

IFRS News

Supplement – Emerging issues and practical guidance

March 2009

Overview

- The IASB and the US FASB have proposed a new revenue recognition model that will have a significant impact on current revenue recognition policies for IFRS and US GAAP reporters.
- Every industry within the scope of the project may be impacted to some extent. Some entities, particularly those that have historically followed industry-specific guidance under US GAAP, will see pervasive changes.
- A single, contract-based, asset and liability model is proposed, where revenue is recognized based on increases in contract assets or decreases in contract liabilities.
- Companies should analyze the impact of this model on current business activities; including contract negotiations, budgeting and information technology.

The future of revenue recognition?

The IASB and FASB's joint revenue project will have a significant impact on entities' revenue recognition policies. Management needs to look at the implications for their business functions. This supplement addresses some of the detail in the main proposals.

The IASB and the FASB published the discussion paper (DP) on their joint revenue recognition project in December. Their objectives are to converge US and IFRS standards on revenue recognition; eliminate existing inconsistencies and weaknesses; and reduce the voluminous sources of US revenue guidance.

The discussion paper (DP) contains preliminary views on a contract-based revenue recognition model. It does not include all of the guidance expected in the future proposed standard, but it provides views on the basic revenue recognition model. The timing for an exposure draft has not yet been determined, but a project completion date of 2011 is expected.

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Start now. Companies should analyze the proposed changes in the revenue recognition model to understand the potential impact on their businesses. Comments made by preparers and users of financial statements at the discussion paper stage are more likely to result in modifications than comments made closer to final publication.

Key provisions

Asset and liability model

The proposed model employs an asset and liability approach, the cornerstone of the IASB's and FASB's conceptual frameworks. Current revenue guidance focuses on an earnings process, but difficulties often arise in determining when revenue is earned. The Boards believe a more consistent application can be attained by using a single contract-based model where revenue recognition is based on changes in contract assets and liabilities.

Scope – contracts with customers

The proposed model focuses on an entity's contracts with its customers. A contract is defined as "an agreement between two or more parties that creates enforceable obligations". A contract can be written, verbal, or otherwise evidenced, either explicitly or implicitly. The definition suggests that a contract exists if an enforceable obligation is created.

Industry-specific contracts are not excluded from the proposed model. Questions have been raised, however, as to whether the proposed model would provide useful information for certain types of contracts such as:

- Contracts for financial and some non-financial instruments;
- Insurance contracts; and
- Leasing contracts.

Contract assets and liabilities – the principle

A contract with a customer includes rights to receive consideration and obligations to provide a good or perform a service. The entity has a net contract asset when the rights exceed the obligations. The entity has a net contract liability when the obligations exceed the rights.

The underlying principle in the proposed model is that revenue is recognized when a contract asset increases or a contract liability decreases. An entity's net asset or net liability in a contract can change for a variety of reasons. For example, when consideration is received from a customer, the entity's contract asset decreases because its right to receive payment has decreased. When an entity satisfies an obligation, such as through the delivery of goods or services, its contract liability decreases because it no longer needs to provide those goods or services.

Identification of performance obligations

A performance obligation is a promise to transfer an asset (either goods or services) to a customer. Performance obligations are often stated in a contract but may arise in other ways. Legal requirements, such as local law requiring an entity to warrant a product, may create performance obligations. A performance obligation may also be created constructively through customary business practices, such as an entity historically providing warranty services to all customers. An enforceable promise to transfer an asset to a customer, whether explicit or implicit is, therefore, a performance obligation.

The objective of identifying and separating performance obligations is to ensure that an entity's revenue is recognized when goods and services are transferred to the customer. Even a simple contract may include many performance obligations; identifying and separating those obligations may be challenging. Separation of a contract into performance obligations is, therefore, needed only when the customer is to receive the promised assets at different times.

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A performance obligation is similar to the current concepts of a "deliverable", "component" or "element", but the notion of a performance obligation has a significantly wider range. Components will not need to have "standalone" value to the customer in order to be accounted for separately. For example, legal requirements such as warranties could be performance obligations, as could customary business practices, such as rights of return. Guarantees, which currently may preclude revenue recognition, could also create separate performance obligations.

Satisfaction of performance obligations – when revenue is recognized

Revenue is recognized as performance obligations are satisfied. This occurs when control of the asset is transferred to the customer. Control of a good typically transfers when the customer

takes physical possession. However, control may transfer to the customer before physical possession (for example, certain "bill-and-hold" arrangements). Control of a service asset normally transfers when the service is performed, either as the service enhances a customer's existing asset or represents a benefit the customer consumes immediately.

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The singular focus on transfer of control in determining when revenue is recognized is a significant change to existing models. Current revenue standards also consider other criteria, such as when risks and rewards are transferred to the customer or when collectibility is reasonably assured. This change could have a considerable impact on the timing of revenue recognition if control of an asset transfers at a different time from risks and rewards.

Timing of revenue recognition may vary depending on whether a contract is for the delivery of a good or performance of a service: a good is typically transferred at a point in time; a service is typically transferred over the contract term.

