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Contact(s)	**Glenn Brady**	gbrady@ifrs.org	+44 (0) 207 246 6460
	April Pitman	apitman@ifrs.org	+44 (0) 207 246 6492
	Allison McManus	amcmanus@ifrs.org	+44 (0) 207 246 6462
	Henry Rees	hrees@ifrs.org	+44 (0) 207 246 6466

Topic

Revenue from Contracts with Customers

Summary of proposals in forthcoming Exposure Draft

Overview

1. This paper provides IFRS Advisory Council members with a summary of the proposals in the forthcoming Exposure Draft on revenue from contracts with customers, which is planned for publication in the fourth quarter of 2011.

2. This paper is for information only. It has been prepared as background to accompany the discussion on the revenue project at the Council's meeting on 11 October 2011.

3. The core principle of these proposed requirements is that an entity should recognize revenue to depict the transfer of promised 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.

4. To achieve that core principle, an entity would apply the following five steps:

   (a) Step 1: Identify the contract with a customer.

   (b) Step 2: Identify the separate performance obligations in the contract.

   (c) Step 3: Determine the transaction price.

   (d) Step 4: Allocate the transaction price to the separate performance obligations in the contract.

This paper has been prepared for discussion at a public meeting of the IFRS Advisory Council of the IASB.

The views expressed in this paper are those of the authors.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretation Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

(e) Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

5. The proposed requirements also specify the accounting for some costs to obtain or fulfill a contract with a customer. An entity would recognize as an asset the incremental costs of obtaining a contract that the entity expects to recover. To account for the costs of fulfilling a contract with a customer, an entity would apply the requirements of other standards (for example, IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*), if applicable. Otherwise, an entity would recognize an asset from the costs to fulfill a contract if those costs meet all of the following criteria:

   (a) Relate directly to a contract (or a specific anticipated contract)

   (b) Generate or enhance resources of the entity that will be used in satisfying performance obligations in the future

   (c) Are expected to be recovered.

Step 1: Identify the contract with a customer

6. A contract is an agreement between two or more parties that creates enforceable rights and obligations. An entity would apply the proposed revenue requirements to each contract with a customer unless specified criteria are met for the combination of contracts.

Step 2: Identify the separate performance obligations in the contract

7. A performance obligation is a promise in a contract with a customer to transfer a good or service to the customer. If an entity promises in a contract to transfer more than one good or service to the customer, the entity would account for each promised good or service as a separate performance obligation only if it is distinct. If a promised good or service is not distinct, an entity would combine that good or service with other promised goods or services until the entity

identifies a bundle of goods or services that is distinct. In some cases, that would result in an entity accounting for all the goods or services promised in a contract as a single performance obligation.

8. A good or service is distinct if either of the following criteria is met:

   (a) The entity regularly sells the good or service separately.

   (b) The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer.

9. Notwithstanding those criteria, a good or service in a bundle of promised goods or services is not distinct and, hence, the entity would account for the bundle as a single performance obligation, if both of the following criteria are met:

   (a) The goods or services in the bundle are highly interrelated and transferring them to the customer requires the entity also to provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted.

   (b) The goods or services are significantly modified or customized in order to fulfill the contract.

10. The proposed standard also includes implementation guidance to help an entity to appropriately identify the performance obligations in specified situations (for example, when other parties are involved in providing goods or services to an entity's customer and the entity must determine whether it is acting as a principal or as an agent of the other party).

Step 3: Determine the transaction price

11. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, sales taxes). To determine the transaction price, an entity would consider the effects of:

(a) *Variable consideration*—If the amount of consideration in a contract is variable, an entity would determine the transaction price by estimating either the expected value (that is, probability-weighted amount) or the most likely amount, depending on which method the entity expects to better predict the amount of consideration to which the entity will be entitled.

(b) *The time value of money*—An entity would adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is significant to the contract. In assessing whether a financing component is significant to a contract, an entity would consider various factors. As a practical expedient, an entity would not need to assess whether a contract has a significant financing component if the entity expects at contract inception that the period between payment by the customer and the transfer of the promised goods or services to the customer will be one year or less.

(c) *Noncash consideration*—If the customer promises consideration in a form other than cash, an entity would measure the noncash consideration (or promise of noncash consideration) at fair value. If an entity cannot reasonably estimate the fair value of the noncash consideration, it would measure the consideration indirectly by reference to the standalone selling price of the goods or services promised in exchange for the consideration.

(d) *Consideration payable to the customer*—If an entity pays, or expects to pay, consideration to the customer (or to other parties that purchase the entity's goods or services from the customer) in the form of cash or credit, or other items that the customer can apply against amounts owed to the entity, the entity would account for the payment (or expectation of payment) as a reduction of the transaction price or as a payment for a distinct good or service (or both).

