International Financial Reporting Standards

Analyst Representative Group
Global Preparers Forum
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AGENDA PAPER 2A

Revenue recognition

A joint project of the IASB and FASB

The views expressed in this presentation are those of the presenter, not necessarily those of the IASC Foundation, the IASB or the FASB

Agenda

- The developed model
- Comment letter analysis
- A discussion of control
- Disclosure discussion

Summary of the model - DP

- Single revenue recognition model for contracts with customers
- Revenue recognised when a performance obligation in the contract is satisfied
  - a performance obligation is satisfied when a good or service has been transferred to the customer, which is when customer obtains control of the good or service
- Amount of revenue recognised is the amount of the transaction price allocated to the performance obligation

Revenue depicts the transfer of goods and services to the customer, not necessarily the activities of the entity

Determining the transaction price

Transaction price: the customer’s promised consideration

Consideration due before/after PO satisfied

- Adjust for effects of time value of money
- Discount at rate reflecting the parties to the contract

Uncertain/contingent consideration

- Probability-weighted estimate of consideration to be received (unless cannot be estimated reliably)

Non-cash consideration

- Fair value the non-cash consideration if it can be estimated reliably, otherwise …
- Selling price of goods & services exchanged

Boundary of the contract

Combining contracts

- Two or more contracts with one customer should be combined if their prices are interdependent

Contract modifications

- A modification to a contract should be accounted for as a separate contract if it is priced independently
- Otherwise accounted for as part of original contract. Effect of modification recognised on a cumulative catch-up basis

Options for additional goods & services

- Accounted for as a PO in the contract if it provides a material right to the customer that the customer would not receive without entering into that contract
- Selling price of option reflects incremental discount adjusted for likelihood of exercise

Comment letter analysis

Respondent analysis (%)

Type		Region	
Preparers	37	Europe	36
Institutions	19	North Am	36
Trade soc	15	Aus & NZ	9
Std setters	9	Global	6

Feedback from comment letters

- Support for creating a single model
- Support for overall direction of model
  - further development and additional guidance needed
- Support for allocated transaction price
- Issues
  - what is a performance obligation
  - when are goods and services transferred (control)

Issue - performance obligations

Proposals

- A performance obligation (PO) is a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer

- POs are bundled based on when the promised assets are transferred to the customer

Feedback

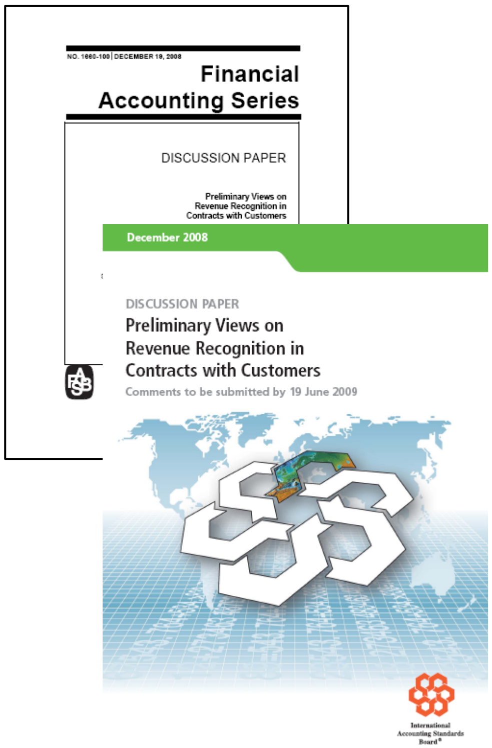
- Definition not clear: entities may identify POs inconsistently
  - eg constructive obligations, non-compete agreements, conditional promises & product liability
- Standard warranty is not a PO

- Bundling principle not practical for continuous delivery (service) contracts
  - could result in identifying many separate POs

Performance obligations - plans

- Redeliberate how transaction price is allocated to performance obligations (PO)
  - allocate transaction price to segments of a contract, which could be a bundle of POs or a single PO
  - a contract segment is identified if there is evidence of a market for that segment
  - segments are combined if individually immaterial or if goods/services attract the same margin or transfer to customer at the same time
- Develop application guidance for identifying POs
- Redeliberate whether there is a difference between a standard and extended warranty

Other feedback from comment letters



- Doesn’t the model need also to deal with costs?
- How does the allocation of transaction price square with other projects measurement basis – IAS 37 Liabilities and Insurance?
- The model seems subject to abuse (eg increased estimates, form over substance)
- Existing standards are fine as they are
- The model might not provide useful information about some contracts. Is a single model feasible?
- Why can’t I still use POC – isn’t it a better depiction of contract activity?
- Need a clearer articulation of control and when it passes

Today's issue - control

Proposals

- Entity recognises revenue when it transfers goods or services to the customer
- Entity has transferred good or service when customer obtains control of it

Feedback

- Meaning of control
    - legal title?
    - physical possession?
- Some prefer 'risks & rewards'
- Many think 'percentage of completion accounting' is being abolished for construction & manufacturing contracts

Control – links with other projects

- ED 10 Consolidated Financial Statements
  - the power to direct the activities of the entity to generate returns
- Derecognition project

Control - definition & indicators

Control of a good or a service is an entity's present ability to direct the use of and receive the benefit from that good or service

- Customer has unconditional obligation to pay for the asset (and payment is non-refundable)
- Customer has legal title to the asset & can sell or exchange it
- Customer can secure or settle debt with the asset
- Customer has physical possession or practical ability to take possession of the asset
- Customer specifies the design or function of the asset
- Customer has continuing managerial involvement with the asset

Case study – manufacturing contract 1

On 1 January, Company C enters into a contract with customer W for engineering equipment to be delivered on 31 December for a fixed price of CU 240,000. Payments on account of CU 60,000 are made quarterly.

