.

Impact of early adopting AASB 9 and AASB 15 on trail commission payables

Under AASB 9 the classification and measurement models for financial assets and financial liabilities are different. For financial liabilities AASB 9 does not require a business model test or a contractual cash flow test for financial liabilities to be measured at amortised cost. Consequently, assuming that trail commission payables do not meet the requirements for fair value accounting, they would be measured at amortised cost subsequent to initial recognition.

Paragraph 108 of AASB 15 specifically addresses the timing of recognising a contract asset versus a receivable. In the absence of specific guidance for the timing of recognising a financial liability, it must be assumed that the adoption of AASB 15 would not impact the accounting of trail commission payables.

As explained earlier, if an entity early adopts AASB 9 (without early adopting AASB 15) trail commission receivables will be measured at fair value through profit or loss. This could result in an accounting mismatch for entities with both trail commission payables and trail commission receivables. Under AASB 9 it would be possible to elect to measure trail commission payables at fair value by invoking the fair value option on transition to AASB 9. However, we would not recommend this. If the fair value option is invoked for the trail commission payable and AASB 15 is subsequently adopted on the mandatory effective date, trail commission receivables will be accounted for as contract assets under AASB 15 (applying variable consideration guidance as measurement). This will result in another accounting mismatch as the fair value option applied to trail commission payables is irrevocable.

Conclusion

Given the impact of early adopting AASB 9 on the measurement of trail commission receivables, (i.e., measuring trail commission receivables at fair value through profit or loss) clients need to consider carefully whether it is advisable to early adopt AASB 9 without AASB 15.

If AASB 15 is early adopted at the same time as AASB 9 it will result in trail commission receivables being accounted for as contract assets under AASB 15. Consequently, entities will apply the AASB 15 variable consideration guidance to the measurement of the contract asset rather than be required to account for the trail commission receivable at fair value through profit or loss under AASB 9.

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