EFRAG

European Financial Reporting Advisory Group

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

LONG-TERM CONTRACTS I

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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 IASB's 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 effect 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 are better or worse than 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

Four companies with long-term contracts participated in the field-test, among others:

- EADS
- Ferrovial
- Thales

One participant wanted to remain anonymous.

The results of each company's tests were presented at a workshop on 19 January 2012 in Brussels.

Results of the field-test – implementation and application

A member of the IASB staff was present at the workshop and provided her views and explanations to 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 in some cases unsure about how to apply the criteria for when to consider a good or service to be distinct

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.

Participants were unsure about how to interpret some of the requirements. In particular participants were uncertain about:

- Whether the construction of a number of similar items under the same contract should be considered as separate performance obligations or the bundle of items should be considered as one performance obligation when significant development activities were associated with developing the first item. Paragraph BC78 of the ED states that goods or services should not be considered distinct if 'the risk that an entity assumes to fulfil its obligation to transfer one of those promised goods or services to the customer is a risk that is inseparable from the risks relating to the transfer of the promised goods or services in that bundle'. However, participants did not consider this objective to be reflected in paragraph 29 of the ED.

- Whether the delivery of a good and a related maintenance service should be considered as one or two distinct performance obligations, when the service was necessary for the product to work appropriately and only the seller of the good could provide the service. The scenario was considered for highly technological and customised equipment like onboard radar on a defence aircraft.

- How 'the same pattern of transfer' in paragraph 30 of the ED should be interpreted. Participants, for example, considered it unclear whether it would be appropriate to account for two distinct goods as one performance obligation in the annual report if the two distinct goods were transferred within the same year – but not in the same quarters. Furthermore, if the two distinct goods could be accounted for together in the annual report, participants considered it unclear whether this could also be the case in quarterly reporting.

- Whether the development of a series of relatively specialised items followed by the installation of these items into assets belonging to the customer should be considered as one or more performance obligations. In the relevant case, the customer could only use the items when they were installed in the relevant assets. In addition, the installation was complex and it was unclear whether another company would be able to do the installation.

Performance obligations satisfied over time

Participants were uncertain about whether the criteria for when to consider a good or

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):

service to be satisfied over time were met for certain contracts

- 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. Compensation for performance completed to date includes payment that approximates the selling price of the goods or services transferred to date.

Participants were unsure about 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.

Some participants were in doubt about when an entity would have a right to payment for performance completed to date. They were, for example, unsure about whether only contract terms should be regarded, or the likely outcome of a lawsuit and/or commercial practice should be taken into consideration when determining the entity's right to consideration. In addition, some participants considered it difficult to assess whether the compensation, the entity would be entitled to, would commensurate compensation for performance completed to date. These participants found it unclear how high the margin should be in order to meet this criterion.

A participant was also in doubt about how to assess the criterion: 'another entity would not need to substantially re-perform the work the entity has completed to date'. The ED states that in evaluating the criterion, the entity should presume that another entity fulfilling the remainder of the contract would not have the benefit of any asset presently controlled by the entity. However, the participant was unsure about whether assets transferred to - and therefore controlled by - the customer could be taken into consideration when assessing whether another entity should need to substantially re-perform the work the entity had performed to date. If that was the case, the criterion was considered circular as the satisfaction of the criterion would mean that control of any asset developed would be regarded as having been transferred from the entity to the customer.

Time value of money

Participants were uncertain about how to assess whether a contract includes 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 at the date control is transferred.

A participant was uncertain about when the ED considered there to be a financing component included in a contract. More particularly, the participant was uncertain whether a financing component existed if:

- the patterns of cash inflows and revenue recognition were different, or
- payments were received before or after the asset was fully completed.

Customer acceptance clauses

Participants were uncertain about how to account for customer acceptance clauses when performance obligations were satisfied over time

The application guidance of the ED includes guidance on how to account for customer acceptance clauses. The guidance only refers to the section of the ED that provides guidance for performance obligations that are satisfied at a point in time. Participants found it unclear whether customer acceptance clauses should be considered when performance obligations were satisfied over time.

Cost to fulfil a contract

A participant was uncertain about what cost to fulfil a contract would result in an asset

Paragraphs 91 to 93 of the ED specify that an entity shall recognise an asset from certain costs to fulfil a contract.

A participant did not think it was clear what costs would result in an asset.

