

IASB and FASB issue revised revenue recognition proposals

What you need to know

- ▶ The IASB and FASB jointly issued their revised converged revenue recognition model for contracts with customers on 14 November 2011.
- ▶ The proposed standard will also align the accounting treatment for sales of certain non-financial assets (e.g., disposals of property, plant and equipment) with the new model.
- ▶ The proposed standard will apply to all entities across all industries and replace:
 - ▶ IAS 11 *Construction Contracts*
 - ▶ IAS 18 *Revenue*
 - ▶ IFRIC 13 *Customer Loyalty Programmes*
 - ▶ IFRIC 15 *Agreements for the Construction of Real Estate*
 - ▶ IFRIC 18 *Transfers of Assets from Customers*
- And
- ▶ SIC 31 *Revenue – Barter Transactions involving Advertising Services*
- ▶ The comment period for the proposed standard ends on 13 March 2012.

Highlights

The International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) (collectively, the Boards) have jointly released a second exposure draft (ED), *Revenue from Contracts with Customers*. The outcome of this joint project will result in a single revenue model to be applied by both IFRS and US GAAP reporters when the proposed standard becomes effective.

At a high level, the proposed five-step model is consistent with the June 2010 ED, as is the core principle to recognise revenue when 'control' of goods or services transfers to the customer. However, the Boards have made some significant changes to the application of those steps to address concerns raised by constituents on the original ED, such as the timing of revenue recognition and practicality of some of the requirements. In certain cases, this will alleviate the burden but, for some entities, when and how much revenue is reported may still be significantly impacted.

Here, we discuss the main requirements of the revised revenue recognition model and highlight proposed changes that might impact current practice.

The five step model:

1. Identify the contract with a customer
2. Identify the separate performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations
5. Recognise revenue when (or as) the entity satisfies a performance obligation

Scope of the revised proposals

The ED specifies the recognition and measurement of revenue arising from most contracts with customers. Therefore, it is likely to affect all entities to some degree. The ED will also apply to the recognition and measurement of gains and losses on the disposal of certain non-financial assets such as property, plant and equipment and intangible assets, which are not considered outputs of an entity's ordinary activities. Lease contracts, insurance contracts, financial instruments and certain non-monetary transactions remain outside the ED's scope.

Applying the model to a contract

Step 1: Identify the contract with a customer

Existence of a contract

Contracts may be oral, written or implied by an entity's customary business practices. A contract must have commercial substance, be appropriately approved, have defined rights for each party and specify the terms and manner of payment for the goods or services to be transferred.

Combination of contracts and contract modifications

Entities can combine two or more contracts that are entered into at or near the same time with the same customer, and account for them as a single contract, provided they meet **any** of the following criteria:

- ▶ The contracts are negotiated as a package with a single commercial objective
- ▶ The amount of consideration in one contract depends on the price or performance of the other contract
- ▶ The goods or services in the contracts are a single performance obligation

Entities will need to assess any contract modifications to determine whether they create a new separate contract or adjust the original contract.

What's changed from the original ED?

The original ED required entities to consider combining or segmenting contracts. This was in addition to identifying distinct promised goods or services. The additional step of segmenting the contract is no longer required in the revised ED.

Step 2: Identify the separate performance obligations in the contract

The next step of the model requires an entity to evaluate the terms of the contract and its customary business practices to identify the promised goods or services that are distinct, and hence, accounted for separately. For example, giving a customer a 'buy one get one free' promotional incentive may currently be treated as a marketing expense, but would be accounted for as a promised good or service under the revised ED. Current IFRS does not explicitly address the accounting for multiple element

arrangements, which has resulted in diversity in practice. The proposed standard will provide more guidance on transactions with multiple elements. For some entities, more performance obligations may be identified than under current practice.

A good or service is distinct if either:

- ▶ The entity regularly sells the good or service separately

Or

- ▶ The customer can benefit from the good or service on its own or together with other readily available resources.

A good or service that is part of a bundle of goods or services is not distinct, hence, the bundle is accounted for as one performance obligation if both:

- ▶ The goods or services are highly interrelated and the entity provides a significant service to integrate them into item(s) for which the customer has contracted

And

- ▶ The goods or services are significantly modified or customised to fulfil the contract.

As a practical expedient, two or more distinct goods or services can be treated as one performance obligation if they have the same pattern of transfer to the customer.

What's changed from the original ED?

