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IFRS Project Insights

Revenue Recognition

20 October 2011

The IASB and the FASB are undertaking a joint project to develop a revenue model that would apply to all industries and all types of revenue-generating transactions. This new standard will replace IAS 11 Construction Contracts and IAS 18 Revenue.

The IASB issued DP Preliminary Views on Revenue Recognition in Contracts with Customers in December 2008. The IASB issued ED/2010/6 Revenue from Contracts with Customers (ED) in June of 2010.

In January 2011, the Boards began their redeliberations on the proposals in the ED.

Tentative Decisions Reached during Redeliberations

Combining Contracts

Contracts that are interrelated should be combined, if they are entered into at the same time and generally with the same party (or a related party) and one or more of the following criteria are met: (1) the contracts were negotiated as a package with a single commercial objective, (2) the amount of consideration in one contract depends on the other contract, or (3) the goods and services in the contracts are interrelated in terms of design, technology, or function. The only indicator not carried forward from the ED is “the contracts are performed either concurrently or consecutively” because the Boards felt applying this indicator could result in an entity combining contracts perpetually when the entity enters into a series of independent contracts with customers.

Identifying Separate Performance Obligations

If an entity promises in a contract to transfer more than one good or service to the customer, the entity would account for each promised good or service as a separate performance obligation only if it is distinct. If a promised good or service is not distinct, an entity would combine that good or service with other promised goods or services until the entity identifies a bundle of goods or services that is distinct. In some cases, that would result in an entity accounting for all the promised goods or services in a contract as a single performance obligation.

A good or service is distinct if either of the following criteria is met:

- the entity regularly sells the good or service separately, or
- the customer can benefit from the good or service either on its own or together with resources that are readily available to the customer.

Notwithstanding those criteria, a good or service in a bundle of promised goods or services is not distinct and hence, the entity would account for the bundle of goods or services as a single performance obligation if both the following criteria are met:

a) the goods or services in the bundle are highly interrelated and transferring them to the customer requires the entity also to provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted; and
b) the goods or services are significantly modified or customised in order to fulfil the contract.

Resources that are readily available to the customer include resources obtained by the customer from previous transactions or events, goods or services that the customer has already received under the contract, and goods or services that the customer could purchase separately from the entity or another entity.

Recognition of Revenue

Sale of Services
The Boards tentatively decided to have separate guidance for the sale of goods and sale of services because the Boards agreed that continuous transfer of control guidance should be different for the sale of goods and for the sale of services. An entity would recognise revenue for the sale of a service if an entity determines that a performance obligation is satisfied continuously. A performance obligation would be satisfied continuously if:

a) the entity's performance creates or enhances an asset that the customer controls as the asset is being created or enhanced (e.g., controlling work-in-process), or
b) the entity's performance does not create an asset with an alternative use to the entity (e.g., highly specialised equipment) and at least one of the following conditions is met:
   (i) the customer receives a benefit as the entity performs each task (e.g., processing transactions);
   (ii) another entity would not need to reperform the task(s) performed to date if that other entity were to fulfil the remaining obligation to the customer (e.g., shipping assets from one location to another); or
   (iii) the entity has a right to payment for performance to date even if the customer could cancel the contract for convenience (compensation for performance to date includes 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).

The entity must then select a method for measuring progress toward complete satisfaction of that performance obligation. The guidance in the ED will be included in the final standard as well as an emphasis that the objective of measuring progress is to faithfully depict the entity's performance and clarify the descriptions of the output and input methods.

The Boards discussed measuring progress for uninstalled materials. For example, a contractor enters into a contract to build a power plant for a customer and the contract specifies the turbine that the entity must procure and install at the plant. The contract is a single performance obligation. At the end of the reporting period, the entity has delivered the turbine to the site and the customer has obtained control of it. Installation of the turbine is expected to commence in the following reporting period. The Board tentatively decided that an entity should measure progress by recognising revenue for the transfer of those goods in an amount equal to the costs of the transferred goods.

