

# IFRS news

Emerging issues and practical guidance\*

Issue 72 – March 2009

## Reporting entity takes shape at the IASB

Partner in the Global Accounting Consulting Services central team and *IFRS news* publisher Mary Dolson looks at how some of the forthcoming standards might align the reporting entity with the business model.

The successful completion of three current projects (and a possible fourth) would constitute a reshaping of the reporting entity. The projects are:

- ED 9, 'Joint activities': a standard expected mid 2009.
- ED 10, 'Consolidated financial statements': standard scheduled for early 2010.
- Derecognition: ED expected in April 2009; standard scheduled for 2010.
- The possibility of a project on equity accounting.

Will the changes resulting from these projects align the reporting entity more closely with the business model seen through management's eyes?

Some of the changes are predictable, but others are less clear. The finalisation of ED 9 will see the end of proportionate consolidation as a policy choice. Proportionate consolidation is often used with a business model based on cooperation with local partners or for projects that are both risky and expensive with no single entity able to absorb the risk or supply the capital. Adoption of the dual model (own assets, liabilities and equity for the residual) or equity accounting will be mandated.

The current projects on consolidation and derecognition at the IASB pre-dated the current economic crisis but were accelerated as a consequence of it. Planned discussion papers were scrapped for both. These projects grapple with a fundamental question in accounting: what's in the reporting entity and what's not?

ED 10 proposes a single, control-based model. Observers seem split: some reject the proposals, calling for more disclosure immediately and further consideration of other changes; others see the potential to improve practice and eliminate some diversity. ED 10 sought comments on equity accounting, with the tantalising possibility that IAS 28, 'Investments in associates', poised awkwardly between a collapsed consolidation and a financial asset, could be up for improvement.

The derecognition project is expected to result in an exposure draft with, unusually, two models. The exposure draft is expected to have a 120-day comment period, and the IASB is planning roundtables.

These projects are an opportunity to reshape the reporting entity. The accelerated timetable presents a real challenge, with major projects moving straight to exposure drafts. A good result is crucial for high-quality financial reporting.

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## Proposals for revenue recognition – an overview



The IASB issued the long-awaited revenue recognition discussion paper in December 2008. Mark Lohmann and Katie Woods in PwC's Global Accounting Consulting Services provide some background to this paper and outline the key issues. This month's *IFRS news* supplement, 'The future of revenue recognition' contains more detail of the proposed requirements.

This joint IASB/FASB project sits near the top of the convergence road-map of 'projects to be finalised by 2011'. A converged revenue standard would go some way to eliminate the 200 different pieces of US accounting guidance on revenue recognition as well as existing IFRS guidance in IAS 18, 'Revenue' and IAS 11, 'Construction contracts'. There is a perception that US guidance is voluminous and the IFRS guidance seems to lack guidance or be inconsistent. For example, IFRS lacks guidance in identifying and measuring components in multiple-element arrangements.

### What are the main proposals?

Revenue recognition will be based on the changes in contract assets and liabilities using a single contract-based revenue recognition model. All revenue contracts (with the possible exception of contracts for financial instruments, insurance and leasing) will apply the same revenue recognition model. The contract is comprised of contract assets (the right to receive payment) and contract liabilities (the obligation to perform under the contract). Revenue is recognised when either the net contract liability is reduced or the net contract asset has increased, both as a result of the entity discharging its contract liabilities by performing.

This may make sense conceptually; however, the practical reality is more complicated. The first area to consider is what the proposals mean by 'performing'. Each contract will need to be broken into performance obligations (the promise to transfer an asset – either a good or service). Revenue is recognised as control of the promised asset for each of the obligations is passed from the seller to the buyer. Performance obligations are similar to the concept of separable deliverables and components of an arrangement but may be wider than those seen in current practice. Then there is the concept of control: how does it compare with current requirements?

An example of the impact of using change in control to recognise revenue is seen when looking at construction contracts and,

where applicable, service contracts. These have historically been accounted for under the percentage-of-completion method. This method will no longer exist. Revenue in such arrangements will be recognised based on transfer of control. If control passes during the period of construction or service (referred to as continuous transfer), revenue recognition is likely to be similar. If it does not, revenue will be deferred until the customer takes control of the asset. For example, a ship yard building a ship often applies percentage-of-completion accounting and recognises revenue as the ship is built. Under the proposed model, the control of the ship transfers when it is finished. The building of the ship represents inventory, and revenue is recognised when the ship is complete and control is transferred to the customer.

