Practical guide to IFRS

9 July 2010

Revenue recognition – full speed ahead

Latest instalment: a joint IASB/FASB Exposure Draft

At a glance

- The IASB and FASB ('the boards') released an exposure draft on 24 June 2010, proposing a new revenue recognition standard that could significantly change the way entities recognise revenue.
- The proposed standard is a single, contract-based, 'asset and liability approach': revenue is recognised when an entity satisfies its obligations to its customers, which occurs when control of an asset (whether a good or service) transfers to the customer.
- The boards expect to issue the final standard in 2011, with a likely effective date no earlier than 2014. Full retrospective application will be required.
- Management will need to evaluate how the proposed standard might change current business activities beyond accounting, including contract negotiations, key metrics (including debt covenants), budgeting, controls and processes, and information technology requirements.

The main details

1. The boards' objective in issuing a converged standard is to increase the consistency of revenue recognition for similar contracts, regardless of industry. The boards noted that existing guidance under US GAAP may in some cases provide different revenue recognition models for contracts with similar economic characteristics. Existing IFRS contains less guidance than US GAAP on revenue recognition, and the boards noted it is sometimes difficult to apply beyond simple transactions, leading to diversity in practice.

PwC observation: The proposed guidance will affect some companies more than others, although all companies should expect some level of change. The boards have identified the following areas that may be significantly affected:

- Recognition of revenue based solely on the transfer of goods or services.
- Identification of separate performance obligations.
- Licensing and rights to use.
- Effect of credit risk.
- Increased use of estimates.
- Accounting for contract-related costs.

2. This guidance explores the proposed standard. The comment period ends on 22 October 2010.

3. The boards' conclusions are tentative and subject to change until they issue a final standard.

PwC observation: Since the discussion paper comment period ended in June 2009, the boards have continued to seek feedback through forums and direct interaction with constituents. The boards plan to hold public roundtable meetings once the comment period ends to solicit views and obtain additional information from interested parties. We encourage management to engage with the boards, comment on the exposure draft and continue to monitor the boards' progress toward a final standard.

Key provisions

Asset and liability model

4. The proposed standard employs an 'asset and liability approach, the cornerstone of the IASB's and FASB's conceptual frameworks. Current revenue guidance under both frameworks focuses on an 'earnings process', but difficulties often arise in determining when an entity earns revenue. The boards believe a single, contract-based model based on changes in contract assets and liabilities will lead to greater consistency in the recognition and presentation of revenue.

PwC observation: The proposed standard will represent a significant shift in how revenue is recognised in certain circumstances. It moves away from specific measurement and recognition thresholds and removes industry-specific guidance. The effect could be significant, requiring management to perform a comprehensive review of its existing contracts, business models, company practices and accounting policies.

The proposed standard may also have broad implications for an entity's processes and controls. Management may need to change its existing IT systems and internal controls in order to capture information to comply with the proposed guidance. The effect may extend to other functions such as treasury, income tax and human resources. For example, changes in the timing or amount of revenue recognised may affect long-term compensation arrangements, debt covenants and other key ratios.

The proposed standard might also affect mergers and acquisitions in a number of ways, including deal models (for example, amount and timing of revenue recognition may be different) and how earn-outs are triggered if determined based on revenue.

5. A contract with a customer includes a right to receive consideration and an obligation to provide goods or perform services. The entity has a contract asset when the rights exceed the obligations, and a contract liability when the obligations exceed the rights. If an entity receives no consideration at inception of the contract, the contract position is zero and no entries are recorded.

6. An entity records a contract asset when it has a right to consideration from a customer due to the transfer of goods or services. A contract liability is recorded when the entity has received consideration prior to transferring goods or services to the customer.

PwC observation: A contract asset or contract liability is recorded when consideration is received or performance obligations are satisfied. A contract asset exists when an entity satisfies a performance obligation, even though it might not have an unconditional right to receive the consideration. The contract asset is transferred to receivables when the right to receive consideration depends only on the passage of time.

Scope

7. The proposed standard focuses on an entity's contracts with customers. It defines a contract as *"an agreement between two or more parties that creates enforceable rights and obligations".* A customer is "*a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities".* A contract can be written, verbal or implied.

8. The proposed standard applies to an entity's contracts with customers, except for:

- Lease contracts.
- Insurance contracts.
- Certain contractual rights or obligations within the scope of other standards, including financial instrument contracts.
- Certain guarantees (other than product warranties) within the scope of other standards.
- Non-monetary exchanges whose purpose is to facilitate a sale to another party.

9. Some contracts include components that are in the scope of the revenue standard and other components that are in the scope of other standards (for example, a lease contract that also includes maintenance services). An entity applies the other standard first if that standard specifies how to separate or measure components of a contract. Otherwise, the principles in the revenue standard are applied.

PwC observation: The proposed standard addresses contracts with customers across all industries rather than focusing on specific industries. Industry-specific guidance will be replaced by the proposed standard. The boards are requesting feedback as part of the comment letter process on whether any aspects of the proposed standard should be different for non-public companies, including private companies and not-for-profit organisations.

Most transactions accounted for under existing revenue standards will be within the scope of the proposed standard. Transactions in industries that recognise revenue without a contract with a customer (for example, certain biological, agricultural and extractive industries) are not in the scope.

10. Management will need to carefully assess performance obligations in contracts to ensure they have identified the appropriate standard to follow for separation of performance obligations and the measurement of consideration allocated to those obligations. For example, the proposed standard requires the use of relative selling price for allocation of consideration to performance obligations; other standards may require the use of fair value or other measures. This difference will affect the consideration allocated to a performance obligation at inception of a contract.

Applying the model

11. Entities will perform the following five steps in applying the proposed standard:

- Identify the contract with the customer.
- Identify the separate performance obligations in the contract.
- Determine the transaction price.
- Allocate the transaction price to the separate performance obligations.
- Recognise revenue when each performance obligation is satisfied.

