JOINT IASB/FASB MEETING, APRIL 2008, AGENDA PAPER 1A
OBSERVER NOTE

# Revenue Recognition

# - A European Contribution -

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London, 21 April 2008

# Pro-active Accounting Activities in Europe

# PAAinE – Proactive Accounting Activities in Europe (1)

## = Initiative of EFRAG and the 17 National Standard Setters

## Why?

- Pooling some of their resources and working more closely together
- Improving the input of Europe to the global accounting debate
- Gaining greater influence on the global standard-setting process
- Focussing on long-term pro-active work
- Stimulating debate on important items on the IASBs agenda at an early stage in the standard-setting process

# PAAinE – Proactive Accounting Activities in Europe (2)

- Objectives of PAAinE Discussion Papers:
  - To stimulate, carry out and manage pro-active development activities
  - To encourage the development of common views
  - To ensure that Europe gives consistent messages to the IASB
- Issued so far:
  - Conceptual Framework, Equity/Liability, Pensions, Performance Reporting and
  - **Revenue Recognition**

# Revenue Recognition

# - The Background -

The paper has been developed **against the background of the joint project of IASB and FASB:**

**IFRS Framework: Revenue shall reflect measurable changes in net assets arising in the course of the ordinary activities of an entity**

= Asset ./. Liability
**= Expected consideration ./. Performance obligation**

**Resulting questions:**

Does signing of a contract lead to (measurable) changes in net assets?
Recognition of selling revenue?
Measurement of performance obligations?

**Measurement of performance obligation**: legal layoff amount

**Re-measurement**: yes!

# **REVENUE** is an important number!

… **but** there are significant weaknesses in existing standards

→ No sufficient guidance on **Multiple Element Arrangements**

→ **Conceptual inconsistencies**/ different approaches used

**IAS 18**
sale of goods

↓

transfers of risks and rewards

**IAS 11**
construction contracts, services

↓

as work progresses (percentage of completion)

**NEED FOR A COMMON SET OF PRINCIPLES THAT APPLY TO ALL TRANSACTIONS**

**But measuring every performance obligation at the legal layoff amount?**

# PAAinE Revenue Recogntion

DRSC and EFRAG decided to work together to prepare a paper that would **stimulate debate within Europe**

The paper examines revenue recognition from first principles

It develops a Framework within which to address in a consistent way the revenue issues that are arising and will arise in the future

Paper has been **published in July 2007** jointly by

- European Financial Reporting Advisory Group (**EFRAG**),
- Deutsches Rechnungslegungs Standards Committee (**DRSC**) and
- Conseil National de la Comptabilité (**CNC**)

# PAAinE Revenue Recogntion (cont.)

Reactions to the paper so far:

Paper included an Invitation to Comment

17 comment letters were received

Comment letters are posted on the websites of EFRAG (www.efrag.org) and DRSC (www.drsc.de)

→ A summary of the comments received has been prepared and will be published later in April.

# Content of the PAAinE-Paper

# The goal we set ourselves

**IASB/FASB** address the issue of revenue recognition **starting from the Framework definition of income**

that is: **"Income is measurable changes in assets and liabilities in the course of the ordinary activities of an entity"**

⇧

**Asset/Liability Approach**

⇧

**PAAinE:** starts from the question: **What shall revenue reflect?**

**uses IAS 11 and IAS 18 thinking** as a starting point to develop an asset/liability approach

## What the PAAinE paper does:

… develop an asset/liability approach starting from the question „**What shall revenue reflect**?“ (revenue being the top line of the income statement),

… discuss different **possible meanings** of the revenue number,

… discuss **when** revenue arises under different approaches (**recognition**).

## What the PAAinE paper does not:

… discuss **measurement** issues in depth. It especially does not discuss defining revenue as changes in the fair value (legal layoff amount) of performance obligations (this is mainly due to perceived practical problems with such an approach).

# What shall the revenue number reflect? – IFRS Framework

The answer the **IFRS Framework** gives:

… **Revenue shall reflect measurable increases in assets/ decreases in liabilities in the course of the ordinary activities of an entity.**

Which assets? / Which liabilites?