Risk and reward transfer will no longer be relevant in assessing whether revenue should be recognised. Other criteria used today such as acceptance of the good, customer intent or payment terms will only assist in identifying when control has been transferred. The singular focus on transfer of control could result in a legalistic approach to revenue recognition.

Another significant area of change is in relation to costs. The proposed standard does not intend to give any guidance on cost recognition. Management will be required to look to other standards (IAS 2, IAS 16 and IAS 38) to determine how costs are accounted for.

Some areas are not covered by the discussion paper, such as measurement of the contract asset (including impact of time value of money and contingent consideration), contract modifications, presentation and disclosure and application guidance on the identification, satisfaction and measurement of performance obligations. The Board will continue to discuss these during the DP's comment period.

The deadline for comments is 19 June. Preparers and users should consider the impact that these proposals will have, as changes in the accounting for revenue could impact nearly all entities.

### IFRS transition guidance for technology sector



PricewaterhouseCoopers technology group has released guidance on transition to IFRS for the industry in the US.

*Navigating the Move to IFRS: Global Insights for Technology Companies* explores the key accounting topics that are most relevant to

technology companies and potentially complex areas of difference between US GAAP and IFRS. These include revenue recognition, research and development, share-based payments and income taxes.

Contact your local PwC office to order hard copies. The PDF can be downloaded from [www.pwc.com/technology](http://www.pwc.com/technology)



## Beginners' guide: debt or equity?

You may stay awake at night worrying about the economy or whether your children will get into university. But maybe there's something else that should be occupying your mind – is it debt or is it equity? Marie Kling and Tina Farington of PricewaterhouseCoopers' Accounting Consulting Services in the US give you something else to worry about in this beginner's guide to debt and equity.



Common shares that give a residual interest in an entity are equity and a standard-term loan offered by a bank is debt (financial liability). Between these two simple points lies a host of instruments for which the question "Is it a financial liability or is it equity?" can be more challenging to answer, particularly as many entities look to shore up their balance sheets as a result of recent market events. Many performance indicators and lending covenants are measured by these accounting concepts. The distinction is also important because changes in the value of equity are not recorded in the financial statements, but subsequent changes in the value of a financial liability will affect the income statement. Re-measurement of a financial liability in these turbulent times can create significant income statement volatility.

Given the potential consequences, management should not underestimate what may seem like a simple question, as the guidance can sometimes be challenging to navigate.

### Defining financial liability and equity

Assets minus liabilities equals equity, meaning equity is generally understood as a residual concept. This concept is also embedded in the financial instruments guidance. IAS 32, 'Financial instruments: Presentation', provides a definition of a financial liability, and equity is considered to be the residual. How do these concepts work in practice?

#### *Financial liability – a contractual obligation to pay cash*

A financial liability is a contractual obligation to deliver cash or another financial asset, which an entity cannot avoid. This obligation can be created in a number of ways.

The obligation may be a simple one to pay cash on specified dates in the future in exchange for cash received today. For example, an entity issues a bond for C100 that pays interest of 10% annually until it matures in 10 years. At the end of the 10 years, the principal will be repaid. The instrument is a financial liability from management's perspective. The entity is contractually obliged to pay cash for the interest and principal.

The obligation to pay cash may occur at unspecified dates in the future. For example, an instrument may have features that allow for early repayment. A bond may be issued with a 'call' feature that allows the entity to call the debt and pay the holder. For example, the instrument may also contain a 'put' that allows

the holder to ask for repayment. This instrument is also a financial liability\* despite the uncertainty about when the principal will be repaid.

Finally, the obligation to pay cash may occur as a result of an event that is outside the control of entity and the investor. For example, an entity issues an instrument that is repayable in cash if the entity does not achieve a successful listing on the local stock exchange by a specified date. The entity is obliged to pay cash if the successful listing does not occur. This instrument is also a financial liability.

