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International Accounting Standards Board

INFORMATION FOR OBSERVERS

SAC Meeting:	**November, London**
Project:	**Revenue Recognition: Project Update** ***(Agenda Paper 6)***

INTRODUCTION

1. The purpose of this paper is to update the SAC about progress in the revenue recognition project.

PROJECT BACKGROUND

2. In 2002, the Board commenced its project on revenue recognition jointly with the FASB. 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 2006, the two Boards published a Memorandum of Understanding (MoU) in which they set a goal of issuing "one or more due process documents relating to a proposed comprehensive standard" on revenue recognition by 2008.

4. The Boards discussed revenue recognition issues throughout 2003–2006 in order to develop an asset and liability model for revenue recognition. Under

such a view, revenue is a function of changes in assets and liabilities and is not based on the notions of realisation and the completion of an earnings process.

5. However, progress was limited in developing a model due to fundamental differences in Board members' views on several key issues. Board members seemed to fall within one of two camps. Some Board members preferred a model in which the assets and liabilities would be measured at fair value (a so-called fair value model). Others preferred a model in which the assets and liabilities would be measured by reference to the customer consideration (a so-called allocated customer consideration model). Each of these models had some support on both of the Boards: there was not a clear majority among Board members for either of the two models.

6. Accordingly, in October 2006 the Boards decided to develop both of these models independently. Instead of trying to forge a single, compromise model at this stage in the project, they decided that they should aim to get a better and more complete understanding about what both models would look like and what each would entail. They also decided that an initial due process document, as envisaged by the MoU, could explain and illustrate the two models and that this would provide an appropriate basis for seeking constituent feedback.

7. Therefore, over the last year, the staff and two small groups of Board advisers (each drawn from both boards) have developed two revenue recognition models. At the IASB's meeting with the FASB in October, the staff provided a summary of each of the models—the Measurement model (formerly the fair value model) and the Customer Consideration model.

8. These summaries did not delve into every detailed aspect of the models. Their purpose was to update all Board members on development by highlighting the key features of each model and illustrating how each would be applied in three common revenue recognition situations. The summaries and the examples are available on the IASB website.[1]

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[1] See: http://www.iasb.org/NR/exeres/32E392E1-5460-4AD1-B2FC-F63954981434.htm

9. In subsequent months, the Boards will consider a more complete analysis of the two models. That analysis will include:

   a. A more detailed description of the model (key principles)

   b. The completeness and coherence of the model, and issues of practicability

   c. Whether and how each represents an improvement over current practice.

DUE PROCESS DOCUMENT

10. The summaries of the model prepared for the October joint meeting will form the basis of the due process document. Hence, the Boards envisage that the due process document will be a discussion paper containing an explanation of both models and a set of illustrative examples.

11. The Boards view the due process document as the opportunity to seek input on two different revenue recognition models. Because the document will illustrate both models, constituents will be better able to express their views about the wider issues involved. Once the due process document is issued, we will also seek wider input from targeted sources, including the advice of this forum.

12. Neither of the two models in the document will represent a fully-formed, final solution. The distinct characteristics of each model will serve to illustrate the range of issues involved in considering revenue transactions. The purpose of the discussion paper is not necessarily to choose between either model, but to prompt an informed discussion of the strengths and weaknesses of both. This will assist the Boards as they move to the next phase of the project, which will be to develop a single, general comprehensive model for revenue recognition.

13. The Boards acknowledge that constituents are better able to respond constructively to due process documents that contain a preliminary view because there is a clear focus. In this instance, however, given the trade-off between reaching a preliminary view and issuing an initial due process

document, they have concluded that it would be more productive to articulate the two models rather than trying to reach agreement on a single model (which could easily take another year). Until we issue a document, we cannot initiate the debate with our constituents.

14. Presently, we plan to issue the due process document in the first quarter of next year.

INTRODUCTION TO THE TWO MODELS

15. Although the objective of the meeting is not to seek your input on the two models (we will do this next year), Appendix A includes a high-level summary of the two models. In addition, Appendix B includes an illustrative example.

SUMMARY OF THE TWO MODELS

Shared characteristics of the two models

A1. In both models, revenue arises from recognising increases in specified assets and decreases in specified liabilities, rather than from a separate evaluation of how much performance occurred in a period. In other words, the amount of revenue to be recognised is determined by considering how much assets and liabilities change in a period.

