Financial Accounting Standards Board

International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB and FASB. Paragraph numbers correspond to paragraph numbers used in the joint IASB-FASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB/FASB Meeting:	**24 October 2006, Norwalk**
Project:	**Revenue Recognition**
Subject:	**Due Process Document (Agenda Paper 7) (also issued as observer note for IASB meeting Agenda Paper 16)**

INTRODUCTION

1. The purpose of this paper is to seek the Boards' approval of a revised approach for undertaking the Revenue Recognition project and to consider the nature of the initial due process document planned for issue next year.

BACKGROUND

2. In 2002 the Boards embarked on their joint project on Revenue Recognition. The objective of the project is to develop coherent conceptual guidance for revenue recognition and a comprehensive standard on revenue recognition that would be based on those concepts.

3. In February this year the Boards published a Memorandum of Understanding (MoU). Under this MoU, the Boards set a goal of making 'significant progress' in areas in which the current accounting practices of US GAAP and

IFRSs are regarded as candidates for improvement. With respect to the Revenue Recognition project, the Boards set a goal of issuing 'one or more due process documents relating to a proposed comprehensive standard' by 2008.

REACHING A PRELIMINARY VIEW BY DECEMBER 2007

4. The staff believes that the MoU goal needs to be met. This is because the only way in which the outside world can determine whether we are making 'significant progress' on this project is by issuing a due process document. *[Remainder of paragraph omitted from observer note]*

5. [Paragraph omitted from observer note]

6. [Paragraph omitted from observer note]

7. [Paragraph omitted from observer note]

THE STAFF ALTERNATIVE—DEVELOP THE TWO MODELS

8. Over the last four years, the Boards have been developing an asset and liability model for revenue recognition. That is, revenue is viewed as a function of changes in assets and liabilities, consistent with the existing definition of revenue, and not overridden by tests based on the notions of realisation and the completion of an earnings process. Furthermore, the Boards have narrowed the possible implementations of the asset and liability model to two broad versions. Under one version the performance obligations are initially measured at fair value (fair value model), and under the other they are initially measured by allocating the customer consideration amount (customer consideration model).

9. Of course, portraying the differences between the two models as essentially a difference in the measurement attribute is likely to underestimate the difference between the two models. For instance, in the customer consideration model, the Boards decided to identify the separate performance obligations in a contract based on a notion of utility to the customer. Thus, both the initial identification and measurement of the performance obligation would be from the customer's perspective. The Boards did not conclude on the identification of performance obligations under the fair value model, but the decision in the customer consideration model might not be appropriate in the fair value model. Hence, the initial identification of performance obligations might be different under the two models.

10. The two models remain incomplete in different areas. Each of these models has support from members of each Board; however, there is not a clear majority among either Board for either of the two models.

11. Accordingly, the staff thinks that the solution … is to develop both models. *[Remainder of paragraph omitted from observer note]*

12. [Paragraph omitted from observer note]

HOW BEST TO DEVELOP THE TWO MODELS

13. As noted, both models have their supporters on the Boards. Therefore, the staff thinks that the best way to progress the development of the two models, without compromising either, would be to form two small groups of Board advocates. The purpose of the groups would be to advise and assist the staff in developing and completing the models. We suggest keeping each group small, say three Board members, drawn from both Boards.

14. The staff's initial plan is that we and each of the groups meet three or four times over the next six months … to work through the main remaining issues. The staff will prepare 'working group' style papers for each meeting with the advisors.

15. [Paragraph omitted from observer note]

16. The staff envisages the output from these meetings to be an articulation of each of the models, in a form that would be suitable for inclusion in a due process document. In addition, the staff believes that each group should illustrate its model using the same set of examples, comparing and evaluating the outcomes with the current requirements of US GAAP and IFRS. A proposed set of examples, together with our rationale for choosing each of those examples, is included in Appendix B.

