30 Cannon Street, London EC4M 6XH, England
Phone: +44 (0)20 7246 6410, Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: http://www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at the Analyst Representative Group meeting, to assist them in following the discussions. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff papers prepared for the ARG meeting. Paragraph numbers correspond to paragraph numbers used in the ARG agenda paper.

INFORMATION FOR OBSERVERS

ARG Meeting: **February 2009, London**

Project: **Revenue recognition**

(Agenda paper 3)

OBJECTIVE

1. This session has been structured to provide an overview of the discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers,* published on 19 December 2008. The summary section of the discussion paper is reproduced below.

2. Further information on the discussion paper can be obtained from the revenue recognition project page on the IASB website:

www.iasb.org/Current+Projects/IASB+Projects/Revenue+Recognition/Revenue+Recognition.htm

3. This site has links to the discussion paper itself; an executive summary of the paper; and recordings of two audio webcasts held earlier this month.

4. The session will consist of:

   a. a ten minute overview of the discussion paper presented by the IASB staff

   b. an open discussion of areas where it is envisaged current practice may change for some transaction.

POINTS FOR DISCUSSION

5. The model proposed is consistent with many aspects of current practice. The recognition model is, however, based on the satisfaction of performance obligations, rather than on the entity's own performance. We think, therefore, some construction and manufacturing entities will be affected if their construction or manufacturing activities do not result in the continuous transfer of goods and services to the customer over the life of the contract. In those cases, no revenue will be recognised until completion, when the finished product is transferred to the customer and the performance obligation is satisfied. This will be a significant change for some manufacturers and constructors where percentage of completion is currently used and revenue recognised continuously as the contracted asset is built or assembled regardless of whether the customer is receiving any good or service.

Changes to levels of unbundling

6. The proposed model defines a performance obligation as a promise to transfer a good or service which could be separately sold by the entity. Under this definition contracts are likely to be subdivided into more bundles (or 'deliverables' or 'components') than currently. This could result in margin being accounted for by each performance obligation, rather than smoothed over the contract as a whole.

7. In addition, some obligations for post-delivery services, which may currently be accounted for as cost accruals (eg warranties), will now have revenue attributed to them. Some contract revenue, therefore, would be recognised

over the warranty period rather than all revenue being recognised on delivery of the primary good.

8. The proposed changes to unbundling also include allowing the use of estimated sales prices in identifying separate elements. This will represent a significant change where, as in much US GAAP, objective evidence of a sales price is currently required to identify individual bundles.

OBJECTIVE OF THE DISCUSSION

9. We would appreciate comments on whether the model proposed does provide more decision useful information, particularly with respect to the two proposed changes discussed. We would also appreciate any comments you have as to whether the model could be usefully applied to all revenue contracts.

Extract from

Preliminary Views on Revenue Recognition in Contracts with Customers

Introduction

S1 Revenue is a crucial part of an entity's financial statements. Capital providers use an entity's revenue when analysing the entity's financial position and financial performance as a basis for making economic decisions. Revenue is also important to financial statement preparers, auditors and regulators.

S2 The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) initiated their joint project on revenue recognition primarily to clarify the principles for recognising revenue. In US generally accepted accounting principles (GAAP), revenue recognition guidance comprises more than a hundred standards—many are industry-specific and some can produce conflicting results for economically similar transactions. In International Financial Reporting Standards (IFRSs), the principles underlying the two main revenue recognition standards (IAS 18 *Revenue* and IAS 11 *Construction Contracts*) are inconsistent and vague, and can be difficult to apply beyond simple transactions. In particular, those standards provide limited guidance for transactions involving multiple components or multiple deliverables.

S3 This discussion paper invites comments on the boards' preliminary views on a single, contract-based revenue recognition model. The boards are developing that model to improve financial reporting by providing clearer guidance on when an entity should recognise revenue, and by reducing the number of standards to which entities have to refer. As a result, the boards expect that entities will recognise revenue more consistently for similar contracts regardless of the industry in which an entity operates. That consistency should improve the comparability and understandability of revenue for users of financial statements.

S4 Because the boards are still developing the proposed model, this discussion paper does not include all the guidance that would be included in a proposed standard. Instead, this discussion paper presents the basic model and its implications in order to seek views from respondents before the boards publish a proposed standard.

