

Snapshot: Revenue from Contracts with Customers

This snapshot is a brief introduction to the exposure draft *Revenue from Contracts with Customers*. It provides an overview of the main proposals that were developed jointly, and unanimously agreed upon, by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB).

Project objectives: The project objective is to improve financial reporting by clarifying the principles for recognising revenue and creating a single joint revenue recognition standard for IFRSs and US GAAP that companies can apply consistently across various industries and capital markets.

Project stage: In June 2010 the IASB and the FASB published the proposed standard. It is the result of extensive discussions of the boards and reflects the input received through external consultation. It contains proposals on the recognition, measurement and disclosure of revenue and related costs from contracts with customers.

Comment deadline: The exposure draft is open for public comment until 22 October 2010.

Next steps: The boards invite comment from all interested parties. During the comment period the boards will undertake further outreach activities to ensure that the views of all interested parties are taken into consideration when finalising the standard in 2011.



Why are the boards undertaking this project?

Revenue is a crucial number to users of financial statements in assessing a company's performance and prospects.

Users need useful information about revenue. However, existing requirements need improvement to meet these needs.

In particular, there are four main issues that need to be addressed:

- US GAAP consists of broad revenue concepts and numerous industry- and transaction-specific requirements that can result in different accounting for economically similar transactions.
 - IFRSs contain fewer requirements, but the two main standards on revenue can be difficult to apply to complex transactions. In addition, they have limited guidance on important topics (eg multiple-element arrangements).
 - The disclosure requirements of US GAAP and IFRSs often result in information that is inadequate for users to understand a company's revenues.
 - IFRSs and US GAAP have insufficient guidance on accounting for some contract costs, which can result in diversity in practice.
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How are we addressing the issues?

To address the weaknesses in existing requirements, the boards propose a single global principle-based standard.

The proposed new standard would clarify when to recognise revenue, how to measure revenue and what to disclose in contracts to provide goods or services to customers. The boards also propose guidance to clarify the accounting for some contract costs.

The proposed standard would apply to all contracts with customers except for:

- lease contracts
- insurance contracts
- financial instrument contracts.

The proposals would improve IFRSs and US GAAP by:

- removing inconsistencies in existing standards
- providing a more robust framework for addressing revenue recognition issues
- improving comparability across companies, industries and capital markets
- requiring enhanced disclosures
- clarifying accounting for contract costs.

The exposure draft is based on proposals contained in the boards' discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers* published in December 2008.

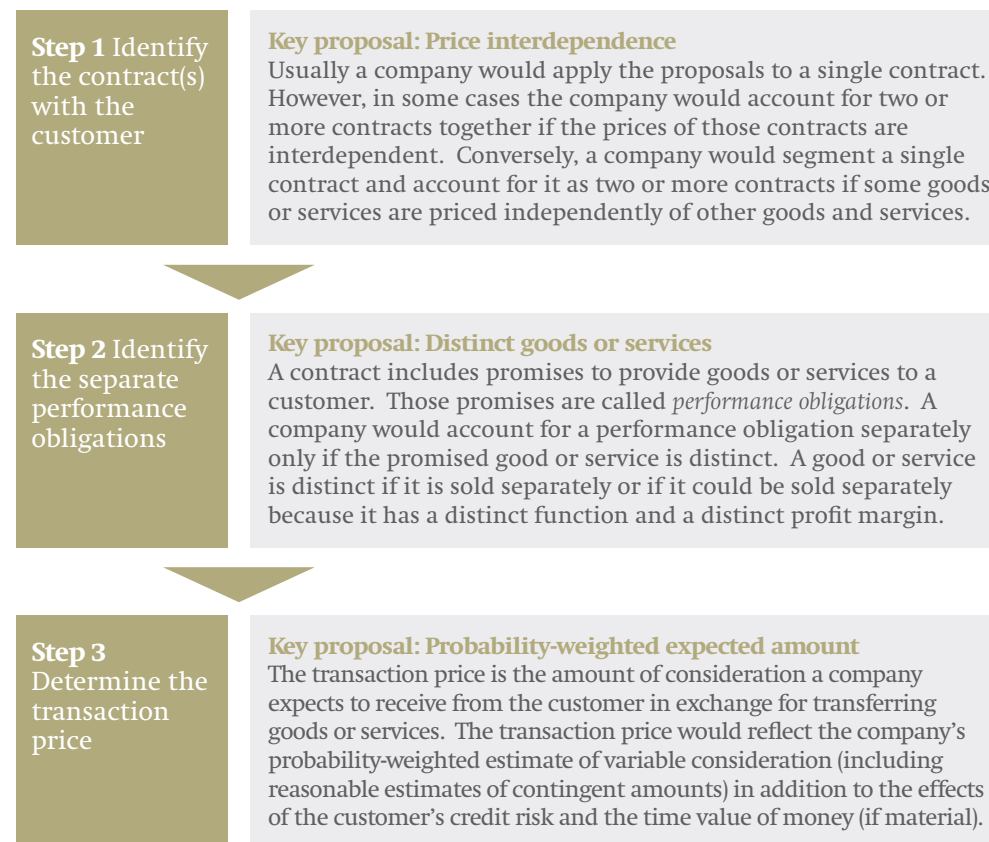
In jointly developing the exposure draft, the boards considered more than 220 comment letters received on the discussion paper as well as other information gained in extensive consultation with interested parties including preparers, auditors, users and regulators. The boards have used that information to develop and refine the proposals in the discussion paper.