17. The chapter and the worked examples should then be brought to each of the Boards next year for evaluation, discussion and possible further development. The main point to note is that the Boards will have the complete picture, which should allow for a better evaluation of the models.

18. *[Paragraph omitted from observer note]*

19. *[Paragraph omitted from observer note]*

20. *[Paragraph omitted from observer note]*

21. *[Paragraph omitted from observer note]*

22. *[Paragraph omitted from observer note]*

CONTENT OF THE DUE PROCESS DOCUMENT

23. *[Paragraph omitted from observer note]*

24. … [T]he staff's view is that the core of the due process document would consist of three sections: one discussing the assets and liabilities that arise in contracts with customers and the other two discussing how those assets and liabilities, and the changes in those assets and liabilities, are accounted for under the fair value model and the customer consideration model respectively. An appendix to the paper would include the examples fully worked under the two models and compared with current accounting under US GAAP and IFRS.

25. The paper would also need an introductory chapter explaining why the Boards are undertaking this project and, hence, explaining the main problems associated with much of the current literature. The staff notes that some constituents do not see a need for this project. They believe that the main issue with revenue recognition under US GAAP is the volume of the literature and believe that the solution is to develop a general standard similar to IAS 18 but improved by incorporating guidance from EITF 00-21 *Revenue Arrangements with Multiple Deliverables* and SAB 104 *Revenue Recognition*. We need to make a persuasive case that approaching the issue from an asset and liability perspective (ie considering the changes in elements), rather than an earnings-process perspective (which dominates much of the current literature), will help us address consistently the questions of whether and when revenue has been earned.

26. The introductory chapter would also need to explain why the Boards have developed the two models and emphasise the Boards' final goal of reaching a common view on revenue recognition and developing a single converged standard.

27. A concluding chapter should summarise the different outcomes under the two models and the consequences of the models. By consequences, the staff has two things in mind.

28. First, we need to explain the relative advantages and disadvantages of the two models. For instance, we should highlight that one consequence of the fair value model is that any error in the initial measurement of performance obligation may result in day one revenue (and profit). On the other hand, whilst avoiding this problem, a customer consideration model can result in similar and even identical obligations being measured differently, because the history of each obligation can be determinative. This can impair the comparability of the financial statement information.

29. Secondly, we should explain which aspects of each model are required that are not required under the other model. For instance, at this stage the staff thinks that a customer consideration model will almost certainly require some form of an onerous contract test (or what the IASB, in its project on Insurance Contracts, describes as a liability adequacy test). Depending on the approach to subsequent measurement under the fair value model, such a test may not be required under that model. On the other hand, for a fair value model, issues will arise concerning the sources of the measures and whether they are from Levels 1, 2 or 3 of the hierarchy.

30. An outline of a due process document containing the two models is proposed in Appendix A.

DEPTH OF THE DUE PROCESS DOCUMENT

31. The staff views the initial due process documents as establishing the basic structure of what an asset and liability model would entail for revenue recognition. We think it should highlight the principal issues that would need to be addressed under such a model and offer one or two views of how to

resolve those issues (depending on whether the Boards reach a preliminary view). We do not view the document as the first draft of revised concepts and a general revenue recognition standard.

32. Accordingly, we think that there will be issues that will eventually require standards-level guidance but which do not need to be addressed in the due process document. For example, we do not think that the paper need address issues surrounding identifying implied contractual promises. Indeed, discussing issues such as this may distract from the discussion of the main principles. Similarly, if there is a need for an onerous contract test under the customer consideration model, the paper does not need to specify the details of that test (eg measurement objective, whether the additional liability can be reversed if circumstances subsequently change, reporting the change). It should be enough to highlight that this is a requirement of that model and the issues that would need to be resolved.

