EFRAG

European Financial Reporting Advisory Group

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

LONG-TERM CONTRACTS II

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Preparation of the feedback statement

Summary of the input received from companies with long-term contracts

This note summarises the input received from the field-test of the November 2011 IASB Exposure Draft *Revenue from Contracts with Customers* ('the ED') performed by European companies with long-term contracts.

This feedback statement has been prepared for the convenience of European constituents by EFRAG's 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 the 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 represent an improvement to current accounting practice. The field-test only provides some 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 do therefore 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

Four companies participated in the field test

The following companies with long-term contracts participated in the field-test:

- ABB
- Alcatel-Lucent
- Areva
- Siemens

The results of each company's tests were presented at a workshop on 1 March 2012 in Brussels.

Results of the field-test – implementation and application

A member of the IASB staff and a member of the FASB staff were 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.

Guidance on how to identify separate performance obligations

Participants were uncertain about how to apply some of the criteria for when to consider a good or service to be distinct for some of the selected contracts

Paragraphs 28 to 30 of the ED include guidance on how to identify separate performance obligations. Paragraph 28 provides criteria for when a good or service is distinct.

Paragraph 29 specifies that a good or service in a bundle of promised goods or services is not distinct and, therefore, the entity shall account for the bundle as a single performance obligation if both of the following criteria are met:

- 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
- the bundle of goods or services is significantly modified or customised to fulfil the contract.

In addition, paragraph 30 specifies that an entity may account for two or more distinct goods or services as a single performance obligation, if the goods or services have the same pattern of transfer to the customer.

Paragraph B10 states that if a customer has the option to purchase a warranty separately, an entity shall account for the promised warranty as a separate performance obligation.

Participants experienced certain problems in applying some of the requirements. In particular, participants were unsure about:

- When a service of integrating goods or services would be a ‘significant service’.

- Whether the first supply of fuel assemblies delivered in relation to the engineering of a nuclear island should be considered to be a separate performance obligation or a part of the engineering of the nuclear island. The fuel assemblies for the initial cores were necessary for testing the operationality of the power plant and their installation into the power plant was more complicated than the installation of adjacent fuel assemblies. Accordingly, although the fuel assemblies could be purchased from another supplier, a customer would generally choose the same supplier for the assemblies necessary for the initial cores as for the engineering of the nuclear island. Participants considered it unclear whether a significant service of integrating the fuel cores into the power plant was provided.

- Whether a particular warranty that could be purchased separately should be accounted for as a separate performance obligation or as part of the single performance obligation encompassing the goods or services. The warranty was considered strongly interrelated with a (maintenance) service provided and a performance guarantee. Participants assessed that, on the one hand, paragraph B11 of the ED would require the warranty to be accounted for separately. On the other hand, paragraph 29 would suggest the warranty to be considered as part of the single performance obligation.

- Whether a guarantee related to an asset’s performance and the related penalty (or bonus) payments should be considered as a warranty, a separate performance obligation, or as a performance bonus scheme that would not be considered as a separate performance obligation but affect the transaction price of a contract.

- Whether a newly introduced standard warranty that was offered for competition reasons, and covered a longer period than it had previously done, should be accounted for as a separate performance obligation.

- Whether the criteria for identifying separate performance obligations should be considered from the entity's or the customer's perspective.

Performance obligations satisfied over time

Participants were unsure about how to interpret some of the criteria for when to consider a good or service to be satisfied over time

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 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.

Paragraph 36 of the ED specifies that when evaluating whether an asset has an alternative use to the entity, an entity shall consider at contract inception the effects of contractual and practical limitations on the entity's ability to readily direct the promised asset to another customer.

Participants were unsure about how to assess whether an asset had an alternative use. It was, for example, considered unclear whether an asset had an alternative use if it could be sold to another customer, but this would not be likely due to the limited number of potential customers. This could, for example, be the case when the item produced was designed for a particular geographical area and there were not many customers who were interested in using the asset for that area. Participants were uncertain as to what was meant by 'ability to readily direct' in the ED and whether the availability of potential customers should be considered when assessing the criteria.

A participant was also in doubt about what asset to consider when assessing the alternative use. It could be that during the first part of the construction period an asset could easily be redirected to fulfil another customer's order, but it would become more and more difficult as the asset was completed. Accordingly, if the asset to be considered would be the asset in its current condition, the criteria for considering the asset to be transferred over time would not be met until the asset had been partly finalised. On the other hand, if the asset to be considered would be the final asset, the criteria would be met from the start of the construction.

One participant was unsure about whether the requirement of a right to payment for performance completed would be met in cases where the entire work to date had been completed by a subcontractor. In the particular case, the entity would only have a right to consideration that would cover the cost of the subcontractor, which included the subcontractor's margin, but not any additional margin for the entity.

