

## Revenue from Contracts with Customers

### EFRAG Outreach

The purpose of this document is to summarise the IASB's re-deliberations in relation to the Exposure Draft *Revenue from Contracts with Customers* (the 'ED') and thereby enable participants of the EFRAG outreach events to assess whether the concerns raised in relation to the ED have been solved.

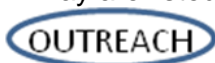
According to the IASB, the core principle is that revenue recognition should depict the transfer of goods or services in an amount that reflects the consideration expected to be received in exchange for those goods or services.

The IASB has identified the following steps to apply the core principle:

- 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.

On the following pages, the IASB's re-deliberations are summarised for each of these main steps. In addition, some main concerns raised in European constituents' comment letters to the IASB in response to the ED are summarised for each of the issues that have been re-deliberated. This summary only lists some of the concerns raised. In addition, it has not been the intention to indicate how many respondents shared a particular concern. Terms like 'European respondents' and 'some European respondents' therefore do not convey any information about how frequently a concern was expressed. Before considering re-deliberations related to each of the steps mentioned above, some general concerns from the European constituents' comment letters are, however, summarised. The last pages of this document include some specific issues and some examples illustrating the effects of a few of the re-deliberations.

On the following page, the issues that will be considered at the EFRAG outreach events in May are listed. These issues are also identified by the



logo on the following pages.

While particular issues have been selected for discussion, participants are also encouraged to express major concerns relating to any other issue regarding the IASB's re-deliberations at the events.

On the following page, a list of issues the IASB has yet to consider is also presented.

**Issues to be considered at EFRAG's outreach events**

<b>Step</b>	<b>Issue</b>
Identify the separate performance obligations	Separate performance obligations
Determine the transaction price	Collectability
	Time value of money
	Use of probability weighted amounts
	Limitations for uncertain amounts
Allocate the transaction price	Estimating stand-alone selling prices
Recognise revenue when a performance obligation is satisfied	Continuous transfer

**Issues not selected for discussion**

<b>Step</b>	<b>Issue</b>
Identify the contract(s) with the customer	Combining contracts
	Contract modifications
Identify the separate performance obligations	Definition of a performance obligation
	Marketing incentives
Allocate the transaction price	Allocation basis
	Performance obligations to consider
Recognise revenue when a performance obligation is satisfied	Transfer of control
	Collectability threshold
	Measurement of progress
Specific issues	Breakage
	Onerous test
	Customer's right to require repurchase
	Warranties
	Licences and rights to use
	Fulfilment costs

**Main issues yet to be considered by the IASB and FASB**

- Disclosures
- Transition methodology
- Effective date and early adoption
- Cost benefit considerations and other sweep issues
- Telecommunication entities (additional industry considerations)

## General concerns

### Comments

- No need for a new standard on revenue recognition.
- A thorough discussion and definition of the terms 'revenue' and 'performance' should be undertaken in advance of deliberations at standard level.
- The proposed model would not portray the economic activity and performance of the entity and as such would not result in decision-useful information.
- The proposed model will not improve the quality of information provided to users and simultaneously result in a large increase in costs, both for users and preparers of financial statements.
- The proposals are quite difficult to read and comprehend.
- Revenue recognition will follow arbitrary patterns.
- Revenue should not be recognised on the basis of transfer of control.
- It will be difficult to implement in practice, increases subjectivity and, as a result, will worsen comparability.
- The proposals will result in a separation of financial accounting and management control.
- The IASB should rigorously test whether the proposals are superior to those they replace and whether the proposals are capable of consistent and understandable application.
- The proposals may create a false impression of consistency and comparability. The proposals appear to allow or require more judgment and estimates, and provide opportunities for significant abuse.

### Re-deliberations

At its January 2011 meeting, the IASB affirmed the core principle in the exposure draft that an entity should recognise revenue to depict the transfer of goods and services to a customer.

Identify the contract(s) with the customer

→ Combining contracts

→ Contract modifications

## Combining contracts

### The ED

The ED required an entity to combine two or more contracts and account for them as a single contract, if the amount of consideration for goods or services in one contract was dependent on the amount of consideration for goods or services in another contract (the prices of the contracts being interdependent). The ED specified that the price of a contract was not interdependent with the price of another contract solely because the customer received a discount on goods or services in the contract, as a result of an existing customer relationship arising from previous contracts. The following indicators of one or more contracts having interdependent prices were included:

- the contracts are entered into at or near the same time;
- the contracts are negotiated as a package with a single commercial objective; and
- the contracts are performed either concurrently or consecutively.

### Concerns

European respondents thought the requirements were unclear as the guidance on when prices were interdependent was unclear. Particularly, respondents thought the guidance in an example (Example 2) in the application guidance seemed inconsistent with the specification in the ED, that a price of a contract was not interdependent with the price of another contract solely, because the customer received a discount on goods or services in the contract as a result of an existing customer relationship arising from previous contracts.

