

# Another step towards a final revenue standard

## What you need to know

- ▶ The IASB and the FASB reached conclusions on estimating the transaction price when variable (uncertain) consideration exists, such as in royalty arrangements and potential performance bonuses.
- ▶ The Boards retained the relative standalone selling price method for allocating the transaction price. However, they have agreed that a residual technique could be used to estimate standalone selling prices for some performance obligations and will permit an alternative allocation approach in certain circumstances involving uncertain consideration.
- ▶ The Boards have made tentative decisions on the accounting for licences and rights to use intangible assets (intellectual property), repurchase options and fulfilment costs.

## Overview

At their April meeting, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) covered the last of the more significant topics in their redeliberations of the revenue recognition Exposure Draft (ED). These topics included the accounting for uncertain (variable) consideration and allocating the transaction price. The Boards also reached conclusions on applying the proposed model to certain unique transactions.

This publication summarises these developments and is a continuation of our *Supplement to IFRS Outlook Issue 99: New revenue recognition model is taking shape* (SCORE No. AU0822) issued earlier in April 2011.

## Determining the transaction price with uncertain consideration

The ED required that an entity estimate the transaction price at the inception of the contract, including uncertain (variable) consideration, based on the probability-weighted amount it expects to receive. Many constituents found this requirement overly complex and felt it could lead to results that were not meaningful. For example, in situations in which an outcome is binary, the likely result using a probability-weighted approach is an amount that is not a potential outcome.

The Boards tentatively decided that the probability-weighted approach should be used if it is the best predictor of the ultimate consideration to be received. If not, the transaction price should be estimated based on the most likely amount to be received (although it's not clear what the "most likely" threshold is intended to represent when the potential outcome is not binary).

The Boards agreed to allow use of a residual technique for estimating the standalone selling price of a delivered item with volatile pricing.

However, the Boards considered that uncertain consideration should only be recognised in revenue if it is reasonably assured to be received. The Boards concluded that consideration is not reasonably assured if the customer can avoid paying the variable amount without breaching the contract. For example, sales-based royalty payments due to an entity are not reasonably assured until the sale, on which the royalty is based, occurs.

Furthermore, if an entity has no experience with similar types of revenue contracts, or if prior experience is not predictive of future outcomes, uncertain consideration would not be reasonably assured. To determine whether prior experience provides predictive value or not, the Boards felt a number of factors should be evaluated. These included the time until the uncertainty is expected to be resolved, susceptibility to factors outside the influence of the entity and the number and variability of possible consideration amounts.

#### How we see it

The availability of an alternative model to estimate uncertain consideration should provide preparers a reasonable estimation technique in situations in which a probability-weighted estimate does not provide a meaningful amount. Indeed, the change in the proposed accounting for sales-based royalties will be welcomed by many entities that enter into contracts with extended royalty streams.

## Allocating the transaction price

The ED required that the transaction price be allocated to performance obligations on a relative standalone selling price basis. It also indicated that the standalone selling price used for this allocation should be based on observable inputs when available, or management's estimate of a standalone selling price. Respondents questioned their ability to estimate a standalone selling price, especially for performance obligations that are never sold on a standalone basis and are sold at highly variable prices (e.g., software licences). Based on this feedback, the Boards noted that when the standalone selling price of a good or service is highly variable, a residual technique could be used to estimate standalone selling price.

The Boards also decided to allow the transaction price allocation approach to deviate from the relative selling price method in certain circumstances involving uncertain consideration. When uncertain consideration exists, the Boards decided that the uncertain consideration would be allocated entirely to a single performance obligation if both of the following conditions are met:

- ▶ The contingent payment relates specifically to the entity's efforts to satisfy that performance obligation

And

- ▶ The amount allocated (including the change in the transaction price due to the contingent payment) 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.

While the application of this tentative conclusion is clear with respect to changes in uncertain consideration (all changes are allocated to the specified performance obligation), it is less clear how the allocation would be made at inception when allocating both fixed and uncertain consideration. Greater clarification is expected in the final standard.

## Licensing and rights to use

The ED provided guidance for licences and rights to use intellectual property (collectively, licences) on how to determine when "control" of the licence is transferred to the customer (licensee). Many constituents did not agree with the Boards' proposal to distinguish between exclusive and non-exclusive licences as it could have resulted in distinctly different accounting for similar transactions.

