

The IASB and the FASB are undertaking a joint project to develop a revenue model that would apply to all industries and all types of revenue-generating transactions. This new standard will replace IAS 11 *Construction Contracts* and IAS 18 *Revenue*.

The IASB issued DP *Preliminary Views on Revenue Recognition in Contracts with Customers* in December 2008. The IASB issued ED/2010/6 *Revenue from Contracts with Customers* in June of 2010.

At the November 2010 joint meeting, the staffs provided an overview of the outreach activities performed since the ED was issued, the primary issues raised by constituents during these activities and the preliminary plan as they work toward a final standard.

The outreach activities highlighted two fundamental issues with respect to the proposed model and a number of other common concerns and themes. The two fundamental issues highlighted relate to the application of the guidance on “control” and “separation.” As currently described in the ED, constituents believe the notion of control is not sufficiently clear to allow entities to determine when control has transferred to the customer (and therefore when revenue should be recognised). It was noted that this concept is significantly more difficult to implement for entities in service and construction industries.

The second fundamental issue relates to the identification of separate performance obligations (accounting units) within a contract. Many constituents believe the guidance in the ED is impractical and may not result in useful information. Specifically, they commented that the ED may result in identifying units of accounting that are too detailed and not consistent with how entities’ activities are viewed by management or other users.

Other concerns or themes focused on the practicality and cost/benefits of certain provisions such as the probability-weighting of contingent consideration, adjustments to the transaction price for collectability and time value of money, onerous performance obligation tests, disclosures, and retrospective application.

At the December 2010 joint meeting, the Boards reviewed an initial summary of the comment letters and considered a proposed time table for the redeliberations of matters highlighted by respondents. Currently, they plan to redeliberate the two fundamental issues (control and separation) at the January 2011 meeting and the other issues at the February 2011 meeting.

At the January 2011 joint meeting, the Boards began their redeliberations on the exposure draft by discussing: (1) segmenting a contract, (2) identifying separate performance obligations and (3) determining the transfer of goods and services.

Segmenting a contract

The Boards tentatively decided to eliminate the proposal to segment a contract as two or more contracts when the prices of some goods or services in the contract are independent of the prices of other goods or services in the contract. Consequently, an entity would separate a contract only if separate performance obligations are identified in the contract.

Identifying separate performance obligations

The Boards tentatively decided that the final standard should clarify that the objective for identifying separate performance obligations is to depict the transfer of goods or services and also the profit margin that is attributable to those goods or services. The Boards tentatively decided to retain the principle of ‘distinct goods or services’ as the basis for identifying separate performance obligations but requested the staff develop additional guidance with examples to assist in better understanding the attributes of a distinct good or service (distinct function, separable risks and different pattern of transfer to the customer). The Boards also

tentatively decided that it would not be necessary for the final standard to include additional requirements on accounting for perfunctory, incidental or other similar obligations.

Determining the transfer of goods and services

The Boards agreed to retain the core principle in the exposure draft that an entity should recognise revenue to depict the transfer of goods and services to a customer.

Goods

The Boards tentatively decided that an entity should recognise revenue when the customer obtains control of the good. The Boards also tentatively decided to make the following changes to the proposals: (1) describe control as opposed to defining it, (2) add 'risks and rewards of ownership' as an indicator of control, and (3) remove 'the design or function of the good or service is customer-specific' as an indicator of control.

Services

The Boards tentatively decided that an entity should recognise revenue for the entity's performance of contractually-agreed tasks if:

- the customer controls the work-in-process; or
- another entity would not need to reperform the task if that other entity were required to fulfill the remaining obligation to the customer; or
- the entity has a right to payment for the performed task and the entity's performance to date could not be put to an alternative use by the entity (i.e., the performance to date has not created an asset that could be transferred to another customer).

The Boards tentatively decided that an entity would recognise revenue for a service only if the entity could reasonably measure its progress toward successful completion of the service. The Boards requested the staffs provide guidance to assist in determining which method (output, input or passage of time) an entity should use to measure its progress toward completion of a service.

Goods and services

The Boards tentatively decided that if an entity promises to transfer both goods and services, the entity should first determine whether the goods and services are distinct using the guidance on identifying separate performance obligations. If the goods and services are distinct, the entity would account for them as separate performance obligations. If the goods and services are not distinct, the entity would account for the bundle of non distinct goods and services as a service.

Summary of Exposure Draft

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. 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.

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).

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.

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.

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.

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 standalone selling prices is allocated strictly in proportion to the stand-alone selling price of each distinct good or service.

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.

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; and
- the design or function of the good or service is customer-specific.

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.

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.

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.

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.

Disclosures

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

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 later this year seeking stakeholder input about effective dates and transition methods on a range of projects.

Thinking ahead

- Entities should not assume that their current revenue recognition policy will necessarily be consistent with the proposed model. Basing revenue recognition on the concept of control, rather than the existing distinction between goods and services, may represent a significant shift for some entities and care will be needed to determine how the new approach would be applied to their circumstances. In many cases, this will require a significant amount of judgment as will determining whether multiple performance obligations exist and when those performance obligations are satisfied.
- Although some entities may find that the impact of the new proposals is small, for others the impact may be very significant. For example:
 - It is possible that a single contract will include both elements 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.
 - Some entities currently applying a percentage of completion model may instead be required to recognise revenue at a later point of delivery to the customer. Particular focus will be needed where entities currently apply percentage of completion accounting but the customer has neither physical possession of, nor legal title to, any work in progress.
 - Entities with multiple element contracts may find that the elements currently unbundled do not correspond to distinct goods and services under the proposed model. This will affect, and may delay, the timing of revenue recognition.
 - The new rules proposed on allocating revenue between performance obligations may result in a different profile of revenue recognition for some entities, and may also affect the relative profitability of different elements of a contract.
 - Some entities that have not previously deferred revenue for warranty obligations may find that deferral is required.
 - Under current IFRSs, a customer's credit risk affects whether revenue is recognised. 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.
 - The new proposals in respect of onerous performance obligations may result in 'Day 1 losses' for some entities, particularly in sectors where it is the norm to supply certain products as 'loss leaders' or loss products are bundled with highly profitable products such that the bundle as a whole is profitable.
 - The proposals may result in entities recognising revenues over the term of a 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.
 - 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.

- Robust accounting policies may need to be developed because of the extent to which judgement is involved.
- Sales forces and analysts may need to be educated on the key aspects of revenue recognition.
- Entities may need to consider the timing and manner of sales force compensation based on changes in the way revenue is recognised.
- Entities should consider the effect that any revised profile of revenue recognition and profit under the proposed model may have on existing debt covenants.
- Information technology system changes may be required to track performance obligations and capture the information necessary to comply with the proposed disclosures.

Next steps

At their joint meetings in February 2011, the Boards are expected to discuss the following topics: (1) costs of obtaining a contract, (2) combining contracts, (3) contract modifications and (4) product warranties. A final standard is expected to be issued in June 2011.

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