### Re-deliberations

At its February 2011 meeting, the IASB tentatively decided that an entity should combine, and account for as a single contract, two or more contracts that are entered into at or near the same time with the same customer (or related entities) 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 in one contract depends on the other contract; and
- the goods and services in the contracts are interrelated in terms of design, technology, or function.

## Contract modifications

### The ED

The ED required that an entity should account for a contract modification together with the existing contract, if the prices of the modification and the existing contract were interdependent. The ED listed the following indicators of two or more contracts having interdependent prices:

- the contracts are entered into at or near the same time;
- the contracts are negotiated as a package with a single commercial objective; and
- the contracts are performed either concurrently or consecutively.

### Concerns

European respondents thought the requirements were unclear as the guidance on when prices were interdependent was unclear. Particularly, respondents thought the guidance in an example (Example 2) in the application guidance seemed inconsistent with the specification in the ED, that a price of a contract was not interdependent with the price of another contract solely because the customer receives a discount on goods or services in the contract, as a result of an existing customer relationship arising from previous contracts.

### Re-deliberations

At its February 2011 meeting, the IASB tentatively decided that if a contract modification results only in the addition of a separate performance obligation or obligations at a price that is commensurate with that additional performance obligation, the entity should account for the contract modification as a separate contract. Otherwise, the entity should re-evaluate the performance obligation and reallocate the transaction price to each separate performance obligation.

Identify the separate performance obligations

→ Definition of a performance obligation

→ Separate performance obligations

→ Marketing incentives

## Definition of a performance obligation

### **The ED**

The ED defined a performance obligation as an enforceable promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer.

### **Concerns**

Among all the comment letters sent to the IASB (including non-European), a few respondents (primarily from the software industry) questioned why the definition of a performance obligation was limited to 'an enforceable promise' to transfer a good or service. They thought that limiting the definition of a performance obligation to 'enforceable' promises could result in an entity not accounting for promised goods or services that the customer reasonably expected to receive and was paying for (e. g. 'when-and-if-available' upgrades).

### **Re-deliberations**

At its February 2011 meeting, the IASB tentatively decided to amend the definition of a performance obligation by deleting the word 'enforceable'.

## Separate performance obligations



### The ED

The ED required a two-step approach for identifying separate performance obligations. Firstly, an entity should segment a single contract and account for it as two or more contracts, if the price of some goods or services in the contract was independent of the price of other goods or services in the contract. Criteria for when goods or services were priced independently were included in the ED. Secondly, within a contract, each promised good or service should be accounted for as a separate performance obligation, if they were to be considered distinct. It would be considered distinct if the entity, or another entity, sold an identical or similar good service separately, or the entity could sell the good or service separately because it had a distinct function and a distinct profit margin.

### Concerns

European respondents found the requirements unclear, complex and costly to apply. For example, it was considered unnecessarily complex to require a two-step approach and to consider what other entities sold separately. Not least in relation to construction contracts, concern was raised that the requirements would result in many separate performance obligations being identified. In addition, recognising revenue separately for each of these performance obligations would not reflect the overall profitability of a contract. Also, some respondents were concerned about (only) considering price interdependence as the criterion for separating contracts, and others thought that considering whether a good or service had a distinct profit margin was inappropriate for different reasons.

### Re-deliberations

At its January and February 2011 meetings, the IASB tentatively decided that the revenue standard should clarify that the objective of identifying separate performance obligations is to depict the transfer of goods or services and also the profit margin that is attributable to those goods or services. The IASB tentatively decided on a one-step approach, requiring an entity to account for a bundle of promised goods or services as one performance obligation, if the entity provides a service of integrating those goods or services into a single item that the entity provides to the customer. If goods or services are not linked by an integration service, an entity should account for them as a separate performance obligation if:

- the pattern of transfer of the good or service is different from the pattern of transfer of other promised goods or services in the contract, and
- the good or service is distinct.

A good or service is distinct if either:

- the entity regularly sells the good or service separately, or
- the customer can use the good or service either on its own or together with resources that are readily available to the customer.

## Marketing incentives

### **The ED**

The ED required that, within a contract, each promised good or service should be accounted for as a separate performance obligation, if they were considered to be distinct. They would be considered distinct if the entity, or another entity, sold an identical or similar good service separately, or the entity could sell the good or service separately, because it had a distinct function and a distinct profit margin.

### **Concerns**

European respondents did not think that marketing or promotional incentives should be considered as separate performance obligations. In particular, telecommunications entities did not think that a handset provided to a customer should be considered as a separate performance obligation.

### **Re-deliberations**

At its January 2011 meeting, the IASB tentatively decided that it was not necessary for the revenue standard to include additional requirements on accounting for perfunctory, incidental or other similar obligations (e.g. marketing incentives).