33. The staff thinks that we should not overlook the educative nature of the paper. We must not forget that although in some respects an asset and liability approach can be seen as a better explanation of some of current practice (in that revenue is typically deferred today because the entity has not fulfilled its obligation), it also represent a different way of viewing revenue recognition. For example, the staff notes that some of the letters that the IASB recently received on its proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* indicate that some constituents view the question of revenue recognition on a guarantee or warranty as divorced from liability recognition. We should not underestimate the importance of explaining some of the basic features of the approach (and that will be common to both models).

QUESTIONS FOR THE BOARDS

34. Do the Boards agree with the proposal to (a) develop both models and (b) initially develop the models outside Board meetings using small groups of supporting Board members?

35. Do the Boards agree that the due process document could explain, illustrate and seek comment on both models?

36. Do the Boards agree with the proposed approach for structuring the due process document? Are there any other issues not covered in the outline in Appendix A that must be addressed prior to issuing the due process document? Do the Boards agree that the proposed examples in Appendix B will be sufficient to illustrate the two models?

DUE PROCESS DOCUMENT: REVENUE RECOGNITION
Proposed outline

1 Background and context

- Reasons for the Boards undertaking the project
  - Illustration of problems under current literature arising from applying earning-process perspective
  - Conflicts and inconsistencies in the literature and proliferation of the literature

- Why adopt an asset and liability model?
  - Explanation of how it answers the question of whether revenue has arisen (or been generated) and when it should be recognised
  - Overview of what an asset and liability model entails

- Overview of remainder of document
  - Rationale for developing two revenue recognition models
  - Emphasising the ultimate goal of a converged general standard on revenue recognition

2 Contracts

- Explanation and rationale for focusing discussion primarily on contracts (express or implied) with customers

- Explanation that customer related intangible assets are outside the scope of the discussion

- Analysis of assets and liabilities arising under contracts
  - Contractual promises obtained/made as the economic resource/burden, and contractual rights and obligations linking the entity that is the promise/promisor to those promises
  - Conditional, unconditional and mature rights and obligations
  - Wholly executory and partially executory contracts

3 Customer consideration model

- How are the separate performance obligations in a contract identified?

- How are performance obligations measured on initial recognition?

- Contract acquisition costs
  - Does a customer consideration model need to address the accounting of these costs?

- How are performance obligations subsequently accounted?
    - Effects of entity's partial performance
        - When, if ever, is a performance obligation *partly* extinguished?
    - Effects of non-performance changes in performance obligations, eg changes in selling prices, changes in historical experience
        - When, if ever, is a performance obligation remeasured for non-performance changes?
        - Are performance obligations subject to a liability adequacy (onerous contract) test?
    - Derecognition upon settlement

- How are contract assets measured on initial recognition and subsequently?
    - Unconditional rights to receive customer consideration in partially executed contracts in which the seller performs first
    - Unconditional rights to a customer's stand-ready performance (that is, the contract payment is contingent on the seller's performance): contingent consideration
    - Accounting for subsequent changes in asset values

- How are the changes in assets and liabilities arising from contracts reported in profit or loss?
    - Definition of revenue
    - Distinguishing revenue from gains (or some other positive component of comprehensive income)
    - Treatment of a remeasurement of a performance obligation arising from a non-performance change in the obligation

4 Fair value model

- How are the separate performance obligations in a contract identified?

- How are performance obligations measured on initial recognition?
    - Measurement of performance obligations for which there are no observable market prices
    - Reliability of measures: accounting treatment if reliability threshold not met

- Subsequent accounting of performance obligations
    - Measurement of performance obligations for which there are no observable market prices
    - Reliability of measures: accounting treatment if reliability threshold not met
    - Derecognition upon settlement

- How are contract assets measured on initial recognition and subsequently?
    - Unconditional rights to receive customer consideration in partially executed contracts in which the seller performs first
    - Unconditional rights to a customer's stand-ready performance (that is, the contract payment is contingent on the seller's performance): contingent consideration
    - Accounting for subsequent changes in contract asset values

- How are the changes in assets and liabilities arising from contracts reported in profit or loss?
    - Definition of revenue (or some other positive component of comprehensive income)
    - Distinguishing revenue from gains
    - Treatment of a remeasurement of a performance obligation arising from a non-performance change in the obligation

5 Comparison and evaluation

- Analysis of the differences in the outcomes under the two models
- Discussion of the advantages and disadvantages of the two models
- Discussion of the qualitative characteristics that the Boards will use to decide between the two models

Appendix

Worked examples (cradle to grave) under both models. The examples should also be compared with existing US GAAP and IFRS (see Appendix B for further details of the examples).