#### *Equity – residual interest in the entity's assets*

Equity is the interest remaining in the entity's assets after deducting all the liabilities. In other words, the instrument is equity if the entity is not required (but may choose) to pay out cash or another financial asset. For example, an entity issues shares; the dividends are only payable when declared by the board of directors. The entity can pay dividends and can choose to buy back shares (a treasury share transaction). Investors may expect dividends and/or shares to be bought back, but the entity is not obliged to do either. The market may 'punish' a stock that is not paying dividends, but this does not create an obligation. The instrument meets the definition of equity, as the entity has discretion over the dividend payments and it cannot be forced to 'redeem' the shares.

#### *Rules on substance of the contract*

The substance of a contractual arrangement determines whether or not the entity is obliged to pay cash. It might make 'sense' for an entity to pay dividends or buy back the instrument, but it is not mandatory. An instrument might have a feature that creates an economic incentive or punishment for the entity to make a payment or redeem the instrument. This 'economic compulsion' is not relevant to the classification as equity or financial liability. For example, an entity issues a preferred share with a fixed dividend of 5% of the face amount that can be deferred indefinitely. The dividend increases to 25% if the entity does not call the instrument by a certain date. The entity may be economically compelled to call the instrument before the date the dividend payment escalates to 25%. However, there is no contractual obligation to exercise the call and redeem the instrument or to pay the higher amount of dividend. The instrument is therefore equity.

\* A narrow subset of redeemable instruments can be classified as equity if they meet certain strict criteria. The instrument amongst other criteria must be the most residual instrument that the entity issues. Many instruments that can be put back to the entity for cash are likely to continue to be classified as financial liabilities.

### Settlement in shares, not always equity

Instruments are sometimes settled using the company's own shares rather than cash. Even though the company delivers its own shares to settle the instrument, the instrument does not necessarily meet the definition of equity. It is the type of settlement that determines whether or not the instrument is equity. Only instruments that are settled by delivering a fixed number of shares in exchange for a fixed amount of cash meet the definition of equity. This is commonly referred to as the 'fixed-for-fixed' principle.

So, in other words, an instrument is a financial liability if any of the features are present:

- The number of shares to be issued is variable;
- The amount of cash that will be paid is variable; or
- The instrument is settled 'net' (ie, for either cash or shares).

For example, management issues a warrant that allows the investor to receive 100 shares at an exercise price of C5 per share. The entity is obliged to deliver its own shares when the investor exercises the warrant. This instrument meets the definition of equity because the entity will deliver a fixed number of shares (100) and receive a fixed amount of cash (C500).

Another example is a warrant that can be net settled with shares. That is, if the fair value of the shares at the date of exercise of the warrant is C150 and the exercise price of the warrants is C100, the net difference of C50 is settled in shares. The number of shares will vary according to the fair value of the shares at the date of exercise. The instrument does not meet the fixed-for-fixed principle and is therefore a financial liability.

Instruments with provisions that can adjust the amount of cash or the number of shares to be delivered need to be carefully analysed – they are likely to violate the fixed-for-fixed principle. Settlement choices by either the entity or the investor also fail the fixed-for-fixed principle for equity classification.

### Compound instruments

Some instruments are either a financial liability or equity in their entirety, but other instruments may have elements of both. These instruments are referred to as compound instruments; the financial liability and equity component are accounted for separately.

This concept is particularly important when dealing with instruments such as convertible bonds, where the investor is able to convert the bond into shares rather than receive the principal paid in cash upon maturity. The key point with these instruments is to look at each feature and determine the classification of each of the features based on the basic principles described above.

For example, management issues a 10-year convertible bond for C100 million, which pays mandatory interest of 3%. The bond allows the holder to convert the C100 million into ordinary

shares at a ratio of 10 shares per C1,000. The bond has two features: (1) a conversion option into shares; and (2) an obligation to pay cash for the interest and principal of the bond (the principal being repaid if the bond is not converted). The bond has characteristics of both a financial liability and equity. The obligation to redeem the bond and the mandatory 3% interest payments are accounted for as a financial liability. The equity conversion option meets the fixed-for-fixed principle, so it is accounted for as equity.