PwC observation: A ‘performance obligation’ is similar to what is known today as a deliverable, element or component of an arrangement. See further discussion of performance obligations in paragraph .19 below.

The ‘transaction price’ is the consideration the seller expects to receive from the buyer in exchange for providing goods or services. See further discussion of measuring the transaction price in an arrangement in paragraph .26 below.

Identify the contract with the customer

12. The proposed standard applies to contracts with customers, whether written, verbal or implied. There is a wide array of common business practices and legal requirements associated with customer contracts, across geographical and business boundaries. Management will need to consider not only written contracts but also customary practices to determine whether a contract exists.

13. A contract exists only if:

- The contract has commercial substance.
- The parties to the contract have approved the contract and are committed to satisfying their respective obligations.
- The entity can identify each party's enforceable rights regarding the goods or services to be transferred (that is, determine the performance obligations).
- The entity can identify the terms and manner of consideration to be paid by the customer.

14. An entity may need to combine two or more contracts − or segment (that is, divide) one contract into two or more contracts − to properly reflect the economics of the underlying transaction.

15. An entity should combine two or more contracts into one if the prices of those contracts are interdependent. Contracts generally have interdependent pricing if they are:

- Entered into at or near the same time.
- Negotiated as a package with a single commercial objective.
- Performed concurrently or consecutively.

16. The price of a contract is 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.

17. Management should segment one contract into two or more contracts if some goods or services priced within the contract are independently priced from other goods or services in that contract. Contracts have goods or services with independent pricing if:

- The entity, or another entity, regularly sells the goods or services on a stand-alone basis; and
- The price for all goods or services in the contract approximate the sum of the stand-alone selling price for each good or service (that is, there is not an inherent discount for the purchase of bundled goods/services).

PwC observation: The boards believe that contract segmentation ensures that the accounting reflects the economics of the underlying transaction. For example, the segmentation of a contract may be important when variable consideration included in the transaction price relates to only one obligation in a contract (see further discussion in paragraphs .28 - .30 below). Changes in variable consideration for separate contracts are allocated only to the contract to which the variable consideration relates. Changes in variable consideration in a single contract are allocated to all performance obligations based on the ratio used to allocate the transaction price to performance obligations at inception.

18. A contract modification is combined with the original contract if the prices of the original contract and the modification are interdependent (that is, treat the modification and original contract as one contract). Management first considers the factors in paragraph .13 above to determine whether a contract modification exists. It then considers the factors in paragraphs .15 and .17 above to determine whether a modification is priced interdependently or independently of the original contract.

PwC observation: Contract modifications come in a variety of forms. A modification can be a change in the scope of work, a change in pricing or both. It is unclear how the proposed standard applies to some modifications. For example, it is common in some industries (such as aerospace and defence, and engineering and construction) for the parties to agree on a modification to the scope of the work, but to agree subsequently on pricing (that is, unpriced change orders). Significant judgement has been and will continue to be required to determine whether a change order, particularly an unpriced change order, is interdependent on, or independent of, the original contract.

Modifications that are priced interdependently with the original contract may result in a cumulative catch-up adjustment to revenue at the time of the modification.

Identify and separate performance obligations in the contract

19. A performance obligation is an enforceable promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer. A contract may explicitly state performance obligations, but these may also arise in other ways. Legal or statutory requirements may create performance obligations even though such obligations are not explicit in the contract. Customary business practices, such as an entity's practice of providing customer support, might also create a performance obligation.

PwC observation: Identifying the performance obligations in a contract is critical in applying the proposed standard, as the identification of performance obligations affects:

- How the transaction price is allocated.
- The timing of revenue recognition, which is based on satisfaction of performance obligations.
- The recognition of onerous performance obligations (see paragraphs .43 - .44 below for further discussion of onerous performance obligations).

20. The objective of identifying and separating performance obligations is to ensure that revenue is recognised when such obligations are satisfied (that is, when goods and services are transferred to the customer). Careful evaluation is required to identify all performance obligations in a contract.

21. It is not generally necessary to account for performance obligations separately if they are satisfied at the same time or over the same period of time. An entity might need to account for performance obligations separately if it transfers the promised goods or services at different times (or continuously).

PwC observation: Separation of performance obligations may be necessary in other situations, even if not required for revenue recognition purposes. For example, management might need to separate a contract that provides for the concurrent transfer of goods or provision of services for income statement presentation or segment disclosures.

22. An entity recognises revenue from performance obligations separately if they are distinct from other goods or services promised in the contract and are delivered separately.

23. A good or service is distinct and accounted for separately if the entity or another entity sells an identical or similar good or service separately. A good or service that has a distinct function and a distinct profit margin from the other goods or services in the contract is also distinct, even if not sold separately.

24. A good or service has a distinct function if it provides utility either on its own or together with other goods or services available in the marketplace. A good or service has a distinct margin if it is subject to distinct risks and the entity can identify the resources needed to provide the good or service.

PwC observation: The determination of whether a good or service is distinct will require judgement on the part of management and an understanding of how other goods or services sold in the market may interact with the entity's products.

Each performance obligation does not have to have a different profit margin (that is, a different amount or percentage) to be distinct. Rather, a profit margin must be identifiable for each performance obligation in order for them to be distinct. The proposed standard does not specify how to determine whether a good or service is subject to distinct risks, or how this determination relates to a good or service having a distinct margin.

Consider an example where an entity sells specialised electronic equipment. The entity's contract price for the equipment includes delivery and installation at the customer's site. The equipment does not require any modifications or enhancements (other than installation) in order to be used by the customer. The entity typically installs the electronic equipment, although other entities could install the equipment.

The entity has two separate performance obligations if control of the equipment transfers upon delivery and the equipment is distinct from the installation. The entity would not account for the two performance obligations separately if control of the equipment transfers only upon successful installation.

