Boards near completion of the revenue recognition standard

What you need to know

- The Boards moved a step closer to finalising their new revenue recognition standard this week, clarifying how aspects of variable consideration and collectibility will be addressed in the standard.
- The Boards also addressed how entities should determine whether a contract meets the criteria to be within the scope of the proposed standard and the accounting for contracts that are not in the scope.
- The Boards have indicated that they expect to issue a final standard in the third quarter of 2013.

Overview

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) met at their July 2013 joint meeting to discuss how three topics will be handled in the final revenue recognition standard.

At the meeting, the Boards discussed constituents’ concerns about how aspects of variable consideration and collectibility would be reflected in the estimated transaction price for an arrangement. Further, the Boards clarified how entities should determine whether a contract meets the criteria to be within the scope of the proposed standard and the accounting for contracts that do not meet the criteria.

The Boards have indicated that they expect to issue a final standard in the third quarter of 2013.

Determining the transaction price

The proposed model requires an entity to estimate the transaction price, which is defined as the “amount of consideration to which an entity expects to be entitled.” In feedback received on the 2011 exposure draft (ED) and during the drafting process of the final standard, constituents continued to raise concerns about how collectibility and variable consideration should be reflected in this estimated amount.
Collectibility
The Boards discussed whether a customer’s ability to pay (i.e., credit risk) should be considered when estimating a transaction price. The Boards tentatively concluded to retain the principle that the amount of consideration to which an entity will be entitled may be affected by an entity’s willingness to accept a reduction (e.g., price concession, discount) in the consideration promised by the customer. Furthermore, the Boards believe this to be true even if the entity decides to accept a lower price resulted from a customer’s inability to pay the contractual amount.

The Boards tentatively concluded that if an entity has an established practice of providing discounts or price concessions, or the entity enters into an arrangement with the expectation of collecting less than the stated contractual amount, such actions may represent concessions implied or granted by the entity that would be reflected in the transaction price rather than impairment losses that would not affect the transaction price. The Boards decided to provide additional guidance, to be developed in the drafting process, in the final standard to help preparers make this determination.

How we see it
The distinction between a price concession related to a customer’s inability to pay and an impairment loss will be subjective and could be challenging to make. We anticipate implementation of this aspect of the standard may be difficult.

Variable consideration
The Boards previously determined that if the consideration that an entity expects to be entitled to is variable, the amount of variable consideration included in the estimated transaction price should be constrained. Specifically, the Boards concluded that the transaction price should not include amounts of variable consideration that could result in a significant revenue reversal in the future.

At this meeting, the Boards reaffirmed those decisions and clarified how the constraint would be applied. The Boards tentatively concluded that if an entity expects including the entire estimate of the variable consideration in the transaction price would result in a significant revenue reversal, then it would include in the transaction price the portion not subject to a significant reversal (i.e., a minimum amount). The requirement to estimate a minimum amount would apply to all performance obligations whether satisfied at a point in time or over time.

The Boards also tentatively decided not to specify the circumstances when the minimum amount would be zero. Furthermore, the Boards affirmed their decision not to specify an exception for sales-based royalties on licences of intellectual property.

The Boards plan to include indicators in the final standard to help entities determine whether variable amounts may be subject to significant reversal.

Requiring recognition of a minimum amount of variable consideration will substantially change practice for some entities.
How we see it

- Entities will need to apply judgement in determining the amount of variable consideration that is not subject to significant reversal. Such judgements and estimates will need to be updated each reporting period.

- The requirement to estimate and recognise a minimum amount of revenue for variable consideration will be a substantial change in practice for certain entities.

- For example, entities that sell their products through a distributor or reseller may not know the final sales price until the product is sold to the end customer. A common practice today is to use a ‘sell-through’ model whereby sales to the distributor or reseller are not recognised until the product is sold to the end customer. Under the proposed standard, this practice may no longer be acceptable if that revenue or a portion of that revenue is not subject to significant revenue reversal (i.e., a minimum amount).

- To further illustrate, an entity that grants a licence of intellectual property to a customer typically receives royalty payments that are determined based on the customer’s sales of products using the underlying intellectual property. Today, such royalties are considered contingent revenue and are recognised as the customer’s sales occur. Under the proposed requirement, the entity may determine that some portion of this variable consideration is not subject to significant revenue reversal at the time of the transfer of the intellectual property and, if so, would have to include such amount in the transaction price. This may affect the timing of revenue recognition. The estimate would need to be updated each reporting period.

Identifying a contract with a customer

The proposed standard includes criteria for determining whether an arrangement would be in the scope of the model. One criterion requires that “the parties are committed to perform their respective obligations and they intend to enforce their respective contractual rights.” Constituents raised questions about whether and how collectibility should be considered when assessing this criterion. Constituents also questioned how entities would account for contracts that do not meet the scope requirements of the revenue standard.

Consideration of collectibility

In papers prepared for the July meeting, the staffs indicated that an assessment of collectibility is implicit in determining whether parties are committed to perform. That is, if an entity believes there is a significant risk about a customer’s ability to pay, that risk may suggest the customer does not intend to perform under the contract. In such cases, the entity likely would not have an arrangement that is within the scope of the proposed standard. However, the staffs also clarified that uncertainties about whether a customer may only partially perform under the contract (i.e., the customer will pay a portion but not all of the transaction price), would not prevent an entity from determining this criterion has been met. In these situations, entities would consider whether the arrangements include variable consideration (e.g., a price concession) when determining the transaction price, as discussed above.

The Boards tentatively decided to clarify the objective and application of the criteria for determining whether an entity has a contract with a customer within the scope of the proposed standard. The objective would be focused on an entity’s overall qualitative assessment of the facts and circumstances of the contract with the customer to determine whether the parties are committed to the contract.
Accounting for arrangements that do not meet the scope requirements

Constituents also raised questions on the accounting for arrangements that are determined not to be within the scope of the proposed standard (because the criteria specified within the requirements have not been met). The Boards tentatively decided that an arrangement that does not meet the criteria to be considered a contract with a customer, including arrangements for the transfer of non-financial assets, would not be accounted for under the proposed revenue recognition standard, even by analogy.

Instead, the Boards agreed that the proposed standard would clarify that for arrangements not meeting the specified criteria, an entity would account for any consideration received as a liability. Such amounts would be recognised as revenue only when one of the following conditions is met:

► The arrangement subsequently meets the criteria to be considered within the scope of the proposed revenue standard.
► The entity has no remaining obligations to the customer and one of the following is met:
  ► All of the promised consideration has been received and the amounts are non-refundable.
  ► The contract has been cancelled and the consideration received is non-refundable.

Next steps
The Boards will continue to address any remaining ‘sweep’ issues and have indicated that they plan to issue the new standard in the third quarter of 2013.