

IFRS industry insights

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

Respondents requested that the Boards clarify how to evaluate the transfer of control for services.

In June 2010, the IASB and FASB ('the Boards') took a major step towards developing an entirely new revenue recognition standard by issuing a set of proposals in the form of an exposure draft (ED). These proposals would significantly affect the recognition of revenue in the consumer business industry. Since issuing the ED, the Boards have conducted extensive outreach. The comment period on the ED, which ended on 15 December 2010, garnered over 950 responses, and afterwards the Boards hosted roundtable sessions that included participants from all constituencies, including preparers, users and auditors, from a wide cross section of industries. Respondents from the consumer business industry expressed concern over a number of proposals in the ED, including the satisfaction of performance obligations, breakage, uncertain consideration, the licensing of intellectual property, the treatment of warranties and contract costs. The Boards recently discussed these topics and made some tentative decisions which differ from the proposals in the ED and are following this up with further outreach activities.

Satisfaction of performance obligations

The ED would require an entity to recognise revenue when it satisfies a performance obligation by transferring control of the promised good or service to the customer. Several consumer business industry respondents commented that the Boards should improve the guidance for determining when control of goods or services is transferred to a customer. In particular, many respondents indicated that the proposed control guidance was insufficient for the provision of services because the indicators given were more applicable for determining the transfer of control of tangible products. Respondents requested that the Boards clarify how to evaluate the transfer of control for services.



In February 2011, the Boards tentatively decided that revenue recognition should be based on "control" for both the sale of goods and services but the final standard should include separate guidance for goods and services because the Boards believe that the transfer of control of goods is fundamentally different to the transfer of control of services. That is, the transfer of control for goods generally occurs at a point in time while provision of services generally occurs over time. The Boards tentatively decided to make revisions to the indicators for determining that a customer has obtained control of a good, including adding "risks and rewards of ownership" to the list of indicators and removing "the design or function of the good or service is customer specific" from the list of indicators. On the basis of these tentative decisions, the following indicators would be used to determine whether a customer has obtained control of a good:

- the customer has an unconditional obligation to pay;
- the customer has legal title;
- the customer has physical possession; and
- the customer has the risks and rewards of ownership of the good.

An asset with alternative use is an asset that the entity could readily direct to another customer.

The Boards also tentatively decided that an entity would recognise revenue over time for the provision of a service if a performance obligation is satisfied continuously, which would occur if:

- the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced (consistent with the guidance for the transfer of control of a good); or
- the entity's performance does not create an asset with alternative use to the entity and at least one of the following criteria is met:
 - the customer receives a benefit as the entity performs each task;
 - another entity would not need to reperform the task performed to date if that other entity were to fulfil the remaining obligation to the customer without the benefit of any controlled inventory; or
 - the entity has a right to payment for performance to date even if the customer could cancel the contract for convenience.

For a customised service contract where the customer owns the work-in-progress as the asset is being assembled, the revenue associated with that service would be recognised over the period of the contract. For service contracts where the customer does not control the work-in-progress, an entity will need to determine whether an asset is created with an alternative use to the entity. An asset with alternative use is an asset that the entity could readily direct to another customer. All facts and circumstances would need to be considered, including the contract terms, the significance of the costs involved to reconfigure the asset, discounts that would need to be provided to sell the asset to another customer and consequences to the entity (including legal ramifications) of directing the asset to another customer. An entity that determines that an asset does not have an alternative use must also meet one of the three criteria noted above to recognise revenue over time.

The staffs provided the following examples of services that may give rise to a continuous transfer of control on the basis of the first two of the new criteria (assuming that the customer does not control the work-in-progress and the entity's performance does not create an asset with alternative use to the entity):

- an entity that processes transactions on behalf of a customer because the customer receives a benefit as each transaction is processed; and
- an entity that provides shipping services for a customer because the customer would not need to reperform the shipment of goods that are provided to date.

In evaluating whether an entity has a right to payment for performance to date, the entity must have a right to a fixed or variable amount that is intended to compensate the entity for its performance to date even if the customer can terminate for convenience (i.e. for reasons other than the entity's failure to perform as promised). Compensation for performance to date would include payment for recovery of the entity's costs plus a reasonable profit margin rather than compensation for the entity's potential loss of profit if the customer cancels the contract.

For entities that sell bundles of goods and services that are considered separate performance obligations, the tentative decision to include separate guidance for the sale of services will help in limiting the effect that the new standard would have on the timing of revenue recognised for the service.

Example

An entity regularly sells a product and maintenance services to customers as a bundled package. The product and services are considered separate performance obligations. The maintenance contract requires the entity to perform daily maintenance for the customer. The maintenance services would likely meet the proposed criteria for continuous transfer of control because the entity's performance of the maintenance services would not create an asset that could be transferred to another customer. Additionally, the customer immediately receives a benefit as the daily maintenance services are performed. Therefore, the entity would generally recognise revenue relating to the maintenance contract over the contract

The tentative decision clarifies for the consumer business industry the accounting for breakage and represents an acceptable approach under current practice.