The equipment has a distinct function because it has utility together with installation services that are available from other entities. Assuming the entity can separate the costs of the electronic equipment from the costs of installation, the profit margin on the equipment is also distinct from the margin on the installation.

The equipment and the installation are distinct in this example.

25. Management combines goods or services that are not distinct with other goods or services until there are bundles of goods or services that are distinct. The combination of goods or services that are not distinct on their own may result in an entity accounting for all the goods and services promised in the contract as a single performance obligation.

PwC observation: Management will need to consider carefully which performance obligations are combined to create a ‘distinct’ performance obligation and should not default to combining all performance obligations in a contract. Each contract should be assessed to determine the risks, margins and the timing of the transfer of control of individual performance obligations. Performance obligations that have different risks or margins or for which control transfers at different times should not be combined.

Determine the transaction price

26. The transaction price in a contract reflects the consideration the customer promises to pay in exchange for goods or services.

27. The transaction price is readily determinable in some contracts because the customer promises to pay a fixed amount of cash due when the entity transfers the promised goods or services. In other contracts, management will need to consider a number of variables when determining the transaction price, such as:

- Variable consideration.
- Collectability.
- Time value of money.
- Non-cash consideration.
- Consideration paid to a customer.

PwC observation: Companies will need to apply significant judgement to determine the transaction price when it is subject to the variables noted above.

Amounts collected on behalf of third parties (for example, sales taxes) will not be presented in revenue under the proposed standard. Such amounts are excluded from the transaction price.

Variable consideration

28. The transaction price may include an element of consideration that is variable or contingent on the outcome of future events, including (but not limited to) discounts, rebates, refunds, credits, incentives and performance bonuses. When a contract includes variable consideration, the transaction price includes the probability-weighted estimate of variable consideration receivable. This estimate requires management to assess the probability of each possible outcome.

PwC observation: Variable consideration, also commonly referred to as contingent consideration, can come in a variety of forms. Some contingencies may relate to the future performance by the seller that is fully within the seller's control; other contingencies may only be resolved by the actions of the buyer or other third parties. The amount of judgement needed to estimate variable consideration will depend on the nature and terms of the contingency.

29. An estimate of variable consideration is included in the transaction price when management can make a reasonable estimate of the amount to be received. The proposed standard states that an estimate is reasonable only if an entity:

- Has experience with similar types of contract (or can refer to the experience of other entities if it has no experience of its own); and
- Does not expect circumstances surrounding those types of contract to change significantly (that is, experience is relevant to the contract).

30. Management should assess whether circumstances may reduce the relevance of an entity's experience, including:

- The impact of external factors.
- The length of time until the uncertainty is expected to be resolved.
- The extent of the experience.
- The number of possible consideration amounts.

PwC observation: Some industries and entities may experience a significant change in the timing of revenue recognition due to the proposed treatment of variable consideration. Variable consideration that management can estimate reasonably is included in the transaction price at the probability-weighted amount. The proposed standard requires an assessment of variable consideration at contract inception and at each reporting period. Entities might recognise revenue earlier than under existing guidance when management can reasonably estimate variable consideration. Significant change might also arise in industries where revenue is currently restricted to the cash received because revenue is contingent on a future event.

Throughout the contract life, management will assess variable consideration that cannot be reasonably estimated at contract inception. Revenue is recorded when a reasonable estimate can be made. An entity might recognise revenue before the contingency is resolved in most cases, which might increase the volatility of reported results.

The boards have included factors to consider in determining whether management can make a reasonable estimate of variable consideration. Entities with similar transactions may recognise revenue at different times if one entity determines that it can reasonably estimate variable consideration while another entity concludes it cannot. These differences may be the result of entities having different levels of experience or operating in different markets.

Collectability

31. Collectability refers to the customer's ability to pay the consideration agreed in the contract. The transaction price is adjusted to reflect the customer's credit risk by recognising the consideration expected to be received on a probability-weighted basis.

32. Changes in the assessment of consideration to be received due to changes in credit risk are recognised as income or expense, separately from revenue.

PwC observation: Current guidance requires revenue to be recognised when payment is reasonably assured (or probable). As collectability is no longer a recognition threshold, revenue might be recognised earlier than current practice. Collectability affects the measurement of revenue under the proposed standard, as credit risk is reflected as a reduction of the transaction price at contract inception rather than as bad debt expense. Subsequent changes to the assessment of collectability will be recognised as income or expense, rather than as revenue.

Time value of money

33. The transaction price should reflect the time value of money wherever the effect is material. Management should use a discount rate that reflects a financing transaction between the entity and its customer that does not involve the provision of other goods or services.

PwC observation: Management will need to consider the time value of money for a contract that includes a material financing component. However, the proposed standard does not specify the length of time to consider when determining whether a financing component is material. Management should consider the credit characteristics of the customer to determine the discount rate used.

The following example illustrates the accounting for a customer payment made in arrears when a material financing component exists:

An entity sells a product for C50,000, with payment due two years after delivery of the product. The entity determines that an 8% discount rate is appropriate, based on the two-year term and the credit characteristics of the customer. Revenue of C42,867 (C50,000 / (1.08 x 1.08)) is recognised when the entity transfers the product to the customer. The entity has an unconditional right to consideration upon transfer of the product and records a receivable, rather than a contract asset.

The following example illustrates the accounting for customer payment made in advance when a material financing component exists:

An entity sells a product to a customer for C10,000, with payment due one year before the delivery of the product. The entity recognises a contract liability of C10,000 when the customer pays the consideration. The entity determines that a 5% discount rate is appropriate, based on the one-year term and the credit characteristics of the entity. The entity recognises interest expense of, and increases the measurement of the performance obligation by, C500 ((C10,000 x 1.05) - C10,000) during the year before it transfers the product. The carrying amount of the contract liability is C10,500 (C10,000 + C500) immediately before the performance obligation is satisfied. The entity records revenue of C10,500 when the product is transferred to the customer. This is a significant change from current practice.

