Topic **Revenue presentation**

International Financial Reporting Standards


# Revenue from Contracts with Customers

IFRS Advisory Council meeting, 11 October 2011

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## Agenda



- Background and project status
- Overview of the revised revenue proposals
  - – summary of steps to apply the proposed model
  - – other changes
- Outreach objectives
  - – what we want to know during the re-exposure process
- Outreach plans
- Breakout discussion
- Reporting back

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## Background

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- Project objective—to develop a single, principle-based revenue standard for IFRSs and US GAAP
- The revenue standard aims to improve accounting for contracts with customers by:
  - providing a more robust framework for addressing revenue issues as they arise
  - increasing comparability across industries and capital markets
  - requiring better disclosure

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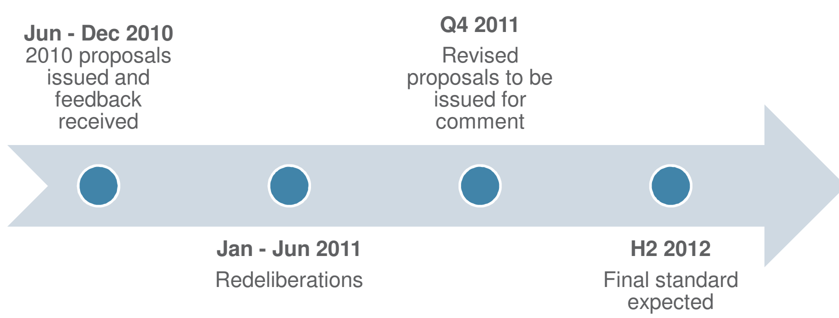
## Project status

- Although not a required due process step, the draft revenue standard will be re-exposed for public comment

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## Overview of revised proposals

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**Core principle in 2010 Exposure Draft:**

Recognise revenue to depict the transfer of goods or services in an amount that reflects the consideration *expected to be received* in exchange for those goods or services

**Steps to apply the core principle:**

1. Identify the contract(s) with the customer
2. Identify the separate performance obligations
3. Determine the transaction price
4. Allocate the transaction price
5. Recognise revenue when a performance obligation is satisfied

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## Overview of revised proposals (cont)

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**A change to the core principle:**

Recognise revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity *expects to be entitled* in exchange for those goods or services

**Steps to apply the core principle are the same:**

1. Identify the contract(s) with the customer
2. Identify the separate performance obligations
3. Determine the transaction price
4. Allocate the transaction price
5. Recognise revenue when a performance obligation is satisfied

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## Step 1: Identify the contract(s)

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**Objective:** to identify the bundle of contractual rights and obligations to which an entity would apply the revenue model

- Specified criteria must be met to apply the model to a contract
- Some contracts would be combined and accounted for as one contract
- Contract modifications
  - some accounted for as a separate contract
  - otherwise, re-evaluate remaining performance obligations

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## Step 2: Identify the separate performance obligation(s)

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**Objective:** to identify the promised goods or services that are distinct and, hence, that should be accounted for separately

- Responses to 2010 ED suggested criteria for identifying separate performance obligations need clarification
  - meaning and relevance of 'distinct function' and 'distinct profit margin' criteria unclear
  - the 'good or service is sold separately by the entity (or another entity)' criterion risks breaking up some contracts (eg construction) more than users would find useful

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## Step 2: Identify the separate performance obligation(s)

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- A good or service is distinct if either:
  - the entity regularly sells the good or service separately
  - the customer can benefit from the good or service on its own or together with other readily available resources
- A good or service that is part of a bundle of goods or services is not distinct if both:
  - the goods or services are highly interrelated and the entity provides a significant service to 'integrate' them into items for which the customer has contracted
  - the goods or services are significantly modified or customised to fulfil the contract

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## Step 3: Determine transaction price

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**2010 objective:** to determine amount of consideration that an entity expects to *receive* in exchange for promised goods or services

- Common responses to 2010 ED included
  - probability-weighted estimates not relevant for binary outcomes and costly to prepare
  - reflecting customer credit risk in initial estimate of transaction price would be costly and subsequent reassessment of credit risk might result in 'lost' revenue
  - adjusting the transaction price for the effects of the time value of money could be complex

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## Step 3: Determine transaction price

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**New objective:** to determine amount of consideration that an entity expects to *be entitled* in exchange for promised goods or services

- Estimate variable consideration at expected value or most likely amount
  - use the method that is a better prediction of the amount of consideration to which the entity will be entitled
- Adjust for time value of money only if there is a financing component that is significant to the contract
- Customer credit risk accounted for under other standards and presented adjacent to revenue line on income statement

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## Step 4: Allocate transaction price

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**Objective:** to allocate to each separate performance obligation the amount to which the entity expects to be entitled

- Allocating on a relative standalone selling price basis will generally meet the objective
  - estimate selling prices if they are not observable
  - residual estimation techniques may be appropriate
- Contingent amounts are allocated entirely to one performance obligation if specified criteria are met

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## Step 5: Recognise revenue

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**Objective:** to recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service