- Warranty contract
- Multiple-element transaction: sale of good with a right of return and warranty
- Construction contract
- Loan commitment fee
- Software contract
- Service contract

APPENDIX B

PROPOSED EXAMPLES TO BE ILLUSTRATED

1 Warranty contract

B1. A retailer sells (separately) a three-year extended warranty on a new product line. During the term of the warranty, it becomes evident that more (or fewer) claims are arising under the warranty than initially expected (or priced). The retailer pays its salesmen an irrevocable commission on the sale of the warranty.

Rationale for example

B2. A warranty is a good example, because the accounting under IAS 18 *Revenue* is broken and inconsistent. The example will include ‘selling profit’, because that is an important difference between the two models. The example can also illustrate the effects of a selling cost on profit recognition. It is also a good example of a scenario that may require remeasurement for reasons other than the entity’s performance and the approach to remeasurement is likely to be different under the two models. In addition, the principles of a warranty contract apply to many other types of contracts.

2 Multiple-element transaction

B3. Sale of good with a right of return and a warranty.

Rationale for example

B4. To illustrate the disaggregation of a common type of transaction and the principle that revenue is attributed to each of the elements in a contract (subject to Boards deciding that revenue is attributed to the return right). This is an important difference from IAS 18, in which revenue is sometimes attributed to the dominant element only. The example also illustrates the return right, which has been a significant issue in practice.

3 Construction contract

B5. An entity builds an asset for a customer under a contract that spans more than one accounting period. Two versions of the contract should be illustrated. In the first version, payment will not be due until the asset is complete and accepted by the customer. In the second version, part payment is due from the customer on completion and acceptance of a specified phase of the construction. (For instance, we could use the example of a boat contract, the part payment being due on completion of the hull.)

Rationale for example

B6. It is likely that this example will illustrate important differences between the two models in the pattern of revenue recognition. Furthermore, it will illustrate the role of customer acceptance in the customer consideration model.

4 Loan commitment fee

B7. A mortgage company advertises a fixed rate mortgage. Applicants are required to pay a loan origination fee and a buy-down fee on funding. The example should illustrate an applicant whose application is turned down and others whose applications are accepted (of which one elects not to be funded and two that are funded, with the loan of one being retained and the other being sold and replaced by an identical loan that was purchased in the marketplace).

Rationale for example

B8. The primary purpose of the example will be to contrast the models with current practice (eg Statement 91 *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*) under which identical things can be accounted for differently depending on the history of the transaction.

5 Software contract

B9. Sale of a sales-tax software licence. The sales contract provides for a perpetual licence , initial training for 10 employees and one year's customer support.

Rationale for example

B10. To illustrate the disaggregation of a contract under the two approaches and the differences in the initial measurement of the obligations. It may also highlight differences in the amount of revenue recognised for each element compared with SOP 97-2 *Software Revenue Recognition.*

6 Service contract

B11. Entity contracts at a fixed fee to provide a financial statement audit for the year ending December 2007. Audit procedures will be conducted in the last quarter of 2007 and first quarter of 2008. The audit opinion must be provided by 31 March 2008.

Rationale for example

B12. To illustrate an example of a discrete service contract (compared with one that is continuous such as a warranty). We might also consider a service contract that includes a retainer arrangement, for example an accountant that charges a fixed monthly fee to address routine technical questions.