The accounting for the time value of money may result in a significant change for certain entities, particularly in situations where consideration is paid in advance, as the amount of revenue to be recognised could be greater than the amount of consideration ultimately received. Determining whether the time value element in a contract is material could be particularly challenging in long-term or multiple-element arrangements where product/service delivery and cash payments may occur throughout the arrangement.

Non-cash consideration

34. An entity measures non-cash consideration received for satisfying a performance obligation at its fair value. When management cannot estimate fair value reliably, it measures the non-cash consideration received indirectly by reference to the stand-alone selling price of the goods or services transferred in exchange for the consideration.

Consideration paid to a customer

35. Consideration paid to a customer (for example, cash or credit) is assessed to determine if the amount should be reflected as a reduction in the transaction price or as a payment for discrete goods or services received from the customer.

36. An entity reduces revenue when it pays consideration to a customer at the later of when:

- The entity transfers the promised goods or services to the customer; or
- The entity promises to pay the consideration (even if the payment is conditional on a future event). That promise may be implied by customary business practice.

PwC observation: The underlying concepts for both non-cash consideration and consideration paid to a customer (for example, rebates expected to be paid to customers) are consistent with current revenue guidance under IFRS and US GAAP. We do not anticipate a significant change in these areas on adoption of the proposed standard.

Allocate the transaction price to the separate performance obligations

37. Consideration should be allocated to separate performance obligations in a contract based on relative stand-alone selling prices.

PwC observation: The proposed standard will significantly affect entities that currently use the residual method to allocate arrangement consideration. The proposed standard does not permit this method. Management will need to make an estimate of selling price for each separate performance obligation when the stand-alone selling price is not available. Use of estimated selling prices will often result in earlier revenue recognition for entities currently applying the residual method. The residual method allocates the discount inherent in an arrangement to the first performance obligation satisfied rather than spreading the discount rateably over all performance obligations. The proposed standard requires the discount to be spread rateably.

Estimating stand-alone selling prices

38. The best evidence of stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately. Management should estimate the selling price if a stand-alone selling price is not available, maximising the use of observable inputs. Possible estimation methods include:

- Cost plus a reasonable margin.
- Stand-alone sales prices of the same or similar products, if available.
- Cash flow models or other valuation techniques.

PwC observation: Estimating the stand-alone selling price of performance obligations is a key aspect of applying the proposed standard. Management should not presume that a contractual price (that is, list price) reflects the stand-alone selling price of a good or service. The proposed standard should result in a better reflection of the economics of the transaction, but it may create challenges in developing, documenting and supporting the estimated stand-alone selling price. It is important that management considers whether new internal systems and processes (and related internal controls) are required to support the process of developing estimates and allocating transaction price.

Recognise revenue when performance obligations are satisfied

39. Revenue should be recognised when a promised good or service is transferred to the customer. An entity transfers a promised good or service and satisfies a performance obligation when the customer obtains control of that good or service. A customer obtains control of a good or service if it has the ability to direct the use of, and receive the benefit from, the good or service.

40. Performance obligations can be satisfied at a point in time or continuously over time. Management should use judgement to assess the transfer of control for each separately identified performance obligation in a contract. Indicators that the customer has obtained control of the good or service may include:

- The customer has an unconditional obligation to pay.
- The customer has legal title.
- The customer has physical possession.
- The customer specifies the design or function of the good or service.

PwC observation: These indicators are not a checklist nor are they exhaustive. Management should consider all relevant facts and circumstances to determine whether the customer has obtained control of the good or service. Other potential indicators that control might be transferring continuously include: (1) whether the customer has the unilateral ability to sell or pledge the asset − for example, as collateral; or (2) whether the customer has custodial risk of loss associated with the asset.

Continuous transfer of goods and services

41. An entity may transfer control of a good or service to the customer continuously as it manufactures the goods or performs the services. Management should consistently apply the method that best depicts the transfer of goods or services to determine how much revenue to recognise when control is transferred continuously. This may be a straight-line basis if the entity transfers goods or services continuously and evenly over time to the customer throughout the contract. Management should apply the same method to similar contracts.

PwC observation: Management that currently use the percentage of completion method should review the contracts to determine whether control transfers continuously during construction. The percentage of completion method, as a stand-alone model, will no longer exist. Entities that transfer control of the asset under construction continuously will recognise revenue as control transfers, not using a completed contract method. The resulting revenue recognition may be similar to today's accounting if an entity currently recognises revenue based on the transfer of assets to the customer.

42. Methods for recognising revenue when control transfers continuously include:

- Output methods that recognise revenue on the basis of units produced, units delivered, contract milestones or surveys of work performed.
- Input methods that recognise revenue on the basis of costs incurred, labour hours expended or machine hours used.
- Methods based on the passage of time.

PwC observation: Management will need to consider the relevant facts and circumstances to determine whether there is continuous transfer of control. Careful consideration is also needed to determine which measurement method most appropriately reflects transfers of goods or services to the customer. In particular, use of input methods or recognition based on the passage of time need to reflect the transfer of control of the good or service to the customer, rather than simply reflecting the activities of the entity. A consistent measurement method might not be applicable for all types of contracts that an entity enters into if the contracts differ.

Subsequent measurement

43. Performance obligations are assessed at contract inception and at each reporting date to determine whether the obligation has become onerous. A performance obligation is onerous when the present value of the probability-weighted direct costs to satisfy the obligation exceed the consideration (that is, the amount of transaction price) allocated to it. Prior to recognising a liability for an onerous performance obligation, the entity should recognise any impairment loss on assets directly related to the contract.

44. Onerous performance obligations should be updated each reporting period using current estimates. Any changes in the measurement of the liability would be recorded as an expense or a reduction of an expense. The entity reduces the expense previously recorded on satisfaction of the onerous performance obligation.

PwC observation: Direct costs include direct materials, direct labour, indirect costs that are either specifically attributable to the contract or specifically reimbursable under the terms of the contract, and those costs that are incurred only because the entity entered into the contract.

