

IASB and FASB propose a single revenue recognition model

What you need to know

- ▶ This joint proposal will result in a single revenue recognition model for most revenue transactions
- ▶ Revenue will be recognised on individual elements when control of the contracted good or service is transferred to the customer
- ▶ The proposed model provides more guidance when compared with current IFRS
- ▶ The proposal will 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*
 - SIC 31 *Revenue – Barter Transactions Involving Advertising Services*
- ▶ The comment period ends on 22 October 2010

Highlights

Recently, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) (collectively, the Boards) issued the Exposure Draft (ED) *Revenue from Contracts with Customers*. The proposed model provides the principles that entities should apply in determining the amount, timing and uncertainty of revenue recognition arising from contracts to provide goods and services to their customers.

Although the accounting for some transactions may not be significantly changed, it is likely that all entities will be affected by the new guidance. The proposals will also introduce more detailed guidance on the accounting for certain transactions, such as multiple-element arrangements, than is currently contained in IAS 18 *Revenue*. IFRS reporters that have looked to US GAAP for guidance on these transactions will also need to consider these changes. This is because the proposed model brings the two frameworks together, and reduces the amount of industry-specific guidance that currently exists under US GAAP.

The accounting for some components that are common to revenue transactions, including product warranties and contingent consideration, will also be affected by the proposed guidance.

The model

The proposed model includes the following five steps that entities would apply to determine the appropriate amount and timing of revenue recognition:

1. Identify the contract(s) with the 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, and
5. Recognise revenue when each performance obligation is satisfied

The Boards are proposing that entities apply the new guidance retrospectively for all periods presented in the period of adoption. The ED does not include a proposed effective date. Instead, the effective date will be considered as part of another project on the effective dates for all of the major joint projects under development and expected to be completed in 2011.

Under the proposed model, the entity evaluates the terms of the contract as well as the entity's normal business practices to identify all promised goods and services.

Scope

The ED provides proposed guidance on the accounting for revenue arising from contracts with customers. The proposed guidance will apply to all contracts with customers except:

- ▶ Lease contracts
- ▶ Insurance contracts
- ▶ Financial instruments
- ▶ Certain nonmonetary transactions

Additionally, the ED provides that the recognition and measurement principles of the proposed model should also be applied to the sale of some non financial assets that are not an output of the entity's ordinary activities – for example, the sale of property, plant and equipment or intangible assets.

Differences compared with current IFRS

IAS 18 focuses on revenue recognition upon the transfer of the "risks and rewards". The proposed model will instead focus on the transfer of "control", which may provide different results, particularly for those entities using a percentage of completion model for revenue recognition. The proposed requirement to identify performance obligations and allocate the transaction consideration to those performance obligations based on their relative stand alone selling prices provides greater guidance than currently included within IFRS.

Certain aspects of the proposed model will likely result in more significant differences from the current accounting treatment. These are discussed below.

Identify the contract with the customer

In order to apply the proposed revenue recognition model, an entity must first identify the contract(s). The proposed guidance indicates that contracts may be written, verbal or implied, and that the entity's business practices may influence its determination of whether or not a contract exists.

The ED also indicates that while in most cases the requirements of the proposed guidance will be applied to a single contract with a customer, there may be situations where the entity should either combine multiple contracts or segment a single contract for purposes of revenue recognition. Similarly, contract modifications may be combined with the original contract, or treated as a separate contract, depending on the interdependence between the original contract and the modification.

Identify the separate performance obligations

Distinct goods and services

Under the proposed model, the entity evaluates the terms of the contract as well as the entity's normal business practices to identify all promised goods and services. For example, an established business practice of providing warranty coverage for 90 days is likely to represent a promised service, even if a contract with a customer does not explicitly provide for warranty claims.

An entity must determine if promised goods and services should be treated as separate performance obligations.

The proposed model indicates that promised goods and services should only be treated as separate performance obligations if the good or service is “distinct”. The proposed model indicates a good or service is distinct if either:

- ▶ The entity, or another entity, sells an identical or similar good or service separately; or
- ▶ The entity could sell the good or service separately because it meets both of the following conditions:
 - ▶ The good or service provides utility either on its own or together with other goods and services available in the market place (from other entities); and
 - ▶ It has a distinct profit margin, evidenced by distinct risks and the entity can separately identify the resource needed to provide the good or service

How we see it

This guidance on multiple-element arrangements is new to IFRS, and may represent a significant change for many entities. In particular, those using percentage of completion methods for revenue recognition may see a significant change. Currently, many entities frequently identify the entire contract as a single unit of account. Under the proposed model, it is likely that such entities will identify more than one performance obligation within a contract.

Product warranties

Product warranties are commonly included in the sale of goods. These warranties may or may not reflect separate performance obligations, depending on the objectives of the warranty provided. Under the proposed model, the obligation related to warranties results in an initial deferral of revenue, which is then recognised as the warranty services are provided. Costs associated with the fulfilling warranty obligations would be expensed as incurred.