When do changes in assets/ liabilities occur?

When are they recognized? (FW.93)

**Many possible answers!**

# What could/ should the revenue number reflect? – <u>Economically</u>

**Revenue could reflect,** for example,

… that the company has completed a defined part or all of a contract;

… activity of the company under a binding contract, in a way that revenue mirrors progress under contracts (or even activity outside contracts);

… Changes in the fair value (legal-layoff amount) of performance obligation;

… or even a mixture of the above (as it does now).

# What should the revenue number reflect? – PAAinE Paper

**Revenue could/should reflect**,

… that the company has completed a defined part or all of a contract, or

… activity of the company under a binding contract, in a way that revenue mirrors progress under contracts (~~or even activity outside contracts)~~, or

… ~~Changes in the fair value (legal-layoff amount) of performance obligation~~, or

???… even a mixture of the above (as it does now). ???

## Note:

A **binding contract** is a **necessary precondition**!

# Asset/Liability-Approach

= revenue is measurable changes in assets and liabilities

## Critical events approach
(similar to IAS 18)

revenue = arises when the supplier fulfils the performance obligations arising under a contract

## Continuous approach
(similar to IAS 11)

revenue = measured progress towards contract completion (percentage of completion)

### Approach A

fulfils all performance obligations

### Approach B

fulfils all performance obligations under a part-contract (part-contract as defined by contract)

### Approach C

substantively fulfils performance obligations of part-contract (part-contract as defined by economic measures)

### Approach D

recognised continuously over the course of contract, as the contract progresses and the entity perfoms

# Critical Events Approaches (A-C)

# The Critical Events Approaches

**Revenue should reflect**,

… that the company has completed a defined part or all of a contract.

| | |
|---|---|
| **Approach A** | complete contract fulfillment |
| **Approach B** | fulfillment of part contracts as defined by contract itself |
| **Approach C** | fulfillment of part contracts as defined by economic measures |

# Asset/Liability-Approach

= revenue is measurable changes in assets and liabilities

## Critical events approach
(similar to IAS 18)

revenue = arises when the supplier fulfils the performance obligations arising under a contract

## Continuous approach
(similar to IAS 11)

revenue = measured progress towards contract completion (percentage of completion)

### Approach A

fulfils all performance obligations

### Approach B

fulfils all performance obligations under a part-contract (part-contract as defined by contract)

### Approach C

substantively fulfils performance obligations of part-contract (part-contract as defined by economic measures)

### Approach D

recognised continuously over the course of contract, as the contract progresses and the entity perfoms

# Approach C: Fulfillment of part or all of a contract

**Revenue should reflect**,

… that the company has completed a defined part or all of a contract,

… with part contracts as defined by economic measures.

**How to disaggregate the contract?**

Each **part-contract** comprises the work necessary to produce an **item of output** that the **customer**

**… can either use** for its intended purpose **or**
**… can sell** at an amount that reflects its worth when used for that intended purpose.

# How to account for Multiple Element Arrangements?

## Disaggregation of the contract

… follows the criterion chosen for when revenue arises,

… that is, it will identify/separate items of part-output, that have value to the customer.

# Why is the critical events approach C an asset/liability approach?

**Revenue** = measurable changes in assets and liabilities

**FW.49(a) asset** = resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity

**<u>Assets:</u>** raw material, inventory, costumer lists, newspaper mastheads, non-competition agreements, … } not only receivables!

**If the entity expects to fulfil the contract and it expects the customer to pay, performance of the entity results in „a resource controlled by it as a result of past events and from which future economic benefits are expected to flow to the entity.“**

# How reliable is the resulting revenue number?

## Starting point for application of the critical events approach C:

- There must be a binding contract with a customer.
- The approach is only applicable,
  … if entity has reliable projections regarding contract fulfillment,
  … if entity expects to fulfil the contract and
  … if entity expects customer to pay.

