

IFRS ALERT 2011/04

DECEMBER 2011

REVENUE FROM CONTRACTS WITH CUSTOMERS



On November 14, 2011, the IASB and the FASB jointly issued a revised Exposure Draft *Revenue from Contracts with Customers* (the ED). The ED revises the initial Exposure Draft on this topic issued in June 2010 and would replace IAS 18 *Revenue*, IAS 11 *Construction Contracts* and related Interpretations (IFRIC 13 *Customer Loyalty Programmes*, IFRIC 15 *Agreements for the Construction of Real Estate*, IFRIC 18 *Transfers of Assets from Customers* and SIC 31 *Revenue – Barter Transactions Involving Advertising Services*) and most of the requirements on revenue recognition in FASB Accounting Standards Codification™ (ASC) Topic 605.

The objective of the ED is to clarify existing revenue recognition principles and develop a common standard for IFRS and US GAAP. This includes removing inconsistencies and perceived weaknesses in existing revenue standards and also improving the comparability of revenue recognition practices across companies, industries and capital markets.

Scope, Effective Date and Transition

The ED is applicable to all entities that enter into contracts with customers unless those contracts are within the scope of other standards (for example, lease contracts, insurance contracts or financial instruments). The effective date of the proposed standard would not be before 1 January 2015. Early adoption is permitted by the IASB's proposal; however, the FASB plans not to permit early adoption. Retrospective application is required under the ED, although certain transition relief is available.

Proposed Model

The proposed model is built on the contract between a vendor and a customer for the provision of goods and services. The ED addresses when the vendor should recognise revenue and how much should be recognised. It attempts to depict the transfer of goods and services to customers in an amount that reflects the consideration the vendor expects to receive. To accomplish this objective, the proposed standard requires the application of the following five steps:

1. Identify the contract 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 in the contract.
5. Recognise revenue when (or as) the entity satisfies a performance obligation.

STATUS

Exposure Draft

EFFECTIVE DATE

To be confirmed but not sooner than periods beginning 1 January 2015

ACCOUNTING IMPACT

Significant changes proposed for the accounting and disclosure of revenue.

1. Identify the contract

The proposal applies to all oral, written or implied contracts with the following characteristics:

- The contract has commercial substance.
- The entity and customer have approved the contract and are committed to performing under the contract.
- The entity can identify each party's rights with respect to the goods or services to be transferred.
- The entity can identify the payment terms with respect to the goods or services to be transferred.

These provisions are generally applied to each individual contract with a customer. However, if certain criteria are met, separate contracts with the same party entered into at or near the same time must be combined under the ED. Contracts are to be combined and accounted for as a single contract if 1) they are negotiated with a single commercial objective, 2) the consideration paid in one contract is dependent on another contract, or 3) the goods or services to be provided under the contracts represent a single performance obligation (i.e., they are not "distinct" as described below).

The proposed standard also addresses contract modifications. A contract modification would be accounted for as a separate contract if 1) it includes a separate performance obligation and 2) the additional consideration paid reflects the entity's stand-alone selling price for that performance obligation. If these criteria are not met, the modification is accounted for as an adjustment to the original contract. Depending on the circumstances, the modified contract (i.e. the adjustment) would be allocated to the remaining performance obligations on a prospective basis or reflected as a cumulative catch-up adjustment to revenue, whether positive or negative.

2. Identify the separate performance obligations

The ED defines a performance obligation as a contractual promise to deliver a good or service to the customer. Each promised good or service is treated as a separate performance obligation if it is "distinct". A good or service is distinct if it is regularly sold separately by the entity, or the customer benefits from the good or service on its own or together with resources that are readily available to the customer.

Nevertheless, the proposals require a bundle of goods or services to be combined and treated as a single performance obligation if both are 1) highly interrelated and the entity provides a significant service of integrating the goods or services into the combined item and 2) significantly modified or customised to fulfil the contract. The ED does not define "highly interrelated" and judgment will be required to determine when performance obligations are considered highly interrelated.

3. Determine the transaction price

A contract's transaction price is the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services. The transaction price can be a fixed or variable amount. The proposal contains guidance for variable consideration, the time value of money, non-cash consideration, and consideration payable to a customer when determining the appropriate transaction price.

The amount of consideration can vary for a variety of reasons including discounts, rebates, refunds, performance bonuses, etc. If the consideration is variable, an entity would estimate the transaction price using one of two methods:

1. The expected value method – consideration is equal to the sum of probability weighted amounts in the range of total possible consideration, or
2. The most likely amount method – consideration is the single most likely amount in the range of possible amounts.