In some contracts, an entity promises to transfer goods to a customer in connection with a service. For example, an entity may enter into a contract to paint a house and the paint is delivered to the house in advance of the painting taking place. Should the entity recognize revenue for the paint when it is delivered or as the paint is used? It may be difficult to determine when an asset is transferred if that asset is used in satisfying a future performance obligation. It is, therefore, presumed that an asset used in satisfying a future performance obligation is not transferred to the customer until used. This presumption can be overcome if the contract terms or local law clearly indicate that the asset has been transferred to the customer before being used to satisfy other obligations.

Customer acceptance, intent and payment terms may help determine when a performance obligation is satisfied.

- Contract terms may specify that payment is only due once the asset is formally accepted. When goods have been delivered to the customer in accordance with contract specifications, written acceptance may only be a formality and would not prevent revenue from being recognized upon delivery.
- Customer intent alone does not impact when a performance obligation is satisfied. However, contract negotiations may reflect the customer's intent by specifying when control transfers and thus when performance obligations will be satisfied. Consider a manufacturer that sells computers. The customer does not intend to use each of the individual components separately (for example, monitor, keyboard and mouse), but the contract could stipulate that the components are delivered at separate times. If delivered separately, revenue is recognized for each item upon delivery as a performance obligation has been satisfied. If the contract stipulates that control over all components does not transfer until the final component is delivered, revenue is not recognized until the final component is delivered.
- Customer payment terms and the customer's ability to recover those payments may help to determine whether an asset has been transferred. If an entity enters into a service contract that requires non-refundable progress payments during the contract, this may indicate that the partially completed asset transfers to the customer as the contract progresses.

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The preliminary views around customer acceptance, intent and payment terms illustrate that the transfer of control is critical to the timing of revenue recognition. The inability of a customer to use an asset that has been received does not affect revenue recognition unless the parties agree that control is not transferred. The pattern of customer payments only impacts revenue recognition to the extent it is an indicator that transfer of control over an asset has occurred (for example, when non-refundable payments are made).

Measurement of performance obligations

Performance obligations are initially measured using an original transaction price approach, which reflects the consideration the customer promises to pay in exchange for goods or services. The discussion paper does not express a preliminary view on how an entity measures a contract right (asset), but the guidance is expected to be based on the transaction price. The time value of money and any uncertainties, such as contingent consideration, will also need to be addressed. Because contract rights and performance obligations are expected to be based on the transaction price, an entity's net position in the contract is nil at contract inception. No revenue would be recognized at contract inception as no performance obligations have been satisfied.

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Measurement of a transaction price is straightforward when the consideration in the arrangement is a fixed amount of cash but is more complex when there is uncertainty as to the total amount to be paid, such as when a portion of the consideration is contingent on a future event. The Boards will, therefore, continue to discuss what impact such complexities may have on the measurement of contract rights.

When a contract contains multiple performance obligations, contract consideration is allocated to the separate performance obligations based on relative standalone selling prices. The best evidence of standalone selling price is the price charged by the entity for separately selling the good or service. Management should estimate the selling price if separate selling prices are not available. No estimation method is prescribed nor is any particular method precluded, but any estimation method should maximize the use of observable inputs. Examples of estimation methods provided include expected cost plus a margin or the price a market participant would be willing to pay.

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The proposal allows allocation of consideration only on the basis of relative standalone selling prices. This is consistent with current practice where the fair value of all components is known and any discount in the transaction is allocated ratably to the components. The proposal precludes other allocation methods, including the residual method.

The proposal would require a price to be estimated when stand-alone selling prices are not available. Deferral of revenue due to an inability to estimate selling price or due to restrictions imposed by current standards (for example, vendor specific objective evidence (VSOE) or vendor objective evidence (VOE)) is no longer allowed.

Initial measurement of performance obligations using fair value or exit price has tentatively been rejected. Reasons given include:

- The pattern of revenue recognition and, in particular, the potential for recognition of a contract asset and revenue at contract inception;

- Complexity due to difficulties in measuring the exit price; and
- The risk of errors in identifying and measuring performance obligations.

Subsequent to initial measurement, revenue is recognized as the entity satisfies its performance obligations. The amount of revenue recognized is equal to the transaction price allocated to such performance obligations at contract inception.

Measurement of performance obligations is not reassessed after contract inception unless those obligations become onerous. A contract is onerous when the expected costs to satisfy a performance obligation exceeds that performance obligation's carrying amount. An onerous contract is remeasured to the entity's expected cost of satisfying the performance obligation and a loss is recognized.

There is some debate over whether performance obligations should be remeasured only when they are onerous. There are concerns that useful information will not be provided to investors in situations where outcomes are highly variable due to volatile prices or where significant changes in circumstances are likely, such as certain insurance contracts.

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The proposal only outlines initial views over when an obligation becomes onerous and the subsequent implications. An onerous test similar to the one currently used may be adopted. However, all practical aspects of accounting for onerous obligations have not yet been fully explored; there may be additional changes to the proposal in this area.

