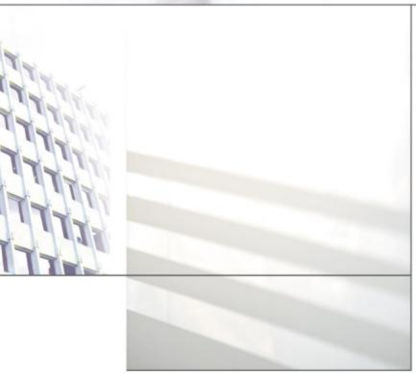

European Financial Reporting Advisory Group

European field-test of IASB Exposure Draft *Revenue from Contracts with Customers*

12 December 2011

The core principle of the proposed standard

Introduction

These slides have been prepared by the EFRAG secretariat to support participants in the European field-testing of the IASB's Exposure Draft *Revenue from Contracts with Customers*. The slides will explain the core principles of the proposed standard and highlight some issues participants should pay attention to when performing the field-test.

Core principle

An entity should recognise 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.

Steps to apply when recognising revenue

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

The steps will be explained on the following slides.

Identify the contract(s) with the customer

Step 1:

Identify the contract(s) with the customer

- **Why is this step important?** Identifying the contract ring fences the transaction price and the separate performance obligations to which the transaction price should be allocated.
- **What are the issues to consider?**
  - **Is there a contract?** The proposals only apply to contracts where all of the following criteria are met:
    - the contract has commercial substance;
    - the parties involved have approved the contract and are committed to perform their respective obligations;
    - the entity can identify each party's rights regarding the goods or services to be transferred; and
    - the entity can identify the payment terms for the goods or services to be transferred.
  - **Is the counterparty a customer?** The proposals only apply to contracts with customers. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities.

Identify the contract(s) with the customer

Step 1:

Identify the contract(s) with the customer

- **Combination of contracts:** Two or more contracts shall be considered as a single contract if it is entered into at or near the same time with the same customer (or related parties) and at least one 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 services promised in the contracts are a single performance obligation.
- **Contract modifications:** Contract modifications should be accounted for as follows:
  - If it is only a price change it should be considered as a change in the transaction price (see later).
  - If it adds distinct goods or services and a right to receive an amount of consideration that reflects the entity's standalone selling price it should be accounted for as a separate contract .

Identify the contract(s) with the customer

Step 1:

Identify the contract(s) with the customer

- **Contract modifications (continued):**
  - In other cases:
    - If the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification (Scenario A), the entity shall account for the contract modification as a termination of the original contract and the creation of a new contract.
    - If the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied at the date of the contract modification (Scenario B), the entity shall recognise the effect of the modification as revenue at the date of the contract modification on a cumulative catch-up basis.
    - If the remaining goods or services are a combination of Scenario A and Scenario B, the entity shall allocate to the unsatisfied separate performance obligations the amount of consideration received from the customer - but not yet recognised - plus the amount of any remaining consideration that the customer has promised to pay. For a performance obligation satisfied over time, an entity shall update the transaction price and the measure of progress towards complete satisfaction of the performance obligation.

Identify the contract(s) with the customer

Step 1:

Identify the contract(s) with the customer

Examples of issues that should be considered

- Do you have some agreements which do not meet the standard’s definition of a contract?
- Do you have some contract that should be combined?
- Is the contract with a customer? Contracts with, for example, collaborators and partners are outside the scope of the standard.

Identify the separate performance obligations

Step 2:

Identify the separate performance obligations

- **Why is this step important?** Revenue is recognised when a separate performance obligation is satisfied. Identifying separate performance obligations is therefore important for the pattern of revenue being recognised. As the onerous test is to be carried out at a performance obligation level identifying separate performance obligations is also important in this regard.
- **What is a performance obligation?** A promise in a contract to transfer a good or service to the customer.
- **What is the main issue to consider?** The main issue arises when an entity promises to transfer more than one good or service to a customer in a contract. In this case the entity shall account separately for each promised good or service if it is distinct (a separate performance obligation).
- **When is it distinct?** A good or service is distinct if the criteria for considering it to be indistinct (explained on the next slide) are not met and either of the following criteria is met:
  - the entity regularly sells the good or service separately; or
  - 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.

