EFRAG

European Financial Reporting Advisory Group

EUROPEAN FIELD-TEST OF THE IASB'S EXPOSURE DRAFT REVENUE FROM CONTRACTS WITH CUSTOMERS

SOFTWARE

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Preparation of the feedback statement

Summary of the input received from European software companies

This note summarises the input received from European software companies' field-tests of the IASB's Exposure Draft *Revenue from Contracts with Customers* ('the ED'), published in November 2011.

This feedback statement has been prepared for the convenience of European constituents by the EFRAG secretariat. It has been reviewed by participants in the field-test**.**

About the field-test

Focus on application issues, the effect on financial statements and cost of applying the proposal

The purpose of the European field-test of the ED was to:

- identify potential implementation and application difficulties;
- assess the potential impact of the proposals on financial statements;
- estimate the effort required to implement and apply the proposals.

The field-test did not assess whether the requirements proposed in the ED represented an improvement to current accounting practice. The field-test only provides input for such an assessment.

The participants in the field-test were asked to select some of their contracts, apply the requirements proposed in the ED on these contracts and report their findings at workshops.

All European entities expressing a wish to participate in the field-test were invited to participate. The entities participating in the field-test therefore do not constitute a representative sample of the entities that will be affected by the proposals. Similarly, the assessed directions and changes in elements of financial position and performance only reflect the outcome of the selected contracts based on the accounting practice currently chosen for those contracts.

Participating companies

Seven companies participated in the field-test

Seven companies participated in the field-test, including:

- Alcatel-Lucent
- ABB
- Sage
- SAP
- Siemens
- Vivendi

One participant wanted to remain anonymous.

The results of each company's tests were presented at a workshop in Brussels on 3 February 2012.

Results of the field-test – implementation and application

A member of the IASB staff was present at the workshop and provided explanations on many of the issues raised by participants. The issues listed below reflect implementation and application problems that were identified by participants before the additional explanations were provided.

Scope

A participant was unsure about how to recognise revenue from non-enforceable arrangements

The requirements of the ED deal with revenue from contracts with customers. A contract is defined in the ED as an agreement between two or more parties that creates enforceable rights and obligations. Paragraph BC32 of the Basis for Conclusions notes that a contract with a customer must be enforceable at law for an entity to recognise the rights and obligations arising from that contract.

A participant noted that in some cases an arrangement could initially be unenforceable. In those cases the requirements of the ED would apply from the point in time when the contract would become enforceable. In other situations, an arrangement would never become enforceable at law (for example because the arrangement had been agreed orally and the local jurisdiction required contracts to be in writing to be enforceable). In those situations, if both parties performed under the arrangement, revenue, as defined in the ED, would nevertheless arise. The

participant thought that this revenue should be recognised at some point in time.

The participant believed that current requirements were also applicable for revenue arising under agreements that were not legally enforceable. The participant was therefore unsure about how to account for revenue from non-enforceable arrangements when the existing requirements in IAS 11 *Construction Contracts* and IAS 18 *Revenue* would be withdrawn as suggested by the ED.

Guidance on when to combine contracts

Participants were, in some instances, uncertain about how to apply the guidance on when to combine contracts

Paragraph 17 of the ED states that an entity shall combine two or more contracts entered into at or near the same time with the same customer (or related parties) and account for the contracts as a single contract if one or more of three listed criteria are met.

Participants at the workshop were uncertain about what was meant by 'at or near the same time' in paragraph 17 of the ED. They were, for example, in doubt about whether two contracts were entered into at or near the same time, if one contract was entered into four months after the first contract, but it had been expected that both contracts would be agreed when negotiating each contract.

One participant was also unsure about whether an entity should combine contracts entered into with the same (ultimate) customer when one contract was entered into directly with the entity and another contract was entered into via a third party (either agent or principal) of the entity and at least one of the three criteria in paragraph 17 of the ED were met.

Guidance on how to identify separate performance obligation

Participants were, in some cases, in doubt about how to separate performance obligations

According to paragraph 24 of the ED, a performance obligation is a promise in a contract to transfer a good or a service to the customer. The entity shall account for each promised good or service as a separate performance obligation if it is distinct.

Paragraph 28 of the ED specifies that a performance obligation is distinct if either of the following criteria is met:

(a) the entity regularly sells the good or service separately; or

(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.

However, paragraph 29 states that even when either of the criteria above is met, a performance obligation is not distinct, 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 that the entity also provides a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted; and

(b) the bundle of goods or services is significantly modified or customised to fulfil the contract.

