

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2010/15 REVENUE FROM CONTRACTS WITH CUSTOMERS



Background

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have jointly issued an Exposure Draft *Revenue from Contracts with Customers* (the ED). The objective of the joint project is to clarify the principles of revenue recognition, and to develop a common standard for International Financial Reporting Standards (IFRSs) and US Generally Accepted Accounting Principles (US GAAP).

The primary aims of a common revenue standard would be to remove inconsistencies and weaknesses in existing revenue recognition standards and provide a more robust framework for addressing revenue recognition issues that develop in practice. This in-turn would improve the comparability of revenue recognition across entities, industries, jurisdictions and capital markets and simplify the preparation of financial statements by reducing the number of requirements that currently need to be referred to in IFRSs and (particularly) US GAAP.

The joint proposals developed by the IASB and the FASB set out in the ED 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*TM (ASC) Topic 605.

The proposals set out in the ED would affect any entity that enters into contracts to provide goods or services to customers that are a result of the entity's ordinary activities unless those contracts are within the scope of another IFRS or requirement under US GAAP.

The ED proposes full retrospective application with the IASB having taken a tentative decision to allow first-time adopters of IFRSs to early adopt the new standard. The IASB has not yet reached a decision on whether it would permit existing IFRS preparers to early adopt. A specific effective date has not yet been determined, but the IASB and FASB plan to invite additional comments from stakeholders through a separate consultation in this regard.

STATUS

Exposure Draft

EFFECTIVE DATE

To be confirmed

ACCOUNTING IMPACT

Significant changes proposed for the accounting and disclosure of revenue

Proposals

Scope

The proposals in the ED would apply to a contract an entity has with a customer except for the following contracts which are within the scope of other IFRSs:

- financial instrument contracts;
- insurance contracts;
- leasing contracts; and
- non-monetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange (e.g. swaps of oil which is in different locations).

A contract is defined in the ED as an agreement between two or more parties that creates enforceable rights and obligations.

For a contract with a customer that would be partially within the scope of the ED and other IFRSs, the ED proposes that an entity first use the guidance in the other IFRSs on how to separate and initially measure any parts of the contract unless those other IFRSs do not contain such guidance, in which case the entity will use the guidance in the ED to separate and initially measure those parts of the contract.

Core Principle

The core principle set out in the ED is that an entity should recognise revenue on a basis that reflects the consideration that it receives or expects to receive from its customers in exchange for goods or services that the entity transfers to its customers.

The ED proposes that an entity apply the following steps in order to achieve this principle:

- (a) identify the contract(s) with a customer;
- (b) identify the separate performance obligations in the contract;
- (c) determine the transaction price;
- (d) allocate the transaction price to the separate performance obligations; and
- (e) recognise revenue when the entity satisfies each performance obligation.

Identifying the contract

The ED notes that a contract exists for the purpose of the applying its proposals only if the contract:

- has commercial substance;
- the parties to the contract have approved the contract and are committed to satisfying their respective obligations;
- each party's enforceable rights regarding the goods and services transferred can be identified; and
- the terms and manner of payment are identified.

A contract does not exist if either party can terminate a wholly unperformed contract without penalty.

In situations where an entity needs to combine one or more contracts to a customer to appropriately determine the timing and amount of revenue, the ED proposes that two or more contracts be combined and accounted for as a single contract if the consideration in one contract is dependent on the consideration in another contract, i.e. the prices of those contracts are interdependent. The ED provides some explanatory guidance to assist in determining when two or more contracts have interdependent prices.

Conversely, in situations where elements in a single contract need to be segmented to appropriately determine the timing and amount of revenue, the ED proposes that a single contract be segmented and accounted for as two or more contracts if the prices for some of the goods and services in the contract are independent of the price of the other goods or services in the contract. The ED provides some explanatory guidance on when prices for goods and services within a contract are independent of other goods or services in the same contract. When a contract is segmented in accordance with the guidance, the ED requires an entity to allocate the total amount of consideration received in the contract in proportion to the stand-alone selling prices of the goods or services identified in the contract.

When there is a modification in the scope or price of a contract, the proposal in the ED is for an entity to account for the contract modification together with the existing contract if the prices of the modification and the existing contract are interdependent. In such cases, the cumulative effect of the contract modification is recognised in the period the modification occurs. However if the prices of the contract modification and the existing contract are not interdependent the ED proposes that the contract modification be accounted for as a separate contract.

Identifying separate performance obligations

The proposal in the ED is for an entity to evaluate the terms of the contract and its customary business practice to determine if the promised goods or services in the contract represent separate performance obligations and, if so, to account for those performance obligations separately.

Under the ED, a good or service, or a bundle of goods or services represent separate performance obligations if they are 'distinct'. The ED considers a good or service, or a bundle of goods or services to be distinct if either the entity, or another entity, sells the same or similar good or service separately or the good or service could be sold separately by an entity because the good or service has a distinct function (i.e. it has utility on its own or together with other goods or services) and a distinct profit margin.

