

IFRS Practical Matters



Revenue recognition project: Round 2 for the exposure draft

Revised model would still change current practice

The IASB and FASB have revised their June 2010 proposal on revenue recognition. While the proposal has been somewhat simplified, significant effort and management judgement would still be required in order to comply with the standard.

Here's what the revised proposal would mean to you:

- ▶ The new proposed revenue model is closer to current IFRS than the previous proposal, but would still require entities to make many estimates and use significant judgement when using it.
- ▶ Key metrics, including gross margins, could change due to differences in the timing of recognition and presentation of revenue and certain expenses.
- ▶ Employees and stakeholders would need to be educated on how the changes impact the entity.
- ▶ More disclosures surrounding management judgements would be required in the financial statements.
- ▶ Key processes and controls that support the entity's internal control structure would need to be updated.
- ▶ IT systems and manual processes that support the accumulation and reporting of data would need to be modified.
- ▶ Tax planning strategies, transfer pricing and tax filings may be affected.
- ▶ Financial statements would need to be restated retrospectively.



How has the revenue recognition model changed?

In November 2011, the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) (collectively, the Boards) jointly issued a revised exposure draft (ED) on revenue recognition. The revised proposal considers input received from nearly one thousand comment letters and other outreach efforts. The ED simplifies some of the concepts in the 2010 proposal as well as providing additional application guidance. However, the basic revenue recognition principle and model have not changed from the original proposal – i.e., an entity must recognise revenue when it transfers promised goods and services to the customer, and the amount recognised should be the consideration to which the entity expects to be entitled. In current practice, IFRS and US GAAP standards on revenue recognition differ; but under the ED, they would essentially converge.

Entities would apply a five-step revenue recognition model, which is the same as in the 2010 proposal. However, what has changed is how certain aspects of these steps would be applied. While the basic principles of the revised ED are straightforward, especially when applied to simple revenue transactions, use of management judgement and estimates could prove challenging. In addition, many entities may find that the new ED changes the timing and amount of revenue recognition for certain transactions.

Five-step revenue recognition proposed model

Step 1: Identify the contract

Step 2: Identify the separate performance obligations

Step 3: Determine the transaction price

Step 4: Allocate the transaction price to separate performance obligations

Step 5: Recognise revenue as performance obligations are satisfied

Proposal snapshot – What are the basic elements of the proposed model?

- ▶ It would apply to all contracts with customers except leases, insurance, financial instruments and certain nonmonetary exchanges.
- ▶ It would also apply to the sale of non-financial assets, such as property, plant and equipment or intangible assets.
- ▶ Revenue would be recognised when, or as, the customer obtains control of the good or service. The Boards acknowledge that control of a good or service may transfer continuously, and have developed criteria to help entities assess whether control transfers at a point in time, or continuously over time.
- ▶ When either party to a contract has performed, an entity would recognise a contract asset or contract liability.
- ▶ All uncollectible amounts would be recognised in the income statement in a separate line item that is presented next to revenue.
- ▶ An entity would recognise a liability and expense on onerous performance obligations that are satisfied over a period of greater than one year even if the overall contract will not result in a loss.
- ▶ Variable consideration would be allocated to the performance obligations and recognised when the estimated amounts are “reasonably assured”, which could change the timing of revenue recognition.
- ▶ The volume of disclosures would increase significantly.
- ▶ Entities would apply the final standard retrospectively, although some practical relief from full retrospective application would be permitted.



While the Boards noted that retrospective application could be burdensome for some entities, particularly those with a large number of long-term arrangements, they ultimately rejected a prospective or limited retrospective basis of adoption. The Boards believe preparers would have the time and flexibility to apply the final standard retrospectively because of the relief provided, and the long lead-time between the issuance of a final standard and its effective date (which the Boards have stated would be no sooner than 1 January 2015). Early adoption would be permitted for existing IFRS preparers and first-time adopters of IFRS, but not under US GAAP.

How has the revenue recognition model changed?

The following sections illustrate how the Boards' proposal on revenue has changed from the original June 2010 version, and highlight certain changes from current IFRS. The discussion focuses on areas that will affect your business.

