

New revenue recognition model is taking shape

Supplement to IFRS Outlook

What you need to know

- ▶ The IASB and FASB have been addressing respondents' concerns about their June 2010 proposal for revenue recognition. The IASB work plan indicates that the final standard will be balloted by the end of June 2011 and published in the second half of 2011.
- ▶ The Boards' amended recognition model for services and long-term contracts that are satisfied continuously will likely result in more transactions being accounted for using a proportional performance recognition method.
- ▶ The Boards' revised criteria for identifying separate performance obligations could change when revenue (or a loss) is recognised.
- ▶ The Boards have yet to deliberate potential changes around estimating the transaction price (including variable consideration) and allocating the transaction price to the identified performance obligations.

Overview

The International Accounting Standards Board and Financial Accounting Standards Board (collectively, the Boards) are re-deliberating various aspects of their joint revenue recognition exposure draft Revenue from Contracts with Customers (ED) in response to feedback received from respondents. Many of the changes the Boards are making to their proposal will result in current practice under IFRS being unaffected.

The IASB recently updated its work plan¹ indicating that while all Board decisions will be made and final votes will be completed on the revenue recognition standard by June 2011, no final standard will be issued until sometime in the second half of the year. However, as discussed further below, the Boards have yet to reach conclusions on some important issues. Therefore, it is not clear whether these issues will create any further delays.

To date, the Boards have addressed many matters identified in their re-deliberation plans. We summarise below the more significant changes to the model proposed in the ED. This summary does not include all tentative decisions made by the Boards.

Identifying the contract with the customer

Existence of a contract

The Boards confirmed that different definitions of a contract will exist for the revenue standard and for financial instruments as the standards have different objectives and scopes. The Boards confirmed that the transaction price need not be specified in a contract for revenue to be recognised. Rather, the seller would estimate the transaction price, applying the standard, and account for the contract accordingly.

Segmenting a contract

The Boards agreed with constituents that their proposed guidance on segmenting a contract was confusing. The Boards therefore decided to eliminate the requirement to segment a contract and instead require separation of a contract solely into separate performance obligations.

¹ IASB work plan - projected timetable as of 28 March 2011 is published at <http://www.ifrs.org/Current+Projects/IASB+Projects/IASB+Work+Plan.htm>. This is updated on a regular basis.

Identifying the separate performance obligations

Under the original proposal, an entity would have to evaluate the terms of the contract as well as the entity's normal business practices to identify all promised goods and services. The entity then would have to determine whether these goods and services represent separate performance obligations by determining whether they were distinct.

Definition of a performance obligation

The Boards first settled on a revised definition of "performance obligation." The ED initially defined a performance obligation as "...an enforceable promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer". Constituents interpreted this definition to mean that only legally enforceable obligations would meet the definition. The Boards concluded that a performance obligation need not be legally enforceable and the final standard will include a revised definition without the word "enforceable".

Separating performance obligations

After identifying the performance obligations in a contract, an entity must determine whether the performance obligations are separable. The key is determining whether one or more good or service is "distinct". The Boards received considerable feedback on the proposals in the ED regarding the concept of "distinct". As a result, the Boards have simplified the model for determining whether goods and services should be accounted for separately and a two-step process should now be used; as follows:

- ▶ Account for a bundle of promised goods or services as one performance obligation, if the entity provides a service of integrating those goods or services into a single item that the entity provides to the customer.
- ▶ Account for a promised good or service, or a bundle of goods or services, as a separate performance obligation if:
 - ▶ The good or service has a different pattern of transfer to the customer from other goods and services in the contract (if the pattern of transfer does not differ between the goods or services, revenue recognition would be the same whether they are separated or combined).And
- ▶ The good or service has a distinct function. A good or service has a distinct function if either:
 - ▶ The entity regularly sells the good or service separately; Or
 - ▶ The customer can use the good or service either on its own or together with resources that are readily available to the customer (including resources obtained in previous transfers of goods or services or that the customer could purchase separately)

Determining whether a promised item represents a good or a service

In a change from the ED, the Boards tentatively decided to provide separate guidance for goods and services. To help entities determine whether they are providing a good or a service, the Boards defined a service as any performance obligation that is satisfied continuously, and concluded that a performance obligation is satisfied continuously if:

