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IFRS industry insights

The Revenue Recognition Project – An update for the consumer business industry

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During April – June 2011, the IASB and FASB ('the Boards') continued their discussions on the revenue recognition project and made a number of tentative decisions, some of which differed from the proposals in the exposure draft (ED) that was issued last year. Specifically the Boards reached tentative decisions on financial statement disclosures and transition requirements and modified their previous tentative decisions on contract costs. These are some of the topics that consumer business industry respondents expressed concern over in their comment letters on the ED. The Boards also decided to re-expose their tentative decisions reached for public comment. In the second part of our IFRS Industry Insights series for the consumer business industry, we discuss these topics and effects the tentative decisions may have on the consumer business industry.

Contract costs

The ED would require contract costs to be capitalised only if the costs give rise to an asset in accordance with other IFRSs, or relate directly to the contract, generate or enhance resources of the entity that will be used in satisfying future performance obligation and are expected to be recovered. Therefore, amounts paid to obtain a customer contract such as costs of selling, marketing, advertising and negotiations would typically be expensed when incurred.

Several respondents indicated that there was a lack of clarity as to what costs could be capitalised and recommended that the Board clarify this point.

In February 2011, the Boards changed their view and tentatively decided that costs considered "incremental" and that are expected to be recovered would be capitalised. Incremental costs are those costs that are directly attributable to obtaining a contract that would not have been incurred if the contract had not been obtained (e.g., sales commissions).

Additionally, in May 2011, the Boards tentatively decided to permit the recognition of contract acquisition costs as a period cost (as opposed to capitalising) for contracts with an expected duration of one year or less. The Boards also tentatively decided that capitalised contract acquisition costs should be amortised on a systematic basis consistent with the pattern of transfer of goods or services to which the asset relates, which may include goods or services beyond those that are promised in the initial contract (e.g., renewal periods). The Boards supported only permitting an entity to look forward beyond the initial contract period if the entity has demonstrated that it has sufficient historical experience indicating that the contract will be renewed with the same customer.

The tentative decisions clarify the acquisition costs that are capitalisable and would require some types of acquisition costs (e.g., marketing and selling expenses) to be expensed as incurred while other types of acquisition costs (e.g., sales commissions) would be capitalisable. Consumer business industry respondents would also need to determine their accounting policy in relation to acquisition costs for short-term contracts with duration of one year or less.

Several respondents suggested that the disclosures should not be mandatory but should be presented as an indicative list of possible disclosures for management to consider.

Example

An entity incurs sales commissions relating to the acquisition of a contract with an existing customer. The contract is for a period of two years and provides the customer the ability to renew the contract for an additional two years. The entity has entered into these types of contracts in the past with this customer and others and it believes it has sufficient historical experience that indicates the contract will be renewed. The services are provided to the customer ratably over the contract period and the contract is expected to generate sufficient cash flows to recover all costs incurred or expected to be incurred relating to the contract. In this situation, the sales commissions would be capitalisable because they are directly attributable to obtaining the contract and are recoverable from future cash flows. The asset would be amortised ratably over four years because the entity's historical experience indicates that the customer will renew the contract.

Disclosures

The ED would require entities to disclose extensive quantitative and qualitative information about contracts and the significant judgements made in applying the ED's proposals to those contracts. The ED would require that an entity provide, at minimum, revenue disaggregated into categories, a reconciliation of contract balances and a description of the entity's performance obligation including a maturity analysis of outstanding performance obligations and liabilities recognised for onerous performance obligations.

While there was general support from the consumer business industry respondents for the disclosure objective, many respondents did not agree with the level of detail and proposed package of disclosures. Additionally, some respondents felt that the lack of clarity around disclosures might lead to companies disclosing more information than is required. Several respondents suggested that the disclosures should not be mandatory but should be presented as an indicative list of possible disclosures for management to consider. The respondents also noted that some of the disclosures proposed may provide useful information only to users of the financial statements of entities that operate in particular industries and questioned whether the benefits of the disclosures would justify the costs in terms of systems, preparation and validation of the data, as well as audit.

For example, the backlog disclosure is generally regarded as providing useful information about entities with long duration contracts such as in the construction, engineering or outsourcing industries. However, many respondents thought that such information is less relevant to users of the financial statements of consumer business entities that typically enter into shorter duration contracts. Some respondents also noted that some of the disclosures proposed might duplicate other disclosure requirements such as the segment reporting disclosures required by IFRS 8 *Operating Segments*.

