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June 2010

iGAAP Alert.

IASB issues revenue recognition exposure draft

In a nutshell

The IASB's new revenue proposals could affect the recognition of revenues and profits for many entities, and in some cases the impact may be very significant.

Applying some of the new concepts, especially that of 'control' of a good or service, may require considerable judgement.

Some of the proposals may lead to outcomes that are counter intuitive, especially in relation to the allocation of revenue between distinct elements of a contract.

Entities should not underestimate the proposed disclosure requirements, which are very extensive.

In some cases, changes may be required to accounting systems.

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The proposal

On 24 June 2010, the International Accounting Standards Board (IASB) and U.S. Financial Accounting Standards Board (FASB) published a joint exposure draft ED 2010/6 *Revenue from Contracts with Customers*. The ED is the next step in developing an entirely new revenue recognition standard. The Boards' objectives are to develop a common, comprehensive, principles-based revenue standard that can be applied consistently to complex transactions across a wide range of industries. The Boards believe that the proposals would be a significant improvement over the current revenue recognition guidance that can be vague, inconsistent and difficult to apply to complex transactions.

Similar to the existing IFRS guidance, the ED proposes a model based on a contract with a customer, with revenue being recognised when goods and/or services are transferred to the customer. A contract is defined as "an agreement between two or more parties that creates enforceable rights and obligations."

Scope

The proposals would apply to a contract with an entity's customer except for:

- financial instrument contracts;
- insurance contracts;
- leasing contracts; and
- nonmonetary 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 similar items).

> **Observation**
> It is possible that a single contract will include both elements that are within the scope of the proposals and elements that are outside their scope. It will be necessary to separate these elements so as to account for each of them under the applicable guidance.

Steps to applying the proposed model

Under the proposals, an entity should:

- identify the contract(s) with a customer;
- identify the separate 'performance obligations' in the contract (i.e. obligations to deliver goods and/or services);
- determine the transaction price;
- allocate the transaction price to the separate performance obligations; and
- recognise the allocated revenue when the entity satisfies each performance obligation.

Identification of a contract

There may be situations when an entity would combine two or more contracts as a single contract. According to the ED, combining of contracts would be appropriate if the prices of those contracts are interdependent. Conversely, an entity may treat a single contract with a customer as two or more contracts if elements within the contract are priced independently of other elements.

Identification of separate performance obligations

Under the ED, an entity evaluates all goods and/or services promised in the contract to determine whether there are separate performance obligations. The proposals would require an entity to account separately for a good or service if it is *distinct*, meaning that the good or service either is sold separately in the customer's market or could be sold separately because it would be useful in itself or in conjunction with another product that is available separately.

Observation
IFRSs do not currently provide guidance relating to the unbundling of multiple element arrangements. Accordingly, many entities apply an approach based on the principles in local country GAAPs. The proposed guidance could change the timing of revenue recognition in multiple element arrangements.

Determining the transaction price

Time value of money
The time value of money should be considered when its effect is material. The adjustment for the time value of money would be applicable when a payment is due significantly before or after the transfer of goods and/or services. Therefore, it may become more common to adjust revenues for the time value of money when a prepayment is made by a customer or a credit period is granted to a customer.

Variable consideration
When an entity has delivered goods or services, sometimes the amounts it will receive in the future are not fixed. Under the proposals, future variable consideration would be recognised using an 'expected value' approach, but only where that expected value can be measured reliably. Such an approach requires management to develop probabilities for each possible scenario based on the relevant past experience and assess as to whether it believes circumstances will change significantly.

Observation
Entities should look carefully at the impact of the proposed rules on variable consideration. Revenue may be recognised earlier under the proposed approach if the variable consideration is reliably measurable. Estimates may need to be updated based on changes in facts and circumstances which could lead to increased volatility.

Credit risk of the customer
Under the proposals, the customer's credit risk affects **how much** revenue is recognised rather than **whether** revenue is recognised. An entity would adjust the transaction price to reflect the customer's credit risk using a probability-weighted approach.

Observation
Under current IFRSs, the customer's credit risk affects whether revenue is recognised. Revenue is only recognised if it is probable that the benefits will flow to the entity. Therefore, entities that currently defer the recognition of revenue because of significant uncertainties over whether the customer will be able to pay would likely recognise revenue earlier than at present and at a different amount.