The proposed standard may represent a significant change for US GAAP and IFRS. US GAAP does not permit accounting for onerous contracts outside of certain specific guidance (for example, construction contract guidance); IFRS guidance generally requires an assessment of onerous contracts at the contract level, not the performance obligation level. An assessment at the performance obligation level may lead to an entity recognising a liability for performance obligations that are onerous even though the overall contract is profitable. Management might be reluctant to enter into contracts that include loss-making performance obligations with the expectation of overall profitability in light of this proposed guidance.

It is not necessary to account for performance obligations separately if they are satisfied at the same time. However, it is unclear how a contract to provide services concurrently would be accounted for if one of the obligations is onerous. The proposed standard does not address whether the entity would be required to separate concurrent services to account for one performance obligation that was onerous.

45. Management must remeasure the contract asset each reporting period, or as circumstances change, to reflect changes in the transaction price. It allocates these changes to separate performance obligations on the same basis as at contract inception (that is, using the same allocation percentages) and recognises those changes in the revenue allocated to satisfied performance obligations as revenue in the period of change.

Disclosure

46. The boards believe that the proposed disclosures will assist users of financial statements in understanding the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

47. Disclosures will focus on:

- Qualitative and quantitative information about performance obligations, rights to consideration and onerous performance obligations to help users understand the characteristics of the entity's contracts with customers.
- The significant judgements and changes in judgements that will explain the effect of those judgements on the timing and amount of revenue recognised in financial statements. These disclosures should include (a) the effect on the amount of revenue recognised in the current period, and (b) an indication of the expected effect on the timing and amount of revenue that will be recognised in future periods.

PwC observation: The disclosure requirements are more detailed than currently required under IFRS and US GAAP and focus significantly on the judgements made by management.

Management should carefully consider how much information should be disclosed about the anticipated impact of the proposed standard on the entity's financial statements before the effective date. Management might need to include increasing disclosure about the impact of adoption as the adoption date approaches.

Transition

48. The proposed standard requires full retrospective application, including application to those contracts that do not affect current or future periods but affect reported historical periods.

PwC observation: The boards have not decided on the effective date for the proposed standard; however, they have discussed possible effective dates no earlier than 2014 to provide management adequate time to prepare for and implement the proposed standard. The boards plan to seek separate feedback on the effective date because of the quantity of proposed standards expected in 2011.

The boards intend retrospective application to drive consistency in reporting among periods presented as well as among entities. The transition requirements may affect some entities more than others, depending on the number of reporting periods included in an entity's financial statements, as well as the number and nature of contracts outstanding at adoption of the proposed standard. We expect the effort and cost required for full retrospective application will have a significant impact on some entities.

Although the proposed standard does not address early adoption, the FASB prefers to prohibit early adoption; the IASB proposes to allow first-time adopters of IFRS to adopt early.

Other considerations

Identification of performance obligations

49. The boards considered the impact of the following items on the identification of performance obligations in a contract:

- Principal versus agent.
- Options to acquire additional goods or services.
- Licences and rights to use.
- Rights of return.
- Product warranties and product liabilities.
- Non-refundable upfront fees.

Principal versus agent

50. Management will need to consider whether the entity is acting as a principal or an agent in a contract. An entity would recognise revenue gross if it is the principal, and net if it is acting as an agent. The entity is acting as a principal if its performance obligation is to provide the goods or services. It is acting as an agent if it is arranging for another party to provide those goods or services.

51. The entity acting as the principal should recognise revenue gross when it obtains control of the goods or services of another party in advance of transferring those goods or services to the customer.

52. An entity that does not obtain control of the goods or services should consider whether it is acting as an agent. Indicators that the company is acting as an agent include:

- The other party has primary responsibility for fulfilment of the contract (that, primary obligor).
- The entity does not have inventory risk.
- The entity does not have discretion in establishing prices.
- The entity does not have customer credit risk.
- The entity's consideration is a commission.

PwC observation: This proposed principle and list of indicators is consistent with current guidance under IFRS and US GAAP. We do not anticipate significant change in this area.

Options to acquire additional goods or services

53. An entity may grant a customer the option to acquire additional goods or services. That promise gives rise to a performance obligation if the option provides a material right to the customer that the customer would not receive without entering into the contract. The entity should recognise revenue allocated to the option when the option expires or when it transfers additional goods or services to the customer.

54. The estimate of a stand-alone selling price for a customer's option to acquire additional goods or services will reflect the discount the customer obtains when exercising the option. The estimated selling price is adjusted for:

- The discount that the customer would receive without exercising the option.
- The likelihood that the option will be exercised (that is, breakage/forfeiture)

55. A contract may include renewal options (that is, an option for goods or services similar to the original goods or services) or cancellation clauses. An entity may allocate the transaction price to the optional goods or services by reference to the goods or services it expects to provide and the expected consideration.

56. An option to acquire additional goods or services at their stand-alone selling price does not provide the customer with a material right, even if it arises only because the customer entered into the previous contract. Such an option is a marketing offer, which does not provide the customer with a material right.

PwC observation: Options come in a variety of forms including sales incentives, customer award credits (or loyalty points), contract renewal options, volume discounts and other discounts on future goods or services. The accounting for these options as separate performance obligations may be a significant change from existing guidance.

The following example illustrates the accounting for a customer loyalty programme.

An entity provides a customer loyalty programme to its customers. The programme grants customers one point per C10 spent on purchases. Each point earned has a cash value of C1, which the customer may redeem against future purchases. Customers purchase products for C1,000 and earn 100 points redeemable against future purchases. Management expects that customers will redeem 95 of the 100 points earned. Management also estimates that the stand-alone selling price of one point is C0.95 based on the history of redemption. The stand-alone selling price of the products to customers without the points is C1,000.