The Boards have tentatively decided that the final standard would not distinguish on such a basis. Instead, all promises to grant licences would be accounted for as a single performance obligation in which the entity recognises revenue when the customer obtains the right to use and benefit from the asset.

However, as many of these agreements include uncertain consideration (e.g., royalty payments), the entity would apply the criteria discussed above. That is, when expected consideration related to the licence is reasonably assured, this amount would be recognised when the customer obtains control of the licence. When the receipt of uncertain consideration is not reasonably assured at the outset of the agreement, it would not be recognised until it becomes reasonably assured (e.g., the entity would recognise sales-based royalty revenue over the term of the licence).

## Repurchase options

The ED proposed that if the customer has the ability to require the entity to repurchase the asset, the customer has obtained control of the asset (i.e., the customer has the ability to direct the use of the asset) and that a sale should be recorded. These arrangements would be treated essentially the same as a sale with the right of return.

Some constituents suggested that, in some cases, options granted to customers are not always at or near the original purchase price. In certain industries, the option is exercisable after an extended period of time (e.g., three to five years after the original purchase date). As a result, the specified repurchase price is set below the original transaction price to reflect the decline in value that occurs based on the customer's use of the asset during that period. These constituents argued that this structure did not represent a sale of an asset, but instead a right to use the asset for the option period, which should be accounted for as a lease.

The Boards have tentatively decided that if the customer has a significant economic incentive to exercise its right to put the asset, the customer is effectively paying the entity for the right to use the asset for the option period. The Boards concluded that an entity should account for such transactions under the leasing standard. The Boards will provide factors in the final standard to help determine whether a customer has a significant economic incentive to exercise the repurchase option, including the relationship between the repurchase price and the expected future market value of the asset and the amount of time until the option expires.

The Boards also agreed that when a transaction involves the sale of an intangible asset with a repurchase option that provides the customer a significant economic incentive, the revenue standard will require the transaction to be accounted for under the lease standard.

### Fulfilment costs

In addition to the proposed revenue model, the ED also provided guidance for accounting for an entity's costs incurred in fulfilling a contract. The Boards tentatively affirmed the proposal in the ED, which states that costs incurred that do not give

rise to an asset eligible for capitalisation in accordance with other authoritative guidance (e.g., IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets*), may be capitalised if the costs meet all of the following criteria:

- ▶ The costs relate directly to the contract
- ▶ The costs generate or enhance resources of the entity to be used in satisfying performance obligations in the future

And

- ▶ The costs are expected to be recovered

In addition, the Boards tentatively decided to clarify certain aspects of the proposed requirements on "abnormal costs."

Specifically, the Boards clarified that 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 when incurred.

The Boards also clarified that costs that relate directly to a contract include costs that are incurred before the contract is obtained if those costs relate specifically to the contract.

### Changes to the IASB's work plan

On 14 April 2011, the IASB posted a podcast interview with the chairs of the IASB and FASB, Sir David Tweedie and Ms. Leslie Seidman, which announced that after evaluating the issues remaining on their revenue recognition, leases, financial instruments and insurance contracts projects, the Boards have jointly decided to extend their timetables by "a few months". The impact of this statement on the IASB's work plan has still to be reflected on their website. Currently, the IASB's recently updated the project plans on their website indicate that final standards would be issued on these projects in the second half of the year and that "ballot drafts" would be circulated for IASB member approval before 30 June 2011.

### How we see it

While it is unclear how these announcements will impact the IASB's work plan they should provide an opportunity for the project staff to extend their outreach programmes and field test recent decisions.

Given the significant changes the Boards have made to the ED, this provides an opportunity for IFRS preparers to consider the decisions and communicate any concerns they may identify with the revised proposals.

### Next steps

- ▶ It is expected that the Boards will discuss the remaining issues outstanding at their May meetings. However, these decisions should not be significant to the revenue recognition model.
- ▶ Constituents should consider the decisions to date and how these will be applied in practice.
- ▶ Where necessary, constituents should communicate any significant concerns about the recent decisions to the Boards or their project staff as soon as possible
- ▶ While the Boards' recent decisions eliminate some of the significant changes that would have resulted from the proposal in the ED, a final standard would still trigger significant accounting changes for many entities.

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