Sale of Goods
An entity should recognise revenue when the customer obtains control of the good. The following changes will be made to the proposals in the ED: (1) describe control as opposed to defining it, (2) add 'risks and rewards of ownership' as an indicator of control, and (3) remove 'the design or function of the good or service is customer-specific' as an indicator of control.

Warranties
Separately priced warranties sold by the entity would be treated as a separate performance obligation and revenue would be allocated to the warranty service. Otherwise, the entity should account for a warranty as a warranty obligation (cost accrual) unless the warranty provides a service to the customer in addition to assurance that the delivered item is as specified in the contract. There was no clear view on whether an entity that does not sell a separately priced warranty should look to warranties offered by third parties in determining whether its warranty is a service. The Boards requested the staffs develop implementation guidance which will be discussed at a future meeting.

Contract Acquisition Costs
Incremental costs expected to be recovered should 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. Costs would be evaluated at the individual contract level and incremental costs would not include those costs that are incremental in attempting to obtain a contract (e.g., travel costs).

The Boards tentatively decided, however, to permit the recognition of contract acquisition costs as a period cost (as opposed to capitalised costs) for contracts with an expected duration of one year or less.

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.

An impairment loss should be recognised to the extent that the carrying amount of the capitalised contract acquisition costs exceeds the recoverable amount. The recoverable amount is:

- the amount of consideration the entity expects to receive in exchange for the good or service to which the asset relates, less
- the costs that relate directly to providing those goods or services.

The amount of consideration would be the total transaction price allocated to performance obligations under the proposed model. The Boards requested that the staff prepare additional guidance on allocating an impairment loss to the assets subject to the impairment test. The IASB tentatively decided that a subsequent reversal of an impairment loss (and an increase in the carrying amount of the capitalised acquisition costs to its recoverable amount) should be recognised if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. However, the FASB tentatively decided not to allow for the reversal of an impairment loss which is consistent with US GAAP.

Breakage

Breakage refers to those instances when customers do not exercise all of their contractual rights to goods or services (e.g., unredeemed gift cards). If an entity can reasonably estimate the amount of expected breakage, the entity should recognise the effects of the expected breakage as revenue in proportion to the pattern of rights exercised by the customer. Otherwise, the entity should recognise the effects of the expected breakage when the likelihood of the customer exercising its remaining rights becomes remote.

Onerous Contracts

A contract loss must be recognised to the extent that the present value of the expected direct costs of satisfying a separate performance obligation exceeds the amount of the transaction price allocated to that obligation. The scope of the onerous guidance would be limited to those contracts with performance obligations that are satisfied over a period of greater than one year. The costs used in applying the onerous test and measuring the onerous liability would be the lower of (a) the direct costs to satisfy the remaining performance obligation or (b) the amount that the entity would have to pay to exit the performance obligation if the entity is permitted under the contract to do so other than by transferring the promised goods or services.

Contract Modifications

If a contract modification results only in the addition of a separate performance obligation(s) at a price that is commensurate with that additional performance obligation, the entity should account for the contract modification as a separate contract. Otherwise, the entity should re-evaluate the performance obligation and reallocate the transaction price to each separate performance obligation.

Collectability

The Boards tentatively decided that a customer's ability to pay the promised amount of consideration should not affect whether a contract exists and should not affect whether the entity recognises revenue upon transfer of a good or service.

The Boards tentatively decided to recognise revenue at the gross amount (i.e., the contractual amount specified) considering credit risk separately. An entity would present a gross revenue line item and a separate line item adjacent to the revenue line item for the initial estimate of expected losses relating to collectability and would include in that same line item any subsequent adjustments due to changes in that estimate. These two line items would then total to a net revenue balance.

Time Value of Money

The Boards reaffirmed the exposure draft's proposal that an entity would adjust for the time value of money if the contract includes a financing component that is significant or material to the contract.

The Boards agreed to provide clarifying guidance that in determining whether a financing component is significant or material, an entity would consider whether: (1) there is a significant timing difference between transfer and payment, (2) the interest rate in the contract (either explicit or implicit) is significant, and (3) the amount of consideration would have been substantially different had payment occurred upon transfer. Additionally, the Boards tentatively decided to permit a practical expedient such that an entity would not be required to consider the time value of money when the period between payment and transfer is less than one year.

