

# IAS Plus Update.

## Discussion paper proposes new basis for revenue recognition

In December 2008, the International Accounting Standards Board (IASB) published for public comment a discussion paper (DP) entitled *Preliminary Views on Revenue Recognition in Contracts with Customers*. The DP represents the first step jointly with the US Financial Accounting Standards Board (FASB) in the development of a new, converged Standard on this subject.

The IASB has requested comments on the DP by 19 June 2009.

### Key proposals

The DP discusses the framework that should underpin revenue recognition requirements, but does not address specific application issues. These will be covered in the next stage of the project. Key proposals in the DP include:

- basing revenue recognition on contracts with a customer – specifically, on increases in an entity's net position in a contract with a customer as a result of the entity satisfying its performance obligations under the contract;
- recognising revenue for each performance obligation when the customer obtains control of the promised asset (good or service), so that it is the customer's asset;
- regarding both the supply of goods and the supply of services as being the transfer of an asset to a customer;
- accounting for performance obligations separately to the extent that the promised assets (goods or services) are transferred to the customer at different times (this is sometimes referred to as 'unbundling' or 'multiple element' accounting, although the DP does not use these terms); and

- allocating the transaction price at inception between the performance obligations on the basis of the relative stand-alone selling prices of the associated goods and services.

Although these proposals draw on a framework that has much in common with existing practice, they would result in significant changes to revenue recognition for some entities. One of the most important changes proposed is the focus on recognising revenue only when the customer obtains control of the associated asset. This could, for example, significantly affect entities that currently apply a percentage of completion approach for construction contracts, but where the customer does not control the asset during the period of construction. Under the proposed model, such entities would instead recognise revenue only when the customer obtains control of the asset, which might not be until the end of the construction period.

### Objectives of the revenue project

The IASB believes that the principles underlying the two main revenue recognition Standards at present (IAS 18 *Revenue* and IAS 11 *Construction Contracts*) are inconsistent and vague. In the US, revenue recognition guidance comprises more than a hundred standards, many being industry-specific, which can produce conflicting results for economically similar transactions. The boards' objective is to develop a model that can replace most of the existing revenue standards, to improve the comparability and understandability of revenue for users of financial statements.

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## Revenue would be recognised based on increases in an entity's net position (the combination of its rights and obligations under a contract).

The boards have yet to decide whether any particular contracts with customers should be excluded from the proposed model. The DP notes that the proposed model might not always provide decision-useful information about contracts with high potential volatility (e.g. some contracts for financial instruments or commodities) and some insurance contracts.

### **A contract-based revenue recognition principle**

The DP proposes that revenue should be recognised based on increases in an entity's net position in a contract with a customer. The entity's net contract position is the combination of its rights and obligations under the contract. A contract need not be in writing – it is any agreement between two or more parties that creates enforceable obligations.

The DP's focus on contracts means, for example, that gains recognised under IAS 41 *Agriculture* as a result of biological transformation would not be regarded as revenue for the purposes of the DP. This is because such gains relate to changes in value in a biological asset, and not to a contract with a customer.

Whether the entity's net contract position is a contract asset, a contract liability or a net nil position depends on the measurement of the remaining rights and obligations in the contract. For example, where a customer has paid in full for goods or services before they have been supplied, this will typically give rise to a contract liability, because the entity will have an obligation to supply those goods or services, but will have no right to receive further consideration from the customer. Conversely, where the entity has satisfied all its obligations under a contract, it will typically have a contract asset for any further consideration that is due from the customer.

The DP proposes that revenue should be recognised when a contract asset increases or a contract liability decreases (or some combination of the two) as a result of the entity satisfying its performance obligations under the contract.

### **Performance obligations**

The boards' preliminary view is that an entity's performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer. A contractual promise can be explicit or implicit.

The DP gives the example of a contract to provide painting services in which it is understood that the seller (the entity) will source the paint. If the contract does not contain an explicit obligation for the seller to supply paint, such an obligation is nevertheless implicit.

When an entity promises to provide a good, it is clear that it is promising to transfer an asset to the customer. The DP argues that a promise to provide a service is similarly a promise to transfer an asset. From the customer's perspective, a service is an asset when received, even though the customer may consume that asset immediately and, therefore, recognise an immediate expense.