The fair value of the financial liability is determined first, and the residual is recorded as equity. Cash received from the investors less the fair value of the liability equals the equity portion. The liability's fair value is determined by discounting the stream of cash flows using a current market rate for a similar liability that does not have the conversion feature. The concept is to measure what the cost would have been for the financial liability component.

The interest on the convertible instrument in the example is 3%, but a similar instrument without the conversion feature may pay a market rate of 5%. This means that the cash flows would be discounted using the 5% rate. So, if management issued the instrument for C100 million, and the fair value of the liability component is C80 million, the residual is recorded in equity at C20 million. Management will need to accrete the liability component back to its par value of C100 million, so the interest expense recognised in the income statement will be higher than if it had been accounted for as one instrument using the stated rate of interest.

A non-convertible instrument may also have both a debt (financial liability) and an equity component, such as mandatorily redeemable preferred stock that pays discretionary dividends. The mandatory redemption feature is a financial liability and the discretionary payment of dividends is an equity component.

### In summary

Classification as a financial liability or equity will have significant consequences for the accounting, calculation of performance ratios and determination of lending covenants. All of the terms and conditions should be carefully considered when classifying an instrument as a financial liability or equity. As with all of the beginner's guides, consultation with an expert is advisable, as many financing arrangements come with different bells and whistles that create complexity and need to be carefully assessed.

Three points to start with when considering classification are:

- A contractual obligation to pay cash, even if contingent on a future event, results in financial liability classification.
- Instruments settled in the entity's own shares are classified as equity only if the exchange results in the delivery of a fixed number of shares for a fixed amount of cash.
- Instruments that contain both financial liability and equity components are accounted for separately.

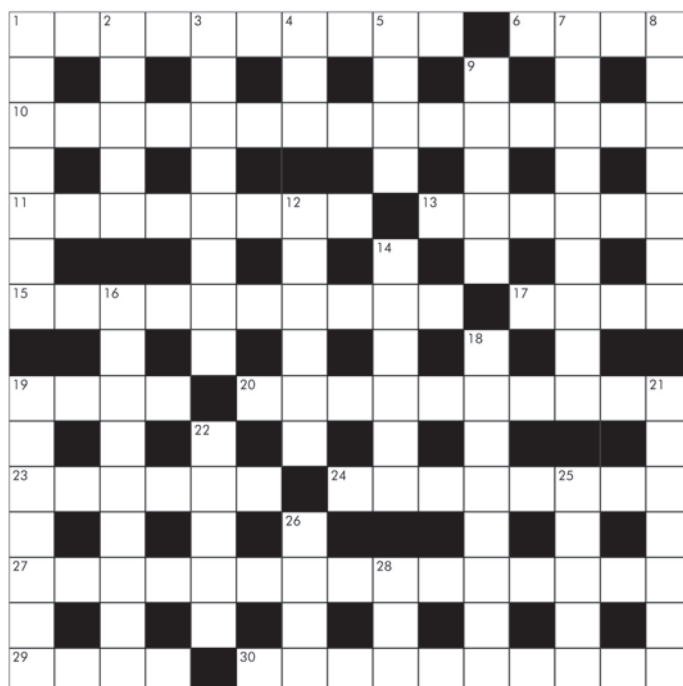
# Crossword

## Across

- 1 Financial instrument whose value is based on another security (10)  
 6 Operating at a \_\_\_\_, resulting in 1 down (4)  
 10 One whose business is the management of burial and cremation services (7,8)  
 11 Profit is an opinion, while this is a fact (4,4)  
 13 Monetary, of public revenue (6)  
 15 Napkins, serviettes, etc. (5, 5)  
 17 As scarce as hens' teeth in the current environment (4)  
 19 Hundredth part of various monetary units (4)  
 20 One of the salads eaten in Passover-time in the Old Testament (6,4)  
 23 Basic functional unit of the nervous system (6)  
 24 Condemned to misery or destruction (8)  
 27 Understanding between Britain and France in 1904 (7,8)  
 29 Lack of something that one really cannot do without (4)  
 30 Last year's business combination, this year's goodwill \_\_\_\_\_ (10)