The method selected depends on the approach that the entity expects to better predict the amount of consideration to which it will be entitled. For example, it would be appropriate to estimate the most likely amount when the contract has only two possible outcomes (e.g. the customer either will, or will not, pay a performance bonus).

When determining the transaction price, an entity would not consider the effects of customer credit risk (i.e. collectibility). Instead, an entity would account for customer credit risk by applying the provisions of IAS 39 *Financial Instruments: Recognition and Measurement* (IFRS 9 *Financial Instruments* if that has been adopted), or ASC 310, *Receivables*. Any impairment losses or reversals recognised in profit or loss for collectability would be presented as a separate line item adjacent to the revenue line item and not with other expense items.

Payments that an entity makes (or expects to make) to its customer are treated as a reduction of the entity's transaction price unless the payment is in exchange for a distinct good or service, as described above, that the customer transfers to the entity.

4. Allocate the transaction price

For contracts with more than one performance obligation, an entity must allocate the transaction price using a relative stand-alone selling price basis. The best evidence of stand-alone selling price is based on the observable price at which the good or service can be sold separately. If an observable price is not available, the stand-alone price should be estimated. In other words, it is not appropriate to combine distinct performance obligations because of the difficulty in estimating stand-alone sales prices.

The ED provides several examples of estimating the selling price. These include a market-based approach, an expected cost plus margin approach, and a residual approach. The residual approach may only be used if the stand-alone price is highly variable or uncertain, although it applies to both delivered and undelivered performance obligations.

Any changes to the transaction price subsequent to contract inception are generally allocated to all performance obligations on the same basis as at inception. However, in limited circumstances, the change is allocated to one or more specific performance obligations, rather than rateably to all of the obligations.

5. *Recognise revenue*

Revenue is recognised when the entity satisfies each performance obligation. Obligations are satisfied when (or as) the entity transfers control of a promised good or service to a customer. This occurs when (or as) the customer can direct the use of and can obtain substantially all the remaining benefits from the promised good or service. The ED provides indicators for assessing when control has transferred. Entities will need to exercise judgment to determine if the performance obligations are transferred over a period of time, or at a single point.

One of the following two criteria must be met for control to transfer over time:

1. The entity's performance creates or enhances an asset controlled by the customer as it is created or enhanced (e.g., work in process), or
2. The entity's performance does not create an asset with alternative use to the entity and at least one of the following criteria is met:
 - a. The customer simultaneously receives and consumes benefits.
 - b. If another entity was hired to perform the remaining obligation, it would not need to substantially re-perform the work already completed by the entity.
 - c. The entity has the right to payment for performance completed to date and expects to fulfil the contract as promised.

If the entity determines that control is transferred continuously, the corresponding revenue would be recognised over time by using an input or output method for measuring progress toward completion. Input methods include resources consumed, labour hours expended, costs incurred, etc. Output methods are generally more visible to the customer and include milestones reached or units produced, etc.

When control is transferred at a point in time, rather than continuously, some key indicators of when revenue should be recognised are listed below. Note that no individual factor is determinative:

- The entity has a present right to payment for the asset.
- The customer has legal title to the asset.
- Physical possession of the asset has been transferred to the customer.
- The customer has the significant risks and rewards of ownership of the asset.
- The customer has accepted the asset.

In addition to the general principle of recognising revenue when control is transferred, variable consideration associated with a performance obligation that has been satisfied is only recognised when collection is reasonably assured. Entities will be required to exercise judgment to make that determination based on their experience with similar contracts, where that experience is still considered predictive.

Other key areas

The ED includes specific guidance related to several additional topics, some of which are discussed below:

- Onerous performance obligations
- Contract costs
- Sale with a right of return
- Warranties
- Principal vs. agent considerations
- Customer options for additional goods and services
- Customers unexercised rights
- Nonrefundable upfront fees
- Licensing and rights to use
- Repurchase agreements
- Consignment arrangements
- Bill-and-hold arrangements
- Customer acceptance

Onerous performance obligations

For performance obligations that, at inception, are expected to take more than one year to satisfy, entities must assess whether the performance obligations are onerous. That condition exists when the lowest cost of settling the performance obligation exceeds the allocated transaction price. If the cost exceeds the remaining revenue to be recognised, a liability (and the corresponding expense) is recorded for the excess.