Determine the transaction price

→ Collectability

→ Time value of money

→ Use of probability weighted amounts

→ Limitations on uncertain amounts

## Collectability



### The ED

The ED required an entity to adjust the amount of promised consideration to reflect the customer's credit risk. Hence, when an entity satisfied a performance obligation, the entity should recognise revenue at the probability-weighted amount of consideration that the entity expected to receive. Once the entity recognised a receivable, the effects of changes in the assessment of credit risk should be recognised as income or expense rather than as revenue.

### Concerns

European respondents did not think that credit risk should be reflected in revenue. Some thought it should be reflected if the entity had adjusted the contract price for a specific customer to reflect that customer's credit risk – but revenue should generally not be adjusted to reflect the credit risk. Different reasons for not including credit risk in revenue were expressed. It was noted that the revenue figure would be most useful if it were to represent quantity multiplied by price. It was also pointed out that it would be costly for entities to reflect the credit risk in revenue because of the current IT-systems in place.

Some constituents were concerned that subsequent changes in the credit risk – before a receivable would be recognised (according to the ED a receivable should only be recognised for un-contingent rights to payments) should affect revenue. They thought this would create useless volatility in revenue. It was also thought to be unfortunate that changes in estimates of credit risk should affect different lines in the income statement depending on whether the criteria for recognising a receivable were met or not. It would often result in subsequent changes not being reflected in the revenue line where the initial estimation was included.

### Re-deliberations

At its March 2011 meeting, the IASB tentatively decided that an entity should not reflect the effects of a customer's credit risk in the measurement of the transaction price and, hence, revenue upon transfer of a good or service to the customer. Consequently, an entity would recognise revenue at the promised amount of consideration (i.e. at the stated contract price). An entity should recognise an allowance for any expected impairment loss from contracts with customers. The corresponding amounts in profit or loss should be presented as a separate line item adjacent to the revenue line item (as contra revenue).

## Time value of money



### The ED

The ED required an entity to adjust the amount of promised consideration to reflect the time value of money – if the effect was material. The discount rate to be used was the rate that would be used in a separate financing transaction between the entity and its customer. The requirement applied to both deferred consideration and amounts received in advance.

### Concerns

European constituents were concerned that the benefits of the proposal would not outweigh the costs. Especially it was thought to be very complicated to consider the time value of money in relation to multiple element contracts. To make the standard less costly for preparers, different kinds of simplifications were suggested by constituents. As a cost for users of financial statements, some constituents argued that reflecting the time value of money would result in more subjective figures in the financial statements, as the discount rate would be assessed by the management of the entity. Another comment raised was that payments before or after goods or services were transferred did not necessarily have to do with financing. Upfront payment could, for example, be required for protection reasons. Some constituents thought it was difficult to determine the discount rate, and therefore something like a simple fall-back option should be introduced. Finally, some thought that if the amount of promised consideration should be adjusted to reflect the credit risk, and if credit risk should also be considered when determining the discount rate, the credit risk would be 'double counted'.

### Re-deliberations

At its March 2011 meeting, the IASB tentatively decided that an entity should adjust the promised amount of consideration to reflect the time value of money if the contract includes a financing component that is significant to that contract. In assessing whether a contract has a significant financing component, an entity should consider various factors, including:

- whether the amount of customer consideration would be substantially different if the customer paid in cash at the time of transfer of the goods or service;
- whether there is a significant timing difference between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and
- whether the interest rate that is explicit or implicit within the contract is significant.

The IASB also tentatively decided that, as a practical expedient, an entity should not be required to assess whether a contract has a significant financing component if the period between payment by the customer and the transfer of the promised goods or services to the customer is one year or less.

## Use of probability weighted amounts

### **The ED**

The ED required that the transaction price should reflect the probability-weighted amount of consideration that an entity expected to receive from the customer in exchange for transferring goods or services.

### **Concerns**

European respondents were concerned about applying the probability-weighted-amount method to all cases. Some were against applying the method at all, while others thought it was appropriate under certain conditions (e.g. in situations with a large number of similar transactions and/or when the number of possible outcomes was high).

### **Re-deliberations**

At its April 2011 meeting, the IASB tentatively decided that when the customer promises an amount of consideration that is uncertain:

- an entity's objective when determining the transaction price is to estimate the total amount of consideration to which the entity will be entitled under the contract; and
- to meet that objective, an entity should estimate either of the following amounts depending on which is most predictive of the amount of consideration to which the entity will be entitled:
  - the probability-weighted amount; or
  - the most likely amount.

## Limitations for uncertain amounts



### The ED

The ED required that an entity should recognise revenue from satisfying a performance obligation only if the transaction price could be reasonably estimated. It was stated that the transaction price could be reasonably estimated only if both of the following conditions were met:

- the entity had experience with similar types of contracts (or access to the experience of other entities if it had no prior experience); and
- the entity's experience was relevant to the contract because the entity did not expect significant changes in circumstances.