The option (that is, the points) provides a material right to the customer, so the entity will allocate the transaction price between the product and the points on a relative estimated selling price basis, as follows:

Product	C913	(1,000 x 1,000 ÷ 1,095)
Points	C87	(95 x 1,000 ÷ 1,095)

Customers redeem 65 points at the end of the first year, and management continues to expect that customers will ultimately redeem 95 points. The entity therefore recognises revenue of C60 (65 ÷ 95 points) x (C87) related to the option.

Customers redeem an additional 20 points in the second year (cumulative points redeemed are 85). Management has revised its estimate of total redemptions from 95 points to 98 points. Cumulative revenue for the option is C75 (85 ÷ 98) x C87). Because the entity previously recognised option revenue of C60 in year one, it recognises C15 (C75 - C60) of incremental revenue in year two for the option.

Customers have redeemed 98 points at the end of the third year. Management continues to expect that customers will redeem only 98 points. Cumulative revenue at the end of the third year is C87. The entity recognises an additional C12 (C87 - C75) for the option in year three.

Licences and rights to use

57. The recognition of revenue for the licence of intellectual property depends on whether the customer obtains control of the asset. The contract is a sale (rather than a licence or a lease) of intellectual property if the customer obtains control of the entire licensed intellectual property (for example, the exclusive right to use the licence for its economic life). The entity recognises revenue when control of the intellectual property transfers if the transaction is a sale.

58. The performance obligation is satisfied over the term of the licence if the customer licenses intellectual property on an exclusive basis but does not obtain control for the entire economic life of the property. The entity generally recognises revenue over the term of the licence in this situation.

59. A contract that provides a non-exclusive licence for intellectual property (for example, off-the-shelf software) is a single performance obligation. An entity recognises revenue when the customer is able to use the licence and benefit from it (that is, when control transfers but no earlier than the beginning of the licence period).

PwC observation: A licence is accounted for as a sale if it is for substantially all of the intellectual property's economic useful life or if the licence of the intellectual property is granted on a non-exclusive basis. A licence is accounted for over the term of the licence only when it is provided on an exclusive basis for less than the asset's economic life.

Entities may grant exclusive rights by reference to time, geography, or distribution channel or medium. The proposed standard clarifies when a licence is exclusive, but it is unclear how an entity should determine the economic life of the asset when it can re-licence the intellectual property subsequently in the same window or territory once the existing licence expires. Determination of the licensed asset (that is, the unit of account) and the related economic life will be crucial in determining when revenue is recognised.

Rights of return

60. An entity will account for the sale of goods with a right of return as follows:

- Revenue is not recognised for goods expected to be returned, and a liability is recognised for the refund to be paid to customers, using a probability-weighted approach.
- The refund liability is updated for changes in expected refunds.
- An asset and corresponding adjustment to cost of sales is recognised for the right to recover goods from customers when the entity settles the refund liability. The asset is initially measured at the original cost of the goods less any expected costs to recover those goods (that is, the former carrying amount in inventory less costs to recover the products).

61. A contract that provides the customer with the right to exchange one product for another product of the same type, quality, condition and price (for example, a red shirt for a blue shirt) does not provide the customer with a return right.

PwC observation: The accounting for return rights is similar to today's failed sale model (that is, an entity does not recognise revenue for goods it expects customers to return). Entities that are unable to estimate returns will be precluded from recognising revenue prior to the lapse of the return right. The proposed standard will require full derecognition of inventory that an entity has sold and recognition of an asset for the entity's right to recover goods from the customer. The return right (that is, the asset) is assessed for impairment in accordance with existing standards.

Product warranties and product liabilities

62. The proposed standard draws a distinction between quality assurance warranties and insurance warranties. A quality assurance warranty provides a customer with coverage for latent defects (that is, those that exist when the asset is transferred to the customer but that are not yet apparent). This warranty does not give rise to a separate performance obligation but recognises the possibility that the entity has not satisfied its performance obligation. In other words, the entity has not provided an asset that operates as intended at the time of delivery. Management will need to determine the likelihood and extent of defects in the products it has sold to customers at each reporting period to determine the extent of unsatisfied performance obligations. An entity does not recognise revenue at the time of sale for defective products that it will subsequently replace in their entirety. Management will defer revenue for warranties that require replacement or repair of components of an item, but only for the portion of revenue attributable to the components that it must repair or replace.

63. An insurance warranty provides a customer with coverage for faults that arise after the entity transfers control to the customer (for example, normal 'wear and tear'). Insurance warranties give rise to a separate performance obligation. The entity allocates a portion of the transaction price to insurance warranties at contract inception.

64. Management will need to consider the following factors to determine whether a warranty provides coverage for latent defects or for faults that arise subsequent to the transfer of the product to the customer:

- Whether the warranty is required by law.
- Whether the product could have been sold without the warranty.
- The length of the warranty coverage period.

65. A warranty required by law to protect the customer from the risk of purchasing defective products is not a performance obligation. A warranty sold on a stand-alone basis or as an optional extra (for example, an extended warranty) is a performance obligation. Products that can be sold without a warranty suggest that the warranty is not a performance obligation. A longer coverage period suggests that the warranty or part of the warranty is a performance obligation.

66. Product liability obligations (for example, when an entity is legally obliged to pay consideration if its products cause harm or damage) are not performance obligations. An entity accounts for these liabilities in accordance with ASC 450-20, 'Loss Contingencies', or IAS 37, 'Provisions, contingent liabilities and contingent assets'.

PwC observation: Management will need to use significant judgement to determine whether a defect is latent or has arisen subsequent to a sale. It might be difficult to apply the guidance for quality assurance warranties when the entity is required to repair or replace only a component of the asset sold. For example, the contract may have only one performance obligation (such as, the sale of a car) but the entity may be required to determine the amount of consideration associated with individual components of the car (such as, the seats or the brakes) that are expected to be defective and subsequently repaired.