The proposals reflect feedback that the boards received during the consultation period for the discussion paper.

What do the boards propose?

The core principle of the proposed standard is that a company should recognise revenue when it transfers goods or services to a customer in the amount of consideration the company expects to receive from the customer.

A company would follow five main steps to apply the core revenue recognition principle



Step 4 Allocate the transaction price to the performance obligations

Key proposal: Relative selling price allocation

A company would allocate the transaction price to all separate performance obligations in proportion to the stand-alone selling price of the good or service underlying each performance obligation. If the good or service is not sold separately, the company would estimate its stand-alone selling price.

Step 5 Recognise revenue when a performance obligation is satisfied

Key proposal: Control

A company would recognise revenue when it satisfies a performance obligation by transferring the promised good or service to the customer. The good or service is transferred when the customer obtains control of the promised good or service. The amount of revenue recognised is the amount allocated to that performance obligation in Step 4.

In addition, the exposure draft proposes further cost guidance and enhanced disclosure requirements.

Proposed cost guidance

A company would recognise the costs of obtaining a contract (eg selling and marketing costs) as expenses when incurred. If the costs incurred in fulfilling a contract are not eligible for capitalisation in accordance with other standards (eg inventory), the company would recognise an asset only if those costs:

- relate directly to a contract
- relate to future performance under the contract and
- are expected to be recovered.

Proposed disclosure requirements

The boards propose enhanced disclosure requirements to help users of financial statements better understand the amount, timing and uncertainty of revenue and cash flows from contracts with customers. Those proposals would require a company to disclose qualitative and quantitative information about:

- its contracts with customers, including a maturity analysis for contracts extending beyond one year
- the significant judgements, and changes in judgements, made in applying the proposed standard to those contracts.

What will change?

The effect of the proposals on existing revenue recognition practices will vary from industry to industry. For some contracts, such as many straightforward retail transactions, the proposals would have little, if any, effect. However, the proposals could affect existing practices for other contracts, such as construction contracts or multiple-element arrangements.

Principle: Revenue recognised only from the transfer of goods or services to a customer

How it would affect existing accounting

This proposal would affect some long-term contracts currently accounted for using a percentage of completion method when the customer does not receive goods or services continuously (eg some construction and some software development contracts). Under the proposal, a company would apply the percentage of completion method of revenue recognition only if the company transfers services to the customer throughout the contract—ie if the customer owns the work in progress as it is built or developed.

Principle: Identification of separate performance obligations for distinct goods or services

How it would affect existing accounting

A company would be required to account for all goods or services that are distinct as separate performance obligations. This proposal could result in some revenue being attributed to goods or services that are now considered incidental to the contract—for instance, to mobile phones that are provided free of charge with airtime contracts and to some post-delivery services, such as maintenance and installation.

This proposal could also result in a company identifying more performance obligations in construction contracts compared with present practice. This could result in the company reporting different margins for different parts of the contract, rather than reporting a single margin for the entire contract.

Principle: Probability-weighted estimates of the consideration expected to be received

How it would affect existing accounting

A company would be required to include reasonable estimates of contingent consideration in the transaction price allocated to performance obligations. In contrast to present practice, this proposal could result in a company recognising some revenue on the transfer of a good or service, even if the consideration amount is contingent on a future event—for example, an agent that provides brokerage services in one period in exchange for an amount of consideration to be determined in future periods, depending on the customer's behaviour.

Principle: Customer's credit risk reflected in the measurement of revenue

How it would affect existing accounting

When determining how much revenue to recognise, a company would be required to reflect the possibility that the customer might not pay the promised amount of consideration. In contrast to present practice, this proposal could result in a company recognising some revenue when it transfers a good or service to a customer even if there is uncertainty about the collectibility of the consideration, rather than deferring revenue recognition until the consideration is collected.