Breakage

The ED provided guidance on breakage indirectly through the guidance on allocating consideration to customer options. The ED would require that an option be accounted for as a separate performance obligation only if the option provides the customer with a material right that the customer would not receive without entering into that contract. The ED indicates that the stand-alone selling price for a customer's option often must be estimated and should reflect the discount that the customer would obtain when exercising the option, adjusted for (a) any discount that the customer could receive without exercising the option and (b) the likelihood that the option will be exercised. The breakage would be recognised when the future goods or services are transferred because it would be reflected in the amount of consideration attributed to each good or service expected to be transferred. However, the ED did not address breakage when there is a single performance obligation in the contract.

Many entities in the consumer business industry provide customers the right to make a non-refundable prepayment to the entity for the right to receive future goods or services. Examples of these types of transactions include gift cards, gift certificates and layaway sale deposits. Several consumer business industry respondents requested specific guidance on breakage (e.g., non-use of gift cards) when only a single performance obligation exists in the contract (e.g., the sale of a gift card only).

In February 2011, the Boards tentatively decided that if an entity can reasonably estimate the amount of expected breakage, the entity would recognise the effects of the expected breakage as revenue in proportion to the pattern of rights exercised by the customer. Otherwise, the entity would recognise the effects of the expected breakage when the likelihood of the customer exercising its remaining rights becomes remote.

The tentative decision clarifies for the consumer business industry the accounting for breakage and represents an acceptable approach under current practice. To recognise the effects of the expected breakage as revenue over time, a retailer would need to have sufficient historical information to estimate the timing and amount of breakage. Otherwise, the allocated revenue would only be recognised when the possibility of the customer not exercising its remaining rights is remote.

Example

An entity sells a CU100 gift card that expires in two years and estimates on the basis of historical experience with similar gift cards that the amount of breakage is 10% or CU10. The customer purchases a product for CU45 and uses its gift card. The entity would recognise revenue of CU50 (revenue from transferring the product of CU45 + breakage of CU5 $[CU10 * 45 / (100-10)]$). If the entity could not reasonably estimate the timing and amount of breakage on its gift cards, the entity would only recognise revenue for breakage when it becomes remote that the gift card will be redeemed.

Uncertain consideration

The ED would require that an entity measure revenue in an amount that the entity expects to receive in exchange for satisfying a performance obligation. The ED proposed that an entity would estimate the amount of consideration that it expects to receive using an expected value technique (i.e., a probability-weighted approach).

Several consumer business respondents expressed concern that estimating the transaction price using an expected value technique may not be suitable for all situations and may be overly complex to apply. For example, in situations when an entity is certain to receive one of two possible consideration amounts (i.e., a binary outcome), the expected value technique may generate a result that does not reflect a possible outcome and would therefore not be meaningful.

The Boards also tentatively decided that an entity should recognise revenue at the amount allocated to a satisfied performance obligation unless the entity is not reasonably assured to be entitled to that amount.

In April 2011, the Boards tentatively decided that an entity would generally determine the transaction price using an expected value technique. In applying an expected value technique, an entity would not be required to identify all possible scenarios. If an entity does not have the information to use an expected value technique or the distribution of the possible outcomes is such that the use of an expected value technique would not provide a reasonable estimate of the transaction price (e.g., binary outcomes), the entity would determine the transaction price using a best estimate technique.

The Boards also tentatively decided that an entity should recognise revenue at the amount allocated to a satisfied performance obligation unless the entity is not reasonably assured to be entitled to that amount. The entity would not be reasonably assured if:

- the customer could avoid paying an additional amount of consideration without breaching the contract;
- the entity has no experience with similar types of contracts; or
- the entity has experience, but that experience is not predictive of the outcome of the contract.

The tentative decision to require an expected value technique in most circumstances will require retailers that have the necessary information to apply an expected value technique to estimate the transaction price using multiple scenarios. This would be likely to require a significant amount of judgement and may result in financial statement volatility if there are changes in estimates. However, the tentative decision to allow for the use of a best estimate approach in certain circumstances would alleviate some of the respondents' concerns relating to unreliable estimates when there is a lack of information or only two possible outcomes.

An entity will need to consider in a separate step whether it is reasonably assured that they are entitled to the revenue allocated to a satisfied performance obligation. The terms of the contract and the extent of an entity's historical experience with similar types of contracts will be key factors in determining whether the reasonably assured threshold is met.