A2. The specified assets and liabilities in both models are those that arise directly from enforceable contracts with customers. A contract can be either an asset or a liability to the entity, depending on the remaining unperformed rights and obligations in the contract. A contract would be an asset (a contract asset) to the entity if the remaining unperformed rights exceed the remaining unperformed obligations. A contract would be a liability (a contract liability) to the entity if the remaining unperformed obligations exceed the remaining unperformed rights.

Measurement model overview

A3. To measure the asset or liability arising from the contract, the underlying unperformed rights and obligations in the contract are measured at their current exit price. This is the price that a market participant would pay (or require) to obtain (or assume) the remaining unperformed rights and obligations in the contract. The contract is measured this way at inception and subsequently.

A4. Because the model focuses on the contract asset and liability, revenue is defined as an *increase* in a contract asset or a *decrease* in a contract liability. Hence, revenue is *recognised* when:

- an entity obtains a contract in which the underlying rights exceed the underlying obligations (because this would result in a new contract asset).

- the entity subsequently satisfies its obligations in the contract by providing goods or services to the customer (because this would either increase a contract asset or decrease a contract liability).

A5. The *amount* of revenue that is recognised is derived from the *increase* in the exit price of the contract asset or *decrease* in the exit price of the contract liability.

A6. Because the model is predicated on explicit measurements of the assets and liabilities, it is described as the *measurement model*.

Overview of the customer consideration model

A7. To measure the contract under this model, the underlying rights in the contract are measured at inception at the amount promised by the customer (often referred to as the customer consideration). That amount is then also allocated to the separate performance obligations identified within the contract based on the sales price of the good or service underlying each performance obligation. The amount of the identified performance obligations in total always equals the customer consideration at inception.

A8. Because the customer consideration amount is allocated to the identified performance obligations, the sum of these performance obligations and the measure of the rights are equal at inception. Thus, the measure of the contract at inception is typically zero—neither an asset nor a liability arises at contract inception.

A9. Separate performance obligations within the contractual obligations are identified at inception, based on the timing and nature of their extinguishment. As each performance obligation identified in the contract is satisfied, the resulting decrease in the contract liability or increase in the contract asset results in the recognition of revenue.

A10. In this model, revenue is the decrease in contract liability, or increase in contract asset, that results from an entity satisfying its performance obligations.

Summary comparison of the two models

A11. The two models are compared in the summary table below:

	Measurement Model	**Customer Consideration Model**
What is revenue?	An *increase* in a contract asset or a *decrease* in a contract liability that results from (a) obtaining an enforceable contract with a customer to provide goods and services and (b) providing those goods and services to the customer.	An *increase* in a contract asset or a *decrease* in a contract liability that results from an entity satisfying its performance obligations.
Contract Inception		
Measurement of contract at inception	Measure the remaining rights and obligations in the contract at their current exit price.	Measure the rights in the contract at the amount of consideration received or receivable. The amount of consideration received or receivable is then allocated to the identified performance obligations based on the separate selling price of the underlying good or service.
Identifying the separate performance obligations	At any reporting date, the entity measures *all* of the remaining unperformed obligations in the contract. All obligations to a customer arising from the contract are included in the measurement of the contract (including obligations such as warranties and return rights).	The identified performance obligations are restricted to the obligations agreed upon by the entity and its customer in the contract. 'Ancillary obligations' may arise directly from the contract, but these are not considered performance obligations. No consideration is allocated to these obligations.

ILLUSTRATIVE EXAMPLE: HOUSE PAINTING

16. This is one of the examples presented to the joint board in October to illustrate some of the differences noted above.

B1. Consider the following facts and assumptions:

> PainterCo is a contractor that provides painting services for commercial and private residences. PainterCo contracts with a customer on June 25 to paint the customer's house for CU3000. The price is inclusive of all paint, which PainterCo obtains at a cost of CU800. PainterCo's cost for labour and other painting materials is CU1600. The customer is given the right to obtain its own paint, although the customer does not opt to do so in this example and instead purchases the paint and painting services jointly.
>
> All paint necessary to complete the contract is delivered to the customer's house on June 30. PainterCo renders the painting services continuously from July 1 through July 3. In accordance with the contract terms, the customer pays in full upon completion of the house painting.
>
> The time value of money is ignored for simplicity. PainterCo reports monthly.