Allocation of the transaction price to different elements
The ED requires the transaction price to be allocated between distinct elements in proportion to the stand-alone selling price of each element. The best evidence of a stand-alone selling price is the observable price of a good or service that is sold separately. However, in situations where goods or services are not sold separately, the ED would require an entity to develop an estimate based on a reasonable approach. Any discount to the aggregate of stand-alone selling prices is allocated strictly in proportion to the stand-alone selling price of each distinct good or service.

Observation

There is currently limited guidance under IFRSs relating to the allocation of the transaction price to different elements. Entities that look to other GAAPs, such as the U.S. guidance on Vendor Specific Objective Evidence, may find that the allocation of revenue is very different under the proposals. In addition, entities like mobile phone operators that provide free or heavily discounted handsets to customers may find that their accounting for multiple element contracts changes under the proposals.

The proposals may result in allocations that do not necessarily reflect the economics of the transaction. For example, when low-margin elements are bundled with high-margin elements, an entity may provide a discount to the customer on the high-margin element. Under the proposals, that discount must be allocated pro rata to all elements in the contract which may result in the entity recognising a loss on the low-margin element even though no discount was provided on that particular element. For example, this might affect software suppliers that grant discounts against the licence element within a package. Also, in some cases estimating the stand-alone selling price of an item that is not sold separately could be particularly challenging.

Recognising allocated revenue

Revenue would be recognised when the customer obtains *control* of the goods or services. This aspect of the proposals is of fundamental importance to many, but it is also one that will likely require the most judgement. The principle outlined is that "a customer obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service". A customer has obtained control if it has the present right to use the asset for its remaining economic life or to consume the asset in the customer's activities, together with the present right to obtain substantially all of the potential cash flows from that asset. The transfer of control of a product or service can be at a point in time or continuous.

Observation

Under IAS 18, revenue from the sale of goods is typically recognised at a single point in time when the risks and rewards have been transferred to the customer. Revenue from services and construction contracts is typically recognised using the percentage of completion method as services are being performed. Under the proposals, entities must assess whether the customer has obtained control of the product or service. Revenue would not be recognised until control is transferred to the customer.

The proposals may have a significant impact for entities that currently apply a percentage of completion model but the customer has neither physical possession of nor title to any work in progress. They may be required to recognise revenue when the product is completed and delivered to the customer. For example, this might affect entities that produce customer-specific reports, software or specialist equipment.

The ED provides the following indicators for determining whether control has passed to the customer, but emphasises that none is individually determinative and that some will not always be relevant:

- the customer has an unconditional obligation to pay;
- the customer has legal title;
- the customer has physical possession;
- the design or function of the good or service is customer-specific.

Observation

Under IAS 11 and IFRIC 15, whether the design or function of the good or service is customer-specific determines if a contract is a construction contract and, therefore, whether revenue is recognised on a percentage of completion basis. Under the proposals, this factor will no longer be sufficient in and of itself and judgement will be required as to whether the customer has control of any work in progress.
An example in the draft application guidance indicates that control will have passed if the design or function is customer-specific and the customer also has the ability to take possession of the work in progress during manufacturing and engage another entity to complete the manufacturing. It is not immediately clear whether the customer's ability to take possession of any work in progress is an essential factor, or whether other factors might instead be sufficient.

When control is deemed to be transferred continuously, an entity must determine how to recognise revenue. According to the ED, "an entity shall apply to that performance obligation one revenue recognition method that best depicts the transfer of goods or services to the customer. The entity shall apply that method consistently to similar performance obligations and in similar circumstances."

The following are acceptable methods of recognising revenue:

- output methods that recognise revenue on the basis of units produced, units delivered, contract milestones, or surveys of work performed;
- input methods that recognise revenue on the basis of costs incurred, labour hours expended, or machine hours used; and
- methods based on the passage of time.

Onerous performance obligations

An entity would evaluate an individual performance obligation to determine whether it is onerous. A performance obligation would be onerous if the direct costs that would be incurred to satisfy the obligation are greater than the allocated transaction price. If so, a separate liability would be recognised for that individual performance obligation.

Observation

Under current IFRSs, an entity evaluates the contract as a whole to determine whether it is onerous. If so, a provision is recognised for that onerous contract. Some entities choose to sell items at a loss to generate future profitable business. Under the proposals, any contract that includes such items will, at the date of signing, result in the recognition of an onerous performance obligation provision – even if those items are bundled with other profitable items so that the contract as a whole is profitable.