The ED included a list of factors that reduced the relevance of an entity's experience.

### Concerns

European respondents within the pharmaceutical industry thought the ED would result in revenue from a licence being recognised when the licence was transferred to a customer, even when the transaction price was fully dependent on the sale to third parties that the customer would undertake, using the licence.

Some audit firms and organisations were concerned to include amounts of consideration, where the variability was within the control of the customer, in the transaction price.

Other respondents were concerned that the list of factors that reduced the relevance of past experience was overly restrictive – particularly in relation to long-term contracts containing, for example, escalation clauses.

### Re-deliberations

At its April 2011 meeting, the IASB tentatively decided that an entity should recognise revenue at the amount allocated to a satisfied performance obligation, unless the entity is not reasonably assured to be entitled to that amount. That would be the case in each of the following circumstances:

- the customer could avoid paying an additional amount of consideration without breaching the contract (e.g. a sales-based royalty);
- the entity has no experience with similar types of contracts (or no other persuasive evidence);
- The entity has experience, but that experience is not predictive of the outcome of the contract based on an evaluation of the factors proposed in the exposure draft (for example, susceptibility to factors outside the influence of the entity, the amount of time until the uncertainty is resolved, the extent of the entity's experience, and the number and variability of possible consideration amounts).

Allocate the transaction price

→ Allocation basis

→ Estimating stand-alone selling prices

→ Performance obligations to consider

## Allocation basis

### **The ED**

The ED required an entity to allocate the transaction price to all separate performance obligations in proportion to the stand-alone selling price of the good or service underlying each of those performance obligations at contract inception (i.e. on a relative stand-alone selling price basis).

### **Concerns**

European respondents were concerned that the proposed allocation method would allocate too much of a discount to low margin items and too little to high margin items. The approach could result in an onerous performance obligation being recognised for low-margin items (see, however, the section, 'Onerous Test' below). Some respondents thought that allocation of the transaction price should instead be based on margins, while others thought that discounts should be allocated to goods or services to which the discount related. Some respondents more broadly stated that the initial allocation of the transaction price, as well as subsequent changes, should reflect the economic substance. Entities within the telecommunication sector in particular (but also others) thought the allocation based on stand-alone selling prices would be costly.

### **Re-deliberations**

At its April 2011 meeting, the IASB discussed whether an entity should be permitted or required to allocate a discount in the contract to the performance obligations in proportion to the individual profit margin on each separate performance obligation, if a relative selling price allocation results in a loss on one or more performance obligations. However, this was not tentatively agreed.

## Estimating stand-alone selling prices

### **The ED**

It was stated in the ED that the best evidence of a stand-alone selling price was the observable price of a good or service when the entity sold that good or service separately. A contractually stated price or a list price for a good or service should not be presumed to represent the stand-alone selling price of that good or service. If a stand-alone selling price was not directly observable, an entity should estimate it. It was mentioned that suitable estimation methods included:

- expected cost plus a margin approach; and
- adjusted market assessment approach.

In the basis for conclusions related to the ED, it was noted that the residual method should not be used to allocate the transaction price to separate performance obligations. However, the residual method could be an appropriate method for estimating stand-alone selling price if there was a directly observable price for one performance obligation but not the other.

### **Concerns**

European respondents (most notably software developers – but also others) thought it should be possible to allocate the transaction price using the residual method. For software developers, it was difficult to determine a stand-alone-selling price of software sold together with other services, as the marginal cost of providing the customer with software, the entity had already sold to other customers, was very low, and its selling price could vary considerably depending on the circumstances it is sold under.

### **Re-deliberations**

At its April 2011 meeting, the IASB tentatively decided that if the standalone selling price of a good or service underlying a separate performance obligation is highly variable, the most appropriate technique to estimate a standalone selling price may be a residual technique. Using a residual technique, an entity would determine a standalone selling price by reference to the total transaction price, less the standalone selling prices of other goods or services in the contract.

## Performance obligations to consider

### The ED

The ED required an entity to allocate the transaction price to all separate performance obligations in proportion to the stand-alone selling price of the good or service underlying each of those performance obligations at contract inception (i.e. on a relative stand-alone selling price basis).

After contract inception, an entity should allocate any changes in the transaction price to all performance obligations on the same basis as at contract inception. Amounts allocated to satisfied performance obligations should be recognised as revenue, or a reduction of revenue, in the period in which the transaction price changed. An entity should not re-allocate the transaction price to reflect changes in stand-alone selling prices after contract inception.

### Concerns

European respondents thought that subsequent changes in the transaction price should be allocated to the performance obligations based on facts and circumstances.

Some European respondents thought that allocation should be limited to those performance obligations for which a stand-alone selling price was observable or existed.