Paragraph 30 of the ED allows entities to account for two or more distinct goods or services as a single performance obligation if those goods or services have the same pattern of transfer to the customer.

Paragraphs B11 to B12 of the ED specify that if a customer has the option to purchase a warranty separately, the warranty shall be accounted for as a separate performance obligation. On the other hand, if a customer does not have the option to purchase a warranty separately, the entity shall account for the warranty in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, unless the warranty provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

Participants were unsure:

- How the requirements would work for non-traditional goods and services. For example, a participant was uncertain about whether a covenant not to sue (for improper use during a time period of patents not licensed by the customer) and a release from patent infringements should be considered separate performance obligations.

- Whether the order of purchase (order of delivery) would matter when considering paragraph 28(b) of the ED. For example, a costumer could not make use of a software update without having a licence to the software to which the update related. On the other hand, the customer could use the software without the update. Participants were therefore in doubt about whether the update should be considered as a separate performance

obligation if it was 'delivered' after the software, but as a part of the software in cases where it was delivered before the software.

- When a significant service of integrating goods or services would be provided in accordance with paragraph 29 of the ED. Particularly, it was considered unclear whether an entity's service of implementing software for a customer would mean that the entity provided a significant service of integration, and the software and the implementation service therefore should be accounted for as one separate performance obligation. Participants were uncertain about whether factors such as the relative complexity of the integration service and other vendors' capabilities of delivering the same implementation service should be taken into account when performing the assessment.

- When goods or services would have the same pattern of transfer to the customer and accordingly could be accounted for together in accordance with paragraph 30 of the ED. More specifically, participants were uncertain about whether bug fixes, updates, enhancements and support (referred to as post-contract customer support) could be accounted for as a single performance obligation.

- Whether bug fixes and telephone support after purchase of software should be accounted for as separate performance obligations or a warranty for which only a provision should be recognised.

Criteria for transfer of control over time

Participants were unsure about (a) whether performance obligations to provide when-and-if-available software updates should be considered satisfied at a point in time or over time (b) what asset to consider when assessing the criteria for percentage-of-completion accounting and (c) when the compensation for performance completed to date includes payment that approximates the selling price of the goods or services

The ED states that an entity satisfies a performance obligation and recognises revenue over time if at least one of the following two criteria is met (paragraph 35):

- the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or

- the entity's performance does not create an asset with an alternative use to the entity and at least one of the following criteria is met:
  - the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs,
  - another entity would not need to substantially re-perform the

transferred to date

work the entity has completed to date if that other entity were to fulfil the remaining obligation to the customer without having benefit of any asset presently controlled by the entity,

- the entity has a right to payment for performance completed to date and it expects to fulfil the contract as promised. The compensation for performance completed to date includes payment that approximates the selling price of the goods or services transferred to date (for example, recovery of the entity's costs plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract is terminated.

Some participants were uncertain about whether performance obligations to provide when-and-if-available software upgrades/updates should be considered satisfied at a point in time or over time. Those participants were also uncertain as to whether they should distinguish between bug fixes and new versions of software. They thought that bug fixes could be considered as a stand-ready obligation that was satisfied over time. However, new versions of software could both be considered as a stand-ready obligation satisfied over the time of developing the enhancement or as a performance obligations satisfied at the company's discretion when the new version was released. In addition, participants found it unclear what 'asset' to consider when assessing whether the criteria of paragraph 35 of the ED were met. For example, a software company could develop customer specific software for a customer. The customer would then receive a licence to use this software, however, the right to the intellectual property would never transfer to the customer, and the entity could therefore also sell a licence to software based on the previous developed software to another customer. The licence that was to be provided to the customer would not have an alternative use whereas the intellectual property developed could have an alternative use.

Finally, one participant did not find it apparent what exactly was meant by: "payment that approximates the selling price of the goods or services transferred to date (for example, recovery of the entity's costs plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract is terminated". The participant was also uncertain about whether it would matter if the terms changed over the contract term. For example, the entity would only be entitled to cost recovery if the software was less than half finished but to a payment that approximated the selling price if the software was

more than half completed.

Measuring degree of completion

It was considered difficult to assess what would be the value to the customer of performance completed to date

According to paragraph 42 of the ED, if an entity has a right to invoice a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date, the entity shall recognise revenue in the amount to which the entity has a right to invoice.

Participants thought it was difficult to assess whether a right to invoice would correspond directly with the value to the customer of the entity's performance. It was therefore difficult to assess whether paragraph 42 of the ED should be applied to specific contracts.