Identify the separate performance obligations

Step 2:

Identify the separate performance obligations

- **When is it not distinct?** A good or service in a bundle of promised goods or services is not distinct 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.
- **Practical expedient:** An entity may account for two or more distinct goods or services promised in a contract as a single performance obligation if those goods or services have the same pattern of transfer to the customer.
- **What if a good or service is not distinct?** If a promised good or service is not distict, it shal be combined with other promised goods or services until a bundle of goods or services that is distinct is identified. That may result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.

Identify the separate performance obligations

Step 2:

Identify the separate performance obligations

Examples of issues that should be considered

- Performance obligations do not include activities that an entity must undertake to fulfil a contract unless the entity transfers a good or service to the customer as those activities occur. Setup activities are therefore often not performance obligations (which means that revenue is not recognised when these activities are performed).
- Performance obligations can be *explicit, implicit or implied.* Legal requirements, statutory requirements and customary business practices may all create performance obligations that should be identified. Make sure to identify all performance obligations within a contract. Are you providing the customer with something you are currently not considering to be a revenue generating activity (e.g. promotional gifts, customer service, warranties, options for additional goods or services, or destruction of used products)?
- The proposal may split a contract into more separate performance obligations (that should be accounted for separately).

Determine the transaction price

Step 3:

Determine the transaction price

- **Why is this step important?** The transaction price determines the amount of revenue to be recognised.
- **What is the transaction price?** 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 assuming that the transaction will occur in accordance with the existing contract. The transaction price does therefore not reflect credit risk.
- **What are the issues?** One issue arises when the consideration is variable. Another issue is the requirement to consider the time value of money. Non-cash consideration and consideration payable to a customer are other issues, however, these issues will not be considered here.
- **Variable consideration** When the consideration is variable the 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 – which is the sum of probability-weighted amounts in a range of possible consideration amounts. The ED states that an expected value may be an appropriate estimate when an entity has a large number of contracts with similar characteristics

Determine the transaction price

Step 3:

Determine the transaction price

- **Variable consideration (continued)**
  - The most likely amount – the most likely amount is the single most likely amount in a range of possible consideration amounts. The ED states that the most likely amount may be an appropriate estimate when the contract has only two possible outcomes.
- **Time value of money:** If a contract includes a significant financing component, the transaction price shall reflect the time value of money. For payments in arrears, the discount rate should reflect the credit characteristics of the customer. For payments in advance, the entity's credit characteristics should be considered. As a practical expedient, an entity need not to reflect the time value of money if the entity expects at contract inception that the period between payment by the customer and the transfer of the promised goods or services will be one year or less. When more payments are agreed, these should be "assigned" to the satisfaction of performance obligations on a "FIFO basis".
- **Collectability:** As mentioned, the transaction price shall not reflect the customer's credit risk. The credit risk shall be presented separately from the revenue line. The allowance for any expected impairment in contracts with customers shall be accounted for in accordance with IFRS 9 or IAS 39.

Determine the transaction price

Step 3:

Determine the transaction price

Examples of issues that should be considered

- Do you have contracts where it is expected at contract inception that the period between payment by the customer and the transfer of the promised goods or services will be more than one year? In that case it should be considered whether the contract includes a significant financing component, and if so, the transaction price should reflect time value of money. This also applies when the customer pays in advance.
- Do you have contracts where the consideration is variable? Variable consideration includes situations where the entity is transferring goods or services to a customer, but is only entitled to any consideration if one or more criteria are met.
- Do you sell with a right of return?
- Are you acting as a principal or as an agent?
- Do your customers often exercise only a portion of their rights (breakage)?