### Re-deliberations

At its April 2011 meeting, the IASB tentatively decided that an entity should allocate a portion of (or a change in) the transaction price entirely to one, or more, performance obligations if both of the following conditions are met:

- the contingent payment terms of the contract relate specifically to the entity's efforts to satisfy that performance obligation, or a specific outcome from satisfying that separate performance obligation; and
- the amount allocated (including the change in the transaction price) to that particular performance obligation is reasonable relative to all of the performance obligations and payment terms (including other potential contingent payments) in the contract.

Recognise revenue when a performance obligation is satisfied

- Transfer of control
- Collectability threshold
- Continuous transfer
- Measurement of progress

## Transfer of control

### The ED

The ED required an entity to recognise revenue when it satisfied a performance obligation, which it did when the customer obtained control of the promised good or service. A customer obtained control of a good or service when it had the ability to direct the use of, and receive the benefit from, the good or service. The ED contained the following indicators of when the customer had obtained control: the customer has an unconditional obligation to pay, the customer has legal title, the customer has physical possession, and the design or function of the good or service is customer specific.

### Concerns

Concerns related to services and long-term contracts are summarised below under the section, 'Continuous Transfer'. Concerns related to royalty agreements are summarised above under 'Limitations for Uncertain Amounts'.

Respondents were concerned that the approach was legalistic and the same transactions would therefore be accounted for differently in different jurisdictions. Some noted that the model was inconsistent with the leases proposal, where 'risk and rewards' should also be considered.

### Re-deliberations

At its January 2011 meeting, the IASB tentatively decided that, in relation to the transfer of goods, it would carry forward most of the proposed guidance on control from the ED. However, it would:

- describe rather than define control;
- add 'risks and rewards of ownership' as an indicator of control; and
- eliminate the phrase, 'the design or function of the good or service is customer-specific', as an indicator of control.

## Collectability threshold

### **The ED**

The ED proposed that the transaction price should reflect the customer's credit risk if its effects on the transaction price could be reasonably estimated. Accordingly, the customer's credit risk should affect how much revenue an entity recognised when it satisfied a performance obligation, rather than whether the entity should recognise revenue.

### **Concerns**

Some European respondents noted that a criterion for a contract to exist was that the parties to the contract had approved the contract and were committed to satisfying their respective obligations. They thought it would be consistent with this requirement to include a threshold of collectability. Some thought it made more sense to consider collectability as a recognition issue, rather than as a measurement issue, as a customer would most often pay 100 percent or nothing at all. Others thought it was preferable to include a recognition threshold based on credit risk, as they thought it would be consistent with current requirements in IAS 18.

### **Re-deliberations**

At its March 2011 meeting, the IASB tentatively decided that the final revenue standard should not include a revenue recognition criterion that requires an assessment of the customer's ability to pay the promised amount of consideration.

## Continuous transfer



### The ED

The ED required an entity to recognise revenue when it satisfied a performance obligation, which it did when the customer obtained control of the promised good or service. A customer obtained control of a good or service when it had the ability to direct the use of, and receive the benefit from, the good or service. The ED contained the following indicators of when the customer had obtained control: the customer has an unconditional obligation to pay, the customer has legal title, the customer has physical possession, and the design or function of the good or service is customer-specific.

### Concerns

European respondents were concerned that the 'transfer of control' criterion did not work for services (for example transportation services). In addition, construction companies were concerned that the ED would prohibit or limit the use of percentage-of-completion (PoC) accounting for long-term contracts. The construction industry was, among other things, concerned that that implementation guidance seemed to imply that PoC accounting could be applied only if an entity could objectively determine that a good was provided in accordance with the agreed specifications. In addition, not all the indicators provided in the ED seemed to work well.

### Re-deliberations

At its February 2011 meeting, the IASB tentatively decided that an entity satisfies a performance obligation continuously if at least one of the following two criteria is met:

- the entity's performance creates or enhances an asset that the customer controls as the asset is being created or enhanced (this criterion was included to deal with the concern of the construction industry); or
- the entity's performance does not create an asset with an alternative use to the entity and at least one of the following conditions is met:
  - the customer receives a benefit as the entity performs each task;
  - another entity would not need to re-perform the task(s) performed to date if that other entity were to fulfil the remaining obligation to the customer; or
  - the entity has a right to payment for performance to date even if the customer could cancel the contract for convenience.

## Measurement of progress

### The ED

The ED required that when a good or service underlying a separate performance obligation was transferred to a customer continuously, an entity should apply to that performance obligation one revenue recognition method that best depicted the transfer of goods or services to the customer. The entity should apply that method consistently to similar performance obligations and in similar circumstances. The ED listed the output methods, input methods and methods based on the passage of time as suitable methods of recognising revenue to depict the continuous transfer of goods or services to the customer.