The proposed model distinguishes between two types of warranty. Warranties that are only meant to cover latent defects in products that existed when the goods were transferred to the customer are not likely to be separate performance obligations. In these situations, the entity should assess if it has satisfied its performance obligation to deliver the good or service. Conversely, warranties that are meant to cover defects that arise after a customer has taken control of a good are separate performance obligations.

However, both types of warranties will result in an amount of revenue being deferred. For warranties designed to cover latent defects, entities should defer revenue for the products (or portions of products) estimated to have latent defects. Revenue is then recognised when control of the product is deemed to have transferred. When the warranty is considered a separate performance obligation, the revenue allocated to the warranty services is deferred and recognised as the warranty services are performed.

How we see it

The timing of revenue recognition will be affected for all transactions including a warranty clause, regardless of whether or not a warranty is considered a separate performance obligation, because current practice generally provides for the recognition of revenue in full and the accrual of a liability for the incremental cost of satisfying the warranty obligation.

Determine the transaction price

The proposed guidance defines transaction price as “the amount of consideration an entity receives, or expects to receive, from a customer in exchange for transferring goods or services excluding amounts collected on behalf of third parties (for example, taxes).” In many cases, this is readily determinable as the price is fixed and payment is received at approximately the same time the entity transfers control of the promised goods or services.

However, for some transactions, portions of the transaction price may be variable (i.e., contingent on future events). For those transactions, the proposed model provides that an entity must recognise revenue based on the estimated transaction price, if the entity has the ability to make reasonable estimates. The entity’s estimate of the total transaction price should identify the possible outcomes of a contract and the probabilities of those outcomes. Alternatively, if the entity lacks the ability to make a reasonable estimate, the transaction price is limited to the amount of consideration that is fixed or that can be reasonably estimated.

For certain transactions, the timing of the payment will not match the timing of the transfer of goods or services to the customer as the consideration could be prepaid or be paid well after the goods or services are provided. In both situations, the entity would have to consider the effects of the time value of money on the total transaction amount.

In determining the transaction price, the entity must also consider the effects of collectability, non-cash consideration and consideration paid to a customer. For many entities, adjusting the transaction price for these items will be a major change from current practice.

In determining the transaction price, the entity must also consider the effects of collectability (i.e., credit risk of the customer), non-cash consideration and consideration paid to a customer. For example, the proposed model requires the entity to assess, upon satisfaction of the performance obligation, the expected consideration to be collected using a probability-weighted approach. That amount is then used in determining the total transaction price, with any subsequent changes due to changes in collectability in the amount expected to be collected or actually collected recognised in other income or expense (i.e., separate from revenue).

For many entities, adjusting the transaction price for these items will be a major change from current practice.

How we see it

Entities with arrangements including contingent consideration that have the ability to estimate the amount of contingent consideration, will see acceleration in the timing of revenue recognition related to the contingent amount.

Allocate transaction price to the separate performance obligations

Once the performance obligations are identified and the transaction price determined, the proposed model requires an entity to allocate the transaction price to the performance obligations in proportion to their stand alone selling prices, that is, on a relative stand alone selling price basis.

When available, the observable price of a good or service sold separately provides the best evidence of stand alone selling price. However, in many situations, stand alone selling prices will not be readily observable. In such situations, the entity

should estimate the amount for which it would sell each performance obligation on a stand alone basis. The proposed model gives two examples of possible approaches to estimating a stand alone selling price, including a "expected cost plus a margin approach" or an "adjusted market expected approach" (e.g., determination of what a market participant would be willing to pay for the good or service).

Under the proposed model, the stand alone selling price is determined only at contract inception. Amounts allocated to performance obligations are updated to reflect changes in the estimated transaction price as goods and services are delivered, such as additional discounts offered to the customer. However, the stand alone selling prices used to perform the allocation are not updated to reflect changes in the stand alone selling prices after contract inception.

How we see it

Where performance obligations are identified for goods and services that are not sold separately, entities will need to determine the estimated stand alone selling price, which may require significant effort.

Recognise revenue as each performance obligation is satisfied

The proposed model states that revenue allocated to a particular performance obligation should be recognised at the point the customer obtains control of the underlying good or service. A customer "obtains control of a good or service when the customer has the present ability to direct the use of, and receive the benefit from, the good or service."

In many situations, the determination of when the customer obtains control is relatively straightforward. However, in other scenarios, this determination is more complex. In an effort to help entities determine when a customer has obtained control of a particular good or service, the proposed model includes the following indicators that the customer has obtained control:

- ▶ The customer has an unconditional obligation to pay for the good or service
- ▶ The customer has legal title to the good or service
- ▶ The customer has physical possession of the good or service
- ▶ The design or function of the good or service is customer-specific such that the good or service might be of little value to the entity because it lacks an alternative use

The ED acknowledges that some of the indicators may not be relevant to certain transactions. Additionally, none of the indicators are meant to be individually determinative of whether or not the customer has gained control of the good or service.