The ED requires an entity to recognise revenue when it satisfies its performance obligations by transferring the promised goods or services in the contract to the customer. The ED considers a good or service to be transferred when the customer obtains control of that good or service. Control has passed to the customer when the customer has the ability to direct the use of, and receive the benefit from, the good or service. Under the ED the customer's ability to direct the use of the good or service means the present right to use the good or service for its remaining economic life while the ability to receive the benefit from the good or service means the customer's present right to obtain substantially all of the potential cash flows from the good or service.

The ED proposes that an entity consider the following factors when assessing whether the transfer of control to the customer of the goods or services for each separate performance has occurred:

- (a) The customer has an unconditional obligation to pay for the good or service;
- (b) The customer has legal title to the good or service;
- (c) The customer has physical possession; and
- (d) The design or function of the good or service is customer-specific.

The ED stresses that none of the preceding indicators individually determine whether the customer has obtained control of the good or service as some of the factors might not be relevant to a particular contract. All relevant facts and circumstance should be considered to determine if control has passed to the customer.

When a performance obligation is a continuous transfer of goods or services to a customer, the ED requires an entity to apply a revenue recognition method to the performance obligation which best depicts the transfer of the goods or services to the customer and apply that method consistently to similar performance obligations and in similar circumstances. Suitable methods proposed in the ED include output methods such as units produced or delivered or contract milestones, input methods based on the efforts expended to date such as costs of resources consumed or labour hours expended and methods based on the passage as time such as straight-line over the expected duration of the contract.

If an input method is used, the ED requires an entity to exclude the effects of any inputs that do not depict the transfer of goods or services to the customer such as the cost of abnormal amounts of wasted materials, labour or other resources. Also a straight-line time based method can only be used if the services are transferred evenly over the expected duration of the contract.

It is likely that if the proposals set out in the ED are taken forward as drafted, some arrangements which are currently accounted for as construction contracts, with revenue and costs being recorded as contract activity progresses, would instead be accounted for on completion.

Determining the transaction price

The ED proposes that as an entity satisfies each of the performance obligations in a contract, it will recognise revenue equal to the amount of the transaction price allocated to each performance obligation. The ED defines the transaction price for a contract with a customer as the amount of consideration that 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).

An entity would be required to consider the terms of the contract and its customary business practice to determine the transaction price, with this reflecting the probability-weighted amount of consideration that is expected to be received in exchange for transferring the goods or services to the customer.

For many contracts the transaction price is readily determinable because the amount of consideration is fixed and it is paid at or near the time of transfer of the goods or services. However, in other contracts the amount of consideration could vary due to the inclusion of items such as discounts, rebates, refunds and incentives. In addition, an adjustment would be required to take account of the customer's credit risk (see below). Also the proposals in the ED would require the transaction price in variable consideration contracts to be estimated at each reporting date for changes in circumstances during the reporting period.

If an entity expects to refund any of the consideration received from a customer, the ED requires the entity to recognise a refund liability as the probability-weighted amount of consideration that the entity expects to refund to the customer. The refund liability is required to be updated at each reporting period for changes in circumstances.

The ED requires revenue to be recognised from satisfying a performance obligation only if the transaction price can be reasonably estimated. The transaction price can be reasonably estimated if the following two conditions are met:

- An entity has experience with similar types of contracts (or access to the experience of other entities if it has no experience of its own); and
- The entity's experience is relevant to the contract because the entity does not expect significant changes in circumstances.

The ED provides some explanatory paragraphs on these conditions and surmises that if an entity cannot reasonably estimate the transaction price, it should not recognise revenue from satisfying a performance obligation until such time that the transaction price can be reasonably estimated. If an entity is able to reasonably estimate some of the consideration, the ED does permit the transaction price to include only the amount that can be reasonably estimated.

The ED proposes that an entity consider the effects of the following when determining the transaction price:

- Collectibility – refers to a customer's credit risk or ability to pay the amount of consideration. An entity would be required to reduce the amount of consideration to reflect customer credit risk.
- The time value of money – the amount of consideration would be adjusted to reflect the time value of money if the contract includes an implicit or explicit material finance component;
- Non-cash consideration – if an entity received or expected to receive non-cash consideration, the non-cash consideration would be required to be measured at fair value unless that fair value could not be reasonably estimated. In those cases, the non-cash consideration would be measured indirectly by reference to the stand-alone price of the goods or services transferred in exchange for the consideration; and
- Consideration payable to the customer – if an entity paid or expected to pay consideration to the customer (or other third party) in the form of cash, credit or other amounts that could be applied by the customer against the amounts it owed to the entity, the entity would be required to determine whether that amount is a reduction in the purchase price (and hence revenue), a payment for a distinct good or service from the customer (and hence accounted for as a purchase from a supplier) or a combination of both. If the later, the transaction price would be reduced by the excess, if any of the consideration payable to the customer over the fair value of the good or service received from the customer.