## Down

- 1 Excess of liabilities over assets (7)  
 2 Rows of soldiers standing side by side (5)  
 3 Testified and established the truth (8)  
 4 Sesame, a type grown in India (3)  
 5 Not binding in law (4)  
 7 Part of mid-brain that is concerned with sight (5,4)  
 8 Excess of income over expenditure (7)  
 9 Pacioli said that for every credit should have one (5)  
 12 Starting-point from which measurement is made (6)  
 14 Characterised by extreme activity and excitement (6)  
 16 Raised step behind a rampart (9)



- 18 Ball that keeps low (8)  
 19 See 22 down  
 21 It is unlikely to be repaid (3,4)  
 22 & 19 down Successful business activity (5,7)  
 25 Individual portion of capital stock of a corporation (5)  
 26 Length of time to repayment of a loan (4)  
 28 Female reproductive cells (3)

**Crossword solutions**  
 Across: 1 Derivative; 6 Loss; 10 Funeral director; 11 Cash flow; 13 Fiscal; 15 Table linen; 17 Jobs; 19 Cent; 20 Bitter herb; 23 Neuron; 24 Accused; 27 Entente Cordiale; 29 Need 30; Impairment.  
 Down: 1 Deficit; 2 Ranks; 3 Verified; 4 Tip; 5 Void; 7 Optic lobe; 8 Surplus; 9 Debit; 12 Origin; 14 Hectic; 16 Banquette; 18 Grander; 19 Concern; 21 Bad debt; 22 Going; 25 Share; 26 Term; 28 Ova.

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# IFRS news

## Emerging issues and practical guidance\*

Supplement – March 2009

### The future of revenue recognition

The IASB and FASB's joint revenue project will have a significant impact on entities' revenue recognition policies. Management needs to look at the implications for their business functions. This supplement addresses some of the detail in the main proposals.

The IASB and the FASB published the discussion paper (DP) on their joint revenue recognition project in December. Their objectives are to converge US and IFRS standards on revenue recognition; eliminate existing inconsistencies and weaknesses; and reduce the voluminous sources of US revenue guidance.

The DP contains preliminary views on a contract-based revenue recognition model. It does not include all of the guidance expected in the future proposed standard, but it provides views on the basic revenue recognition model. The timing for an exposure draft has not yet been determined, but a project completion date of 2011 is expected.

## Overview

- The IASB and the US FASB have proposed a new revenue recognition model that will have a significant impact on current revenue recognition policies for IFRS and US GAAP reporters.
- Every industry within the scope of the project may be impacted to some extent. Some entities, particularly those that have historically followed industry-specific guidance under US GAAP, will see pervasive changes.
- A single, contract-based, asset and liability model is proposed, where revenue is recognised based on increases in contract assets or decreases in contract liabilities.
- Companies should analyse the impact of this model on current business activities; including contract negotiations, budgeting and information technology.

#### Insight

Start now. Companies should analyse the proposed changes in the revenue recognition model to understand the potential impact on their businesses. Comments made by preparers and users of financial statements at the discussion paper stage are more likely to result in modifications than comments made closer to final publication.

#### Key provisions

##### *Asset and liability model*

The proposed model employs an asset and liability approach, the cornerstone of the IASB's and FASB's conceptual frameworks. Current revenue guidance focuses on an earnings process, but difficulties often arise in determining when revenue is earned. The Boards believe a more consistent application can be attained by using a single contract-based model where revenue recognition is based on changes in contract assets and liabilities.

##### *Scope – contracts with customers*

The proposed model focuses on an entity's contracts with its customers. A contract is defined as 'an agreement between two or more parties that creates enforceable obligations'. A contract can be written, verbal, or otherwise evidenced, either explicitly or implicitly. The definition suggests that a contract exists if an enforceable obligation is created.

Industry-specific contracts are not excluded from the proposed model. Questions have been raised, however, as to whether the proposed model would provide useful information for certain types of contracts such as:

- Contracts for financial and some non-financial instruments;
- Insurance contracts; and
- Leasing contracts.

### Contract assets and liabilities – the principle

A contract with a customer includes rights to receive consideration and obligations to provide a good or perform a service. The entity has a net contract asset when the rights exceed the obligations. The entity has a net contract liability when the obligations exceed the rights.