Allocate the transaction price

Step 4:

Allocate the transaction price

- **Why is this step important?** The allocation of the transaction price affects how much revenue is recognised when a particular separate performance obligation is satisfied. It also affects whether a performance obligation is deemed onerous.
- **What are the issues?** The issues relate to situations where a contract has more than one separate performance obligation. In those cases an entity shall allocate the transaction price to each separate performance obligation in proportion to the stand-alone selling prices of the distinct good and services underlying each separate performance obligation. If the stand-alone selling prices are not directly observable, the ED lists the following examples of methods that can be used to estimate it: adjusted market assessment approach, expected cost plus a margin approach and a residual approach.
  - Exceptions to the principle of allocating the transaction price to all separate performance obligations within a contract on a stand-alone selling price basis exist for discounts and contingent consideration.

Allocate the transaction price

Step 4:

Allocate the transaction price

- **Discounts:** A discount shall be allocated entirely to one (or more) separate performance obligation(s) in the contract if both of the following criteria are met:
  - The entity regularly sells each good or service (or each bundle of goods or services) in the contract on a stand-alone basis; and
  - The observable selling prices from those stand-alone sales provide evidence of the performance obligation(s) to which the entire discount in the contract belongs.
- **Contingent consideration:** Consideration that is contingent on future events or circumstances should be allocated to a separate performance obligation when the following criteria are met:
  - The contingent payment terms for the distinct good or service relate specifically to the entity's efforts to transfer that good or service (or to a specific outcome from transferring that good or service); and
  - Allocating the contingent amount of consideration entirely to the separate performance obligation is consistent with depicting the amount of consideration to which the entity expects to be entitled in exchange for satisfying each separate performance obligation, when considering all of the performance obligations and payment terms in the contract.
- **Subsequent changes:** An entity shall allocate to the separate performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception.

Allocate the transaction price

Step 4:

Allocate the transaction price

Examples of issues that should be considered

- Would the ED require discounts to be allocated differently than under current practice?
- Are your stand-alone selling prices directly observable, or will you have to estimate them? In the latter case, how should the stand-alone selling prices be estimated?
- Should contingent consideration be allocated entirely to a separate performance obligation?

Recognise revenue when a performance obligation is satisfied

Step 5:

Recognise revenue when a performance obligation is satisfied

- **Why is this step important?** Determining when a performance obligation is satisfied triggers revenue recognition of the part of the transaction price allocated to this performance obligation.
- **What is the issue?** The issue is to determine when a performance obligation is satisfied. This first involves assessing whether the performance obligation is satisfied over time or at a point in time. If it is satisfied at a point in time, it should be determined when this is. If the performance obligation is satisfied over time, the measurement of progress towards complete satisfaction should be addressed. Finally constraints on the cumulative amount of revenue recognised should be considered when the transaction price is variable.

Recognise revenue when a performance obligation is satisfied

Step 5:

Recognise revenue when a performance obligation is satisfied

- **The performance obligation is satisfied over time** when at least one of the following two criteria is met:
  - the activities carried out by the entity create or enhance an asset which is controlled by the customer as the asset is created or enhanced; or
  - the activities carried out by the entity 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 re-perform the work the entity has completed to date if that other entity were to fulfil the remaining obligation to the customer. In evaluating this criterion, the entity shall presume that another entity fulfilling the remainder of the contract would not have the benefit of any asset presently controlled by the entity.
    - the entity has a right to payment for performance completed to date.
- 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.
- When an asset is satisfied over time, an entity shall recognise revenue over time by measuring progress towards complete satisfaction of that performance obligation. The objective when measuring progress is to depict the transfer of control of goods or services to the customer. Appropriate methods of measuring progress include output methods and input methods.

