

# IFRS Briefing Sheet

## Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*

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This IFRS Briefing Sheet summarises the Discussion Paper (DP) *Preliminary Views on Revenue Recognition in Contracts with Customers* that was published by the International Accounting Standards Board (IASB or Board) and the U.S. Financial Accounting Standards Board (FASB) (together, the Boards) on 19 December 2008. Comments are due on 19 June 2009.

Proposed new guidance would require a single revenue recognition model to be applied to all contracts under which revenue is earned, based on allocating revenue to the different performance obligations in the contract.

While the Boards believe that the proposals largely are consistent with the earnings-type model used currently certain areas such as the accounting for construction contracts could be significantly impacted by the proposals.

as revenue as the entity satisfies performance obligations in the contract.

Under the proposed model the contract with a customer would be broken down into separate performance obligations to the extent that they are performed at different times. For example, the sale of goods with a standard one-year warranty would comprise two performance obligations: (1) the sale of goods; and (2) the sale of a warranty.

At inception, the contract price would be allocated to the separate performance obligations on the basis of their relative selling prices, observed or estimated, on a stand-alone basis. The contract price would be recognised as revenue as each performance obligation is satisfied.

A performance obligation would be remeasured only if deemed onerous, i.e., if the entity's estimated cost of performance exceeds the carrying amount of that performance obligation.

### Executive Summary

The DP proposes a single revenue recognition model based on changes in the contract asset or liability with a customer (i.e., the net asset or liability arising from the remaining rights<sup>1</sup> and obligations<sup>2</sup> in a contract<sup>3</sup>). The rights under a contract would be recognised

- 1 Rights to receive payment from the customer.
- 2 The promise to provide goods or services to the customer, i.e., performance obligations.
- 3 An agreement between two or more parties that creates enforceable obligations, not necessarily in writing.

### Contract-based Revenue Recognition Principle

The DP proposes a single revenue recognition model using a contract-based revenue recognition principle that can be applied consistently to various transactions. A contract with a customer conveys rights to the entity to receive consideration from the customer and imposes obligations

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on the entity to transfer goods and / or services to the customer. The rights under a contract would be recognised as revenue as the entity satisfies performance obligations in the contract.

### No Scope Exclusions

To date the Boards have not excluded any contracts with customers from the proposed model. The Boards will consider exclusions once comments on the DP have been received.

### Performance Obligations Identifying Separate Financial Performance Obligations

Performance obligations encompass both statutory and constructive obligations. The DP proposes that performance obligations be accounted for separately when the promised goods or services are transferred to the customer at different times. This is to ensure that revenue recognition represents the pattern of the transfer of goods or services to the customer over the life of the contract.

Theoretically a contract can be broken down into an indefinite number of performance obligations. For example, a company that sells computers must source each part for the computer, assemble the parts, deliver the computer, etc., which could result in a highly complex revenue recognition model. However, the DP proposes that performance obligations be grouped together to the extent that they are satisfied at the same time.

### Satisfaction of Performance Obligations

A performance obligation would be satisfied when the promised goods or services are transferred to the customer. The DP proposes that this takes place when the customer obtains control of the promised goods or services, i.e., the goods or services become the customer's asset. The DP notes that usually this occurs

when the customer takes physical possession of the asset. Accordingly, in the above example, it is likely that all revenue would be recognised when the computer is delivered to the customer.

The DP acknowledges that it may be difficult to determine when an asset is transferred to the customer if that asset also is used in satisfying a subsequent performance obligation. For example, a painting company contracts with a customer on 25 June to paint the customer's property. The contract price is inclusive of the paint, which is delivered to the customer on 30 June. The painting is carried out between 1 and 15 July.

In determining whether revenue should be recognised by the painting company at 30 June, the general principle would require an assessment of who the paint belongs to at 30 June: the painting company, in which case no revenue would be recognised; or the customer, in which case a portion of the revenue under the contract would be recognised. Given the difficulty in determining when an asset is transferred, the DP proposes a rebuttable presumption that an asset (the paint) used in satisfying another obligation (the painting) is not transferred to the customer until the asset is used in satisfying that other performance obligation.

### Measurement of Performance Obligations Initial Recognition and Allocation

The DP proposes that performance obligations be measured initially at the contract price, i.e., the customer's promised consideration; accordingly, no "day one" revenue would be recognised upon contract inception. The Boards have not yet addressed whether or how to reflect the time value of money in initial measurement.

The contract price would be allocated to each performance obligation (or

group of performance obligations satisfied at the same time) in proportion to their relative stand-alone selling prices. An example showing how this allocation would affect revenue recognition is included in this IFRS Briefing Sheet.

When stand-alone selling prices are not available, an entity would be required to estimate them using approaches such as the "expected cost plus a margin approach" or the "adjusted market assessment approach."

### Subsequent Measurement

The DP proposes that a performance obligation be remeasured only when it is deemed to be onerous, i.e., the expected cost of satisfying the performance obligation exceeds the carrying amount of that performance obligation.

### Potential Effects on Current Practice

The proposed model may have significant effects on current practice, including in the following areas:

- *Contract required.* For example, increases in the value of biological assets would not trigger revenue recognition in the absence of a contract with a customer.
- *Identification of performance obligations.* For example, warranties would be accounted for as separate performance obligations in a contract, rather than as cost accruals.
- *Construction contracts.* Contracts accounted for previously on a percentage-of-completion basis would be accounted for on the basis of the timing of discharge of the underlying performance obligations, which may mean that revenue is recognised later than it is currently.

### Response to the IASB

The IASB has invited comments on the DP by 19 June 2009.

**Example**

On 29 February, Vendor enters into a contract with a customer to provide, deliver and install manufacturing equipment for 15,000 due on delivery. Vendor delivers the equipment on 31 March and installs it during April. Title to the equipment passes to the customer at delivery. Vendor separately sells the equipment (inclusive of the delivery service) and installation service for 14,000 and 2,000 respectively. Vendor does not sell delivery services separately from equipment. The allocation of the transaction price of 15,000 would be as follows:

	<i>Stand-alone selling price</i>	<i>Allocation of discount</i>		<i>Measurement of performance obligation</i>
	(A)	(B)		(A) - (B)
Machine and delivery	14,000	875 <sup>(a)</sup>		13,125
Installation	2,000	125 <sup>(b)</sup>		1,875
<b>Total</b>	<b>16,000</b>	<b>1,000</b>		<b>15,000</b>

(a)  $1,000 \times (14,000 \div 16,000)$   
 (b)  $1,000 \times (2,000 \div 16,000)$

Vendor satisfies the equipment and delivery services obligation on 31 March when the equipment is transferred to the customer. Vendor satisfies the installation service obligation in April as installation progresses. Therefore, Vendor's net contract position and revenue recognition are as follows:

	<i>Net contract position at end of month</i>	<i>Revenue recognition during month</i>
February	-	-
March	-1,875 <sup>(a)</sup>	13,125
April	-	1,875

(a) Because the customer paid on delivery of the equipment, there are no remaining rights at 31 March. Therefore, Vendor's net contract position at 31 March is a contract liability of 1,875 (the amount allocated to the remaining performance obligation).

Source: Discussion Paper

If you would like further information on any of the matters discussed in this issue of *IFRS Briefing Sheet*, please talk to your usual local KPMG contact or call any of KPMG firms' offices.

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