### Concerns

The ED's requirements on how to measure progress in the case of continuous transfer did not seem to be an essential issue in the comment letters from European constituents. Some US-based respondents thought, however, that the ED was too strongly biased towards output methods or was not sufficiently clear on which method an entity should select.

### Re-deliberations

In order to clarify how an entity should measure progress towards the complete satisfaction of a performance obligation, the IASB tentatively decided at its February 2011 meeting to:

- emphasise that the objective of measuring progress is to faithfully depict the entity's performance (i.e. the pattern of transfer of goods or services to a customer); and
- clarify the descriptions in the exposure draft of output and input methods.

The IASB also made a tentative decision in relation to situations where an entity merely procures goods that are transferred at a different time from related services (e.g. materials that the customer controls before the entity installs the materials). In those cases, an entity should measure progress by recognising revenue for the transfer of those goods in an amount equal to the costs of the transferred goods.

Specific issues

- Breakage
- Onerous test
- Customer's right to require repurchase
  - Warranties
  - Licences and rights to use
  - Fulfilment costs

## Breakage

### **The ED**

In some arrangements (for example a gift card) a customer makes non-refundable prepayments for future goods or services. The portion of the customer's rights that is not exercised is referred to as breakage.

The ED did not include explicit guidance on breakage.

### **Concerns**

European respondents did not generally raise any issues in relation to breakage. However, respondents from the U.S. thought guidance was needed on this issue.

### **Re-deliberations**

In February 2011, the IASB tentatively decided that if an entity can reasonably estimate the amount of expected breakage, the entity should recognise the effects of the expected breakage as revenue in proportion to the pattern of rights exercised by the customer. Otherwise, the entity should recognise the effects of the expected breakage when the likelihood of the customer exercising its remaining rights becomes remote.

## Onerous test

### **The ED**

The ED required an entity to recognise a liability and a corresponding expense if a performance obligation was onerous.

### **Concerns**

European respondents thought that the onerous test should not be performed at the level of a performance obligation. Instead it should be performed on a contract level. Respondents did not think it made sense to recognise a loss if a performance obligation within an overall profitable contract was onerous.

### **Re-deliberations**

In February 2011, the IASB tentatively decided that the unit of account for the onerous test should be the contract, specifically the remaining performance obligations in the contract.

## Customer's right to require repurchase

### **The ED**

The application guidance of the ED required an entity to account for a customer's unconditional right to require the entity to repurchase the asset (a put option) similarly to a sale of a product with a right of return.

### **Concerns**

The ED did not ask for input on this issue.

### **Re-deliberations**

At its April 2011 meeting, the IASB tentatively decided that, if the customer has a significant economic incentive to exercise a right to require the entity to repurchase a sold asset, the customer effectively pays the entity for the right to use the asset for a period of time. Consequently, the entity should account for the agreement as a lease. To determine whether a customer has a significant economic incentive to exercise their right, an entity should consider various factors, including the relationship of the repurchase price to the expected market value of the asset at the date of repurchase and the amount of time until the right expires.

## Warranties

### The ED

The ED required an entity to distinguish between the following types of product warranties:

- a warranty that provided a customer with coverage for latent defects in the product;
- a warranty that provided a customer with coverage for faults that arose after the product was transferred to the customer.

The first types of warranties did not give rise to a performance obligation, but required an evaluation of whether the entity had satisfied its performance obligation. The latter type of warranties gave rise to a performance obligation, in addition to the performance obligation to transfer the product specified in the contract.

### Concerns

European respondents thought that it was difficult in practice to differentiate between the two types of warranties. Various other ways to differentiate between different types of warranties were suggested. Some respondents thought that at least some warranties should be accounted for under IAS 37 rather than being considered as separate performance obligations.

### Re-deliberations

At its February 2011 meeting, the IASB tentatively decided that an entity should account for some warranties as a warranty obligation (i.e. as a cost accrual) in accordance with IAS 37. To determine which warranties an entity would account for as a cost accrual, the IASB tentatively decided that:

- if a customer has the option to purchase a warranty separately from the entity, the entity should account for the warranty as a separate performance obligation. Hence, the entity should allocate revenue to the warranty service.
- if a customer does not have the option to purchase a warranty separately from the entity, the entity should account for the warranty as a cost accrual, unless the warranty provides a service to the customer, in addition to assurance that the entity's past performance was as specified in the contract (in which case the entity would account for the warranty service as a separate performance obligation).

It was also tentatively decided to develop further the application requirements to help an entity to determine when a warranty provides a service to the customer in addition to assurance that the entity's past performance was as specified in the contract.