Goods and services as a single performance obligation

One of key requirements of the proposal is the identification of separate performance obligations in a contract with a customer. Many respondents to the June 2010 proposal expressed concern that it would require the identification of a large number of individual performance obligations. The ED specifies that an entity would account for a bundle of goods and services as one performance obligation if those bundled goods and services are highly interrelated, and providing them requires significant integration and modification by the entity. For instance, consider a software development entity that is contracted to provide a suite of software products including installation and licences to support an online ordering process. The entity could consider the installation, licences and software to be a single performance obligation if significant

integration and customisation of the software packages is required in order to fulfil the customer's needs.

Performance obligations satisfied over time

The revised ED acknowledges that a performance obligation can be satisfied continuously over time (i.e., services) and provides several criteria for determining when revenue recognition over time is appropriate. The ED's criteria for determining when revenue can be recognised are different from current IFRS. The ED says a performance obligation is satisfied over time if: (1) the entity's performance creates or enhances an asset that the customer controls as the asset is being created; or (2) the entity's performance does not create an asset with alternative use to the entity and certain additional conditions are met. An entity may not have an alternative use for the good or service if the contract precludes the entity from transferring the good or service to another customer, or there are practical limitations to transferring the good or service.

In many situations, determining whether a performance obligation is satisfied over time would be easy. For example, a contract to provide legal services would be satisfied over time if the law firm has a right to payment for performance to date and those services have no alternative use.

However, recognising revenue in contracts involving the construction of complex goods, or a combination of goods and services, could be more difficult. An entity would need to exercise significant judgement for each type of contract it enters into to determine if the performance obligation is satisfied continuously over time. If certain criteria such as creating an asset with 'alternative use' have not been satisfied, revenue would then need to be deferred to the point in time when control of the good or service transfers to the customer (e.g., on completion).


Onerous performance obligations

The ED has modified the scope of the onerous test to include only those performance obligations that an entity satisfies over time and that period of time is greater than one year. Performance obligations satisfied at a point in time or satisfied over a period of less than one year would not be subject to the test. The 2010 proposal did not have this restriction on the scope of onerous performance obligations. Once the entity has recognised a liability and corresponding expense for an onerous performance obligation, the proposed standard would require that the measurement of the obligation be updated at the end of each reporting period to include changes in assumptions or new information.

The proposed standard could result in significant changes for many transactions. Under current IFRS, onerous contracts are considered at the contract level, rather than at the performance obligation level.

Variable consideration

A portion of the transaction price in a contract can vary in amount and timing. Examples of variable consideration include discounts, rebates, refunds, credits, incentives, performance bonuses, penalties, contingencies, price concessions, or other similar items. In a significant change from current IFRS, the ED would allow variable consideration to be estimated and allocated to the performance obligations, and ultimately recognised as revenue, potentially prior to resolving all uncertainty (limited by certain criteria). The ED would require variable consideration to be estimated based on the expected value (the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts) or the amount most likely to be received, whichever best predicts the consideration to be received. The estimate would need to be updated at each reporting period. The 2010 proposal would have required the use of an expected value approach.



For a number of entities, the treatment of variable consideration under the revised model would represent a significant change from current practice. Currently, IFRS preparers often defer measurement of variable consideration until revenue is reliably measurable, which could be when the uncertainty is removed or when payment is received. The ED would allow variable consideration to be allocated to performance obligations and provides a restriction only on recognising variable amounts that are not reasonably assured. As a result, entities may recognise revenue for variable amounts sooner.

Product warranties

The proposed accounting for warranties has been modified significantly since the 2010 proposal and making it similar to current practice. Warranties that provide the customer with assurance that the delivered product is as specified in the contract would not affect the recognition of revenue. Warranties that provide a service to a customer in addition to that assurance would be treated as separate performance obligations. Revenue allocated to these warranties would be deferred, but the amounts may be measured differently from current practice.

Presentation of bad debt expense

The ED requires that an entity must recognise the estimated transaction price as gross revenue. A customer's credit risk (i.e., collectibility) would not be taken into consideration when measuring the recognised gross revenue. This represents a significant change from current practice. It also represents a major change from the 2010 proposal, which required revenue to be reduced by any potentially uncollectible amounts. Under the ED, the expected uncollectible amount (including both the initial estimates and subsequent adjustments) would be presented as a separate income statement line item adjacent to gross revenue.