An insurance warranty includes standard and extended warranties that the entity uses to provide the customer with coverage for faults that arise after control of the product has transferred. Management will be required to allocate a portion of the transaction price to the insurance warranty at the inception of the contract, regardless of whether the insurance warranty is standard with the sale of a product or an extended warranty.

The accounting for warranties is a significant change from current practice under both frameworks. Entities currently account for standard warranties as a liability for the expected costs to repair defective products based on experience with similar contracts. Entities will not recognise revenue for defects that exist at the time of the original sale under the proposed standard.

It may be necessary to separate a warranty between a quality assurance warranty and an insurance warranty when an entity provides coverage for defects that may exist when the product is transferred to the customer, as well as for defects that arise after control of the asset has transferred. This may require a significant amount of estimation and judgement.
Entities may be required to allocate revenue to the portion of the standard warranty that provides coverage for defects arising after sale (that is, insurance warranties), which will alter the timing of revenue recognition for certain product sales.

It is unclear how an entity accounts for situations in which a customer can receive either cash or require specific performance in the satisfaction of an obligation (for example, a cash-settled warranty).

Non-refundable upfront fees

67. Management will need to determine whether a non-refundable upfront fee relates to a separate performance obligation.

68. A non-refundable upfront fee might relate to an activity undertaken at or near contract inception, but it does not indicate satisfaction of a separate performance obligation if the activity does not result in the transfer of a promised good or service to the customer.

69. If the non-refundable upfront fee relates to a performance obligation, management will need to determine whether that performance obligation is distinct from the other performance obligations in the contract.

PwC observation: Entities currently account for non-refundable upfront fees separately when they result in the culmination of a separate earnings process. The terminology has changed under the proposed standard, but we expect the accounting for non-refundable upfront fees to be consistent with current practice.

A non-refundable upfront fee that is not related to a separate performance obligation is included in the transaction price and allocated to the separately identified performance obligations.

Satisfaction of performance obligations

70. The boards also considered the impact of the following items on the satisfaction of performance obligations in a contract:

- Determining whether a good or service is transferred continuously.
- Bill-and-hold arrangements.
- Consignment arrangements.
- Sale and repurchase of a product.
- Customer acceptance.

Determining whether a good or service is transferred continuously

71. Many contracts clearly identify when a good or service is transferred to the customer. It may, however, be difficult to determine when a good or a service is transferred to the customer in contracts that include the production, manufacture or construction of an asset.

72. If the customer has the ability to direct the use of and receive the benefit from the work in process (rather than the completed asset), control of the good or service may transfer continuously and revenue is recognised as the services are performed.

73. If the customer does not control the asset as it is produced, manufactured or constructed, the control of the completed asset transfers, and revenue is recognised when the customer obtains control of the completed asset.

PwC observation: Revenue is recognised when control transfers to the customer. Management should carefully consider how and when control transfers. The point at which control transfers is clear in many contracts; however, it may be difficult to determine when control transfers in certain contracts. For example, a contract may require an entity to issue a report at the end of a consultation or investigative period. Does control transfer as the services are being performed or when the report is issued? This will depend on the facts and circumstances of the arrangement and the nature of the services. Management will need to consider if the services have utility to the customer without the report.

Consider, for example a consulting services agreement in which a final report will be issued at the end of the contract period. The consulting services are intended to identify efficiencies in the accounting and financial reporting function and will be performed over a one-year period. The scope of services is determined by the customer and may be changed at any time during the contract term. The customer will pay the consultant C25,000 per month for services provided and is entitled to any analysis or insight developed by the consultant throughout the contract period. The customer has the ability to specify the scope of work performed, change the scope at any point, access information obtained, and is required to pay for services performed, so the customer has the ability to direct the use of, and benefit from, the consulting services as they are performed. Therefore, the consultant's performance obligation is to provide consulting services over a one-year period on a continuous basis.

Bill-and-hold arrangements

74. In some contracts, an entity bills a customer for a product but does not ship the product until a later date (a bill-and-hold arrangement).

75. Revenue is recognised under the proposed standard on transfer of control of the asset to the customer; management will therefore need to consider the following factors in determining whether the customer has obtained control in a bill-and-hold arrangement:

- The customer must have requested the contract be on a bill-and-hold basis;
- The product must be identified separately as the customer's;
- The product must be ready for delivery at the time and location specified by the customer; and
- The entity cannot have the ability to sell the product to another customer.

76. Management should also consider the following indicators in determining whether the customer has obtained control in a bill-and-hold arrangement:

- Whether the entity's usual payment terms have been modified;
- The possibility that the customer may cancel the contract before delivery occurs; and
- Whether the arrangement meets the definition of a contract explained in paragraph .12 above.

77. If an entity recognises revenue on a bill-and-hold transaction, management will need to consider whether the custodial services are a material separate performance obligation to which it should allocate some of the transaction price.

PwC observation: This proposed principle and list of indicators is consistent with current revenue guidance under IFRS and US GAAP, but management will need to consider all relevant facts and circumstances and use significant judgement to determine whether control has transferred in a bill-and-hold arrangement. We do not anticipate a significant change in this area upon adoption of the proposed standard.

Consignment arrangements

78. Certain industries transfer goods to dealers or distributors on a consignment basis. The transferor typically owns inventory on consignment until a specified event occurs, such as the sale of the product to a customer of the distributor, or until a specified period expires.

79. Management will need to consider the following factors to determine whether revenue should be recognised upon transfer to the distributor or upon ultimate sale to the customer:

- Whether the dealer is obliged to pay for the goods only if the dealer sells them.
- Whether the dealer can return the products.
- Whether the dealer obtains a commission for selling the products to the end-customer.

PwC observation: This proposed principle and list of indicators is consistent with current revenue guidance under IFRS and US GAAP. We do not anticipate a significant change in this area on adoption of the proposed standard. However, the proposed standard focuses on transfer of control rather than the transfer of risks and rewards, so some entities may experience a change in their accounting.