Principle: Allocation of transaction price in proportion to the estimated stand-alone selling price

How it would affect existing accounting

If a company does not sell a distinct good or service separately, it would be required to estimate the price at which it would sell that good or service in order to allocate some of the consideration to it. This proposal will affect some existing practices, particularly in the software sector, that currently result in the deferral of revenue if a company does not have objective evidence of the selling price of a good or service to be provided.

Principle: Expensing of contract acquisition costs

How it would affect existing accounting

A company would be required to recognise as an expense the costs of obtaining a contract. This proposal would affect companies that currently capitalise such costs—for example, commissions and other directly incremental costs—and amortise them over the contract period.

Feedback received on the discussion paper

Nearly all respondents supported the boards' objective to develop a single revenue recognition model for IFRSs and US GAAP to improve existing standards. Most respondents also generally supported the recognition and measurement principles proposed in the discussion paper. However, nearly all respondents asked the boards to develop additional guidance on many of the proposals.

Proposal in discussion paper	Respondents' views	The boards' response
A company should identify separate performance obligations on the basis of when the goods and services are transferred to the customer.	Many respondents thought this principle by itself would not be practical, particularly when many goods or services are transferred continuously to the customer (eg construction contracts).	The exposure draft proposes that only goods or services that are <i>distinct</i> should be accounted for as separate performance obligations. The exposure draft explains that if goods and services are transferred at the same time, a company generally would not need to account for each performance obligation separately.
A performance obligation is satisfied when the customer obtains control of the promised good or service.	<p>Many respondents supported using <i>control</i> to determine when a performance obligation is satisfied. However, nearly all requested additional guidance on control.</p> <p>Some respondents thought that the proposals in the discussion paper would result in completed contract accounting for all construction contracts (ie when the customer obtains legal title or physical possession of the completed asset).</p>	<p>The exposure draft proposes a definition of control and supporting indicators to assist a company to determine when a customer obtains control. It also includes additional guidance and examples to address issues such as bill-and-hold, consignment, and sale and repurchase arrangements.</p> <p>The boards did not intend that revenue should be recognised only upon completion of all construction contracts. However, they did intend that revenue should be recognised only if the customer controls the work in progress as it is developed. The exposure draft proposes additional guidance and examples to distinguish a contract for construction services (revenue recognised throughout the contract) and a contract for a completed asset (revenue recognised on transfer of completed asset).</p>

Proposal in discussion paper	Respondents' views	The boards' response
Contract costs should be recognised as expenses unless eligible for capitalisation under other standards.	Many respondents thought that the boards also needed to address contract costs.	The exposure draft proposes additional guidance for contract costs that are not eligible for capitalisation under other standards.
All product warranties result in separate performance obligations.	Many respondents thought that a standard or manufacturer's warranty should be accounted for differently from an extended warranty.	The exposure draft distinguishes warranties that provide the customer with protection for defects existing at the time of sale from warranties that provide insurance-type coverage for faults arising after the time of sale. Only the latter are separate performance obligations. However, both result in the deferral of revenue.
Application guidance not addressed in the discussion paper.	Most respondents commented that the high-level principles in the discussion paper, in order to be applied consistently, would require application guidance and examples on key issues such as the identification, measurement and satisfaction of performance obligations.	The exposure draft proposes application guidance to clarify how the principles in the standard would apply to features found in various typical contracts, such as right of return, warranties, licenses, options for additional goods or services, principal versus agent considerations and non-refundable fees.

What happens now?

The deadline for comments on the exposure draft is 22 October 2010.

The exposure draft includes questions on the proposals. Respondents may choose to answer all or just selected questions and are also welcome to comment on any other matter that they think the boards should consider in finalising the proposals. Comment letters will be posted on the boards' websites.

The boards will carefully consider all feedback and, as usual, discuss responses to the proposals in public meetings.

The boards also plan to hold public round-table meetings after the end of the comment period.

The boards plan to issue the final standard in 2011.

Stay informed

The boards will announce on their websites the dates of any meetings at which they discuss the responses on the exposure draft.

To stay up to date about the project, to view the exposure draft, submit your comments or to subscribe to a revenue recognition email alert, visit <http://go.ifrs.org/revenue+recognition>

Notes

International Accounting Standards Board (IASB)

30 Cannon Street | London EC4M 6XH | United Kingdom

Telephone: +44 (0)20 7246 6410 | Fax: +44 (0)20 7246 6411

Email: info@ifrs.org | Web: www.ifrs.org

For further information about the IASC Foundation, IASB, copies of International Financial Reporting Standards, International Accounting Standards, exposure drafts and other publications, including details of IASB subscription services, please contact our Publications Department on telephone: +44 (0)20 7332 2730 or email: publications@ifrs.org



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