The underlying principle in the proposed model is that revenue is recognised when a contract asset increases or a contract liability decreases. An entity's net asset or net liability in a contract can change for a variety of reasons. For example, when consideration is received from a customer, the entity's contract asset decreases because its right to receive payment has decreased. When an entity satisfies an obligation, such as through the delivery of goods or services, its contract liability decreases because it no longer needs to provide those goods or services.

### Identification of performance obligations

A performance obligation is a promise to transfer an asset (either goods or services) to a customer. Performance obligations are often stated in a contract but may arise in other ways. Legal requirements, such as local law requiring an entity to warrant a product, may create performance obligations. A performance obligation may also be created constructively through customary business practices, such as an entity historically providing warranty services to all customers. An enforceable promise to transfer an asset to a customer, whether explicit or implicit, is therefore a performance obligation.

The objective of identifying and separating performance obligations is to ensure that an entity's revenue is recognised when goods and services are transferred to the customer. Even a simple contract may include many performance obligations; identifying and separating those obligations may be challenging. Separation of a contract into performance obligations is therefore needed only when the customer is to receive the promised assets at different times.

#### Insight

A performance obligation is similar to the current concepts of a 'deliverable', 'component' or 'element', but the notion of a performance obligation has a significantly wider range. Components will not need to have 'standalone' value to the customer in order to be accounted for separately. For example, legal requirements such as warranties could be performance obligations, as could customary business practices, such as rights of return. Guarantees, which currently may preclude revenue recognition, could also create separate performance obligations.

### Satisfaction of performance obligations – when revenue is recognised

Revenue is recognised as performance obligations are satisfied. This occurs when control of the asset is transferred to the customer. Control of a good typically transfers when the customer takes physical possession. However, control may transfer to the customer before physical possession (for

example, certain 'bill-and-hold' arrangements). Control of a service asset normally transfers when the service is performed, either as the service enhances a customer's existing asset or represents a benefit the customer consumes immediately.

#### Insight

The singular focus on transfer of control in determining when revenue is recognised is a significant change to existing models. Current revenue standards also consider other criteria, such as when risks and rewards are transferred to the customer or when collectibility is reasonably assured. This change could have a considerable impact on the timing of revenue recognition if control of an asset transfers at a different time from risks and rewards.

Timing of revenue recognition may vary depending on whether a contract is for the delivery of a good or performance of a service: a good is typically transferred at a point in time; a service is typically transferred over the contract term.

In some contracts, an entity promises to transfer goods to a customer in connection with a service. For example, an entity may enter into a contract to paint a house and the paint is delivered to the house in advance of the painting taking place. Should the entity recognise revenue for the paint when it is delivered or as the paint is used? It may be difficult to determine when an asset is transferred if that asset is used in satisfying a future performance obligation. It is therefore presumed that an asset used in satisfying a future performance obligation is not transferred to the customer until used. This presumption can be overcome if the contract terms or local law clearly indicate that the asset has been transferred to the customer before being used to satisfy other obligations.

Customer acceptance, intent and payment terms may help determine when a performance obligation is satisfied.

- Contract terms may specify that payment is only due once the asset is formally accepted. When goods have been delivered to the customer in accordance with contract specifications, written acceptance may only be a formality and would not prevent revenue from being recognised upon delivery.
- Customer intent alone does not impact when a performance obligation is satisfied. However, contract negotiations may reflect the customer's intent by specifying when control transfers and thus when performance obligations will be satisfied. Consider a manufacturer that sells computers. The customer does not intend to use each of the individual components separately (for example, monitor, keyboard and mouse), but the contract could stipulate that the components are delivered at separate times. If delivered separately, revenue is recognised for each item upon delivery as a performance obligation has been satisfied. If the contract stipulates that control over all components does not transfer until the final component is delivered, revenue is not recognised until the final component is delivered.

- Customer payment terms and the customer's ability to recover those payments may help to determine whether an asset has been transferred. If an entity enters into a service contract that requires non-refundable progress payments during the contract, this may indicate that the partially completed asset transfers to the customer as the contract progresses.