Contract costs

Under the proposed guidance, the incremental costs associated with obtaining a contract are capitalised if those costs are expected to be recovered. Costs associated with fulfilling a contract that are within the scope of other standards are dealt with in accordance with those standards (e.g., the standards for inventories; property, plant and equipment and intangible assets). Otherwise, the costs associated with contract fulfillment are capitalised only 1) if the costs are directly related to the contract, 2) will generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and 3) are expected to be recovered. Capitalised contract costs are amortised over the period commensurate with the transfer of corresponding good or service. As a practical expedient, contract costs can be expensed as incurred if the expected amortisation period is less than one year.

Warranties

Entities can continue to use the cost accrual method for warranty obligations that only serve to ensure the product meets agreed-upon specifications. However, if the customer has the option to purchase a separate warranty with the product, the warranty should be treated as a performance obligation to which a portion of revenue must be allocated. If the warranty provides a service in addition to ensuring the product meets agreed-upon specifications, the service portion should be treated as a separate performance obligation.

Sale with a Right of Return

Many products are sold with a right of return. Under the proposed guidance, an entity would recognise the following:

1. Revenue based on the amount the entity is reasonably assured to be entitled (considering the products expected to be returned).
2. A refund liability for the portion expected to be repaid to the customer.
3. An asset (and adjustment to cost of sales) for the products expected to be recovered.

The refund liability should be assessed at each reporting period for changes in expectations about the amount of refunds. Likewise, the asset is subject to an impairment assessment each period.

Disclosures

The proposed guidance significantly enhances the required qualitative and quantitative disclosures related to revenue. These disclosure provisions are reproduced in Appendix A.

Comparison of the First and Second Exposure Draft

The revised Exposure Draft reflects the IASB's and FASB's consideration of nearly 1000 comment letters received on the June 2010 ED, and extensive subsequent outreach efforts. The differences between the first and second proposals are summarised in Appendix B.

Comment period

The IASB has requested the submission of comments on its proposals by 13 March 2012.

The Exposure Draft can be accessed [here](#).

Appendix A – Proposed Disclosure Requirements (reproduced from paragraph 109 to 130 of the Exposure Draft)

Disclosure

The objective of the disclosure requirements is to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

- a) Its contracts with customers (paragraphs 113–123)
- b) The significant judgments, and changes in the judgments, made in applying the [draft] IFRS to those contracts (paragraphs 124–127)
- c) Any assets recognised from the costs to obtain or fulfil a contract with a customer in accordance with paragraphs 91 and 94 (paragraphs 128 and 129).

An entity shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. An entity shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics.

Amounts disclosed are for each period for which a statement of comprehensive income is presented and as of each period for which a statement of financial position is presented, as applicable, unless otherwise stated. An entity need not disclose information in accordance with this [draft] IFRS if it has provided the information in accordance with another IFRS.

Contracts with customers

An entity shall disclose information about its contracts with customers, including all of the following:

- a) A disaggregation of revenue for the period (paragraphs 114–116)
- b) A reconciliation from the opening to the closing aggregate balance of contract assets and contract liabilities (paragraph 117)
- c) Information about the entity's performance obligations (paragraphs 118–121), including additional information about any onerous performance obligations (paragraphs 122 and 123).

Disaggregation of revenue

An entity shall disaggregate revenue from contracts with customers (excluding amounts presented for customers' credit risk) into the primary categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. To meet the disclosure objective in paragraph 109, an entity may need to use more than one type of category to disaggregate revenue.

Examples of categories that might be appropriate include, but are not limited to, the following:

- a) Type of good or service (for example, major product lines)
- b) Geography (for example, country or region)
- c) Market or type of customer (for example, government and nongovernment customers)
- d) Type of contract (for example, fixed-price and time-and-materials contracts)
- e) Contract duration (for example, short-term and long-term contracts)
- f) Timing of transfer of goods or services (for example, revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time)
- g) Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries).

Reconciliation of contract balances (see paragraph 1G75)

An entity shall disclose in tabular format reconciliation from the opening to the closing aggregate balance of contract assets and contract liabilities. The reconciliation shall disclose each of the following, if applicable:

- a) The amount(s) recognised in the statement of comprehensive income arising from either of the following:
 - i. Revenue from performance obligations satisfied during the reporting period
 - ii. Revenue from allocating changes in the transaction price to performance obligations satisfied in previous reporting periods.
- b) Cash received
- c) Amounts transferred to receivables
- d) Noncash consideration received
- e) Effects of business combinations
- f) Any additional line items that may be needed to understand the change in the contract assets and contract liabilities.