Time value of money

A participant was uncertain about whether payments received in advance should be regarded as financing when they were received in order to minimise the risk that the customer might not pay for goods or services transferred

The ED requires in paragraph 58 that an entity, when determining the transaction price, adjusts 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.

One participant was unsure whether payments it received before transferring a good or service to the customer should be considered as a financing component, when the purpose of requiring the advance payment was to minimise the risk that the customer might not pay for the goods or services transferred.

Stand-alone selling price

Estimation of stand-alone selling prices was considered difficult or impractical when more goods or services within a contract had highly variable or uncertain prices

Paragraph 70 of the ED requires an entity to allocate the transaction price of a contract 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.

It follows from paragraph 71 of the ED that to allocate an appropriate amount of consideration to each separate performance obligation, an entity shall determine the stand-alone selling price at contract inception of the good or service underlying each separate performance obligation and allocate the transaction price on a relative stand-alone selling price basis.

If a stand-alone selling price is not directly observable, an entity shall estimate it. Paragraph 73 of the ED lists examples of suitable

estimation methods (adjusted market assessment approach, expected cost plus a margin approach and the residual approach).

Participants found it difficult or impractical to estimate the stand-alone selling price of a distinct good or service included in a contract when:

- the marginal cost of providing the good or service was close to nil;
- the price charged for the good or service varied considerably from customer to customer; and
- the contract included several goods and services with the characteristics mentioned above (as it was not possible to apply a residual approach in those circumstances).

Options for discounts

When the price charged for a good or service varied considerably from customer to customer, participants found it difficult to assess whether a written option to purchase that good or service at a specified price should be accounted for as a separate performance obligation

According to paragraph B21 of the ED, if in a contract with more than one performance obligation an entity grants a customer the option to acquire additional goods or services, that option gives rise to a separate performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market).

Participants found that when the price charged for a good or service varied considerably from customer to customer, it was difficult to assess whether a written option to purchase that good or service at a specified price would provide a material right to the customer.

Allocating the transaction price to separate performance obligations

When the number of performance obligations was uncertain, a participant considered it difficult to determine the part of the transaction price to be allocated to these performance obligations

As noted above, the ED could be interpreted as requiring revenue related to when-and-if-available software updates during a specific time period to be recognised when the updates were released by the entity. If this was the intended interpretation, a participant found it difficult to determine the amount of the transaction price to be allocated to these updates, as it was uncertain how many updates the entity would issue in the covered time period.

Contract modifications

Participants found it difficult to assess whether a contract modification provided the entity with a right to receive an amount of consideration that reflected the entity's stand-alone selling price of the promised good(s) or service(s).

Paragraph 21 of the ED states that an entity shall account for a contract modification as a separate contract if the contract modification results in the addition to the contract of both of the following:

- promised goods or services that are distinct; and
- an entity's right to receive an amount of consideration that reflects the entity's stand-alone selling price of the promised good(s) or service(s) and any appropriate adjustments to that price to reflect the circumstances of the particular contract.

Paragraph 22 of the ED provides guidance on how to account for a contract modification that is not a separate contract.

Participants found it difficult to assess whether a contract modification would result in an entity's right to receive an amount of consideration that would reflect the entity's stand-alone selling price for the promised good(s) or service(s) for the particular customer. First of all because participants found it difficult to estimate the stand-alone selling price for some distinct goods and services, as mentioned above. Secondly, because customers in many cases were offered a general discount for whatever would be purchased, and it was considered difficult to assess whether that discount would mirror an appropriate adjustment reflecting the circumstances of the particular contract.

In addition, participants thought that paragraph 22 (c) could be worded in a less complex manner.

Presentation of impairment losses on receivables and contract assets

A participant was unsure whether a subtotal should be presented after the line including credit losses

According to paragraph 69 of the ED, an entity shall present any impairment of receivables and contract assets in profit or loss as a separate line item adjacent to the revenue line item.

One participant was unsure whether a subtotal, a net revenue figure, should be presented after the line item including the impairment losses or the impairment losses should be considered as an expense in arriving to a gross margin or profit figure.

Results of the field-test – impact on financial statements

The test identified the following potential impact on the financial statements:

The ED would change how some companies combine contracts

A participant in the field-test currently combined contracts that were not entered into 'at or near the same time'. According to the ED, these contracts could not be combined. This would result in different levels of profit being reported when the performance obligations in those contracts are satisfied.