B2. This example highlights the relationship between satisfying obligations in a contract and the derecognition of assets that are transferred to a customer to satisfy those obligations.

Proposed Treatment Under the Measurement Model

Contract inception

B3. Upon contract inception, PainterCo incurs obligations to perform according to the terms of the contract and also obtains rights to consideration from the customer in exchange. These remaining contractual rights and obligations are recognised net as either a contract asset or a contract liability. This contract asset or liability is measured at its current exit price, which is the amount that PainterCo would expect to receive or pay to transfer all of its remaining rights and obligations in the contract to a market participant.

B4. In this example, the measurement of the contract asset or liability reflects the following:

a. The price a market participant (e.g. a subcontractor) would charge for providing the paint and the painting services (which includes its costs and its margin).

b. The price a market participant would charge to manage the contract (e.g. for engaging the subcontractor and dealing with the customer) and to guarantee a subcontractor's performance.

c. The expected consideration from the customer (adjusted for risk of non-payment).

B5. Assume that at contract inception, PainterCo estimates that a subcontractor would provide the paint and the painting services for CU2800. In addition, PainterCo estimates that a market participant would charge CU100 for managing the contract and providing performance guarantees. Ignoring the risk of non-payment, a contract asset and revenue of CU100 is recognised (rights of CU3000 less obligations of CU2800 and CU100).

Dr Contract asset	100	
Cr Revenue		100

B6. The contract asset reflects the fact that PainterCo would expect to be compensated by a market participant for obtaining this contract. In other words, a market participant would be prepared to pay PainterCo CU100 for the remaining rights and obligations because it only needs to fulfil the contract and does not need to incur the costs of obtaining the contract.

B7. In that regard, note that the revenue recognised at contract inception would not result in the recognition of a corresponding amount of *margin*. This is because PainterCo also incurs costs in obtaining the contract. However, because these costs are unlikely to be direct costs attributable to this particular contract, they are excluded from this illustration.

Period ended June 30

B8. PainterCo acquires the paint for CU800 and records it as inventory.

Dr Inventory	800	
Cr Cash		800

B9. At June 30, PainterCo measures the contract asset at the amount it would expect to receive on that date if it transferred all of its remaining contractual rights and obligations to a market participant.

B10. In this example, it could be argued that PainterCo's remaining obligations at June 30 are to provide painting services only. This is because the paint has already been delivered to the customer's premises and a market participant would be able to use this paint to fulfil the contract. Although in this example the customer would be likely to be able to return the paint if the painting services were not provided, the risk of the paint being returned can be viewed as part of the obligations a market participant would be required to assume on June 30 if the contract was transferred. Furthermore, it could be argued that it is appropriate for PainterCo to derecognise the paint because it could not compel the customer to return the paint. In other words, it no longer controls the paint. (It could not, for instance, use the paint on other contracts.)

B11. Assume that PainterCo estimates that a subcontractor would provide the painting services for CU2000 (for simplicity, the price for bearing the risk of the paint being returned is ignored). In addition, PainterCo now estimates that a market participant would charge CU75 for managing the contract and for providing performance guarantees. Since there has been no change in the rights, the contract asset is now measured at CU925 (CU3000 – CU2000 – CU75). Therefore, as a result of satisfying obligations in the contract (that is, delivering the paint to customer and providing some contract management services), the contract asset has increased by CU825, which is recognised as revenue.

Dr Contract asset	825	
Cr Revenue		825

B12. The revenue recognised reflects the value of the paint provided to the customer as well as the value of the services provided (i.e. obtaining and delivering the paint).

B13. PainterCo also recognises the cost of the paint when it is taken out of inventory and delivered to the customer's premises.

Dr Cost of sales (expense)	800	
Cr Inventory		800

B14. PainterCo also incurs other costs associated with delivering the paint; however, these are not separately identified in this illustration.

Period ended July 31

B15. During the period ended July 31, PainterCo completes painting the house and receives payment in full for these services. At this point, PainterCo does not have any remaining rights or obligations. The following entry is therefore recorded to reflect the cash payment and to derecognise the contract asset. The difference is recognised as revenue.