Allocating the transaction price to separate performance obligations

At contract inception the ED proposes that an entity allocate the transaction price to the separate performance obligations in proportion to the stand-alone selling price of the good or service underlying the performance obligations. The best evidence of stand-alone selling price would be the observable price of a good or service when sold separately. If a stand-alone selling price was not directly observable, the ED would require an entity to estimate it.

The ED would require the maximum use of observable inputs and the consistent application of estimation method when estimating stand-alone selling prices. Suitable estimation methods include expected cost plus a margin, or an adjusted market assessment.

After inception, any changes in the transaction price, other than for changes in stand-alone selling price, would be allocated to all performance obligations on the same basis as at inception as additional revenue, or as a reduction in revenue, in the period in which the transaction price changes occur.

Onerous performance obligations

An entity would recognise a liability and corresponding expense if a performance obligation is onerous. A performance obligation would be considered onerous if the present value of the probability-weighted costs that relate to satisfying the obligation exceeds the transaction price allocated to that obligation. At each subsequent reporting date the ED would require an entity to update the measurement of the onerous performance obligation liability using current estimates, with any change in the liability being recorded as an expense or reduction of an expense.

Contract costs

The proposals in the ED would, in certain circumstances, allow an entity to recognise certain costs incurred in fulfilling a contract as an asset, if not eligible for recognition under another IFRS (such as IAS 2 Inventories). However, under the proposals, an asset can only be recognized if those costs relate directly to a contract, the costs generate or enhance resources of the entity that will be used in satisfying future performance obligations and they are expected to be recovered.

The ED provides some explanatory guidance on the types of costs that are considered to be directly related to a contract. Directly related costs include:

- direct labour;
- direct materials;
- the allocation of contract management and depreciation of tools and equipment (if they relate directly to contract activities);
- costs that are explicitly charged under the contract; and
- costs that were incurred because the entity entered into the contract.

Costs that are not related and thus are expensed as incurred are costs of obtaining a contract such as advertising and promotion expenses, costs that relate to satisfied performance obligations in the contract (i.e. they relate to past performance) and costs of abnormal amounts of wasted materials and labour.

Any costs recognised as an asset would be classified on the basis of the nature or function of the costs that gave rise to the asset. The asset would then be amortised on a systematic basis consistent with the pattern of the transfer of goods or services to which the asset relates. Finally an impairment loss would be recognised on the asset to the extent that the carrying amount exceeded the amount of the transaction price allocated to the remaining performance obligations less the additional costs that are directly related to satisfying those performance obligations.

Presentation and disclosure

An entity would be required to present a contract in the statement of financial position as either a contract asset or a contract liability depending on the relationship between the entity's and the customer's performance. The ED provides some additional explanatory guidance on when an entity presents a contract asset or a contract liability.

The proposals in the ED would require an entity to provide a number of qualitative and quantitative disclosures about its contracts with customers to help users of an entity's financial statements understand the amount, timing and uncertainty of revenue and cash flows from those contracts, including:

- A disaggregation of revenue for the period;
- A reconciliation from the opening to closing aggregate balance of contract assets and contract liabilities; and
- Information about the entity's performance obligations, including additional information about its onerous performance obligations.

The ED contains additional guidance on the information to be included in order to satisfy these disclosure requirements.

An entity would be required to disclose the judgments, and change in judgements, made in applying the requirements of the ED that significantly affect the determination of the amount and timing of revenue from customers including, determining the timing of satisfaction of performance obligations, and in determining the transaction price and allocating it to performance obligations.

Application Guidance

The ED also includes an Appendix of proposed application guidance that will form an integral part of the final IFRS. This application guidance provides additional information and numerical examples on the following issues:

- (a) Segmentation of a contract;
- (b) Contract modifications;
- (c) Identifying performance obligations;
- (d) Determining whether a good or service is distinct;
- (e) Satisfaction of performance obligations;
- (f) Determining the transaction price;
- (g) Allocating the transaction price to separate performance obligations;
- (h) Contract costs;
- (i) Presentation and
- (j) Disclosure.

With respect to the guidance on identifying performance obligations, the ED provides detailed guidance for the following situations:

- (a) Sale of a product with a right of return;
- (b) Product warranties and product liabilities;
- (c) Principal versus agent considerations;
- (d) Customer options for additional goods or services;
- (e) Non-refundable upfront fees; and
- (f) Licensing and rights to use.

Effective date and transition

The ED proposes full retrospective application with the IASB having taken a tentative decision to allow first-time adopters of IFRSs to early adopt the new standard. The IASB has not yet reached a decision on allowing existing IFRS preparers to early adopt. A specific effective date has not yet been determined but the standard setters plan to invite additional comments from stakeholders through a separate consultation in this regard.

Comment period

The IASB has requested the submission of comments on its proposals by 22 October 2010.

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