Example

An entity enters into a contract to sell a product and service to a customer that requires the customer to pay a fixed amount of CU100,000 plus an additional amount that varies based on the customer's usage of the product. The entity regularly enters into these types of contracts with customers. In addition to the fixed amount, the entity has the opportunity to get paid either 0, CU1,000, CU5,000 or CU10,000. Based on its historical information, the entity estimates that the probabilities of each of the four possible outcomes occurring are 10 percent, 30 percent, 40 percent and 20 percent, respectively. In this case, the entity would likely use an expected value technique which would result in a transaction price of CU104,300 (CU100,000 + [(30% x 1,000)+(40% x 5,000)+(20% x 10,000)]). The transaction price would be allocated to the product and service if they are considered separate performance obligations. If the additional amount did not vary with the entity either receiving a single amount or nothing, the entity would generally use the best estimate technique to determine the transaction price. Revenue allocated to a satisfied performance obligation only would be recognised if the entity is reasonably assured to be entitled to the allocated amount.

Licences of intellectual property

The ED provides guidance on how an entity would account for the licensing of its intellectual property. A licence that transfers control of the entire licensed intellectual property to the customer (e.g. an exclusive licence for the entire economic life) would be treated as a sale. An entity that licenses the use of its intellectual property but does not transfer control of the entire licensed intellectual property to the customer (e.g. a licence for less than its economic life) would need to determine whether the licence is exclusive or non-exclusive. For exclusive licences, the performance obligation would be extinguished over time so revenue would be recognised over the term of the licence. For non-exclusive licences, the performance obligation would relate only to transfer of the licence and therefore revenue would often be recognised at the date the customer is able to use the licence.

The granting of licences and other rights of use is common in the consumer business industry. Several consumer business industry respondents indicated that exclusivity is not reliable evidence to determine which party is controlling the benefits. These respondents noted that exclusivity does not affect the nature of an entity's performance obligation and therefore it would be counterintuitive to have different patterns of revenue recognition depending on whether a licence is exclusive. Furthermore, the ED would represent a significant change in practice for some entities in accounting for licences.

In April 2011, the Boards tentatively decided that the final standard would not distinguish between exclusive and non-exclusive licences. The Boards tentatively decided that a contract where an entity grants a licence to a customer, the promised asset is the licence and the promise to grant that licence represents a single performance obligation that the entity satisfies when the customer is able to use and benefit from the licence (i.e., when the customer obtains control). However, in some circumstances, the entity would recognise licence revenue continuously because either (a) the licence is not separable from other performance obligations in the contract or (b) the contract includes an amount of the transaction price allocated to the performance obligation that is not reasonably assured to be received.

The tentative decision to not distinguish between exclusive and non-exclusive licences would address the concerns of many consumer business industry respondents. However, there may be circumstances when an entity would recognise licence revenue continuously over the contract term. The staffs provided the following example to illustrate a situation where revenue would be recognised continuously over the contract term:

Example

An entity enters into a licence agreement with a customer for five years. Under the agreement, the customer agrees to pay CU1 for each product it manufactures and sells using the entity's intellectual property. When the entity satisfies its performance obligation by transferring the licensed intellectual property, it does not recognise revenue relating to the future royalty payments until the uncertainty is resolved because the amount of the transaction price allocated to the performance obligation is not reasonably assured to be received (the customer can avoid paying an additional amount of consideration). The entity would recognise revenue for the CU1 royalty payment as the customer sells its products and the uncertainty is resolved.

Warranties

The ED distinguished between two types of product warranties – a quality assurance warranty that provides a customer with coverage for latent defects in the product and an insurance warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. A quality assurance warranty would not give rise to a separate performance obligation as it does not provide the customer with a service in addition to the promised product. An insurance warranty would give rise to a performance obligation for warranty services in addition to the performance obligation to transfer the promised good or service. Therefore, an entity would allocate the transaction price between the promised good or service and the promised warranty service.

Many consumer business industry respondents expressed concern that under the proposed guidance, the amount and timing of revenue recognised for goods or services sold with warranties would result in an initial deferral of revenue, rather than just a liability for the expected costs. Entities would need to review the specific terms of each warranty agreement to determine the type of warranty which may be a time consuming and challenging process.

In February 2011, the Boards tentatively decided that if the customer has the option to purchase the warranty separately, the warranty would be accounted for as a separate performance obligation. Otherwise, an entity would account for the warranty as a warranty obligation (cost accrual) unless the warranty provides a service in addition to assurance that the delivered item is as specified in the contract.

The Boards' tentative decision addresses the concerns of the consumer business industry respondents and would generally result in the accounting for standard warranties that is consistent with existing practice.

Contract costs

The ED would require contract costs to be capitalised 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 be expensed when incurred.

In February 2011, the Boards changed their view and tentatively decided that "incremental costs" 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. Therefore, sales commissions and other costs incurred that would not have been incurred if a customer contract had not been obtained would be capitalised. All other costs would be expensed when incurred. An asset would be recognised for capitalised costs and presented on the statement of financial position and subsequently amortised on a systematic basis.

Looking ahead

The Boards still have a number of issues to discuss. The final standard is expected to be issued by the end of 2011. We will provide you periodic updates as significant decisions are reached by the Boards.

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