This change will have a significant effect on the presentation of the income statement and gross margins. While current IFRS requires an entity to measure revenue at the fair value of the consideration received or receivable (which implicitly includes credit risk), but whether the effect of a customer's credit risk should be included in the measurement of revenue has not been explicitly addressed, which has resulted in diversity in practice. Today, entities generally record their bad debt expense below the gross margin line in the income statement.

Investors and stakeholders could potentially be confused by these new presentation requirements. They may also give more attention to uncollectible amounts since they would be presented more prominently on the income statement. As such, it will be important for entities to communicate the new presentation requirements, together with their entity's policy on accounting for bad debts, particularly in the early periods after adoption.

Contract costs

The proposed method of accounting for contract costs differs significantly from current practice. Whereas many entities today expense contract acquisition costs, such as sales commissions, the proposed standard would require capitalisation of incremental costs of obtaining a contract longer than one year (long-term contracts).

The ED also proposes that costs incurred to fulfil a contract (e.g., setup costs) that are not otherwise capitalised under other standards (e.g., inventory, property, plant and equipment) would be recognised as assets and amortised in line with the pattern of transfer of the related good or service.

Increased disclosures

In order to increase transparency, the proposed standard would call for several new disclosures that would require collecting more data than is required under

current IFRS. For example, the ED would require additional disaggregated disclosures of revenue (for example, by type of good or service, geography, or contract duration), roll-forwards of certain asset and liability account balances within the notes to the financial statements, and the disclosure of key estimates. Entities would also need to disclose judgements that significantly affect the amount and the timing of revenue recognition.

How will the entity's business be affected?

As described above, some of the proposed changes have reduced the burden of the original proposal, bringing them more in line with current IFRS, although some differences will continue to exist. Below, we discuss significant implementation considerations that would result from the revised proposal.

Management estimates and judgements

Even though the Boards have attempted to simplify the original proposal, management estimates and judgements would still be an important part of implementing the proposed standard. The model's use of broader principles, rather than more detailed prescriptive requirements, would still require entities to make use of estimates and judgement in the application of the proposed standard.

Identifying separate performance obligations

As discussed above, identifying separate performance obligations is likely to be one of the more challenging aspects of the ED. An entity would have to evaluate all the facts and circumstances of an arrangement and, ultimately, use significant judgement to determine whether to account for promised goods and services as one or more performance obligations. Consider a contract that contains hardware, software-hosting and professional services. Application of the proposed model could lead to three separate performance obligations or any number of combinations.



If an entity determines that hardware is always sold with professional services, it would account for this as a single obligation, with the hosting services accounted for as a separate performance obligation. The judgement needed to determine the appropriate combination of goods and services may result in a combination that differs from current IFRS.

Allocating the transaction price

An entity generally would allocate the transaction price to the performance obligations based on their relative standalone selling prices. This would require the entity to estimate the standalone selling price if it is not otherwise observable.

Allocating the transaction price based on standalone selling prices would potentially have a big impact on certain industries. For instance, telecommunication entities often provide customers with free or significantly discounted equipment at the inception of the arrangement. Currently, little or no revenue may be allocated to this equipment because the related revenue is contingent on the delivery of the ongoing monthly services. Under the ED, entities would allocate the relative selling price of the equipment to this separate performance obligation and recognise the allocated amount upon delivery of the equipment (i.e., more revenue recorded up-front and less over the service period).

An entity would be able to use a residual technique in estimating the standalone selling price of a good or service if the price at which a good or service is sold is highly variable or uncertain. Whether the standalone selling price of a good or service is highly variable or uncertain will require significant judgement. Entities may need to develop policies to ensure they are applying the requirements of the model and exercising judgement consistently for similar transactions.

Estimating the standalone selling prices would be particularly difficult when the price is not currently observable, or when

goods or services are offered as incentives for the customer to purchase more from the seller. For example, the standalone selling price on free periods of maintenance may not be observable and difficult to estimate.

Transfer of control

As noted above, under the ED, revenue would be recognised upon satisfaction of performance obligations. Performance obligations are satisfied when an entity transfers a good or service to a customer, which is evidenced by the customer obtaining control of the good or service. The ED provides several indicators of transfer of control (including evaluating who has title to the asset, present right to payment, and physical possession of an asset). Determining who controls a good or service in a contract will require judgement. As discussed in the previous section, determining when the customer obtains control is not always simple for contracts that provide for the transfer of goods and services continuously over a period of time. Adding to the complexity, the ED requires an entity to select a single revenue recognition method (i.e., an output or input method) for contracts in which the transfer of goods and services is deemed to occur continuously.