## Licences and rights to use

### The ED

The ED required an entity to distinguish between exclusive and non-exclusive rights. If an entity granted a customer a non-exclusive licence to use its intellectual property, it was stated that the entity had a performance obligation to transfer the licence which it satisfied when the customer was able to use and benefit from the rights. If an entity granted a customer an exclusive licence, it was explained that the entity had a performance obligation to permit the use of its intellectual property and it satisfied this continuously during the period in which the entity permitted the customer to use its intellectual property.

### Concerns

European respondents did not think exclusivity was the best factor for determining whether a performance obligation existed after the customer was able to use and benefit from the right transferred. Some thought that the requirements would conflict with the principle of the ED that revenue should be recognised when the customer obtained control. Others thought that the entity's involvement over the life of the contract better reflected whether a performance obligation existed after the customer was able to use the right. Some were concerned about developing requirements for how to account for licences for licensors without also considering licensee-accounting.

It was mentioned in some of the comment letters that the issue should be dealt with in a leases standard rather than in a standard on revenue recognition. Some thought that the issue should not be considered before the revision of IAS 38, in order to avoid inconsistencies.

(See also:

'Limitations for Uncertain Amounts' above)

### Re-deliberations

At its April 2011 meeting, the IASB discussed how an entity should account for contracts in which the entity grants a license or other rights to a customer. The IASB tentatively decided that the promised rights give rise to a performance obligation that the entity satisfies at the point in time when the customer obtains control (i.e. the use and benefit) of the rights. If there are other performance obligations in the contract, an entity should consider whether the rights give rise to a separate performance obligation or whether the rights should be combined with those other performance obligations.

## Fulfilment costs

### The ED

The ED required that if the costs incurred in fulfilling a contract did not give rise to an asset eligible for recognition in accordance with another IFRS, an asset should be recognised only if those costs:

- related directly to a contract (or a specific contract under negotiation);
- generated or enhanced resources of the entity that would be used in satisfying performance obligations in the future (i.e. costs relating to future performance); and
- were expected to be recovered.

### Concerns

European respondents did not think fulfilment costs should be addressed in a revenue recognition standard. In case such requirements should be included, they should result in the same outcome as current requirements.

### Re-deliberations

At its February 2011 meeting, the IASB tentatively decided that:

- An entity should recognise an asset for the incremental costs of obtaining a contract that the entity expects to recover. Incremental costs of obtaining a contract are costs that the entity would not have incurred if the contract had not been obtained.
- An asset recognised for the costs of obtaining a contract should be presented separately in the statement of financial position and be subsequently amortised on a systematic basis consistent with the entity's performance under the contract(s) to which the asset relates.

At its April 2011 meeting, the IASB discussed the accounting for costs of fulfilling a contract with a customer and affirmed the guidance proposed in the exposure draft subject to minor drafting improvements. Specifically, the IASB decided:

- not to amend the scope of the proposed guidance on fulfilment costs in the final standard;
- that the costs that relate directly to a contract include costs that are incurred before the contract is obtained, if those costs relate specifically to an anticipated contract.
- that the costs of abnormal amounts of wasted materials, labour or other resources that were not considered in the price of the contract should be recognised as an expense when incurred.

## Examples

The purpose of this section is to illustrate the outcome of the IASB's tentative decisions – or at least how these decisions could be interpreted. The illustrations are included for the purpose of stimulating a discussion. The examples are therefore not intended to reflect the most common situations – and some examples may reflect extreme cases. The examples have been prepared on the basis of the ED amended by the IASB's re-deliberations up until 1 April 2011.

### Marketing incentives

Entity A is issuing a well-known monthly magazine, A. The magazine is sold at bookstores, but it is also possible to subscribe to the magazine for two years. The subscription fee is 120 CU. As part of a campaign, the customer receives a watch with a stand-alone selling price of 20 CU when subscribing. The standalone selling price of the 24 magazines is 120 CU. The cost of the watch is 14 CU and the direct cost of producing 24 magazines is 50 CU.

Entity B is issuing a less known monthly magazine, B. The prices and costs of the magazine are identical to those of magazine A. However, the entity will have to provide subscribers with a more expensive watch – in order to encourage customers to choose magazine B instead of magazine A. The standalone selling price of this more expensive watch is 50 CU and it costs 28 CU.

In the first month, the entities recognise the following revenue for the first magazine sold under the subscription and for the watch:

	Entity A	Entity B
Revenue watch	17,14 CU	35,29 CU
Revenue first magazine	<u>4,29 CU</u>	<u>3,53 CU</u>
Total revenue:	21,43 CU	38,82 CU
Cost of watch	14,00 CU	28,00 CU
Cost of first magazine	<u>2,08 CU</u>	<u>2,08 CU</u>
Total costs	<u>16,08 CU</u>	<u>30,08 CU</u>
Margin	<u>5,35 CU</u>	<u>8,74 CU</u>

### Continuous transfer (1)

An entity is offering to host its customers' websites (this is done on different unspecified servers and is therefore not a lease agreement). The entity offers the customers a one-month 'full satisfaction or money back' guarantee. This means that every month a customer – without being obliged to give any reasons - can cancel their contract with the entity without having to pay anything for the service provided during that month. The entity has predictive experience with this type of contract.