Potential effects on current practice

The proposed model has similarities to the concepts of revenue recognition under existing standards, but there are a number of clear differences. The more significant of these are outlined below.

- Principle of recognizing all revenue based on the satisfaction of a performance obligation. Revenue is recognized when control of the asset is transferred. This will significantly impact accounting for some construction and other long-term contracts (including service arrangements). Current standards, in many instances, allow revenue to be recognized as the asset is created. An entity may only recognize revenue for its activities when those activities concurrently satisfy performance obligations through the transfer of assets to the customer. Revenue recognition may remain similar to current practice when control of the asset transfers continually as it is constructed. When control is only transferred when the completed asset is transferred to the customer, revenue is recognized when the transfer to the customer occurs.

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The percentage-of-completion method historically used for construction contracts and, where applicable, service arrangements, may cease to exist. Rather, revenue in those arrangements will be recognized based on transfer of control.

- **Identification of performance obligations.** The definition of a performance obligation may result in separation of more obligations within an arrangement. For example, statutory warranty obligations are recorded as a cost accrual at the time of sale under current guidance. Such warranties are a separate performance obligation under the proposed model.

Some of the contract consideration is allocated to the warranty and recognized as that obligation is satisfied. The increase in identification and separation of performance obligations may also require greater use of estimates than is the case under current practice. Industries in which use of estimates relating to revenue recognition is restricted, such as software accounting under US GAAP where VSOE is required, will be particularly impacted.

The components of a construction contract will also be separated more frequently. Current practice only allows separation if the components of a contract are separately negotiated, as opposed to the proposed model, which requires performance obligations to be separated based on when assets are transferred.

- **Sales incentives.** Sales-type incentives such as free products and customer loyalty programs are currently recognized as marketing expense in some circumstances under US GAAP. The proposed model requires those incentives to be considered performance obligations and revenue deferred until such obligations are satisfied, such as when a customer redeems loyalty points. This change aligns US GAAP with the guidance for customer loyalty programmes under IFRS.
- **Capitalization of costs.** Certain costs may currently be capitalized as an asset if they are recoverable, such as certain contract origination costs in the construction industry. Other industries recognize such contract origination costs in profit or loss, but also recognize an equal amount of offsetting revenue, such as cable television entities following US GAAP. The Boards do not intend to provide any cost recognition guidance. Costs associated with a contract will be expensed as incurred unless they meet the definition of an asset under another standard such as inventory, fixed assets or intangible assets.
- **Rights of return.** Rights of return are currently estimated and recognized as a reduction of revenue at contract inception. Two views have been suggested in the proposed model:
 - Rights of return are a performance obligation to provide a service under the contract, resulting in revenue being deferred at contract inception until such obligation is satisfied or when the return right expires; or
 - Rights of return represent a failed sale, as the customer has not accepted the terms of the sale since the arrangement can be rescinded without consequence. An entity may be able to estimate the portion of sales not expected to fail if it has many homogenous transactions and recognize revenue accordingly.

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Both approaches to rights of return create application questions that need to be addressed. For example, measurement of the performance obligation may be difficult if satisfaction of the obligation results in the entity obtaining an asset. If rights of return represent failed sales, an entity may continue to recognize inventory even though the inventory has been transferred to the customer.

• Agricultural, biological and other extractive products.

Provided certain criteria are met, revenue from certain biological, agricultural and extractive products is currently recognized as the value of inventory increases, irrespective of whether a contract has been signed with a customer. Under the proposed model, revenue is recognized when an entity enters into a contract with a customer and a performance obligation arising from that contract is satisfied. The Boards do not intend to change the way inventory is measured, but they are considering whether increases in the value of inventory should be recognized as a component of comprehensive income as opposed to revenue.

Areas for feedback

The Boards have requested feedback on a variety of key areas including: appropriateness of a single model based on assets and liabilities, whether certain contracts should be excluded from the standard, the definition of a performance obligation, and recognition of revenue upon transfer of control.

Timing for comments

Comments on the discussion paper are due by June 19, 2009. The primary purpose of the discussion paper is to provide a preliminary view of the Boards' thinking and to solicit feedback from users, preparers and other interested parties.

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The discussion paper does not address certain topics that are expected to be addressed as a draft standard is developed. Some of the more critical topics are:

- Application guidance for performance obligations;
- Measurement of rights, including the impact of time value of money, uncertainties (such as contingent consideration) and non-cash consideration;
- Possible alternative measurement approaches for certain contracts;
- Measurement of onerous contracts, including which costs to include in the onerous contract test and the unit of account at which the test is performed;
- Presentation and disclosure requirements, such as gross or net presentation of rights and obligations, display of remeasurements and gross or net presentation of revenue;
- Contract cancellation and renewal clauses;
- Combining of contracts;
- Contract modifications (for example, change orders or variations) as well as other changes to contract terms and conditions; and
- Transition guidance.