ARG Meeting

Agenda reference 3

Date June 2009

Revenue Recognition

International Financial Reporting Standards

Revenue recognition

IASB's joint project with the FASB

Analysts' Reporting Group June 2009

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Agenda

- Brief overview of Discussion Paper and initial feedback
- Discussion of disaggregation of margin in long term contracts
- Preliminary discussion of disclosure relating to revenue and the net contract position

Summary of proposals in the DP

- Accounting for the contract with a customer
- Revenue recognised when company satisfies a performance obligation in the contract
- A performance obligation is satisfied when good or service transfers to the customer
- Amount of revenue recognised is the amount of the transaction price allocated to the performance obligation
- Transaction price allocated in proportion to the stand-alone selling price of the goods and services

Summary of headline changes

- Revenue recognised on transfer to customer
  - – who controls good or service or WIP
- Different basis for unbundling
  - – if it could be sold separately
  - – estimate selling price – no VSOE restriction
- Boards consider it a better depiction
- Problems?

Feedback so far…

- Perceived focus on form of contract
- Ability to estimate standalone selling prices
- Recognition
  - – disquiet in some manufacturing and construction sectors
  - – systems changes where currently accounting using cost
- Unbundling
  - – attributing revenue to all POs an improvement, but…
  - – segmenting margin is a problem

Segmented margin

- At present percentage of completion attributes a contract-wide margin to all performance obligations
  - if estimated selling prices attributed to individual POs, margins will vary
  - would the gross margin % of individual POs be useful?
  - why are some multiple element arrangements ‘obviously’ individual performance obligations, but some construction contracts are not?
  - separating performance obligations links revenue with output; identifies cost overruns early

Case study – long term contract

IT Outsourcer contracts with an international bank to provide all of its IT needs for the next 10 years. In order to do this it will design, develop and build the banks transaction processing, dealing and risk assessment systems; develop and build infrastructure to support these application; roll these systems out to 10,000 locations world-wide; and train 60,000 employees in their use. The applications and hardware will be fully maintained, and developed as required, for 10 years from go-live. The total contract value is CU15bn; costs are estimated to total CU12bn.

At present, IT Outsourcer accounts for such contracts on a cost to cost basis over the contract life. The usual life cycle of these projects are:

First 24 months	design and build applications
Next 12 months	roll out hardware
Ten years	maintenance and support

Contract-wide margin

At present outsourcer recognises revenues on a cost to cost basis over the entire contract:

	Revenue	Costs	Margin	
Year 1	3750	3000	750	Design
Year 2	5000	4000	1000	Build
Year 3	3750	3000	750	Roll out
Years 4-13	2500	2000	500	Maintain
	15000	12000	3000	

Separate performance obligations

IT Outsourcer identifies 4 separate performance obligations and estimates their standalone selling prices based on estimated costs plus a margin reflecting risk eg design and build is most risky and requires a margin of 25%; hardware is least and attracts only 5%; service is at 16%.

	Revenue	Costs	Margin	
Year 1	4050	3000	1050	Design
Year 2	5400	4000	1400	Build
Year 3	3150	3000	150	Roll out
Years 4-13	2400	2000	400	Maintain
	15000	12000	3000	

Comparison of the two

	Contract-wide margin		Segmented margin	
	Revenue	Margin	Revenue	Margin
Year 1	3750	750	4050	1050
Year 2	5000	1000	5400	1400
Year 3	3750	750	3150	150
Years 4-13	2500	500	2400	400
	15000	3000	15000	3000

Segmented margin

- How useful would segmented margins be?
- When & why is it appropriate to segment a margin in a contract?
  - Do you think the margin can be segmented on the basis of estimated standalone selling price?
  - Do you think it can be segmented only if the underlying goods/services are sold separately by the entity or other entities
  - [Do you think the margin for interdependent phases of a contract should be segmented, eg the foundation, structural and finishing phase of a construction contract]
- Margin will be bundled in the income statement as all projects are aggregated
  - disclose disaggregated revenues and margins?

Disclosures – income statement

- Began development during DP process
- How should revenues be disaggregated?
  - geographical
  - customer industry sector
  - type of deliverable / activity

Disclosures – balance sheet

- Is further information about the balance sheet position useful?
- How should the contract position be disclosed?
  - geographical
  - customer industry sector
  - type of deliverable / activity

Contract position roll- forward

CU Thousands	Rights	Obligations	Net Liability
Opening net book amount 2009	36,990	-39,867	-2,877
Exchange differences	-381	703	
New contracts signed	61,223	-61,223	
Variations to existing contracts	1,256	-1,256	
Invoices raised	-42,134	-	
Revenue recognised income statement	-	37,562	
Onerous contract charge (note xx)	-	-754	
Closing net book amount 2009	56,954	-64,835	-7,881

Comment period ends 19 June 2009

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