The original ED required all distinct performance obligations to be accounted for separately. This might have inappropriately resulted in a large number of performance obligations for some contracts. The revised ED clarifies that entities would treat multiple goods or services (a bundle) as one performance obligation if the specified criteria are met.

Step 3: Determine the transaction price

The transaction price is the amount of consideration that an entity expects to be entitled in exchange for transferring promised goods or services to a customer. Current IFRS requires revenue to be measured at the fair value of the consideration received or receivable. For some entities, the change in the measurement objective may result in a change to current practice.

Under the revised ED, the transaction price will include the following:

- ▶ An estimate of any uncertain or variable consideration using either a probability-weighted expected value or the most likely amount, whichever is most predictive.
- ▶ The effect of the time value of money only if there is a financing component that is significant to the contract. As a practical expedient, entities can ignore the time value of money when the period between the customer's payment and the entity's satisfaction of the performance obligation is expected to be less than 12 months.
- ▶ The fair value of any non-cash consideration.
- ▶ The effect of any consideration payable to the customer, such as discounts and coupons. This will be accounted for as a reduction of the transaction price unless the payment is for a distinct good or service from the customer.

Collectibility

Current IFRS does not explicitly address whether the effect of a customer's credit risk should be included in the measurement of revenue, which has resulted in diversity in practice. The revised ED clarifies that the transaction price excludes credit risk, but does not propose to change the measurement of credit risk; IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement* would still apply.

What's changed from the original ED?

The Boards originally proposed that a measure of collectability be included within the transaction price. Under the revised ED, the transaction price will not include the customer's credit risk. Instead, it will be presented as contra-revenue directly below revenue in profit or loss.

Step 4: Allocate the transaction price to the separate performance obligations

An entity must allocate the transaction price to each of the identified performance obligations based on the relative standalone selling prices. If standalone selling prices are not directly observable, an entity will need to use estimates, based on reasonably available information, for example, using an expected cost plus a margin approach or an adjusted market assessment approach. In most instances, entities will be able to make estimates of standalone selling prices that represent management's best estimate considering observable inputs. However, it could be more difficult if goods or services are never sold independently by the entity or others.

Only when the standalone selling price of a good or service is highly variable, can a residual technique be used. The revised ED does not prescribe any particular residual technique. However, the selected technique must be consistent with the basis of a standalone selling price, maximise the use of observable inputs and be applied on a consistent basis for similar goods or services and customers.

If the transaction price contains an amount of consideration that is contingent on a future event (e.g., a performance based measure), entities may be able to allocate the entire uncertain consideration, together with any subsequent changes, to a single performance obligation if specified criteria are met.

What's changed from the original ED?

The revised ED provides limited relief for entities that were concerned about the proposal in the original ED to allocate the transaction price based on standalone selling prices; as a residual technique can only be used if the standalone selling price is highly variable.

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation

Revenue will only be recognised when an identified performance obligation is satisfied, by transferring control of a promised good or service to the customer. A performance obligation can either be satisfied over time or at a point in time.

A performance obligation is satisfied over time if the entity's performance either:

- ▶ Creates or enhances an asset (e.g., work in process) that the customer controls as the asset is created or enhanced

Or

- ▶ Does not create an asset with alternative use

And

- ▶ The customer benefits as the entity performs

Or

- ▶ Another entity would not need to re-perform work completed to date

Or

- ▶ The entity has a right to payment for work completed to date and it expects to fulfill the contract as promised

The process of assessing each criterion set out in the revised ED may require significant judgement as the criteria could be interpreted differently, for example, when evaluating whether an asset has an alternative use to the entity.

If the criteria for performance obligations satisfied over time are not met, the performance obligation is deemed to be satisfied at a point in time.

Indicators that control has transferred include:

- ▶ The entity has a present right to payment for the asset
- ▶ The customer has legal title to the asset
- ▶ The entity has transferred physical possession of the asset
- ▶ The customer has the risks and rewards of ownership of the asset
- ▶ The entity has evidence of the customer's acceptance of the asset

The indicators are not exhaustive but provide guidance to help entities assess when control has transferred to the customer.

Revenue is recognised in line with the pattern of transfer. Revenue allocated to performance obligations satisfied at a point in time will be recognised at the point in time when control has transferred. If the performance obligation is satisfied over time, the revenue allocated to that performance obligation will be recognised over the period the performance obligation is satisfied, using a single revenue

measurement method that best depicts the pattern of transfer. This could be an input or output method.

What's changed from the original ED?