#### Insight

The preliminary views around customer acceptance, intent and payment terms illustrate that the transfer of control is critical to the timing of revenue recognition. The inability of a customer to use an asset that has been received does not affect revenue recognition unless the parties agree that control is not transferred. The pattern of customer payments only impacts revenue recognition to the extent it is an indicator that transfer of control over an asset has occurred (for example, when non-refundable payments are made).

#### Measurement of performance obligations

Performance obligations are initially measured using an original transaction price approach, which reflects the consideration the customer promises to pay in exchange for goods or services. The discussion paper does not express a preliminary view on how an entity measures a contract right (asset), but the guidance is expected to be based on the transaction price. The time value of money and any uncertainties, such as contingent consideration, will also need to be addressed. Because contract rights and performance obligations are expected to be based on the transaction price, an entity's net position in the contract is nil at contract inception. No revenue would be recognised at contract inception as no performance obligations have been satisfied.

#### Insight

Measurement of a transaction price is straightforward when the consideration in the arrangement is a fixed amount of cash but is more complex when there is uncertainty as to the total amount to be paid, such as when a portion of the consideration is contingent on a future event. The Boards will therefore continue to discuss what impact such complexities may have on the measurement of contract rights.

When a contract contains multiple performance obligations, contract consideration is allocated to the separate performance obligations based on relative standalone selling prices. The best evidence of standalone selling price is the price charged by the entity for separately selling the good or service. Management should estimate the selling price if separate selling prices are not available. No estimation method is prescribed nor is any particular method precluded, but any estimation method should maximise the use of observable inputs. Examples of estimation methods provided include expected cost plus a margin or the price a market participant would be willing to pay.

#### Insight

The proposal allows allocation of consideration only on the basis of relative standalone selling prices. This is consistent with current practice where the fair value of all components is known and any discount in the transaction is allocated ratably to the components. The proposal precludes other allocation methods, including the residual method.

The proposal would require a price to be estimated when standalone selling prices are not available. Deferral of revenue due to an inability to estimate selling price or due to restrictions imposed by current standards (for example, vendor specific objective evidence (VSOE) or vendor objective evidence (VOE)) is no longer allowed.

Initial measurement of performance obligations using fair value or exit price has tentatively been rejected. Reasons given include:

- The pattern of revenue recognition and, in particular, the potential for recognition of a contract asset and revenue at contract inception;
- Complexity due to difficulties in measuring the exit price; and
- The risk of errors in identifying and measuring performance obligations.

Subsequent to initial measurement, revenue is recognised as the entity satisfies its performance obligations. The amount of revenue recognised is equal to the transaction price allocated to such performance obligations at contract inception.

Measurement of performance obligations is not reassessed after contract inception unless those obligations become onerous. A contract is onerous when the expected costs to satisfy a performance obligation exceeds that performance obligation's carrying amount. An onerous contract is remeasured to the entity's expected cost of satisfying the performance obligation and a loss is recognised.

There is some debate over whether performance obligations should be remeasured only when they are onerous. There are concerns that useful information will not be provided to investors in situations where outcomes are highly variable due to volatile prices or where significant changes in circumstances are likely, such as certain insurance contracts.

#### Insight

The proposal only outlines initial views over when an obligation becomes onerous and the subsequent implications. An onerous test similar to the one currently used may be adopted. However, all practical aspects of accounting for onerous obligations have not yet been fully explored; there may be additional changes to the proposal in this area.

### Potential effects on current practice

The proposed model has similarities to the concepts of revenue recognition under existing standards, but there are a number of clear differences. The more significant of these are outlined below.

- **Principle of recognising all revenue based on the satisfaction of a performance obligation.** Revenue is recognised when control of the asset is transferred. This will significantly impact accounting for some construction and other long-term contracts (including service arrangements). Current standards, in many instances, allow revenue to be recognised as the asset is created. An entity may only recognise revenue for its activities when those activities concurrently satisfy performance obligations through the transfer of assets to the customer. Revenue recognition may remain similar to current practice when control of the asset transfers continually as it is constructed. When control is only transferred when the completed asset is transferred to the customer, revenue is recognised when the transfer to the customer occurs.