12. An entity would not consider the effects of customer credit risk (ie collectability) when determining the transaction price. Rather, an entity would apply IAS 39 *Financial Instruments: Recognition and Measurement* (or IFRS 9 *Financial Instruments* if the entity has adopted IFRS 9) to recognize and measure an allowance for any amounts of promised consideration that the entity assesses to be uncollectible because of customers' credit risk. Upon initial recognition of the receivable, any difference between the measurement of the receivable under IAS 39 (or IFRS 9) and the corresponding amount of revenue recognized would be presented in profit or loss as a separate line item adjacent to the revenue line item. Any subsequent changes in the measurement of that receivable would be presented similarly.

Step 4: Allocate the transaction price to the separate performance obligations in the contract

13. For a contract that has more than one separate performance obligation, an entity would allocate the transaction price to each separate performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each separate performance obligation.

14. To allocate an appropriate amount of consideration to each separate performance obligation, an entity would determine the standalone selling price at contract inception of the good or service underlying each separate performance obligation and allocate the transaction price on a relative standalone selling price basis. If a standalone selling price is not observable, an entity would be required to estimate it.

15. The proposed requirements specify the circumstances in which an entity would allocate a discount or a contingent payment entirely to one (or some) performance obligation(s) in the contract rather than to all performance obligations in a contract.

16. An entity would allocate to the separate performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract

inception. Amounts allocated to a satisfied performance obligation would be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

17. An entity would recognize revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when (or as) the customer obtains control of that good or service.

18. For each separate performance obligation, an entity would determine whether the entity satisfies the performance obligation over time by transferring control of a good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

19. An entity transfers control of a good or service over time and, hence, satisfies a performance obligation and recognizes revenue over time if at least one of the following two criteria is met:

    (a) The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.

    (b) The entity's performance does not create an asset with alternative use to the entity and at least one of the following criteria is met:

        (i) The customer receives a benefit as the entity performs.

        (ii) Another entity would not need to substantially reperform the work the entity has completed to date if that other entity were to fulfill the remaining obligation to the customer.

        (iii) The entity has a right to payment for performance to date and the entity expects to fulfill the contract as promised.

20. For each separate performance obligation that an entity satisfies over time, an entity would recognize revenue over time by consistently applying a method of measuring the progress towards complete satisfaction of that performance obligation. Appropriate methods of measuring progress include output methods and input methods. As circumstances change over time, an entity would update its measure of progress to depict the entity's performance to date.

21. If a performance obligation is not satisfied over time, an entity satisfies the performance obligation at a point in time. To determine the point in time when a customer obtains control of a promised asset and an entity satisfies a performance obligation, the entity would consider indicators of the transfer of control which include, but are not limited to, the following:

    (a) The entity has a present right to payment for the asset.

    (b) The customer has legal title to the asset.

    (c) The entity has transferred physical possession of the asset.

    (d) The customer has substantially all the risks and rewards of ownership of the asset.

    (e) The customer has accepted the asset.

22. In addition, the proposed standard includes implementation guidance on specified topics (for example, repurchase agreements, consignment arrangements, and bill-and-hold arrangements) to help an entity determine when control of a promised good or service is transferred to a customer.

Constraint on the cumulative amount of revenue recognized

23. If the amount of consideration to which an entity will be entitled is variable, the cumulative amount of revenue the entity recognizes for satisfied performance obligations should not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount of consideration allocated to satisfied performance obligations only if both of the following criteria are met:

(a) The entity has experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities).

(b) The entity's experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations.

24. An entity would be required to consider various indicators to determine whether the entity's experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled.

Onerous performance obligations

25. For a performance obligation that an entity expects at contract inception to satisfy over time and that period of time is greater than one year, an entity would recognize a liability and a corresponding expense if the performance obligation is onerous.

26. A performance obligation is onerous if the lowest cost of settling the performance obligation exceeds the amount of the transaction price allocated to that performance obligation. The proposed guidance specifies how an entity would determine the lowest cost of settling the performance obligation.

Contract costs

27. The proposed standard also specifies the accounting for some costs of obtaining or fulfilling a contract with a customer. An entity would recognize as an asset the incremental costs of obtaining a contract that the entity expects to recover. To account for the costs of fulfilling a contract with a customer, an entity would apply the requirements of other standards (for example, IAS 2, IAS 16, or IAS 38), if applicable. Otherwise, an entity would recognize an asset from the costs of fulfilling a contract if those costs meet all of the following criteria:

(a) The costs relate directly to a contract (or a specific anticipated contract).

(b) The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.

(c) The costs are expected to be recovered.

When would the proposals be effective?

28. The Boards decided that on the basis of their current timetable for the project, a final revenue standard would not be effective earlier than for annual reporting periods beginning on or after 1 January 2015. That timing would ensure that for an entity providing two years of comparative annual financial information (in addition to information for the current year), the standard would be issued before the beginning of the earliest comparative annual period presented. The FASB decided that early application would not be permitted. The IASB decided that early application would be permitted.