The equipment is manufactured at Company C's factory and is of a standard design. Legal title passes to Customer W on delivery. If Customer W cancels before delivery, Company W must compensate Company C for any loss of profit.

When does Customer W obtain control of the equipment?

Analysis – manufacturing contract 1

- Applying the indicators of control:
  - Customer W is not involved in the design of the equipment
  - Customer W does not have managerial involvement throughout the contract
  - Customer W cannot take possession of the equipment until delivery
  - Customer W cannot limit Company C's rights to the equipment
  - Company C could sell the equipment to another customer if it was also able to deliver the specified equipment to Customer W on December 31

Customer W does not have the ability to direct the use of and receive the benefit from the equipment until final delivery of the equipment on 31 December

Case study – manufacturing contract 2

On 1 January, Company D enters into a contract with Customer X to build highly-customised engineering equipment to be delivered on 31 December for a fixed price of CU 240,000. Non-refundable payments of CU 60,000 are made quarterly for work completed in the quarter.

The equipment is manufactured at Company D’s factory. Because the equipment is customised, Customer X is involved in the design and manufacturing process. Customer X can negotiate changes to the specification throughout the manufacturing process. Legal title passes to Customer X on delivery. If Customer X cancels before delivery, Customer X must pay Company D for all work completed to date.

When does Customer X obtain control of the equipment?

Analysis – manufacturing contract 2

- Applying the indicators of control:
  - Customer X has an unconditional obligation to pay throughout the contract (non-refundable quarterly payments)
  - Customer X specifies the design of the equipment
  - Customer X has continuing managerial involvement in the manufacturing process

Customer X has the ability to direct the use of and receive the benefit from the equipment throughout the manufacturing process

Discussion 1 - control

- Do you agree with the staff analysis of the two manufacturing examples?
- Is there a clear distinction between example 1 and example 2?

Case study – service contract

Company E is a consulting company. On 1 January it enters into a contract with Client Y to analyse its sales trends in order to assist Client Y in formulating its long-term business plans. Company E charges a fixed fee of CU60,000. The final report is due on 30 June. Client Y makes non-refundable monthly payments of CU10,000. Client Y can change the nature of the analysis produced and can take over any analysis prepared by Company E at any time.

When does Client Y obtain control of the consulting service?

Discussion 2 – control in services

- When does the group think control of the consulting service passes to the client?
- Are the indicators proposed adequate to answer that question?
- Does the definition of control proposed ensure consistency and clarity in identifying when transfer takes place?

Discussion 3 – other types of transactions

- How effectively does this notion of control deal with some other transactions:
  - bill and hold
  - consignment stocks
  - principal versus agent

Disclosure – feedback received from users

- Comment letters
  - User - ‘Convey the prospects for the crystallisation of revenue and value in future periods’
  - User - ‘Recognition of revenue, and of profits, takes place in a way that is reflective of the creation of realisable shareholder value’
- Results of questionnaire

Disclosure - objectives

- An entity shall disclose information that
  - identifies and explains the amounts recognised in its financial statements arising from contracts with customers
  - enables users of its financial statements to evaluate the nature and extent of risks arising from contracts with customers

Disclosure of risk

- The model recognises revenue on the satisfaction of a performance obligation
  - risk in expected timing of satisfaction of performance obligations
- The model allocates consideration
  - risk in estimating total consideration to be allocated
  - risk in estimating standalone selling prices
  - risk in determining performance
- The model does not remeasure until onerous
  - risk resulting from changes in circumstances over contract term

Disclosure of long-term contracts

- Comment letters raised concern that percentage of completion would no longer be used
  - Preparers support POC - ‘improves control and reflects how I manage projects’
  - User view - ‘existing percentage of completion approach is opaque’

Discussion 4 - disclosure of long term contracts

- What disclosure is required for users to evaluate risk?
- What disclosure is required to reflect how preparers manage this risk?
- Would the benefit outweigh the cost to prepare?

Disclosure - disaggregation

- Amounts recognised as revenue
  - ‘through the eyes of management’ consistent with IFRS 8 *Operating segments*
  - by offering or deliverable
  - by customer’s location
  - by customer’s sector
- Outstanding performance obligations
  - by estimated year of satisfaction

Discussion 5 – disaggregation

- Which of these disaggregations are useful?
- Would other types of disaggregation be useful?
- Is this disaggregation possible? Is it costly?

Next step - ED 2010

Contact information:
April Pitman (Project manager) apitman@iasb.org
Manuel Kapsis (Technical associate) mkapsis@iasb.org

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