The original ED primarily focused on the control of goods transferring to the customer. The revised ED does not define 'goods' or 'services'. Instead, the Boards have developed criteria to assess when control of a good or service transfers - either over time or at a point in time. There is no assumption that goods transfer at a point in time or that services transfer over time. Instead, the criteria drive this determination and the timing of revenue recognition. We believe that these criteria require further clarification.

Constraining the amount of revenue recognised

Even after a performance obligation is satisfied, the amount of revenue recognised may be constrained because of variable consideration and rights of return.

- ▶ An entity can only recognise variable consideration to the extent that it is *reasonably assured* to be entitled to that consideration. An entity is reasonably assured to be entitled to the allocated transaction price only if the entity has experience with similar contracts and that experience is predictive of the outcome of the contract.
- ▶ If a right of return is granted and the returns can be reasonably estimated, an entity will reduce the transaction price by the estimated expected returns, recognise a refund liability for that amount and recognise an asset for its right to recover the products from customers on settling the refund liability. If the entity is unable to estimate the level of expected returns, it will not recognise revenue until the returns can be reasonably estimated, which may be at the end of the return period.

Other recognition and measurement issues

Licensing and rights to use: An entity will be required to account for the promise to grant a licence as a performance obligation that the entity satisfies at the point in time when the customer obtains control of the rights. The entity will recognise revenue when the customer obtains the right to use and benefit from the asset, generally at the time the licence is granted.

Product warranties: In a change from the original ED, the revised ED simplifies the requirements for standard warranties, e.g. for product defects. Consistent with current practice, an entity will recognise a liability for the estimated warranty cost for delivered goods or services. Warranties that provide more than standard assurance that the product meets the agreed specifications will be treated as distinct performance obligations.

Costs to obtain and fulfil a contract: Direct costs incurred to fulfil a contract and incremental costs incurred to obtain a contract can be capitalised, provided those costs are expected to be recovered. Otherwise, these costs will be expensed as incurred, as would costs that relate to previously satisfied performance obligations for which there is no future benefit and costs of abnormal amounts of wasted materials or excess labour. Capitalised costs will be subject to amortisation and impairment testing.

Onerous performance obligations: The revised ED requires that an entity recognise a liability and a corresponding expense if a performance obligation satisfied over time (and that time is greater than one year) becomes onerous. Performance obligations satisfied at a point in time will not be subject to the onerous test. Before recognising a liability for an onerous performance obligation, the entity will be required to determine whether the assets related to the contracts are impaired (e.g. capitalised costs of obtaining the contract or inventory) and recognise any impairment loss that has occurred. Once the entity has recorded a liability and corresponding expense for an onerous performance obligation, the entity will remeasure the obligation at each reporting date to include changes in assumptions or new information.

Repurchase provisions: A contract may contain repurchase provisions, either as a component of a sales contract or as a related separate contract. The existence of a repurchase option may mean the entity has not transferred control to the customer. An entity will need to consider the contractual terms and conditions and any other relevant factors in assessing whether a customer has obtained control.

Increased disclosures requirements

Consistent with the original ED, entities will need to provide a significant amount of new disclosures, including disaggregated revenue information, reconciliations of contract assets and liabilities and significant judgements and estimates used in applying the model. Key metrics may also change. For example, the presentation of bad debts expense as a contra revenue line instead of part of operating expenses as it is currently presented will result in a lower gross margin amount.

Transition and effective date

The Boards have not yet proposed an effective date, but have indicated in the ED that it would not be before 1 January 2015. All current IFRS and US GAAP reporters will be required to apply the ED retrospectively, with limited transitional relief. Early adoption will be permitted under IFRS.

Next steps

The Boards have given constituents 120 days to provide feedback; the comment period closes on 13 March 2012.

How we see it

We strongly encourage entities to use the opportunity to re-evaluate the revised model and provide feedback to the Boards – sufficient feedback is essential to develop a robust standard that serves all stakeholders. Given the expected impact of the changes, it is important that all entities assess how they will be affected and provide comments to the IASB and FASB.

Further resources

Our *Thought Center* webcast on the revised ED is scheduled on 29 November 2011. It will feature a panel of subject-matter professionals and a project team member from the IASB to discuss the revised model and impact that the proposals will have on companies reporting under IFRS. Registration details are available on www.ey.com/ifrs. A more detailed publication on this topic will be published in our *Applying IFRS* series, providing an in-depth discussion of the requirements of the revised model, and illustrative examples of how the revised model will be applied to revenue transactions.

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EYG no. AU1008

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