Another participant considered it unclear whether only the contractual terms or also the outcome of potential court cases should be taken into consideration when assessing whether the entity had a right to payment for performance completed to date.

Measuring progress towards complete satisfaction of a performance obligation

Participants were unsure about how much revenue could be recognised on the basis of work performed by subcontractors

According to the ED, an entity shall apply a method of measuring progress of performance obligations satisfied over time that depict the transfer of control of goods or services to the customer. Paragraph 46 of the ED deals with cases where an input method is applied to a performance obligation that includes goods that the customer obtains control of significantly before receiving services related to those goods. The paragraph states that, in these cases, the entity may best depiction its performance by recognising revenue for the transferred goods in an amount equal to the costs of those goods if both of the following conditions are present at contract inception:

- the cost of the transferred goods is significant relative to the total expected costs to completely satisfy the performance obligation; and
- the entity procures the goods from another entity and is not significantly involved in designing and manufacturing the goods.

Some participants were unsure about whether paragraph 46 of the ED should be considered as a requirement, or as guidance that an entity should consider, but only follow if it would result in the best depiction of the performance.

Guidance on when to combine contracts and contract modifications

Participants found it unclear whether additional goods ordered by a customer could be considered distinct when they should be integrated into assets already delivered by the entity

Paragraph 17 of the ED specifies that an entity shall combine two or more contracts entered into at or near the same time with the same customer if one or more of the following criteria are met:

- the contracts are negotiated as a package with a single commercial objective;
- the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- the goods or service promised in the contracts are a single performance obligation.

Paragraph 21 of the ED specifies 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.

Some participants were uncertain about when two or more contracts should be combined because the goods or services promised in the different contracts would constitute a single performance obligation. These participants noted that paragraph 28 of the ED states that a bundle of promised goods or services should be considered as a single performance obligation if:

- 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

- the bundle of goods or services is significantly modified or customised to fulfil the contract.

However, a participant was, for example, unsure about how to account for a contract modification, or a new contract, for the construction and installation of additional items that should be integrated into items already provided to the customer by the entity. The participant was unsure as to whether the additional goods were distinct (a separate performance obligation), as the addition would require a significant integration service of the additional items into the existing items (see *Guidance on how to identify separate performance obligations* above).

Variable consideration

Participant considered it unclear when to apply the expected value method and the most likely amount method

Paragraph 55 of the ED explains that to estimate the transaction price when the amount of consideration is variable, an entity shall use either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

- The expected value – the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the transaction price if an entity has a large number of contracts with similar characteristics.

- The most likely amount – the most likely amount is the single most likely amount in a range of possible consideration amounts. The most likely amount may be an appropriate estimate of the transaction price if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

A participant found it unclear when and how to use the expected value and most likely values. The participant considered it unclear whether the most likely method should only be used for binary outcomes and the expected value method should be used when there would be more than two possible outcomes.

Contract boundaries

A participant was uncertain about whether a short-term contract with a renewal option should be accounted for similarly to a long-term contract with a cancellation option

According to paragraph BC300 of the ED, "a renewal option gives a customer the right to acquire additional goods or services of the same type as those supplied under an existing contract. This type of option could be described as a renewal option within a relatively short contract (for example, a one-year contract with an option to renew that contract for a further year at the end of the first and second years) or a cancellation option within a longer contract (for example, a three-year contract that allows the customer to discontinue the contract at the end of each year)."

A participant was uncertain about whether a cancellation right should be considered equal to a renewal option. In the relevant case, a maintenance contract had a term of fifteen years but the customer was entitled to cancel the contract after ten years for a relatively high termination fee. The participant noted that paragraph BC300 of the ED indicated that a short-term contract with a renewal option should be accounted for similarly to a long-term contract with a cancellation option, however, this guidance was not provided in the ED that only mentioned renewal options.

Time value of money

Participants were uncertain about when the ED considered a contract to include a financing component

According to the ED, the transaction price shall be adjusted to reflect the time value of money if a contract has a financing component that is significant to the contract. The objective when adjusting the promised amount of consideration to reflect the time value of money is for an entity to recognise revenue at an amount that reflects what the cash selling price would have been for the promised goods or services at the point that they are transferred to the customer.

Participants were uncertain about:

- Whether payments received in advance for the purpose of risk management should be considered to be a significant financing component.
- What interest rate to apply. Paragraph 61 of the ED specified that an entity should use the discount rate that would be reflected in a separate financing transaction between the entity

and its customer at contract inception. However, in the example of paragraph IE8 of the ED, the entity's incremental borrowing rate was applied.

A participant thought it would be difficult to apply the proposal as it would require knowledge about the timing of cash-inflows. Sometimes payment terms were determined by reference to events or circumstances rather than to a specific date and it could be difficult to estimate when these events or circumstances would take place.