Determining the Transaction Price: Uncertain Consideration

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.

Allocation of the Transaction Price

The Boards tentatively decided that an entity should allocate to each separate performance obligation the amount of consideration the entity expects to receive in exchange for satisfying that performance obligation. An entity would allocate the transaction price on a relative standalone selling price basis. The Boards tentatively decided that in circumstances where there is a variable performance obligation (e.g., software licence arrangements), the use of the residual method would be appropriate.

Recognition of Revenue

The Boards tentatively decided that when an entity satisfies a performance obligation, the entity should recognise revenue at the amount allocated to that performance obligation unless the amount is not 'reasonably assured' to be received, which would be the case in each of the following circumstances:

1. The customer could avoid paying an additional amount of consideration without breaching the contract (e.g., a sales-based royalty).
2. The entity has no experience with similar types of contracts (or other persuasive experience).
3. The entity has experience, but that experience is not predictive of the outcome of the contract based on an evaluation of various factors (e.g., time until the uncertainty is resolved, susceptibility to factors outside the influence of the entity, the extent of the entity's experience, the number and variability of possible consideration amounts).

The Boards requested the staffs revise the third circumstance above to be more specific on situations where revenue would be constrained, including emphasising that an amount would generally not be reasonably assured when the outcome is outside the control of the entity.

Allocating Subsequent Changes in the Transaction Price

The Boards tentatively decided that an entity would allocate changes in the transaction price on a relative standalone selling price basis to performance obligations in the contract, except when a change in the transaction price relates entirely to one performance obligation. That would be the case if both of the following conditions are met:

- The contingent payment terms of the contract relate specifically to the entity's efforts to satisfy that performance obligation or a specific outcome from satisfying that separate performance obligation; and
- The amount allocated (including the change in the transaction price) to that particular performance obligation is reasonable relative to all of the performance obligations and payment terms (including other potential contingent payments) in the contract).

Licences and Rights to Use Intangible Assets

The Boards tentatively decided that the final standard should not distinguish between the types of licenses (exclusive and non-exclusive). The Boards tentatively decided that in a contract in which an entity grants a license to a customer, the promised asset is the license and the promise to grant that license represents a single performance obligation that the entity satisfies when the customer is able to use and benefit from the license.

Fulfilment Costs

The Boards tentatively decided to retain the existing scope of the ED relating to fulfilment cost guidance rather than addressing these types of costs comprehensively.

The Boards tentatively decided that an entity would first apply the requirements of other applicable accounting standards (e.g., inventory, PP&E, or intangibles assets) in accounting for the costs of fulfilling a contract. If an entity incurs costs to fulfil a contract and those costs are not in the scope of another standard, the entity would recognise an asset arising from fulfilment costs if all of the following conditions are met: a) the costs relate directly to a contract; b) the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and c) the costs are expected to be recovered (e.g., costs of abnormal amounts of wasted materials, labour or other resources that were not considered in the price of the contract should be recognised as an expense as incurred).

The Boards tentatively decided that "costs relating directly to a contract" include pre-contract fulfilment costs that relate directly to a specific anticipated contract. Pre-contract fulfilment costs are costs that an entity incurs prior to obtaining a contract, such as the costs of mobilisation, engineering and design, architectural or other fulfilment costs incurred on the basis of commitments or other indications of interest in negotiating a contract.

The Boards tentatively decided, however, to permit the recognition of contract fulfilment costs as a period cost (as opposed to capitalised costs) for contracts with an expected duration of one year or less.

Capitalised contract fulfilment 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.

An impairment loss should be recognised to the extent that the carrying amount of the capitalised contract fulfilment costs exceeds the recoverable amount. The recoverable amount is:

- the amount of consideration the entity expects to receive in exchange for the good or service to which the asset relates, less
- the costs that relate directly to providing those goods or services.