Performance obligations

An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following:

- a) When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service)
- b) The significant payment terms (for example, when payment typically is due, whether the consideration amount is variable, and whether the contract has a significant financing component)
- c) The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)
- d) Obligations for returns, refunds, and other similar obligations
- e) Types of warranties and related obligations.

For contracts with an original expected duration of more than one year, an entity shall disclose the following information as of the end of the current reporting period:

- a) The aggregate amount of the transaction price allocated to remaining performance obligations
- b) An explanation of when the entity expects to recognise that amount as revenue.

An entity may disclose the information in paragraph 119 either on a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations or by using qualitative information.

As a practical expedient, an entity need not disclose the information in paragraph 119 for a performance obligation if the entity recognises revenue in accordance with paragraph 42.

Onerous performance obligations

An entity shall disclose the amount of the liability recognised for onerous performance obligations along with a description of all of the following:

- a) The nature and amount of the remaining performance obligation(s) in the contract that are onerous for which the liability has been recognised.
- b) Why those performance obligations are onerous.
- c) When the entity expects to satisfy those performance obligations.

An entity shall disclose in tabular format a reconciliation from the opening to the closing balance of the liability recognised for onerous performance obligations. The reconciliation shall include the amounts attributable to each of the following, if applicable:

- a) Increases in the liability from performance obligations that became onerous during the period
- b) Reductions of the liability from performance obligations satisfied during the period
- c) Changes in the measurement of the liability that occurred during the reporting period
- d) Any additional line items that may be needed to understand the change in the liability recognised.

Significant judgments in the application of the proposed guidance

An entity shall disclose the judgments, and changes in the judgments, made in applying this proposed guidance that significantly affect the determination of the amount and timing of revenue from contracts with customers. At a minimum, an entity shall explain the judgments, and changes in the judgments, used in determining both of the following:

- a) The timing of satisfaction of performance obligations (paragraphs 125 and 126)
- b) The transaction price and the amounts allocated to performance obligations (paragraph 127).

Determining the timing of satisfaction of performance obligations

For performance obligations that an entity satisfies over time, an entity shall disclose both of the following:

- a) The methods used to recognise revenue (for example, a description of the output method or input method)
- b) An explanation of why such methods are a faithful depiction of the transfer of goods or services.

For performance obligations satisfied at a point in time, an entity shall disclose the significant judgments made in evaluating when the customer obtains control of promised goods or services.

Determining the transaction price and the amounts allocated to performance obligations

An entity shall disclose information about the methods, inputs, and assumptions used to:

- a) Determine the transaction price.
- b) Estimate standalone selling prices of promised goods or services.
- c) Measure obligations for returns, refunds, and other similar obligations.
- d) Measure the amount of the liability recognised for onerous performance obligations.

Assets recognised from the costs to obtain or fulfil a contract with a customer

An entity shall disclose a reconciliation of the opening and closing balances of assets recognised from the costs incurred to obtain or fulfil a contract with a customer (in accordance with paragraphs 91 and 94), by main category of asset (for example, costs to obtain contracts with customers, precontract costs, and setup costs). The reconciliation shall include amounts related to each of the following, if applicable:

- a) Additions
- b) Amortisation
- c) Impairment losses
- d) Reversals of impairment losses; and
- e) Any additional line items that may be needed to understand the change in the reporting period.

An entity shall describe the method it uses to determine the amortisation for each reporting period.

Appendix B - Summary of changes from the 2010 Exposure Draft
(reproduced from the Basis for Conclusions to the revised Exposure Draft)