Variable consideration

The ED would allow two separate approaches to estimate variable consideration – a probability-weighted estimate or a ‘most likely’ estimate. Upon transition to the new standard, an entity would need to assess, based on its business model and sources of revenue, whether probability weighting or the most likely amount to be received would better predict the amount of consideration to which it will be entitled. The method chosen would have to be applied consistently throughout the contract.

Onerous contracts

If the cost of fulfilling a performance obligation exceeds the portion of the transaction price allocated to that

performance obligation, the entity would record a liability and corresponding expense for that amount (even if the overall contract will not result in a loss). Estimating the cost to fulfil a performance obligation, in particular, those which are expected to be satisfied over several years, such as a long-term service arrangement, could be difficult and require significant assumptions. Furthermore, continuously assessing whether a contract’s individual performance obligations are onerous will be operationally challenging.

Product warranties

If an entity provides more assurance than a normal warranty, it would be accounted for as a separate performance obligation and the recognition of revenue allocated to those warranties would be deferred. Judgement would be required to determine whether the warranty provides more assurance than a standard product warranty and the period of time over which revenue should be recognised for such warranties.

Processes and controls

Additional information will be needed to comply with the expanded revenue disclosure requirements. These enhanced information requirements may require significant modifications to existing internal information-gathering efforts and processes. Entities with decentralised operations will be particularly affected because of the need to accumulate information from multiple locations.

Furthermore, entities may need to modify their IT systems and related general ledger and financial reporting software in order to track, compile and report information in accordance with the proposed standard.

In addition to data accumulation and IT changes, internal reporting processes and controls will most likely also require revision. Entities need to take steps to determine that their internal control processes remain effective in the face of the significant change in the accumulation and reporting of financial information.

Financial statement metrics and communications

Many entities are measured and evaluated based on revenue. While revenue is itself a key metric, it also directly affects other significant measures, such as earnings per share, EBITDA and gross margins, among others. Under the ED, revenue and its related metrics may change. Entities need to consider how such changes will be presented and discussed on analyst calls, in earnings releases and in other shareholder communications.

Financial measures driven by revenue also could affect loan covenants, financing agreements and regulatory requirements. Entities that base bonuses, share-based payments and other compensation plans on such measures may need to reassess the arrangements and whether they would continue to be an appropriate performance measure. By performing an initial impact assessment, an entity will be able to identify the effects of the proposal earlier so it can begin to develop meaningful communication with stakeholders.

Contract terms

The proposed standard could affect the timing and amount of an entity's revenue, particularly for entities with longer-term contracts or those with multiple performance obligations. When a contract involves the construction of an asset over time, the entity will need to demonstrate that control of a portion of the asset has passed to the customer in order to recognise revenue prior to the asset's completion. Factors to consider include the customer's present obligation to pay, the passing of legal title, physical possession of the asset and customer acceptance. Accounting should not drive an entity's business, but the entity should understand the effect that certain contractual terms could have on its ability to recognise revenue at points prior to completion of the asset, and be mindful of those terms as it negotiates contracts with customers.

Tax issues

The tax treatment of revenue differs, in many instances, from the accounting requirements for revenue recognition under the proposed standard. As an entity potentially modifies its existing revenue recognition to address the accounting requirements under the proposed standard, it must also analyse the existing tax treatment to understand the potential impact and to ensure that tax risks have been appropriately managed.

Assessing tax treatments early will help entities reduce tax exposures, identify book versus tax differences presented by the ED and develop the most advantageous tax strategies possible. In addition, there may be synergies to be gained by analysing tax treatments and financial accounting impacts simultaneously, because much of the underlying financial information is the same.

What can you do now?

Although the Boards have not yet finalised an effective date, entities should begin preparing for the proposed standard by identifying potential implementation issues. Preparing to adopt a pervasive new accounting standard like the revenue recognition project is a large undertaking for any organisation. Although still at the proposal stage, there are key differences compared to current practice that will likely remain upon finalisation of the standard. Early planning is the key to a smooth transition: a measured and thoughtful approach to transition is the best way to reduce cost and ensure a successful implementation. Some actions that entities should consider now:

- ▶ Understand the magnitude of the changes to your business from both a financial statement and business perspective.
- ▶ Establish a project management plan for adoption of the proposed standard.