The amount of consideration would be the total transaction price allocated to performance obligations under the proposed model. The Boards requested that the staff prepare additional guidance on allocating an impairment loss to the assets subject to the impairment test. The IASB tentatively decided that a subsequent reversal of an impairment loss (and an increase in the carrying amount of the capitalised fulfilment costs to its recoverable amount) should be recognised if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. However, the FASB tentatively decided not to allow for the reversal of an impairment loss which is consistent with US GAAP.

Sale and Repurchase Agreements – Put Options

The Boards tentatively decided that if a customer has the unconditional right to require the entity to repurchase the asset (a put option) and the repurchase price is below the original sales price and the customer obtains control of the asset, the sale and repurchase agreement would be accounted for as a lease. However, the Boards requested the staffs to revise the wording by including reference to a time factor and clarify that there should be a significant economic incentive for the customer to return the asset. In such circumstances, the revenue standard would require the entity to apply the lease standard. The Boards indicated that the lease model would apply even though the products/services (such as intangible assets) would be scoped out of the lease standard. The Boards tentatively decided that when the repurchase price is at the original sales price, the put option would be accounted for as a sale with a right of return.

Production costs under long-term production programs

The Boards tentatively decided that the accounting for costs of products manufactured for delivery under long-term production programs (transferred to a customer at a point in time) would not be in the scope of the revenue recognition project because these costs relate to accounting for inventory and intangible assets. The Boards indicated that this issue may be addressed as part of a separate project.

Annual disclosures

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, the final standard should:

- include additional examples of potential categories (e.g., contract duration, timing of transfer and sales channel) of which to disaggregate but should 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 any expected impairment loss.
- 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, the final standard should:

- require the presentation of net contract assets and net contract liabilities as separate line items in the statement of financial position.
- permit providing additional detail about contract assets and receivables either on the face of the financial statements or in the notes.
- 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.
- require a reconciliation of contract assets and contract liabilities during the period.

Regarding remaining performance obligations as of period end, the final standard should:

- 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.

Regarding assets derived from acquisition and fulfilment costs, the final standard should:

- 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.

Interim disclosures

The Boards tentatively decided that an entity should apply specific revenue recognition disclosures to interim financial statements. The Boards tentatively decided to require disclosure of the following information in interim financial statements:

- a disaggregation of revenue;
- a tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period;
- a maturity analysis of remaining performance obligations;
- information on onerous performance obligations and a tabular reconciliation of the movements in the
  corresponding onerous liability for the current reporting period; and
- a tabular reconciliation of the movements of the assets recognised from the costs to obtain or fulfil a contract with a customer.

An entity would apply the disclosure principle in IAS 34 (IFRSs) or Topic 270 (US GAAP) to determine if any of the other disclosures proposed in the revised ED should be included in the entity's interim financial statements.

The Boards also tentatively decided to include an alternative approach in the revised ED. The alternate approach would require the disaggregation of revenue to be disclosed while the other disclosures on contract assets and liabilities, performance obligations, costs of fulfilling a contract and onerous contracts would be disclosed only if they are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. The revised ED will request feedback on the costs and benefits of the two approaches.

Effect of the proposed model on the telecommunications and other industries

The Boards tentatively decided that the proposed model should not be revised to address some of the concerns raised by constituents in the telecommunications industry (and other industries with similar concerns) - with particular reference to the contingent revenue cap.

Transition Requirements

The Boards tentatively decided that an entity should apply the revenue standard on a retrospective basis either through adopting a full retrospective application or adopting a retrospective application subject to the following reliefs:

- not require restatement of contracts that begin and end within the same annual reporting period;
- allow the use of hindsight in estimating variable consideration in the comparative period;
- require the onerous test to be performed only at the effective date unless an onerous contract liability was recognised previously in a comparative period; and
- not require disclosure of the maturity analyses of remaining performance obligations for prior periods.

The Boards tentatively decided that if an entity adopts the standard retrospectively subject to any of the above reliefs, it would be required to state:

a) which reliefs have been employed by the entity, and
b) a qualitative assessment of the likely effect of applying those reliefs.