The ED also addresses whether a customer has obtained control of an asset in contracts containing repurchase agreements. The proposed model indicates that if the customer has the ability to require the entity to repurchase the asset, then the buyer has obtained control of the asset and a sale should be recorded. The entity would also recognise a liability for the right of return. Conversely, if the entity has an unconditional obligation (forward) or right (call option) to repurchase the asset, the customer has not obtained control of the asset and such transaction likely represents a lease or a financing transaction rather than a sale.

The timing of revenue recognition is directly related to the determination of when control of a promised good or service has been transferred to the customer. For example, if the arrangement involves a promised good (except for certain customised goods), the entity would likely recognise revenue once the good has transferred to the customer. Alternatively, if the arrangement involves services, the related revenue would likely be recognised as the services are provided (based on the notion that control over those services transfers continuously).

How we see it

Entities currently using a percentage-of-completion method to recognise revenue for their long-term contracts involving goods may determine that control over certain performance obligations within the contract transfers at a point in time rather than continuously over a period of time.

Onerous performance obligations

In situations where an entity determines that the direct costs of fulfilling a performance obligation exceed the amount of transaction consideration allocated to that performance obligation, the proposed model requires that such performance obligations be treated as onerous. If a performance obligation is determined to be onerous, the entity is required to recognise a liability and a corresponding expense to the extent the direct costs exceed the allocated transaction price. The liability for onerous contracts is remeasured at each reporting date using the most current estimates. These changes are recognised as a gain or a further expense.

How we see it

The requirement to recognise onerous performance obligations is similar to the existing requirements under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. However, currently most entities take the contract as the unit of account when considering whether onerous costs will be incurred. Under these proposals, entities will need to consider each performance obligation, which may be at a significantly lower level than at the contract level.

Sale of non-financial assets

The ED provides that the proposed guidance would also be applicable to the sale of some non financial assets, even though the sale of such assets is not an output of the entity's ordinary activities. This would include the sale of intangible assets and the sale of property, plant and equipment (including real estate). As a result, the proposed model would provide guidance on the measurement and recognition of any gain (i.e., not revenue) associated with the sale of such assets.

Under the proposed model, the entity would derecognise the asset when the buyer obtains control of the asset and recognise the gain or loss from the transaction based on the difference between the transaction price and the carrying amount of the asset. Consistent with the discussion above, the determination of transaction price would take into consideration a number of factors, and would be limited to the amounts that can be reasonably estimated.

The proposed model indicates that if the customer has the ability to require the entity to repurchase the asset, then the buyer has obtained control of the asset and a sale should be recorded. The entity would also recognise a liability for a right of return.

Contract costs

The proposed model indicates that costs incurred in connection with fulfilling the performance obligations of a contract that are not eligible for capitalisation under another standard (i.e., IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*) may give rise to a separate asset if the cost:

- ▶ Relate directly to the contract or a specific contract under negotiation
- ▶ Generate or enhance resources of the entity that will be used in satisfying performance obligations in the future and
- ▶ Are expected to be recovered.

The ED provides examples of costs that relate directly to a contract (e.g., direct labour and direct materials) compared with those costs that should be expensed when incurred (e.g., costs of obtaining the contract and costs related to satisfied performance obligations).

Any asset recognised based on this guidance will be recognised in cost of sales as the entity transfers control of the related goods or services, and will be subject to an impairment analysis.

Disclosure requirements

The ED also includes a number of new disclosure requirements. The overall disclosure objective is to provide quantitative and qualitative disclosures to “help users of financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers”. Based on that objective, the ED identifies a number of required disclosures related to an entity’s contracts with customers, including:

- ▶ Disclosure of revenue disaggregated into “categories that best depict how the amount, timing and uncertainty of revenue and cash flows are affected by economic factors”
- ▶ Reconciliation of the opening and closing total balance of contract assets and contract liabilities
- ▶ A description of the performance obligations in the entity’s contracts with customers, including disclosures about the amount of transaction price allocated to and timing of satisfaction of performance obligations expected to be satisfied after one year from contract inception
- ▶ A reconciliation of the opening and closing balance of the total liabilities recognised for onerous performance obligations

The ED also requires entities to provide disclosures surrounding the significant judgments made in the application of the proposed revenue recognition model. This would include judgments that affected the timing of satisfaction of performance obligations and the determination and allocation of the total transaction price.

How we see it

The proposals will result in significantly greater disclosures than currently required under IAS 18.

Looking ahead

The Boards have spent an extensive amount of time on this project, and have made a number of significant decisions since the issuance of their Discussion Paper 18 months ago. Given the potential consequences of the proposed guidance and its ability to significantly affect all entities, we encourage entities to gain an understanding of the proposed guidance, including how it may affect their particular facts and circumstances, and provide the Boards with feedback on the proposal.

In addition, while this publication provides an overview of the proposed model, we intend to provide a more in-depth publication in the coming months to assist entities in gaining this understanding.

Also, in the coming weeks we will be hosting the following webcasts on the Exposure Draft:

- ▶ 22 July 2010 - On this webcast, we will compare the proposed model to the current requirements of US GAAP
- ▶ 27 July 2010 - On this webcast, we will compare the proposed model to the current requirements of IFRS.

Comments on the ED are due by 22 October 2010.

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