- ▶ The entity's performance creates or enhances an asset that the customer controls as the asset is being created
- Or
- ▶ The entity's performance does not create an asset with alternative use to the entity and at least one of the following conditions is met:
 - ▶ The customer receives a benefit as each task is being performed
 - ▶ Another entity would not need to re-perform all of the task(s) performed to date if that other entity were to fulfil the remaining obligation
 - ▶ The entity has a right to payment for performance to date even if the customer or the entity could cancel the contract for convenience

Determining the transaction price

Variable (uncertain) consideration

The third step in the Boards' five-step model is to estimate the transaction price. The ED required that an entity estimate the transaction price, including variable consideration such as performance bonuses or royalties, using probability-weighted-estimates at the inception of the contract. Constituents expressed a number of concerns about this approach. However, the Boards have yet to reach any final conclusions on this topic. We expect the Boards to continue their discussions at the joint Board meeting in April 2011.

Collectibility

In recent re-deliberations, the Boards decided that the effects of a customer's credit risk should not be reflected in the measurement of revenue, which is a change to the proposal in the ED. Entities will present revenue without deducting amounts that may not be collectible and will present an allowance for expected impairment losses on a separate line immediately below gross revenue. The line item will include recognition of the initial allowance as well as the effects of subsequent changes in collectibility.

Time value of money

The Boards affirmed their proposal in the ED to require an entity to consider the time value of money in measuring the transaction price when the effects would be material. However, the Boards also agreed to provide criteria to help entities determine when the effects would be material. The Boards tentatively concluded that an entity must consider the effect of the time value of money only when an arrangement contains a financing component that is significant to the contract. Furthermore, the Boards agreed that an entity should consider the following factors in determining whether a contract contains a significant financing component:

- ▶ The amount of customer consideration would be substantially different if the customer paid in cash at the time of transfer of the goods or service
- ▶ There is a significant difference in the timing of the provision of goods and services and the receipt of payment
- ▶ The interest rate within the contract (implicit or explicit) is significant

In addition, the Boards tentatively concluded that an entity is not required to consider the time value of money when the period between the customer's payment and the entity's satisfaction of the performance obligation is less than one year.

Satisfying the performance obligations

Recognition of revenue

As discussed in '*Identifying the separate performance obligations*' above, the Boards agreed to address the provision of services separately from the provision of goods. Although the core principle of the model – revenue is recognised to depict the transfer of control of goods and services to the customer – will not change, the Boards are revising the proposal to better articulate when services are transferred to the customer.

Transfer of control for goods

The Boards decided not to modify the core principle of transfer of control for goods. However, they decided to make some minor revisions to that proposed model, including removing the definition of "control" and instead including the following indicators to help entities determine whether a customer has obtained control of a particular good or service:

- ▶ The customer has an unconditional obligation to pay
- ▶ The customer has legal title
- ▶ The customer has physical possession
- ▶ The customer has the risk and rewards of ownership

Transfer of control for services

The Boards concluded that revenue for services should be recognised continuously as those services are provided.

Once an entity determines that a performance obligation is a service (based on the criteria specified above), it must select an appropriate measure of progress toward completion. The Boards will carry forward most of the guidance in the ED related to measuring progress. That guidance requires the entity to select a single revenue recognition method that best depicts the continuous transfer of that service (using an output method, input method or a method based on the passage of time). That method would be applied to all arrangements containing similar performance obligations.

Contracts for both goods and services

Since the final standard will distinguish between goods and services and provide specific revenue recognition guidance for each, the Boards also addressed accounting for transactions containing both goods and services. They concluded that if the goods and services are separable, they should be accounted for separately using the appropriate model. However, if they are not separable (i.e., they represent an integrated bundle that

must be accounted for as a single performance obligation or they do not have distinct function from one another pursuant to the separation criteria described above), the model for services should be applied to the combined unit. The Boards believe this would more faithfully depict the economics of the transaction.