Effective date and early application

The Boards tentatively decided that the effective date of the proposed standard would not be earlier than annual reporting periods beginning on or after 1 January 2015.

The FASB tentatively decided that early adoption of the proposed standard would not be permitted, while the IASB tentatively decided to permit early adoption of the proposed standard.

The IASB tentatively decided that first-time adopters of IFRSs would be permitted to apply the revenue recognition standard early.

Relief for first-time adopters of IFRSs

The IASB tentatively decided to provide three reliefs to first-time adopters of IFRSs. Therefore, first-time adopters of IFRSs would apply the revenue recognition standard on a retrospective basis either through adopting a full retrospective application or adopting a retrospective application subject to the following reliefs:

- not require restatement of contracts that begin and end within the same annual reporting period;
- allow the use of hindsight in estimating variable consideration in the comparative period; and
- not require disclosure of the maturity analyses of remaining performance obligations for prior periods.

Convergence

The IASB and FASB have thus far reached the same tentative decisions on the revenue recognition project, with the exception of: 1) the reversal of impairment charges on contract acquisition and fulfilment costs and 2) the FASB tentatively decided that early adoption of the proposed standard would not be permitted, while the IASB tentatively decided to permit early adoption of the proposed standard, as outlined above.

Next steps

The Boards felt that given the importance of the revenue project and the volume of changes that have been proposed, it would be appropriate to re-expose the draft. The Boards tentatively decided that the re-exposure draft would focus on seeking comments from constituents on the understandability, clarity, operationality, interaction of paragraphs, and wording of the overall re-exposure draft. The Boards will re-expose the tentative decisions in November 2011 with a comment period of 120 days.

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

a) Determining when a performance obligation is satisfied over time (i.e. the additional guidance in response to concerns about control and services),
b) Presenting the effects of credit risk adjacent to revenue,
c) 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),
d) Applying the onerous test to a performance obligation satisfied over a long period of time, and
e) Whether the proposed interim revenue disclosures or alternative approach would be more suitable (refer to the Interim disclosure section).

Thinking ahead

- Entities should not assume that their current revenue recognition policy will necessarily be consistent with the proposed model. Basing revenue recognition on the concept of control, rather than the existing distinction between goods and services, may represent a significant shift for some entities and care will be needed to determine how the new approach would be applied to their circumstances. In many cases, this will require a significant amount of judgment as will determining whether multiple performance obligations exist and when those performance obligations are satisfied.
- Although some entities may find that the impact of the new proposals is small, for others the impact may be very significant. For example:
  - It is possible that a single contract will include both elements within the scope of the proposals and elements that are outside their scope. It will be necessary to separate these elements so as to account for each of them under the applicable guidance.
  - Some entities currently applying a percentage of completion model may instead be required to recognise revenue at a later point of delivery to the customer. Particular focus will be needed where entities currently apply percentage of completion accounting but the customer has neither physical possession of, nor legal title to, any work in progress.
  - Entities with multiple element contracts may find that the elements currently unbundled do not correspond to distinct goods and services under the proposed model. This will affect, and may delay, the timing of revenue recognition.
  - The new rules proposed on allocating revenue between performance obligations may result in a different profile of revenue recognition for some entities, and may also affect the relative profitability of different elements of a contract.
  - Some entities that have not previously deferred revenue for separately priced warranty obligations may find that deferral is required.
- The new proposals in respect of onerous performance obligations may result in 'Day 1 losses' for some entities, particularly in sectors where it is the norm to enter into 'loss leader' contracts. The proposed guidance may result in the expensing of costs that were previously capitalised which may affect the profit profile of a contract. Robust accounting policies may need to be developed because of the extent to which judgement is involved.
- Sales forces and analysts may need to be educated on the key aspects of revenue recognition.
- Entities may need to consider the timing and manner of sales force compensation based on changes in the way revenue is recognised.
- Entities should consider the effect that any revised profile of revenue recognition and profit under the proposed model may have on existing debt covenants.
- Information technology system changes may be required to track performance obligations and capture the information necessary to comply with the proposed disclosures.

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