The Boards tentatively decided to retain the disclosures proposed in paragraphs 69-83 of the ED, subject to the following clarifications and changes:

In the disaggregation of revenues:

- include additional examples of potential categories (e.g., contract duration, timing of transfer and sales channel) to disaggregate but not prescribe how an entity should disaggregate revenue;
- require an entity to use several categories to disaggregate revenue if necessary to meet the disaggregation objectives outlined in the ED;
- not require an entity to disaggregate expected impairment losses incurred resulting from a customer's credit risk; and
- permit an entity to disaggregate revenues either on the face of the statement of comprehensive income or in the notes to the financial statements.

In the presentation of contract assets and liabilities:

- require the presentation of net contract assets and net contract liabilities as separate line items in the statement of financial position;
- permit the provisions of additional detail about contract assets and receivables either on the face of the financial statements or in the notes to the financial statements;
- permit the use of labels other than 'contract asset' or 'contract liability' on the statement of financial position in describing these balances, assuming sufficient information is available to users to distinguish between conditional and unconditional rights to consideration; and
- require a reconciliation of contract assets and contract liabilities during the period.

The tentative decisions to include some relief from full retrospective application of the new standard will alleviate some concerns from the consumer business industry.

In relation to the remaining performance obligations as of period end:

- require a maturity analysis of remaining performance obligations from contracts with an original expected duration of more than one year on the basis of the transaction price determined under the proposed model.

In relation to assets derived from acquisition and fulfilment costs:

- require reconciliation of the carrying amount of an asset arising from the costs to acquire or fulfil a contact with a customer, by major classification, at the beginning and end of the period, in conjunction with separate disclosure of additions, amortisation, impairments and impairment losses reversed.

The Boards' tentative decision to clarify certain disclosure requirements will ease some of the concerns raised by the consumer business industry respondents. However, many of the consumer business industry's concerns that the disclosure package would be costly and difficult to implement would continue to exist. Entities may find it necessary to modify their internal systems and processes to gather the necessary information to comply with the proposed disclosure requirements.

Transition requirements

The ED would require entities to apply the new standard retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

The majority of consumer business industry respondents noted that while the retrospective application would provide users with useful trend and comparable information, they felt that retrospective application of the proposed model was not feasible for consumer business industry companies because it would require the assessment of a significant number of deals over at least three years. These respondents also noted that their systems are currently not configured to capture the data required by the proposed model (e.g., historical information necessary to bifurcate services and to estimate the fair value of services) and that the implementation of the appropriate procedures would be expected to take significant time and be cost prohibitive.

The respondents felt that the ED should leave the choice between retrospective and prospective application to the respondents but require explanations from entities which would apply the future standard prospectively.

In June 2011, the Boards tentatively decided that an entity would adopt the revenue standard either by applying a full retrospective approach or adopting a retrospective approach subject to the following reliefs:

- not require restatement of contracts that begin and end within the same prior accounting period to be restated;
- allow the use of hindsight in estimating variable consideration;
- not require recognition as assets of fulfilment and acquisition costs recognised as an expense in prior periods;
- not require the onerous test to be performed in comparative periods but only at the effective date unless an onerous contract liability was recognised previously; and
- not require disclosure for prior periods of the maturity analyses of remaining performance obligations in the first year of application.

The Boards also tentatively decided that if an entity adopts the standard retrospectively subject to any of the above reliefs, it would be required to state which reliefs have been employed by the entity and provide a qualitative assessment of the likely effect of applying those reliefs.

The tentative decisions to include some relief from full retrospective application of the new standard will alleviate some concerns from the consumer business industry. However, even with the availability of the reliefs, a significant amount of cost and effort would be required to adopt the revenue standard.

The Boards have tentatively decided to re-expose their tentative decisions …

Re-exposure of tentative decisions

The Boards have tentatively decided to re-expose their tentative decisions in the third quarter of 2011 with a comment period of 120 days. The Boards will seek comments from constituents on the understandability, clarity, operationality and wording of the overall re-exposure draft (including interaction of paragraphs).

The Boards also tentatively decided to invite comments on four specific areas where constituents generally have not had the opportunity to comment on the revised requirements:

- determining when a performance obligation is satisfied over time (i.e. the additional guidance in response to concerns about control and services);
- presenting the effects of credit risk adjacent to revenue;
- constraining the cumulative amount of revenue recognised to amounts that are reasonably assured (rather than constraining the transaction price to amounts that can be reasonably estimated); and
- applying the onerous test to a performance obligation satisfied over a long period of time.

We will provide you periodic updates as significant decisions are reached by the Boards.

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