#### Insight

The percentage-of-completion method historically used for construction contracts and, where applicable, service arrangements, may cease to exist. Rather, revenue in those arrangements will be recognised based on transfer of control.

- **Identification of performance obligations.** The definition of a performance obligation may result in separation of more obligations within an arrangement. For example, statutory warranty obligations are recorded as a cost accrual at the time of sale under current guidance. Such warranties are a separate performance obligation under the proposed model. Some of the contract consideration is allocated to the warranty and recognised as that obligation is satisfied. The increase in identification and separation of performance obligations may also require greater use of estimates than is the case under current practice. Industries in which use of estimates relating to revenue recognition is restricted, such as software accounting under US GAAP where VSOE is required, will be particularly impacted.

The components of a construction contract will also be separated more frequently. Current practice only allows separation if the components of a contract are separately negotiated, as opposed to the proposed model, which requires performance obligations to be separated based on when assets are transferred.

- **Sales incentives.** Sales-type incentives such as free products and customer loyalty programmes are currently recognised as marketing expense in some circumstances under US GAAP. The proposed model requires those

incentives to be considered performance obligations and revenue deferred until such obligations are satisfied, such as when a customer redeems loyalty points. This change aligns US GAAP with the guidance for customer loyalty programmes under IFRS.

- **Capitalisation of costs.** Certain costs may currently be capitalised as an asset if they are recoverable, such as certain contract origination costs in the construction industry. Other industries recognise such contract origination costs in profit or loss but also recognise an equal amount of offsetting revenue, such as cable television entities following US GAAP. The Boards do not intend to provide any cost recognition guidance. Costs associated with a contract will be expensed as incurred unless they meet the definition of an asset under another standard such as inventory, fixed assets or intangible assets.
- **Rights of return.** Rights of return are currently estimated and recognised as a reduction of revenue at contract inception. Two views have been suggested in the proposed model:

- Rights of return are a performance obligation to provide a service under the contract, resulting in revenue being deferred at contract inception until such obligation is satisfied or when the return right expires; or
- Rights of return represent a failed sale, as the customer has not accepted the terms of the sale since the arrangement can be rescinded without consequence. An entity may be able to estimate the portion of sales not expected to fail if it has many homogenous transactions and recognise revenue accordingly.

#### Insight

Both approaches to rights of return create application questions that need to be addressed. For example, measurement of the performance obligation may be difficult if satisfaction of the obligation results in the entity obtaining an asset. If rights of return represent failed sales, an entity may continue to recognise inventory even though the inventory has been transferred to the customer.

- **Agricultural, biological and other extractive products.** Provided certain criteria are met, revenue from certain biological, agricultural and extractive products is currently recognised as the value of inventory increases, irrespective of whether a contract has been signed with a customer. Under the proposed model, revenue is recognised when an entity enters into a contract with a customer and a performance obligation arising from that contract is satisfied. The Boards do not intend to change the way inventory is measured, but they are considering whether increases in the value of inventory should be recognised as a component of comprehensive income as opposed to revenue.

### Areas for feedback

The Boards have requested feedback on a variety of key areas including: appropriateness of a single model based on assets and liabilities, whether certain contracts should be excluded from the standard, the definition of a performance obligation, and recognition of revenue upon transfer of control.

### Timing for comments

Comments on the discussion paper are due by 19 June 2009. The primary purpose of the discussion paper is to provide a preliminary view of the Boards' thinking and to solicit feedback from users, preparers and other interested parties.

### Insight

The discussion paper does not address certain topics that are expected to be addressed as a draft standard is developed. Some of the more critical topics are:

- Application guidance for performance obligations;
- Measurement of rights, including the impact of time value of money, uncertainties (such as contingent consideration) and non-cash consideration;
- Possible alternative measurement approaches for certain contracts;
- Measurement of onerous contracts, including which costs to include in the onerous contract test and the unit of account at which the test is performed;
- Presentation and disclosure requirements, such as gross or net presentation of rights and obligations, display of remeasurements and gross or net presentation of revenue;
- Contract cancellation and renewal clauses;
- Combining of contracts;
- Contract modifications (for example, change orders or variations) as well as other changes to contract terms and conditions; and
- Transition guidance.