Dr Cash	3,000	
Cr Contract asset		925
Cr Revenue		2,075

B16. PainterCo also recognises the costs of providing the painting services:

Dr Cost of sales (expense)	1,600	
Cr Cash		1,600

B17. The painting services are provided during a single reporting period. If, however, the services straddled multiple reporting periods, then the revenue recognised in any reporting period would be determined by estimating the amount a market participant would require to complete the painting services.

B18. Summarising the above journal entries results in the following:

	Inception	June 30	July 31	Total
Revenue	100	825	2,075	3,000
Cost of sales	-	(800)	(1,600)	(2,400)
Margin	100	25	475	600
Cash	-	(800)	600	
Inventory	-	-	-	
Contract asset	100	925	-	
Retained earnings	100	125	600	

Proposed Treatment Under the Customer Consideration Model

B19. The Customer Consideration model recognises revenue when a performance obligation is satisfied by transferring goods or services to a customer. The contract contains two potential performance obligations—the promise to provide paint and to provide painting services. Both are capable of separate delivery to the customer. However, in this case it is uncertain whether the paint itself is transferred separately from the painting services. Although PainterCo physically delivers the paint to the customer, it does not transfer the paint separately to the customer because PainterCo will utilise the paint in painting the customer's walls. For these reasons, paint is not treated as a performance obligation separate from painting services.

B20. Note that the Customer Consideration model would not always preclude the recognition of revenue for the delivery of paint. If the contract (or operation of law) made it clear that the risks and rewards of paint ownership passed to the customer upon physical delivery of the paint, the Customer Consideration model would treat the delivery of paint as a separate performance obligation, the satisfaction of which would give rise to revenue on its own.

Period ended June 30

B21. At contract inception, PainterCo has the right to the customer's performance (measured at CU3000) and allocates this entire amount to a single performance obligation. As discussed above, the paint is not considered a separate performance obligation, which is why the total consideration is assigned to the combined painting services obligation. PainterCo's net position in the contract is zero because the rights and obligations are equal.

B22. PainterCo pays CU800 to obtain the paint that is recorded in inventory.

Dr Inventory	800	
Cr Cash		800

Period ended July 31

B23. During the reporting period ended July 31, PainterCo completes the house painting services and receives payment in full for those services. The payment of cash satisfies PainterCo's right to the customer's future performance and the completion of the painting service satisfies PainterCo's remaining performance obligation.

Dr Cash	3,000	
Cr Revenue		3,000

B24. PainterCo also recognises the costs of providing the painting service, including the cost of the paint sold.

	Dr	Cr
Dr Cost of sales (expense)	2,400	
Cr Cash		1,600
Cr Inventory		800

B25. Summarising the above journal entries results in the following:

	Inception	June 30	July 31	Total
Revenue	-	-	3,000	3,000
Cost of sales	-	-	(2,400)	(2,400)
Margin	-	-	600	600
Cash	-	(800)	600	
Inventory	-	800	-	
Contract asset	-	-	-	
Retained earnings	-	-	600	

Example summary

B26. In this example, revenue recognition under the Customer Consideration model (see paragraph B25) differs from revenue under the Measurement model (paragraph B18) in two key regards. First, the Customer Consideration model does not recognise any revenue at contract inception. The Measurement model, on the other hand, recognises revenue at inception because the obligations are measured at an amount that is less than the rights to the customer's performance. Whether this generates any margin depends on the expenses that PainterCo incurred in obtaining the contract.

B27. The second key difference concerns the different conclusions under each model regarding when an obligation has been satisfied. Under the Customer Consideration model the paint is not considered to have transferred to the customer because the painter will use the paint in the subsequent painting service. The Measurement model, however, recognises the paint as a separate performance obligation because it concludes that PainterCo no longer controls the paint after physical delivery to the householder.

B28. The outcomes of the two models for this example differ both because of the different measurement approaches of the models and because of the different conclusions reached about when PainterCo satisfies its obligations in the contract with respect to providing the paint, ie different conclusions about when PainterCo should derecognise the paint. At the October joint board meeting, the Boards directed the staff to explore the reasons for these different conclusions in the application of the models with respect to obligation satisfaction/asset derecognition.