Recognise revenue when a performance obligation is satisfied

Step 5:

Recognise revenue when a performance obligation is satisfied

- **The performance obligation is satisfied at a point in time** if it is not satisfied over time. Revenue is recognised when the customer obtains control of the distinct asset (the distinct good or the service). Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the assets. Indicators of the transfer of control, includes, but are not limited to, the following:
  - the entity has a present right to payment;
  - the customer has acquired legal title to the asset;
  - the entity has transferred physical possession of the asset;
  - the customer has the significant risks and rewards of ownership of the asset;
  - the customer has accepted the asset.

Recognise revenue when a performance obligation is satisfied

Step 5:

Recognise revenue when a performance obligation is satisfied

- **Constraints on the cumulative amount of revenue recognised.** If the transaction price is variable, the cumulative amount of revenue the entity recognises to date shall 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:
  - the entity has experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities); and
  - 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.
- **Exception.** If an entity licences intellectual property to a customer and the customer promises to pay an additional amount of consideration that varies on the basis of the customer's subsequent sales of a good or service, the entity is not reasonably assured to be entitled to the additional amount of consideration until the uncertainty is resolved (i.e. when the customer's subsequent sales occur).

Recognise revenue when a performance obligation is satisfied

Step 5:

Recognise revenue when a performance obligation is satisfied

Examples of issues that should be considered

- Are the performance obligations satisfied over time or at a point in time?
- When are the performance obligations satisfied (for performance obligations satisfied at a point in time, the ’risks and rewards’ indicator is just one among several)?
- Do you have any performance obligations where the constraints on the cumulative amount of revenue will have an effect?
- Do you grant your customer the right to use, but not own, intellectual property? Often this performance obligation is satisfied when you provide the customer with the rights to use the intellectual property.
- Do you have any sales-based royalty type agreements?
- Do your contracts include repurchase agreements? Such agreements may result in an asset not being transferred to the customer.
- Do your contracts include customer acceptance clauses? Such clauses may defer revenue recognition until the customer has provided its accept.

Other general guidance

Scope: The following contracts with customers are excluded from the ED: lease contracts (within IAS 17), insurance contracts (within IFRS 4), contractual rights or obligations (within IFRS 9), and non-monetary exchanges between entities in the same line of business to facilitate sales to customers, or to potential customers, other than the parties to the exchange.

Onerous performance obligations: The onerous test is currently performed at the level of the contract. The ED proposes it to be at the performance obligation level. However, the test should be limited to performance obligations that are satisfied over time and that the entity expects at contract inception to satisfy over a period of time greater than one year. 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.

Consider whether you will have to recognise more or less onerous performance obligations (currently onerous contracts).

Contract costs: Guidance is provided for costs incurred in fulfilling a contract with a customer that are not included in the scope of another IFRS. An entity shall recognise as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. However, an entity may recognise the costs as an expense if the amortisation period of the asset , that the entity otherwise would have recognised, is one year or less.

Consider whether more contract costs should be capitalised.

Disclosure requirements

Objective: The objective of the disclosure requirements is to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

- **Contracts with customers**
  - a disaggregation of revenue for the period;
  - a reconciliation from the opening to the closing aggregate balance of contract assets and contract liabilities; and
  - information about the entity's performance obligations, including additional information about any onerous performance obligations.
- **Significant judgements, and changes in the judgements** made in applying the proposals that significantly affect the determination of the amount and timing of revenue from contracts with customers. At a minimum, an entity shall explain the judgements, and changes in the judgements, used in determining both of the following:
  - the timing of satisfaction of performance obligations;
  - The transaction price and the amounts allocated to performance obligations.
- **Any assets recognised from the costs to obtain or fulfil a contract with a customer.** A reconciliation of the opening and closing balances of assets recognised from the costs incurred to obtain or fulfil a contract with a customer, that are not covered by another standard.

The ED includes specific guidance on:

Licences and rights to use

Sales and repurchase

Breakage

Customer acceptance clauses

Consignment arragements

Options to acquire addition goods or services

Non-refundable upfront fees

Principal vs. Agent

Right of return

Warranties

Bill and hold arrangements