- ▶ Determine training requirements for individuals responsible for the key judgements and estimates.
- ▶ Identify common transactions and potential implementation issues.
- ▶ Establish a process for gathering appropriate information to comply with the proposed standard.
- ▶ Voice your views on the ED through the comment letter process.
- ▶ Continue to monitor the Boards' deliberations.

For a more complete technical discussion about the ED and the latest proposed changes, refer to the following publications available through Ernst & Young's website, www.ey.com/ifrs:

- ▶ *IFRS Developments – Issue 18: IASB and FASB issue revised revenue recognition proposals* (November 2011)
- ▶ *Applying IFRS: Revenue from contracts with customers – the revised proposal* (January 2012)



Ernst & Young can bring its multidisciplinary team of accounting, tax, systems and IT professionals to your business to help in assessing what the revised revenue recognition proposal means to you. In the chart below, we outline issues and steps you should consider related to the ED and indicate how Ernst & Young may be able to help you from initial assessment through adoption.

Issues and steps	How Ernst & Young may be able to help
Gain a general understanding of the proposal	<ul style="list-style-type: none"> ▶ Design and deliver training sessions for your personnel ▶ Share insights and views of the IASB, FASB and regulators ▶ Provide input into your comment letter on the ED
Perform a preliminary assessment of the impact of the proposal on the entity's financial statements	<p>Advise and provide input into:</p> <ul style="list-style-type: none"> ▶ Gathering necessary information needed to adopt the proposed standard ▶ Summarising customer contracts ▶ Interpreting the proposed requirements and application to customer contracts (e.g. performance obligation, when control is obtained, the impact of rights to return and warranties and other key contractual terms) ▶ Developing a consistent methodology around judgemental areas such as variable consideration, contract costs, warranties, onerous contracts or selecting a revenue recognition model that best depicts the transfer of goods and services continuously over time ▶ Calculating the income statement impact of adopting the proposed standard ▶ Assessing the impact on key financial ratios and performance such as gross margins ▶ Identification of shortfalls in available information to adopt the proposed standard especially considering the proposed additional disclosures ▶ Developing a process for monitoring performance obligations, costs incurred and the impact to the financial statements
Benchmark the entity against peers and others in the industry	<ul style="list-style-type: none"> ▶ Provide observations of how others are approaching the proposed standard, problems they encountered and solutions developed ▶ Assist in the evaluation of peers, competitors and industry disclosures and expected impact on their financial reporting
Access processes for data collection, internal controls, IT systems	<ul style="list-style-type: none"> ▶ Provide observations and insights based on leading practices on ways the entity could design its business process, IT systems and internal controls in response to the proposed new requirements.
Assess tax positions relating to the proposal	<ul style="list-style-type: none"> ▶ Assist in analysing tax positions arising from adopting the proposed standard, reducing tax exposure and determining tax effects of the proposed model
Plan for ultimate adoption of the proposed standard	<ul style="list-style-type: none"> ▶ Advise regarding your project management and planning, including timeline, tasks and resource allocation
Update accounting manuals and accounting policies	<ul style="list-style-type: none"> ▶ Review and provide input into accounting manuals and policies selected by management and help draft policies in anticipation of the final standard
Communicate effect of adoption to stakeholders– analysts, regulators, shareholders	<ul style="list-style-type: none"> ▶ Advise on developing a communication plan ▶ Advise on drafting communications ▶ Provide an analysis of the information that will be available under the proposed standard

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EYG no. AU1087

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For more information, please contact:

Ken Marshall
Financial Accounting Advisory Services Leader – Americas
+1 212 773 2279
kenneth.marshall@ey.com

Mark Seddon
Financial Accounting Advisory Services Leader – Asia-Pacific
+852 2629 3138
mark.seddon@hk.ey.com

Stephane Kherroubi
Financial Accounting Advisory Services Leader – Europe, Middle East, India, and Africa (EMEIA)
+33 1 46 93 74 72
stephane.kherroubi@fr.ey.com

Tomohiro Miyagawa
Financial Accounting Advisory Services Leader – Japan
+81 3 3503 1191
miyagawa-tmhr@shinnihon.or.jp