- A good or service is transferred when (or as) the customer obtains control of that good or service
- Responses to 2010 ED suggested:
  - clarifying the principles/indicators for determining whether control is transferred (and a performance obligation satisfied) at a point in time or over time
  - control is difficult to apply to construction and services contracts

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## Step 5: Recognise revenue

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- A performance obligation is satisfied over time if the entity's performance either:
  - Creates or enhances an asset (eg WIP) that the customer controls as the asset is created or enhanced, or
  - Does not create an asset with alternative use and:
    - The customer benefits as the entity performs, or
    - Another entity would not need to re-perform work completed to date, or
    - The entity has a right to payment for work completed to date.
- If not over time, must consider indicators to determine at what point the performance obligation is satisfied

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## Other changes



| Constraining the cumulative amount of revenue recognised | |
|---|---|
| ED 2010 proposal | Constrain the transaction price to the amount that can be reasonably estimated |
| Main concerns | The amount of revenue recognised could be unduly constrained because the proposals would allocate to all POs (including unsatisfied POs) the amount of transaction price that can be reasonably estimated |
| Revised proposal | Revenue measured at amount allocated to the performance obligation unless entity not reasonably assured to be entitled to that amount |

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## Other changes



| Onerous performance obligations | |
|---|---|
| ED 2010 proposal | Recognise a loss if a PO is onerous<br>• onerous if costs related to satisfying PO exceed transaction price allocated to that PO |
| Main concerns | • A loss could be recognised on part of contract, either at inception or subsequently, even though the overall contract is profitable<br>• Some POs may be deemed onerous due to the application of other steps in the model |
| Revised proposal | • For POs satisfied over time and that period of time is greater than one year—recognise a loss if the least cost of exiting PO exceeds amount of consideration allocated to that PO<br>• For POs satisfied at point in time—test assets (eg inventory) for impairment |

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## Summary of redeliberations

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- Clarified the Boards' intentions
  - amended principles (eg identifying separate performance obligations)
  - included additional guidance (eg determining when transfer of a service occurs)
- Revised some other proposals
  - many revisions resulted in simplifications (eg measurement, transition)
  - some revised proposals now align more closely with current requirements (eg warranties)

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## Objectives of project outreach

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- To inform and engage (ie information outflows)
  - explain our proposals
  - correct misunderstandings
- To gather facts and obtain feedback (ie information inflows)
  - refine our understanding of transactions and contract terms
  - identify difficulties in applying the principles to specific industries and transactions
  - identify unintended consequences

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## Outreach on 2010 ED on revenue

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- Revenue affects all entities
  - …and everyone in those entities – not just finance
- More than 200 meetings or events on six continents
  - supplemented with webcasts, podcast and email alerts
- Outreach planning coordinated with FASB
- Targeted outreach with affected sectors (eg construction, software, telecoms, pharma)
- Outreach continued throughout board redeliberations
  - outreach supplements, rather than replaces, other due process steps

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## How outreach helps – construction

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- Core principles of identifying performance obligations and determining transfer clarified by considering application to construction contracts
- Frequent, in-depth outreach to understand transactions, refine the boards' thinking and then test the wording
- Testing the drafting against issues raised by IFRIC 15 *Agreements for the Construction of Real Estate* to ensure clear principles



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## What do we want to know?



### General feedback

- Main objective of the re-exposure is to confirm whether the drafting of the revised proposals
  - is clear and complete
  - can be applied in a way that reflects the economic substance of an entity's contracts with customers
  - does not produce unintended consequences

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## General outreach activities planned



| Milestone | Outreach planned (or anticipated) |
|---|---|
| At publication | Snapshot; joint web cast; investor spotlight; investor perspective |
| During the comment period | Conferences (eg Sao Paulo and Melbourne); EFRAG workshops; AOSSG meeting; industry specific forums and user meetings (tbc) |
| During re-deliberations | Roundtables (tbc)<br>Targeted preparer and user meetings (tbc) |

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## What do we want to know?



### Specific feedback

- Specific comments invited on
  - proposed clarification for determining when transfer of a service occurs
  - significant changes to proposals in 2010 ED
- Outreach plans will target sectors most affected by those changes and clarifications

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## Targeted outreach for specific topics



| Topic | Sectors to consult |
|---|---|
| Transfer of control of goods or services over time | Long-term manufacturers; software development; transportation<br>Sell and build real estate, especially in Asian and South American countries (IFRIC 15) |
| Presenting impairment losses arising from uncollectible amounts as contra revenue | Users and various preparers, including software and pharmaceutical industries |
| Constrain revenue to amount that the entity is reasonably assured to be entitled | Fund managers; pharmaceutical industry; franchisors, such as hospitality industry |
| Scope of the onerous test | Constructors; outsourcers; service providers |

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## Other topics for outreach

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- Changes to reporting of telecoms ‘free’ handsets
  - relevant to companies with accounting policies that are consistent with the ‘contingent cap’ in US GAAP
  - further consultation planned with industry analysts
- Sell and build real estate transactions
  - continue dialogue on IFRIC 15 with auditors, regulators, local standard setters
- Disclosure
- Effective date

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## Questions or comments?

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