The ED would change how some companies separate post-contract customer support services

- A participant in the field-test assessed that the ED would require post-contract customer telephone support and the obligation to provide when-and-if-available updates to be considered as two separate performance obligations. Currently the participant accounted for these goods and services together. If the two goods and services are satisfied at different points in time and have different profit margins, the effect of the ED would be that these different margins are reported when the relating goods and services are transferred.

Revenue will be recognised earlier for some companies' contracts where revenue currently is not recognised until there is vendor specific objective evidence of a fair value

- Some participants did currently not recognise revenue on goods or services transferred to the customer when there was no vendor specific objective evidence (VSOE) of a fair value for any of the deliverables under a contract or for any undelivered items. In those cases, no revenue was therefore recognised until there was VSOE of fair value for all of the remaining products or services under a contract. In some cases that meant that no revenue was recognised until the last product or service had been delivered to the customer. The ED requires that an entity estimates the stand-alone selling price when this is not directly observable. Hence, under the proposal revenue recognition is no longer deferred because there is no VSOE of fair value. Accordingly, the proposals will result in revenue being recognised earlier (that is when the related goods or services are transferred) for some contracts of some companies.

The ED will result in revenue being recognised later for some upfront fees that are currently recognised when charged

- A participant charged customers an upfront fee for which no good or service was transferred to the customer. Currently, the participant recognised revenue from this fee when it was charged. Under the ED, the upfront fee should be accounted for as an advance payment and revenue should be recognised when goods or services are transferred to the customer.

Participants considered that the revenue pattern related to when-and-if-available software versions could potentially be affected

- Currently participants recognised revenue related to when-and-if-available updates on a straight line basis over the time period in which the customer had a right to receive any updates. Some (but not all) participants assessed that the ED could be interpreted in a manner that potentially could result in revenue related to when-and-if-available software updates being recognised when updates were made available to the customer. This interpretation of the ED would lead to revenue figures reflecting the point in time when an entity decides to issue an update rather than when the entity is preparing or is standing ready to provide the update.

Fewer provisions for onerous performance obligations satisfied at a point in time or within one year

- The ED prohibits provisions for onerous performance obligations to be recognised in relation to contracts satisfied at a point in time or over a period of one year or less (unless the situation is covered by the reference in paragraph 31 of IAS 2 Inventories to IAS 37 Provisions, Contingent Liabilities and Contingent Assets). Participants assessed that this could result in less provisions.

Results of the field-test – implementation costs and costs savings

The test identified the following potential costs associated with applying the ED:

Increased number of separate transactions would increase costs

- Participants assessed that the ED would result in several post-contract customer services being accounted for separately. This would increase costs of preparing financial statements.

Retrospective application was considered costly

- Some participants assessed that retrospective application would be costly. In this regard it was also noted that the ED incorporates and would replace the guidance of IFRIC 18. IFRIC 18 only applies to assets from customers received on or after 1 July 2009, whereas the ED applies to all assets received from customers (that is also those received before 1 July 2009).

  One participant considered that costs of application could be reduced by:

  - limiting the number of periods for which comparable information should be provided to one year;
  - determining the effective date as, at a minimum, four and a half years after issuance of the final standard; or

- allowing/requiring prospective application (to avoid entities having to prepare revenue figures under both the current practice and the future requirements for the purpose of being able to provide comparative figures).

... but prospective application could also be costly

Another participant, however, assessed that it would be costly, if it would be required only to account for contracts agreed after the effective date in accordance with a new standard. There could be long-term contracts agreed before the effective date that should be accounted for under the current requirements for many years and it would be costly to have two different ways of accounting for contracts in place at the same time.

Costly to provide the reconciliations

- One participant assessed that it would be costly to comply with the disclosure requirements for interim and year-end financial reports. In particular, the participant considered the following disclosures costly to provide:
  - the reconciliation of contract assets and contract liabilities;
  - the analysis of remaining performance obligations; and
  - reconciliation of the balance of any assets recognised from the costs to obtain or fulfil a contract with a customer by main category of asset.

The proposals would reduce the use of non-GAAP measures for communicating financial information internally to management and externally to users of financial statements, and thus reduce costs

- One participant currently deferred revenue recognition in cases where vendor specific objective evidence (VSOE) of fair value could not be established for separate goods or services included in the contract. However, the participant also reported non-GAAP measures to both external and internal users where revenue was recognised for goods and services transferred to a customer even in cases where no vendor specific objective evidence of fair value existed. The requirements of the ED would result in realigning revenue figures for IFRS accounting and the non-GAAP measures, and the proposals would thus remove the costs of preparing two measures of revenue.