# Continuous Approach (D)

# Asset/Liability-Approach

= revenue is measurable changes in assets and liabilities

## Critical events approach
(similar to IAS 18)

revenue = arises when the supplier <u>fulfils</u> the performance obligations arising under a contract

## Continuous approach
(similar to IAS 11)

revenue = measured progress towards contract completion (percentage of completion)

### Approach A

fulfils all performance obligations

### Approach B

fulfils all performance obligations under a part-contract (part-contract as defined by contract)

### Approach C

substantively fulfils performance obligations of part-contract (part-contract as defined by economic measures)

### Approach D

recognised continuously over the course of contract, as the contract progresses and the entity perfoms

# The Continuous Approach (Approach D):

**Revenue should reflect**,

… activity of the company under a binding contract, in a way that revenue mirrors progress under contracts.

**Change in which asset/ liability?**

**When does the change occur?**

**How to disaggregate the contract?**

**Disaggregation as viewed from**

- the entity perspective?
- the customer perspective?

**Revenue should reflect**,

… activity of the company under a binding contract, in a way that revenue mirrors **progress under contracts**.

The **'progress'** of the contract can be **measured** in a number of different ways, including for example:

(a) as the supplier **incurs the costs** inherent in the contract;

(b) as the **risks** inherent in the transaction **decrease or are eliminated** by the supplier;

(c) as the **value of the goods** created under the contract **increases**; or

(d) with the **passage of time**.

In practice, **no single measure** will be **best for all transactions**

Instead, entity should **select measure(s) which best reflects progress** under a contract

Input-otiented measures versus output-oriented measures

Pattern of **revenue recognition depends on measure chosen**

Sometimes not clear which measure better than others (**possible source of inconsistencies** among entities)

# How to account for Multiple Element Arrangements?

There are basically **two alternatives**:

| **No disaggregation of the contract** | **Disaggregation of the contract** |
|---|---|
| - Recognition of revenue according to i.e. costs incurred<br><br>- No disaggregation necessary | - Continuous approach is applied to the elements of a transaction<br><br>- Criteria for disaggregation needed<br><br>- Disaggregation should follow economic substance |

# Why is the continuous approach an asset/liability approach?

**Revenue** = measurable changes in assets and liabilities

**FW.49(a) asset** = resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity

**Assets:** raw material, inventory, costumer lists, newspaper mastheads, non-competition agreements, … } not only receivables!

**If the entity expects to fulfil the contract and it expects the customer to pay, performance of the entity results in „a resource controlled by it as a result of past events and from which future economic benefits are expected to flow to the entity.“**

# How reliable is the resulting revenue number?

## Starting point for application of the continuous approach:

- There must be a binding contract with a customer.
- The approach is only applicable,
  … if entity has reliable projections regarding contract fulfillment,
  … if entity expects to fulfil the contract and
  … if entity expects customer to pay.

# Application of the Approaches

# When does revenue arise?

| | Critical event approach C | Continuous approach |
|---|---|---|
| **Sale of goods** (Supermarket, …) | at point of sale | at point of sale |
| **Services** (cleaning, painting, …) | when a defined part of the contractual obligation is fulfilled | as service is performed |
| **Manufacturing** (chair, table, …) | as defined part of manufacturing is completed | as manufacturing progresses |
| **Long term construction work** (bridge, …) | as defined part of construction is completed | as construction progresses |

# Quest for one single approach to be applied to all transactions!

| | Critical events approach C | Continuous approach |
|---|---|---|
| **Sale of goods** (Supermarket, …) | at point of sale | at point of sale |
| **Services** (cleaning, painting, …) | when a defined part of the contractual obligation is fulfilled | as service is performed |
| **Manufacturing** (chair, table, …) | as defined part of manufacturing is completed | as manufacturing progresses |
| **Long term construction work** (bridge, …) | as defined part of construction is completed | as construction progresses |

**No PoC for construction contracts and services!**

**No changes for simple sales transactions and PoC remains in place!**

# GASB: If one approach is to be chosen:

**Continuous Approach!**

**Revenue should be recognised when activity undertaken pursuant to a contract with a customer gives rise to an asset that reflects performance towards completion.**

- no changes in accounting for over the counter sales transactions
- revenue follows performance of the entity, that is PoC for services and construction contracts
- focus on economic substance (and not on legal form)
- in line with notion of assets/liabilities approach

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