The approach taken in the DP means that revenue will typically be recognised as goods or services are transferred to a customer under a contract. Therefore, it will be necessary to account for performance obligations separately to the extent that the promised assets (goods or services) are transferred to the customer at different times.

By arguing that a service is an asset when received by the customer, the DP is able to specify a single principle for revenue recognition that applies equally to goods and to services. Under IAS 18, different approaches are adopted for goods and for services, so that it is necessary to distinguish between them. In some circumstances, this distinction is not easy to draw.

### **Satisfaction of performance obligations – a control-based approach**

An entity will satisfy a performance obligation and, therefore, recognise revenue when it transfers a promised asset (such as a good or a service) to the customer. The DP proposes that an entity has transferred a promised asset when the customer obtains control of that asset, so that it has become the customer's asset (which, in the case of a service, may need to be recognised as an expense immediately).

Typically, a customer will obtain control of a good when the customer takes physical possession of the good. Similarly, in the case of a service, the service will typically become the customer's asset when the customer receives the promised service.

The DP's proposed focus on control is perhaps the most significant change from the existing model for revenue recognition, which is driven by risks and rewards and distinguishes between goods and services.

It means, for example, that in a contract to construct an asset for a customer, an entity satisfies a performance obligation during construction (and, therefore, recognises revenue) only if assets are transferred to the customer throughout the construction process. That would only be the case if the customer controls the partially constructed asset as it is being constructed. One example cited in the DP in which the customer would have control is where the customer has the right to take over the partially constructed asset and to engage another supplier to complete it. Thus, where the customer has the right to take over such a partially constructed asset, revenue would be recognised as construction activity progresses – irrespective of whether the contract meets the definition of a construction contract.

The DP proposes a rebuttable presumption that an asset to be used by an entity in satisfying another performance obligation in the contract is not transferred to the customer until the asset is used in satisfying that other performance obligation. Thus, for example, paint to be used in providing a painting service would be transferred only as painting takes place. The proposed presumption would be rebutted if other factors, such as the terms of the contract or the operation of law, clearly indicate that the asset is transferred to the customer at a different time. For example, in the circumstances described earlier, the presumption would be rebutted where the customer has the right to retain the paint after delivery and to engage another painter to perform the painting service.

#### **Measurement of performance obligations**

The boards debated several different approaches to the measurement of performance obligations. The DP proposes an approach to measurement which is called the 'allocated transaction price approach'. Although the boards favour this approach, they acknowledge that there are concerns associated with it for some contracts.

The DP proposes that performance obligations be measured initially at the transaction price, i.e. the consideration payable by the customer. Where a contract includes more than one performance obligation, the transaction price would be allocated at inception between those performance obligations on the basis of the relative stand-alone selling prices of the associated goods and services. The boards acknowledge that identifying stand-alone selling prices may be difficult, and will require the use of estimates where stand-alone selling prices do not exist. However, because this approach will be consistent with the principle that revenue is recognised as the entity's obligations under the contract are satisfied (rather than when all obligations under the contract have been satisfied), they believe the use of estimates is appropriate.

As performance obligations are subsequently satisfied, through the delivery of goods or services, the amount of the transaction price allocated to each performance obligation would be recognised as revenue. As a result, over the life of the contract, the total amount of revenue recognised would be equal to the transaction price.

This approach is called the 'allocated transaction price approach' because, after contract inception, it is proposed that performance obligations would not be remeasured, with one exception: the measurement of a performance obligation would be updated if that performance obligation becomes onerous. The DP proposes that a performance obligation would be considered onerous when an entity's expected cost of satisfying the performance obligation exceeds the carrying amount of that performance obligation. In such circumstances, the performance obligation would be remeasured to the entity's expected cost of satisfying the performance obligation, and the entity would recognise a contract loss for the difference.

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**The transaction price would be allocated at inception between performance obligations on the basis of the relative stand-alone selling prices of the goods and services.**

The boards currently favour this approach, which uses a historical allocation of the transaction price, in part because of the practical difficulties in obtaining reliable information to remeasure performance obligations on an ongoing basis. Nevertheless, there are some concerns as to whether the approach is suitable for all revenue contracts, particularly those with highly variable outcomes, such as long-term, fixed-price contracts for goods and services with volatile prices (e.g. a take-or-pay contract for electricity or a commodity). The boards are considering scope, disclosures and another measurement approach for some contracts in order to address these concerns, but have not yet reached a preliminary view on the best way forward. Appendix B to the DP discusses three approaches that could be used for subsequent measurement of performance obligations.