The performance does not create an asset with alternative use to the entity and the customer receives a benefit as each task is performed. Accordingly, the entity should recognise revenue on a continuous basis, even when the customer is not obliged to pay for the service provided during a month.

### **Continuous transfer (2)**

An entity has entered into a contract to produce a set of identical assets specified by the customer. The specifications are quite demanding and it therefore takes the entity several years to construct the first assets meeting the specifications, while the following assets are produced faster. The customer is mainly interested in having his specified assets; it was therefore agreed during negotiations that the entity would be allowed to sell similar assets (or redirect assets under construction) to other customers, as long as it delivers the assets ordered by the customer. As the asset is representing the newest technology, it is possible for the entity to sell similar assets to other customers. According to the contract – and considering the facts and circumstances - the entity controls the assets until they are delivered to the customer. If the customer cancels the contract, the customer is, however, obliged to pay for assets under construction by the entity (up until the number of assets ordered by the customer).

As the entity's performance creates an asset with an alternative use to the entity and the customer does not control the asset being created, the entity cannot apply percentage-of-completion accounting for the assets constructed under the contract.

### **Continuous transfer (3)**

An entity is producing rather standardised goods of different sizes. A customer can choose among different variations. Production is not started until an order is received. When a customer orders a good, a metal plate is created with the number of the good which is fastened on the work-in-progress. The customer is informed about the number of the good and can follow the construction of the good on the internet (pictures of the customer's good in its current condition are taken every week). It is stated in the contract that, if the customer cancels the contract, the customer will have to pay for the work performed to date. However, as it is impossible to transport an incomplete good, the incomplete good will remain the property of the entity. Therefore, when a customer cancels a contract, the entity finalises the good and sells it to someone else. It is therefore quite profitable for the entity when a customer cancels his/her order. Sometimes, customers cancel their orders, but it does not happen often. When it happens, it often happens early in the process because the customer has decided on a bigger good.

The performance of the entity does not

- create or enhance an asset that the customer controls, as the asset is being created or enhanced; and does not
- create an asset that has no alternative use for the entity.

Accordingly, the entity cannot apply percentage-of-completion accounting. Instead, the construction of the goods is considered to be the production of inventory and the revenue should not be recognised until control of the goods is transferred to the customer.

**Continuous transfer (4)**

The facts are identical to those in the example ‘Continuous transfer (3)’, however, now the good produced would not have an alternative use if the customer were to cancel the contract. In this case, the entity is creating an asset with no alternative use for the entity and as the entity has a right to payment for performance to date, even if the customer could cancel the contract for convenience, the entity should apply percentage-of-completion accounting when producing the good.

**Breakage**

An entity sells a gift card to a customer for 100 CU. The customer (or the person the customer gives the gift card to) can use the gift card to buy goods with a total selling price of 100 CU from the entity’s shops. Based on historical experience with similar gift cards, the entity can reasonably estimate the amount of expected breakage to 10 percent or 10 CU. Unredeemed gift card balances are not subject to escheatment laws. Accordingly, when the gift card is used to purchase goods with a selling price of 45 CU, the entity would recognise revenue of 50 CU.

Revenue from transfer of goods	45 CU
Breakage revenue (10 CU * 45 CU/(100 CU – 10 CU))	5 CU
Total	50 CU

**Onerous test and separate performance obligations (1)**

A fictive company sells X-brand tablet PCs, together with a satellite internet subscription of two years. The tablet PC can be used on its own (so can the mobile satellite internet subscription) and the tablet PC is therefore a separate performance obligation. In order to be able to use the satellite internet provided by the telecommunications company, the customer receives a special USB device. This device has no distinct function. Accordingly, two performance obligations exist:

- (a) the tablet PC; and
- (b) two years of access to the internet via satellite (subscription + USB device).

Revenue of 60 CU is allocated to the tablet PC and revenue of 150 CU to the two year access. The cost of the tablet PC is expected to be 30 CU and the cost of the USB device is 100 CU.

After the contract is signed, the company orders the tablet PC. However, due to a shortage, the cost of the tablet PC is 75 CU. The contract as a whole is, on the other hand, still profitable. When the tablet PC is transferred to the customer, the company recognises a loss as the cost of the tablet PC is higher than the revenue allocated to the tablet PC.

**Onerous test and separate performance obligations (2)**

The facts are identical to those in the example 'Onerous test and separate performance obligations (1)'. However, in this case the cost of the USB device turns out to be 160 CU. At contract inception, the entire contract is profitable. However, when the tablet PC has been transferred to the customer, a liability would be recognised for the remaining performance obligations within the contract.