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 calculating an interest cost (or income) based on a contract's net cash balance during the construction period and until the customer had fully paid the promised amount of consideration. The net cash balance was calculated as the cash inflows from the customer less cash outflows to suppliers and other costs related to the contract. If this interest cost (or income) was considered to be significant, revenue was adjusted. 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 result in revenue for some contracts to be recognised at a point in time where it currently was recognised over time

- Some participants in the field-test currently considered performance obligations to be satisfied over time where this might not be possible under the proposal and revenue recognition would hence be recognised later than under current practice. The contracts that potentially could be affected were for customer specified goods where the asset (work in progress) was not controlled by the customer as it was created (the first criterion in paragraph 35 of the ED would not be met). In the cases considered, the entity's performance did not create an asset with an alternative use to the entity (the first part of the second criterion in paragraph 35 of the ED would be met), but the entity was probably not entitled to payment for performance completed to date that would approximate the selling price of the goods or services transferred to date. Participants presented the following situations where revenue potentially should be recognised later than under the current practice applied by the entities:
    - The first case related to a contract of an entity that was constructing defence equipment for the French government. Unlike UK and US defence contracts, contracts with the French government did not entitle the entity 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. In case of the customer's termination, the entity would, however, keep the work-in-progress. The particular entity had almost never experienced that a customer would terminate a contract. It was therefore not clear what the results of any negotiation or lawsuit following a termination would be.

Participants assessed that it would not be possible to consider the performance obligations being satisfied over time under the ED, if the outcome of negotiations or lawsuits were not considered and if the compensation for cost incurred could not be regarded as payment approximating the selling price of the goods or services transferred at a particular date. In that case revenue recognition would therefore be deferred compared with current practice. For the contract considered, the current applied accounting practice would result in 90 percent of the revenue being recognised in the first three years of a four-year contract. The ED could thus result in the entire revenue being recognised in year four. The particular contract represented 6 percent of the entity's revenue. However, the participant assessed that for almost all of its contracts; revenue could only be recognised over time if the entity had a right to consideration that approximated the selling price of the goods or services transferred as none of the other criteria included in the ED for when to recognise revenue over time would be met. The ED could therefore have a very significant impact on the entity's revenue pattern.

- The second case related to a contract from another entity. Under this contract, if a customer would decide to terminate the contract for reasons other than the entity's failure to perform as promised, the customer could choose whether:

    - it wanted to have transferred the work in progress. In this case the customer would have to pay for performance completed to date (including a normal profit margin),

    - it did not want to have transferred the work in progress. In this case, the customer would share the loss related to selling the work in progress to someone else.

Under these circumstances, if the customer's option to obtain the work in progress would not result in the customer controlling the work-in-progress according to the ED, it was assessed by participants that the performance obligation would not be satisfied over time under the ED and revenue recognition would therefore be recognised later than under the current practice applied by the entity.

When measuring progress towards complete satisfaction of a performance obligation on a cost-to-cost basis, the ED was assessed to limit the costs to consider compared with participants' current practice

- The ED specifies that when an entity applies the input method for determining progress towards complete satisfaction and the performance obligation includes goods that the customer obtains control of significantly before receiving services related to those goods, the best depiction of the entity's performance may be for the entity to recognise revenue for the transferred goods in an amount equal to the costs of those goods if both of the following conditions are present at the 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.

  A participant noted that it currently recognised revenue on work performed by subcontractors even when this work had not yet been transferred to the customer. The ED could accordingly change the pattern of revenue recognition by limiting the amount recognised on the subcontractor's work to that transferred to the customer.

Results of the field-test – Costs

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

Participants assessed that it could be costly to assess whether the criteria for recognising revenue over time were met

- Participants assessed that in many cases, the circumstances that could result in contracts performance obligations being satisfied over time were that the entity's performance did not create an asset with an alternative use to the entity and that the entity had a right to payment for performance completed to date. However, in many cases the right to payment would follow from local legislation. Accordingly, participants would have to examine local legislation and assess whether the requirements would result in the entity having a right to payment for performance completed to date that at any point in time would at least compensate the entity for the entity for performance completed to date. Participants considered this to be costly.

A participant assessed that it could be necessary to prepare separate revenue figures for internal reporting

- A participant assessed that if the ED would result in the entity not being able to recognise revenue over time in situations where this was currently done, it could be necessary to manage the entity based on other figures than those used for external reporting. The participant assessed that preparing two sets of revenue figures would be costly.

Participants assessed that complying with the disclosure requirements would be costly

- Participants assessed that it would be costly to comply with the disclosure requirements, particularly the reconciliation of contract balances. A participant noted that the disclosures currently required by IAS 11 on gross amounts due from/to customers were currently only provided at the balance sheet date and the amounts were not directly available from the entity's accounting system. In order to be able to provide the proposed reconciliation, the entity would have to introduce significant changes to its accounting system and it expected that significant time and costs would be associated with processing the reconciliation.

Participants assessed that retrospective application would be costly

- A participant considered that retrospective application of the proposals would be costly, as contracts that were currently completed could have been agreed ten to twenty years ago and retrospective application would require accounting for these contracts to be restated in accordance with the ED.