Warranties

The proposals distinguish between a product warranty that provides coverage for latent defects and a warranty that covers faults that arise after the product is transferred. A latent defect is one that exists but is not apparent when the asset is transferred to the customer. A separate performance obligation would not be recognised for these types of product warranties; instead, revenue relating to the product itself is restricted to reflect the fact that a defective product has been supplied. Accordingly, an entity would need to estimate the amount of unsatisfied performance obligations relating to these types of warranties at the end of the reporting period based on the likelihood and extent of latent defects in the products it has sold to customers. An entity would not recognise revenue for products it expects to be required to replace and would not recognise the portion of revenue that can be attributed to components that the entity expects to be required to repair.

A warranty that is provided to a customer that covers faults that arise after the product is transferred to the customer gives rise to a separate performance obligation. Therefore, a portion of the transaction price should be allocated by the entity to that warranty performance obligation.

Observation
Under current IFRSs, warranties are often recorded as a liability at inception of the contract on the basis of the estimated costs to repair or replace the product. Under the ED, revenue would instead be deferred and recognised on an appropriate basis over the warranty period. This change could have a significant effect on some entities that provide warranties to their customers, particularly in respect of faults other than latent defects.

Rights of return
An entity would not recognise revenue for goods expected to be returned. Instead, a liability would be recognised for the expected amount of returns and that liability would be updated for any changes in estimate. Additionally, an asset and a corresponding credit to cost of sales would be recognised for the right of recovery from the customer.

Licences of intellectual property
A licence that transfers control of the entire licensed intellectual property to the customer (e.g. an exclusive licence for the entire economic life) would be treated as a sale. An entity that licenses the use of its intellectual property but does not transfer control of the entire licensed intellectual property to the customer (e.g. a licence for less than its economic life) would need to determine whether the licence is exclusive or non-exclusive. For exclusive licences, the performance obligation would be extinguished over time so revenue would be recognised over the term of the licence. For non-exclusive licences, the performance obligation would relate only to transfer of the licence and therefore revenue would often be recognised at the date the customer is able to use the licence.

Observation
Under current IFRSs, an entity that licenses the use of its intellectual property would generally recognise revenue when the contractual performance has occurred and to the extent that reliable measurement of revenue is possible. For example, the fixed element of royalty revenues is typically recognised at inception of the contract if there are no outstanding contractual obligations. The proposals may result in entities recognising revenues over the term of the licence instead of recognising revenue upon the granting of the licence. Entities in the pharmaceutical and media sectors, and manufacturers of customer-specific software that allow customer choice over whether to renew a licence may be particularly affected by these proposals.

Contract costs
The proposals include specific guidance on which types of costs would be capitalised or expensed. For example, amounts paid to obtain a customer contract must be expensed when incurred.

Observation
The proposed guidance may result in the expensing of costs that were previously capitalised which may affect the profit profile of a contract. For example, entities that pay significant amounts to third parties (e.g. agents) in order to secure contracts, and currently capitalise the amounts paid, would recognise such costs as an expense when incurred.

Disclosures
The ED proposes extensive disclosure requirements on various aspects of revenue recognition and contracts with customers.

Observation

Many entities will need to consider whether their systems are capable of capturing the necessary information to comply with the proposed disclosures. In addition, it may be challenging to find an approach to these disclosures that is meaningful for users but does not result in excessive length.

Transition

The ED would require full retrospective application. The IASB tentatively decided that first time adopters of IFRSs would be permitted to adopt the new standard early but has yet to decide whether early adoption would be permitted for existing IFRS preparers. The Boards are expected to issue a separate consultation document seeking stakeholder input about effective dates and transition methods on a range of projects.

Next steps

The comment deadline on the ED is 22 October 2010. The IASB plans to hold public round-table meetings – but anyone interested in participating must notify the IASB by email (to jwilson@iasb.org) by 1 October 2010 and submit written comments on the proposals by 22 October 2010.

Examples

The following examples are provided solely to illustrate the application of the proposals using simple fact patterns.