Accounting for product warranties

In a change from the ED, the Boards have tentatively agreed that certain warranties will be accounted for as warranty obligations, using a cost accrual approach, rather than a revenue deferral approach. If the warranty provides the customer with assurance that the delivered product is as specified in the contract, an entity should account for a warranty obligation as a provision. Conversely, only those warranties that provide a service to the customer, in addition to the assurance that the delivered product is as specified in the contract, should be treated as a separate performance obligation.

Accounting for contract costs

In addition to the proposed revenue model, the ED also provided guidance for accounting for an entity's costs incurred in obtaining and fulfilling a contract to provide goods and services to customers. While the Boards have not yet re-deliberated the accounting for fulfilment costs, they have made significant decisions on the accounting for costs to obtain a contract.

The Boards tentatively decided that an entity should recognise the incremental costs of obtaining a contract (i.e., cost that would not have been incurred if the contract had not been obtained) as an asset. Costs should be capitalised only when they are recoverable, either directly (i.e., reimbursable under the contract) or through the margin inherent in the contract.

Capitalised costs would then be recorded as a separate asset and amortised systematically over the period that the goods or services under the contract are transferred. This guidance applies to costs for contracts that have been obtained and contracts that are under negotiation.

Onerous contracts

In response to constituent concerns, and in a significant change from the ED, the Boards tentatively decided that the unit of account for the onerous test should initially be the contract, rather than the separate performance obligation.

The Boards also affirmed their decision to include in the analysis of whether or not a contract is onerous, the direct costs in satisfying the performance obligations under the contract. However, when an entity has made a decision and communicated that it will cancel the contract, the entity would use the costs to exit the contract rather than the costs to satisfy the performance obligations. The re-deliberation plan indicates that the Boards will still discuss the definition of fulfilment costs, which may change the costs included in the onerous test.

However, the Boards did affirm the proposal in the ED that “loss leader” contracts (to provide goods or services at a loss when profits on follow-on sales are expected to exceed the initial loss) will not be excluded from the onerous test. Under the proposed guidance, the loss would be recorded when the entity enters into the contract, if that date differs from the date of delivery.

How we see it

In our view, the revisions to proposals in the ED go a significant way to addressing many of the concerns raised by respondents in the comment process to the ED. However, a number of significant areas are still to be deliberated. We believe the tentative decisions made so far by the Boards need to be field tested by reporting entities. In particular, the new proposals in respect of continuous transfer need to be tested in a variety of situations.

We believe that the stringent timetable for completion of the final standard will require a carefully coordinated process by the joint project team to perform the necessary outreach while they draft these decisions in the final standard.

Next steps

- ▶ The Boards still have several significant issues to address, including: uncertain consideration; allocating the transaction price; accounting for costs; and accounting for licences or rights of use. These issues will be addressed in the coming months. We will update you when these decisions are made.
- ▶ The Boards have not discussed whether the proposed standard will be re-exposed for public comment. Therefore, we would encourage constituents to both remain informed ², and to communicate any significant concerns about the recent decisions to the Boards or the project team as soon as possible.
- ▶ While many of the Boards' recent decisions eliminate some of the significant changes that had been proposed in the ED, a final standard will still result in accounting changes for many entities. All entities should carefully review the final standard upon issuance and begin preparing for implementation.

² The IASB's project team publishes revenue recognition documents, summaries and comparisons on the IASB's website. These can be accessed at <http://www.ifrs.org/Current+Projects/IASB+Projects/Revenue+Recognition/Revenue+Recognition.htm>

Ernst & Young
Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 141,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com

© 2011 EYGM Limited.
All Rights Reserved.

EYG no. AU0822

About Ernst & Young's International Financial Reporting Standards Group

The move to International Financial Reporting Standards (IFRS) is the single most important initiative in the financial reporting world, the impact of which stretches far beyond accounting to affect every key decision you make, not just how you report it. We have developed the global resources – people and knowledge – to support our client teams. And we work to give you the benefit of our broad sector experience, our deep subject matter knowledge and the latest insights from our work worldwide. It's how Ernst & Young makes a difference.

In line with Ernst & Young's commitment to minimise its impact on the environment, this document has been printed on paper with a high recycled content.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.