Steps to Apply the Proposals	Description of Changes to the Proposals
Step 1: Identify the contract(s) with the customer	<ul style="list-style-type: none"> – Changed the proposed <i>indicators</i> on combining contracts to <i>criteria</i>. The criteria are limited to contracts that are entered into at or near the same time with the same customer (or related parties). Added a criterion for goods or services across contracts that are a single performance obligation. – Eliminated the proposal on contract segmentation (but moved the principle to Step 4 on allocating the transaction price). – Revised the proposal on contract modifications to reduce the instances in which an entity would account for a modification on a cumulative catch-up basis.
Step 2: Identify the separate performance obligations in the contract	<ul style="list-style-type: none"> – Retained the definition of a <i>performance obligation</i> subject to the deletion of the term <i>enforceable</i> (to clarify the June 2010 proposals). – Clarified the proposals for identifying separate performance obligations (distinct goods or services) mainly by moving the guidance on a significant contract management service from the implementation guidance/basis into the proposed standard and by deleting reference to <i>distinct profit margin</i> in the proposed standard.
Step 3: Determine the transaction price	<ul style="list-style-type: none"> – Modified the definition of <i>transaction price</i> to refer to the amount to which the entity expects to be <i>entitled</i> rather than the expected amount to be <i>received</i>. – Modified the proposals on determining the transaction price as follows: <ul style="list-style-type: none"> – Collectibility: credit risk no longer included in the transaction price. Accounted for similarly to current practice (except for the presentation adjacent to revenue). – Time value of money: added a one-year practical expedient and clarified when a financing component is significant. – Variable consideration: either an expected value or a most likely amount is required (to simplify the proposals, which would have required a probability-weighted estimate in all cases).
Step 4: Allocate the transaction price	<ul style="list-style-type: none"> – Clarified that it may be appropriate for an entity to estimate a selling price using a residual approach if the price of a good or service is highly variable or uncertain. – Added guidance on when it is appropriate to restrict allocations of discounts, contingent payments, and changes in the transaction price to only some promised goods or services. That guidance uses the 2010 proposed Exposure Draft's principle of price independence (from contract segmentation) but has specific criteria to clarify when goods or services are priced independently (that is, the payment terms relate to the particular good or service and the amount is consistent with the objective of allocating the transaction price).
Step 5: Recognise revenue when a performance obligation is satisfied	<ul style="list-style-type: none"> – Added <i>risks and rewards of ownership</i> as an indicator of when control is transferred at a point in time. – Added criteria for determining when a performance obligation is satisfied over time. – Retained the objective of measuring progress toward completion of a performance obligation, but: <ul style="list-style-type: none"> – Clarified the discussion of alternative methods (that is, output and input methods) – Added guidance on uninstalled materials – Added guidance on reasonable measures of progress – Clarified the meaning of <i>abnormal costs</i>. – Changed the proposed constraint from an entity's <i>reasonable estimate</i> of the transaction price to the entity being <i>reasonably assured</i> to be entitled to the amount of consideration recognised as revenue to date. No change made to the factors to consider when making that determination other than clarifying that an entity is not reasonably assured to be entitled to a sales-based royalty amount until the occurrence of the event that makes the payment due.

Other Issues	
Warranties	<ul style="list-style-type: none"> – Revised the proposed guidance to require an entity to account for some warranties as a cost accrual, which is more consistent with current practice.
Licenses and rights to use	<ul style="list-style-type: none"> – Eliminated the distinction between non-exclusive and exclusive licenses. All rights to use are transferred at a point in time (subject to the separation criteria and the proposal to constrain cumulative revenue recognised to the amount to which the entity is reasonably assured to be entitled).
Onerous test	<ul style="list-style-type: none"> – Modified the scope of the test to a performance obligation that an entity satisfies over a period of time greater than one year. – Added guidance on which costs to include when performing the test (an entity would use the lower of the direct costs to satisfy the performance obligation and the amount the entity would pay to exit the performance obligation, if permitted under the contract).
Acquisition costs	<ul style="list-style-type: none"> – Changed the guidance in the 2010 proposed Exposure Draft so that the incremental costs of obtaining the contract (for example, sales commissions) would be recognized as an asset. As a practical expedient, permitted the option to recognise acquisition costs as an expense if the contract is one year or less. – Added disclosure requirements.
Fulfilment costs	<ul style="list-style-type: none"> – Clarified how an entity would amortise the asset recognised from fulfillment costs (that is, the asset would be amortised in accordance with the pattern of transfer of goods or services to which the asset relates, which might be provided in specific anticipated contracts). – Clarified the guidance on how an entity would test the asset for impairment (that is, revised the wording for precontract costs and specified whether a reversal of an impairment is required). – Added disclosure requirements. – Clarified the scope of the cost guidance developed as part of the revenue project.
Sale and repurchase agreements	<ul style="list-style-type: none"> – Added guidance to specify that an entity should account for a sale with a put option as a lease if the customer has a significant economic incentive to exercise the option.
Disclosures	<ul style="list-style-type: none"> – Limited the instances in which an entity would provide a maturity analysis of remaining performance obligations.
Breakage	<ul style="list-style-type: none"> – Added guidance on how to apply the model when the customer purchases a material right but chooses not to fully exercise that right (that is, breakage). That guidance is consistent with the 2010 proposed Exposure Draft's guidance in the example on customer loyalty points.
Transition	<ul style="list-style-type: none"> – Provided some specified reliefs for transitioning to the proposed standard on a retrospective basis.

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