Next steps

S5 The boards will review the comments received on this discussion paper and modify or confirm their preliminary views. They will then develop, for public comment, an exposure draft of a revenue recognition standard for IFRSs and US GAAP. In doing so, the boards will consider the need for users of financial statements to receive useful information, which can be provided by preparers at a reasonable cost, as a basis for making economic decisions.

S6 Next steps also may include public hearings to discuss the proposed model. After reviewing the comments on this discussion paper, the boards will decide whether to hold public hearings.

S7 During the comment period on this discussion paper, the boards plan to conduct field visits. The boards will focus initially on industries with contracts that the proposed model is most likely to affect. The field visits will continue into the exposure draft stage of the project.

S8 The boards have not yet discussed all matters relating to the proposed model. They will discuss some of those matters during the comment period. For information on the boards' ongoing project activities, please see www.iasb.org or www.fasb.org.

Summary of preliminary views

S9 The boards have reached some preliminary views in developing a revenue recognition model. This section summarises those views.

Scope

S10 The proposed model would apply to contracts with customers. A contract is an agreement between two or more parties that creates enforceable obligations. Such an agreement does not need to be in writing to be considered a contract. A customer is a party that has contracted with an entity to obtain an asset (such as a good or a service) that represents an output of the entity's ordinary activities.

S11 The boards have not excluded any particular contracts with customers from the proposed model. However, because of the potentially broad scope of a standard on contracts with customers, they have considered whether the proposed model, and in particular its measurement approach, would provide decision-useful information for the following contracts:

(a) financial instruments and some non-financial instrument contracts that otherwise would be in the scope of standards such as IAS 39 *Financial Instruments: Recognition and Measurement* and SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*. In the boards' view, because of the potential volatility in the value of those contracts, the proposed revenue recognition model might not always provide decision-useful information about them.

(b) insurance contracts that are in the scope of IFRS 4 *Insurance Contracts* and SFAS 60 *Accounting and Reporting by Insurance Enterprises* (and other related US GAAP). The boards have an active project on their agendas for insurance contracts. In the boards' view, the proposed revenue recognition model might provide decision-useful information for some contracts that the insurance project is considering, but not all of them.

(c) leasing contracts that are in the scope of IAS 17 *Leases* and SFAS 13 *Accounting for Leases* (and other related US GAAP). The boards have a joint project on their agenda for lease accounting. The boards have tentatively decided to defer consideration of lessor accounting and to concentrate on developing an improved lessee accounting model. The boards have not yet decided how the proposed revenue recognition model would apply to lessor accounting.

S12 In future deliberations, the boards will consider the implications of the proposed model for entities that recognise revenue or gains in the absence of a contract. For example, some entities recognise revenue or gains from increases in inventory before obtaining a contract with a customer (in accordance with IAS 41 *Agriculture* and AICPA SOP 85-3 *Accounting by Agricultural Producers and Agricultural Cooperatives*). In this project, the boards do not intend to change the way that those entities measure inventory. However, the boards will consider whether those entities should be precluded from presenting increases in inventory as revenue and should, instead, present those increases as another component of comprehensive income.

S13 The boards plan to consider whether any contracts with customers should be excluded from the proposed model after reviewing comments on this discussion paper.

Recognition

Contract-based revenue recognition principle

S14 The boards propose that revenue should be recognised on the basis of increases in an entity's net position in a contract with a customer.

S15 When an entity becomes a party to a contract with a customer, the combination of the rights and the obligations in that contract gives rise to a net contract position. Whether that net contract position is a contract asset, a contract liability or a net nil position depends on the measurement of the remaining rights and obligations in the contract.

S16 In the proposed model, revenue is recognised when a contract asset increases or a contract liability decreases (or some combination of the two). That occurs when an entity performs by satisfying an obligation in the contract.

Identification of performance obligations

S17 An entity's performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer. That contractual promise can be explicit or implicit.

S18 When an entity promises to provide a good, it is promising to transfer an asset to the customer. When an entity promises to provide a service, it similarly is promising to transfer an asset, even though the customer may consume that asset immediately.

S19 An entity accounts for performance obligations separately if the promised assets (goods or services) are transferred to the customer at different times. The objective of separating performance obligations is to ensure that an entity's revenue faithfully represents the pattern of the transfer of assets to the customer over the life of the contract.