#### **Potential effects on current practice**

Although the approach proposed in the DP has much in common with the existing model, it would change practice in a number of areas. The DP identifies the following as areas that would be affected.

#### **Use of a contract-based revenue recognition principle**

The DP proposes that an entity would recognise revenue from increases in its net position in a contract with a customer as a result of satisfying a performance obligation. Increases in other assets (such as cash, inventory not yet transferred to the customer or biological assets) would not trigger revenue recognition. Entities that at present recognise revenue on a percentage of completion basis for construction-type contracts would recognise revenue during construction only if the customer controls the item as it is constructed. (Conversely, although the DP does not make this explicit, entities that at present recognise revenue only on delivery of completed goods would apparently recognise revenue during construction if it can be demonstrated that the customer controls the item as it is constructed – perhaps because the customer has the right to take over the partially constructed asset and to engage another supplier to complete it.)

#### **Identification of performance obligations**

At present, entities account for some warranties by accruing for expected costs rather than deferring a portion of revenue for future warranty services that may need to be provided. Under the model proposed in the DP, warranty obligations would be regarded as performance obligations, and the revenue allocated to them would be recognised only as the warranty obligations are satisfied.

#### **Use of estimates**

Entities currently complying with the US guidance in Emerging Issues Task Force Issue 00-21 and AICPA Statement of Position No. 97-2 sometimes do not recognise revenue for a delivered item if there is no objective and reliable evidence of the selling price of the undelivered items. Under the model proposed in the DP, such entities would estimate the stand-alone selling prices of the undelivered goods and services and recognise revenue when goods and services are delivered to the customer.

#### **Capitalisation of costs**

At present, some entities capitalise certain costs of obtaining contracts, such as commissions paid to a third party for obtaining a contract with a customer. Under the model proposed in the DP, costs would be capitalised only if they qualify for capitalisation in accordance with other Standards, which would not typically be the case for such commissions. Accordingly, an entity would recognise such costs as expenses as incurred, which may not be in the same period as that in which the related revenue is recognised.

#### **Topics not covered in the discussion paper**

The boards' deliberations in this area are ongoing. The panel on the next page sets out a number of topics to be discussed at future meetings as a draft Standard is developed.

#### **Illustrative examples**

As explained above, the proposals set out in the DP would change the recognition of revenue in a number of areas, and would introduce some new concepts. Appendix A to the DP sets out a number of examples which are intended to illustrate the proposed revenue recognition model.

#### **Next steps**

Comments on the DP are due by 19 June 2009. During the comment period, the IASB and the FASB plan to conduct field visits, focusing initially on industries with contracts that the proposed model is most likely to affect. The boards will evaluate the findings from these visits, along with the comment letters received on the DP, with a view to publishing an exposure draft in 2010. The boards will also decide, in the light of comments received, whether to hold public hearings to discuss the proposed model.

## Topics not covered in the discussion paper

- Scope of a general revenue recognition Standard
- Contract renewal and cancellation options (including return rights)
- Combining contracts
- Changes in a contract's terms and conditions after contract inception
- Measurement of rights, including:
  - the time value of money;
  - uncertainty (including credit risk and contingent consideration); and
  - non-cash consideration.
- Application guidance to help entities identify performance obligations consistently
- Application guidance to help entities assess when performance obligations are satisfied
- Application guidance on how an entity should determine stand-alone selling prices for the purpose of allocating the transaction price to separate performance obligations
- Whether a different measurement approach is required for some contracts and, if so, the criteria for determining when that approach is required and the measurement basis for that approach
- Which costs should be included in the test for whether a performance obligation is onerous and in the remeasurement of an onerous performance obligation
- At what unit of account the test for an onerous obligation should operate (e.g. a single performance obligation, the remaining performance obligations in a contract or a portfolio of homogeneous performance obligations)
- Gross or net presentation of the rights and obligations in a contract
- Gross or net presentation of contract liabilities and contract assets
- Display of remeasurements in the statement of comprehensive income
- Gross versus net presentation of revenue
- Disclosure requirements
- Transition guidance and effective date
- Consequential amendments to other Standards

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