Example 1: Recognising revenue based on control

An entity manufactures large pieces of machinery, which take several years to construct. The items are manufactured based on customer orders, but are not customised. Manufacturing takes place at the entity's factory. Customers are obliged to make progress payments towards the purchase price of the machinery, but do not obtain legal title until construction is complete and delivery has occurred. The entity previously recognised revenue as manufacturing takes place, using a percentage of completion approach.

Under the ED's proposals, the entity needs to consider whether the customer has control of the partly constructed machinery. The entity would not be able to recognise revenue on a percentage of completion basis if it concluded that the customer does not have control of the partly constructed machinery. Instead, the entity would likely recognise revenue in full upon delivery of completed machinery to the customer.

Example 2: Allocation of revenue to distinct goods and services

An entity typically sells products A and B on a stand-alone basis for CU200 and CU100 respectively. The costs to the entity of products A and B are CU110 and CU90, respectively.

The entity offers a discount of CU60 against the price of product A if a customer enters into a single contract to buy products A and B. The total contract value would be CU240. Under IAS 18, the entity determines that it is appropriate to allocate CU140 to product A and CU100 to product B. Thus, it recognises a profit of CU30 on product A and of CU10 on product B.

Products A and B are to be delivered at different times and under the ED are treated as distinct products. The total contract revenue must be allocated in proportion to the products' stand-alone selling prices. Accordingly, revenue of CU160 (240/300 x CU200) would be allocated to product A and revenue of CU80 (240/300 x CU100) would be allocated to product B.

This allocation results in product B being sold at a loss of CU10, because it costs the entity CU90 and the revenue allocated to it is CU80. Accordingly, upon entering into the contract, the entity would recognise an expense of CU10 and a liability of CU10 in respect of the onerous performance obligation. When product A is delivered, the entity would recognise revenue of CU160 and costs of CU110, resulting in a profit of CU50. When product B is delivered, the entity would recognise revenue of CU80 and costs of CU90, and would release the liability of CU10 for the onerous performance obligation, so that overall there is neither a profit nor a loss at the date of delivery.

Example 3: Warranties

At the end of Year 1, an entity sells 10,000 units of a particular product for CU1,000 each, and grants an associated warranty that it will replace, free of charge, any components that fail within four years of purchase. The entity's purchase price for each unit is CU600. The entity's current accounting policy is to recognise revenue in full upon delivery of the product, and to provide for the cost of replacing components during the warranty period, which is estimated at an average of CU72 per unit.

The entity determines that on average 2% of the units sold have latent defects, and these defects are typically dealt with by replacing the entire unit, which will happen early in Year 2. The cost relating to faults other than latent defects (i.e. faults that arise after delivery) is estimated at an average of CU60 per unit, and these costs tend to arise fairly evenly over the four year warranty period (i.e. throughout Years 2 to 5). The entity also determines that the fair value of the product without the four year warranty is CU900 and that the fair value of the four year warranty is CU100.

The table below provides a high-level overview of the recognition of revenue under the current policy and under the ED's proposals. For simplicity, the time value of money is ignored. Under the ED proposals, the revenue recognised in year 1 is reduced by CU1,180,000 which is comprised of CU180,000 (CU 900 x 200 units) relating to latent defects and CU1,000,000 (CU100 x 10,000 units) for the four-year warranty. In year 2, the CU180,000 is recognised as revenue because the entity has extinguished its performance obligation relating to replacing the entire unit and CU120,000 (CU600 x 200 units) is recognised as the associated cost. Additionally, warranty income of CU1,000,000 and the associated costs of CU600,000 (CU60 x 10,000 units) are recognised in years 2-5 using a method that faithfully depicts the transfer of goods (i.e., straight-line).

	Current accounting policy	ED proposals
Year 1	**CU'000**	**CU'000**
Sale of units	10,000	8,820
Cost of units	(6,000)	(6,000)
Warranty provision	(720)	–
Gross profit	**3,280**	**2,820**
Year 2		
Sale of units		180
Warranty income		250
Cost of units		(120)
Warranty costs		(150)
Gross profit		**160**
Year 3		
Warranty income		250
Warranty costs		(150)
Gross profit		**100**
Year 4		
Warranty income		250
Warranty costs		(150)
Gross profit		**100**
Year 5		
Warranty income		250
Warranty costs		(150)
Gross profit		**100**

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Designed and produced by The Creative Studio at Deloitte, London. 4773A

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