Sale and repurchase of a product

80. When an entity sells a product to a customer with an unconditional obligation to repurchase that product in the future, the entity should account for the transaction as a sale of a product with a right of return (see paragraphs .60 - .61 above).

81. When the entity has an unconditional obligation or unconditional right to repurchase the asset (a forward or a call option), the buyer does not obtain control of the asset, and the entity accounts for the transaction as follows:

- A lease, if the entity repurchases the asset for less than the original sales price of the asset; or
- A financing arrangement, if the entity repurchases the asset for an amount that is equal to or more than the original sales price of the asset.

82. The entity continues to recognise the asset, together with a financial liability, for any consideration received from the buyer in a financing transaction. It records the difference between the amount of consideration received from the customer and the amount of consideration paid as interest expense.

PwC observation: An entity may enter into an agreement to repurchase goods sold to a customer. Management will need to consider whether control of the goods transferred to the customer in the intervening period to assess whether a sale has occurred or whether the arrangement is in substance a lease.

Customer acceptance

83. Management will need to determine whether the customer has obtained control of the good or service prior to acceptance if the contract includes a customer acceptance provision.

84. Customer acceptance may be a formality if the entity can objectively determine that the good or service has been transferred to the customer in accordance with the contract specifications.

85. The entity does not recognise revenue prior to acceptance if it is unable to objectively determine that the good or service transferred to the customer meets the contract specifications. This is because management cannot determine whether it has satisfied the performance obligation.

86. When a contract allows the customer a trial or evaluation period, control transfers either upon customer acceptance of the good or at the end of the trial or evaluation period.

PwC observation: The proposed principle for accounting for contracts that include customer acceptance clauses is similar to current revenue guidance. Management will need to consider carefully the terms of the contract and whether they have the ability to determine objectively whether the good or service meets the contractual terms in order to support that control has transferred prior to customer acceptance. Factors that may support management's ability to determine objectively that it has met the contract specifications include:

- The entity's historical experience with meeting specified terms.
- Whether outside factors could affect acceptance.
- The entity's history regarding acceptance clauses.

Other issues

Contract costs

87. The proposed standard includes specific guidance for accounting for costs associated with contracts with customers. An entity recognises costs to obtain a contract (for example, costs of selling, marketing or advertising) as incurred.

PwC observation: Expensing costs to obtain a contract as they are incurred may significantly affect entities that previously capitalised certain pre-contract costs (for example, acquisition costs and legal costs). Management should carefully review its cost capitalisation methods in order to understand the potential effects of these changes.

88. An entity may capitalise the costs to fulfil a contract in certain circumstances. Management will need to evaluate whether the costs incurred in fulfilling a contract are in the scope of other standards (that is, inventory, fixed assets, intangibles) to determine which costs may be recognised as an asset. These costs will be accounted for in accordance with the relevant standards.

89. An entity will recognise an asset for costs that are not within the scope of another standard only if the costs relate directly to a contract, will generate or enhance a resource that the entity will use to satisfy future performance obligations in a contract, and are expected to be recovered under a contract. Entities might capitalise the following costs under the proposed standard:

- Direct labour, including salaries and wages.
- Direct materials, including inventory.
- Allocations of costs, including contract management and depreciation.
- Costs that are explicitly chargeable to the customer under the contract.
- Other costs incurred only due to entering into the contract.

90. Capitalised costs should be amortised (and recognised as cost of sales) as the entity transfers the underlying goods or services that relate to the asset.

91. The entity recognises an impairment loss when the present value of the expected (future) direct costs of satisfying the remaining performance obligations in the contract exceeds the transaction price allocated to those performance obligations. Management should recognise a loss if the expected costs exceed the carrying amount of the asset.

Sales of assets that are not an output of an entity's ordinary activities

92. An entity should apply the recognition and measurement principles of the proposed standard to contracts for the sale of non-financial assets that are not an output of the entity's ordinary activities (for example, property, plant and equipment within the scope of Topic 360 or IAS 16, 'Property, plant and equipment', IAS 38, 'Intangible assets', and

IAS 40, 'Investment property'). The proposed standard will amend existing requirements for the recognition of a gain or loss on the sale of non-financial assets that are not an output of the entity's ordinary activities.

93. The entity will derecognise the asset when the buyer obtains control of the asset and recognise a gain or loss equal to the difference between the transaction price and the carrying amount of the asset. The transaction price will be limited to amounts that management can reasonably estimate at the date of the transfer.

Timing for comments

94. Comments on the exposure draft are due by 22 October 2010. We encourage management to engage in the comment letter process and suggest that entities respond formally to the questions included in the exposure draft. Entities that would like to participate in the boards' future roundtables should notify the boards by 1 October 2010.

Industry insights

95. Extensive industry-specific revenue recognition guidance exists under current US GAAP, while limited revenue guidance exists under IFRS. However, even under IFRS, certain industry practices have developed over time. The proposed standard is likely to have a more significant effect on some industries than others. We will shortly issue supplements to this Practical Guide that discuss some of the more significant implications for a number of industries to help readers identify and consider the implications of the proposed standard on their specific industries.

95. Extensive industry-specific revenue recognition guidance exists under current US GAAP, while limited revenue guidance exists under IFRS. However, even under IFRS, certain industry practices have developed over time. The proposed standard is likely to have a more significant effect on some industries than others. We have therefore issued supplements to this Practical Guide that discuss some of the more significant implications for entities in the following sectors:

- Engineering and construction,
- Entertainment and media,
- Industrial products, and
- Retail and consumer.

Further supplements will be released shortly.

96. We encourage management to read the topics addressed in the supplements and consider the potential effects that the proposed standard could have on their existing revenue recognition practices. The issues discussed in the supplements are intended to assist management in formulating feedback to the boards that can help in the development of a high-quality final standard.

Where to go for more information

97. A summary of all tentative decisions reached by the boards relating to this project can be found at http://www.fasb.org/revenue_recognition.shtml.

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