Recognition of contract costs

Two participants were unsure about how to account for contract costs under the ED

The ED specifies that only costs that (1) relate directly to a contract (or specific anticipated contract); (2) give rise to resources that will be used in satisfying performance obligations in the future and (3) that are expected to be recovered; would be eligible for capitalisation. Capitalised contract costs shall be amortised on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates.

One participant thought that IAS 11 *Construction Contracts* focused on margin smoothing (both revenue and expenses should, according to paragraph 22 of IAS 11, be recognised based on the stage of completion of the contract activity) in its requirements on contract costs. The participant noted that BC221 of the ED seemed to suggest a different approach by stating that the proposals would "ensure that only costs that result in assets are capitalised and an entity would be precluded from deferring costs merely to normalise profit margins throughout a contract by allocating revenue and costs evenly over the life of the contract". However, the participant was unsure about how exactly to account for contract costs under the ED.

Another participant was unsure about whether costs related to contract modifications that the entity expected the customer would approve but were not yet approved by the customer could be capitalised.

Onerous performance obligations

A participant was unsure about whether a performance obligation was onerous if there would be no incremental costs

According to paragraph 87 of the ED, 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. Paragraph 87 states that the costs that *of satisfying the obligation, but costs allocated to the performance obligation were higher than the allocated transaction price*

relate directly to satisfying a performance obligation are those costs described in paragraph 92 of the ED.

According to paragraph 92 of the ED, the costs that relate directly to a contract include:

- direct labour;
- direct materials;
- allocations of costs that relate directly to a contract or to contract activities;
- costs that are explicitly chargeable to the customer under the contract; and
- other costs that are incurred only because the entity entered into the contract.

A participant considered an example where an entity provided its customers with a good or service and wanted to provide an additional customer with the same good or service at a very low price. There would be no incremental costs of providing the additional customer with the good or service. However, if the total cost of providing the goods or services to all the customers was allocated equally to all the goods or services provided, the cost of providing the good or service to the additional customer would be higher than the transaction price allocated to the particular performance obligation. The participant was unsure whether the ED would require an onerous performance obligation to be recognised for the additional good or service (assuming that the performance obligation was satisfied over a period of time greater than one year).

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 account for the time value of money

- The proposal would affect how some companies account for the time value of money. Currently, some participants assessed whether a contract included a significant financing component by comparing the pattern of cash inflows (from the customer) and the cash outflows (to the suppliers). If these patterns were similar, some field-test participants considered that the contract did not include a significant financing component. The ED requires an entity to compare the pattern of cash inflows to the pattern of revenue recognition. Accordingly, the ED could result in a higher or lower amount of revenue being recognised with a correspondingly higher or lower amount of finance cost.

The ED would change the pattern of revenue recognition for some companies as it would limit the use of percentage-of-completion accounting and what cost to consider when determining the percentage of completion on a cost-to-cost basis

- Some participants in the field-test currently applied percentage-of-completion accounting for contracts where this would not be possible under the proposal in situations where the customer did not control the work in progress as it was created or enhanced. In those situations, the timing of revenue recognition would change so that revenue is only recognised when the customer obtains control of the asset (which might be at completion of the contract). The contracts affected were for customer specified goods where the asset was not controlled by the customer as it was created. The goods did not have an alternative use for the entity, but entities were not entitled to compensation of more than cost incurred for performance completed to date if the customer would terminate the contract for reasons other than the entity's failure to perform as promised.

The ED would change the pattern of revenue recognition for a company currently accounting for a product and a licence as if they were one performance obligation

- A participant currently combined the following elements, and accounted for them as a single performance obligation:
    - a contract to provide the documentation needed to complete a power station, put the power station into operation and assist in the construction; and
    - an exclusive licence for a country to use the technology and detailed equipment design and manufacturing technology for the power station

  The participant assessed that under the ED, the elements should be combined into one contract, but this contract would include two separate performance obligations as the customer could benefit from the technology transfer and the documentation separately and as the deliverables were not 'highly interrelated'. The ED would accordingly result in a different revenue recognition pattern for contracts of this participant.

Under the ED, revenue cannot be recognised for contract modifications where neither the price nor the scope has

- A participant currently recognised revenue from contract modifications that were not approved by the customer when it was considered highly likely that the customer would accept the modification, and the modification in any case would not result *been agreed*

in the contract becoming onerous. According to the ED, revenue related to contract modifications should not be recognised until the parties to a contract approve a change in the scope or price of a contract. Accordingly, under the ED the participant would not be able to recognise revenue until at least the scope of the modification has been approved by the customer and the entity expects that the price of the modification will also be approved.

Results of the field-test – Costs

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

Participants assessed that complying with the disclosure requirements would be costly

Participants assessed that it would be costly to comply with the disclosure requirements. In particular, participants assessed that the reconciliation of contract balances would be costly to provide. A participant currently had the required information on a contract level, however, the participant had so many contracts that it would be costly to consolidate the information and ensure the reliability of the information.