December 2008

Discussion Paper

Snapshot: Preliminary Views on Revenue Recognition in Contracts with Customers

This snapshot is a brief introduction to the discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers.* It provides an overview of the major ideas presented by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) in the discussion paper.

Project objective: The objective is to clarify the principles for recognising revenue and to create a joint revenue recognition standard for International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (GAAP) that companies can apply consistently across various industries and transactions.

Project stage: In December 2008 the IASB and the FASB published a discussion paper (DP) for public comment. The DP is an important, non-mandatory step in the boards' due process of creating a standard. In the DP the boards explain their initial views on the topic, including some of the principles that they propose as the basis of a future standard.

Comment deadline: The DP is open for public comment until 19 June 2009.

Next steps: The boards are now seeking feedback from all interested parties. They will consider that feedback as they develop an exposure draft (ED) of a standard which they expect to publish in 2010.

International Accounting Standards Board®

Why are the boards doing the project?

Revenue is a crucial number to users of financial statements in assessing a company's performance and prospects.

However, revenue recognition requirements in US GAAP differ from those in IFRSs and both are considered in need of improvement.

The requirements in US GAAP comprise numerous standards – many are industry-specific and some can produce conflicting results for economically similar transactions. Although IFRSs contain fewer standards on revenue recognition, the two main standards have different principles and can be difficult to understand and apply beyond simple transactions. In addition, they lack guidance on matters such as revenue recognition for multiple-element arrangements.

By developing a common standard that clarifies the principles for recognising revenue, the boards aim to:

- remove inconsistencies and weaknesses in existing revenue recognition standards and practices
- provide a more robust framework for addressing revenue recognition issues
- simplify the preparation of financial statements by reducing the number of standards to which companies must refer
- improve comparability of revenue across companies and geographical boundaries.

What is the scope of the project?

One approach for all contracts with customers

The DP addresses when and how much revenue should be recognised in contracts to provide goods and services to customers. Such contracts are enforceable arrangements and take a variety of forms, covering the simplest to the most complex contracts across various industries. Although the scope of the project is very broad, the boards expect that the accounting for many transactions would not be affected by their proposals.

The boards may decide to exclude some contracts from the scope of the new standard, for instance those within the scope of other standards or projects on the boards' agendas (eg financial instruments, insurance and leases). That is one of the matters on which the boards are seeking feedback.

One approach for all contracts with customers across various industries.

In IFRSs the new standard would replace IAS 18 *Revenue*, IAS 11 *Construction Contracts* and related interpretations. In US GAAP it would replace many standards and interpretations, both general and industry-specific.

What are the boards' initial ideas?

In the DP the boards propose the following principles as the basis of a future standard:

A contract-based revenue recognition model

The boards propose that revenue recognition should be based on accounting for a contract with a customer.

When a company enters into a contract with a customer, the company obtains rights to payment from the customer and assumes obligations to provide goods and services to the customer – 'performance obligations'. The combination of those rights and obligations gives rise to a net contract position that can be an asset, a liability or a net nil position of the company. Revenue arises from increases in that net contract position over the life of the contract.

The boards propose that revenue recognition should be based on accounting for a contract with a customer.

Revenue is recognised when performance obligations are satisfied

The boards propose that a company should recognise revenue when it satisfies a performance obligation in the contract – in other words, when it fulfils a promise to provide a good or a service to the customer. Satisfying a performance obligation increases a company's net contract position.

A company satisfies a performance obligation only when it has transferred (ie provided) the promised good or service to the customer. For a good, that transfer typically occurs when the customer takes physical possession of it, and for a service, when the customer has received the promised service. If a company promises to transfer more than one good or service, it recognises revenue as each promised good or service is transferred to the customer (ie as the company satisfies each performance obligation in the contract).

That recognition principle is consistent with many existing standards and would not change the accounting for many contracts. However, it would change the accounting for some contracts. For example, in some manufacturing or construction contracts, companies recognise revenue as they undertake activities required by the contract – even if the customer is not receiving any good or service as a result of those activities. In those cases, the proposed recognition principle would preclude a company from recognising revenue until the customer receives a promised good or service (ie until the company satisfies a performance obligation).

The boards propose that a company should recognise revenue when it satisfies a performance obligation in the contract.

What are the boards' initial ideas? continued

Amount of revenue based on an allocation of the customer's consideration

The boards propose that revenue is the amount of the payment (ie consideration) received from the customer in exchange for transferring goods and services to the customer.

Typically a customer pays for a bundle of goods and services. If those goods and services are transferred to the customer at the same time, a company simply recognises revenue in the amount of the promised consideration at the time of the transfer. However, if a company transfers goods and services at different times, it needs to determine how much of the total consideration to allocate to each performance obligation.

The boards propose that a company should allocate the consideration to each performance obligation in proportion to the company's stand-alone selling price for the promised good or service underlying each performance obligation. If that price cannot be observed, then it must be estimated. As each performance obligation is satisfied (ie as each good and service is transferred to the customer), the amount allocated to the performance obligation is recognised as revenue.

The boards' proposed principles would result in a company's pattern of revenue recognition depicting the transfer of goods and services to customers, even if the amount of revenue recognised relies on the use of estimated prices. That use of estimates would change the accounting for some contracts. For example, at present some software companies do not recognise revenue when they have provided a good or a service to a customer because there is no objective and reliable evidence of the selling price of the goods or services yet to be provided under the contract.

The boards propose that revenue is the amount of the payment received from the customer in exchange for transferring goods and services to the customer.

Remeasurement of performance obligations

The DP discusses how the measurement of performance obligations affects not only how much revenue is recognised each reporting period, but also how the company's net contract position is depicted in the statement of financial position at the end of each reporting period. Because circumstances can change significantly after the start of the contract, a company might need to update the carrying amount of a performance obligation (ie remeasure a performance obligation) in order to depict faithfully its net contract position.

What are the boards' initial ideas? continued

Remeasurement of performance obligations continued

The boards propose that after contract inception, a company should remeasure a performance obligation when it is deemed 'onerous'. A performance obligation is deemed 'onerous' when a company's expected costs of satisfying a performance obligation exceed the carrying amount of that performance obligation. The carrying amount of an onerous performance obligation is increased to the company's expected costs of satisfying that performance obligation and a corresponding contract loss recognised.

The DP also considers whether performance obligations should be remeasured in instances other than when deemed onerous. The DP notes the types of obligations that some board members think may require such an approach.

The boards propose that after contract inception, a company should remeasure a performance obligation when it is deemed 'onerous'.

How can I comment on the DP?

The DP includes questions related to the boards' proposals. Interested parties may answer all or selected questions in the DP or may comment on any other issue that the boards should consider in developing their initial views into an exposure draft of a joint revenue recognition standard. The boards' deliberations will, as usual, take place in public board meetings as announced on the boards' websites.

The deadline for comments on the DP is 19 June 2009. To view the discussion paper and submit your comments, visit www.iasb.org or www.fasb.org.

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