Satisfaction of performance obligations

S20 An entity satisfies a performance obligation and, hence, recognises revenue when it transfers a promised asset (such as a good or a service) to the customer. The boards propose that an entity has transferred that promised asset when the customer obtains control of it.

S21 In the case of a good, an entity satisfies a performance obligation when the customer obtains control of the good so that the good is the *customer's* asset. Typically, that occurs when the customer takes physical possession of the good.

S22 In the case of a service, an entity similarly satisfies a performance obligation when the service is the customer's asset. That occurs when the customer has received the promised service. In some cases, that service enhances an existing asset of the customer. In other cases, that service is consumed immediately and would not be recognised as an asset.

S23 Consequently, activities that an entity undertakes in fulfilling a contract result in revenue recognition only if they simultaneously transfer assets to the customer. For example, in a contract to construct an asset for a customer, an entity satisfies a performance obligation during construction only if assets are transferred to the customer throughout the construction process. That would be the case if the customer controls the partially constructed asset so that it is the customer's asset as it is being constructed.

Measurement

S24 To recognise a contract, an entity measures its rights and its performance obligations in the contract. The boards have not yet expressed a preliminary view on how an entity would measure the rights. However, measurement of the rights would be based on the amount of the transaction price (ie the promised consideration).

S25 The boards propose that performance obligations initially should be measured at the transaction price—the customer's promised consideration. If a contract comprises more than one performance obligation, an entity would allocate the transaction price to the performance obligations on the basis of the relative stand-alone selling prices of the goods and services underlying those performance obligations.

S26 Subsequent measurement of the performance obligations should depict the decrease in the entity's obligation to transfer goods and services to the customer. When a performance obligation is satisfied, the amount of revenue recognised is the amount of the transaction price that was allocated to the satisfied performance obligation at contract inception. Consequently, the total amount of revenue that an entity recognises over the life of the contract is equal to the transaction price.

S27 The boards propose that after contract inception, the measurement of a performance obligation should not be updated unless that performance obligation is deemed onerous. A performance obligation is deemed onerous when an entity's expected cost of satisfying the performance obligation exceeds the carrying amount of that performance obligation. In that case, the performance obligation is remeasured to the entity's expected cost of satisfying the performance obligation and the entity would recognise a contract loss.

Potential effects on present practice

S28 For many contracts (particularly for commonplace retail transactions), the proposed revenue recognition model would cause little, if any, change. However, in some circumstances, applying the boards' proposed model would differ from present practice. For example:

(a) *use of a contract-based revenue recognition principle*. An entity would recognise revenue from increases in its net position in a contract with a customer as a result of satisfying a performance obligation. Increases in other assets such as cash, inventory in the absence of a contract with a customer, and inventory under a contract with a customer (but not yet transferred to the customer) would not trigger revenue recognition. For instance, entities that at present recognise revenue for construction-type contracts would recognise revenue during construction only if the customer controls the item as it is constructed.

(b) *identification of performance obligations.* In present practice, entities sometimes account for similar contractual promises differently. For example, some warranties and other post-delivery services are accounted for as cost accruals rather than as 'deliverables' in or 'components' of a contract. In the proposed model, entities would account for those obligations as performance obligations and would recognise revenue as they are satisfied.

(c) *use of estimates.* Some existing standards limit the use of estimates more than the boards' proposed model would. For example, entities sometimes do not recognise revenue for a delivered item if there is no objective and reliable evidence of the selling price of the undelivered items (eg EITF Issue No. 00-21 *Revenue Arrangements with Multiple Deliverables* and AICPA SOP 97-2 *Software Revenue Recognition*). In contrast, in the proposed model, entities would estimate the stand-alone selling prices of the undelivered goods and services and recognise revenue when goods and services are delivered to the customer.

(d) *capitalisation of costs.* At present, entities sometimes capitalise the costs of obtaining contracts. In the proposed model, costs are capitalised only if they qualify for capitalisation in accordance with other standards. For example, commissions paid to a salesperson for obtaining a contract with a customer typically do not create an asset qualifying for recognition in accordance with other standards. As a result, an entity would recognise such costs as expenses as incurred, which may not be the same period in which revenue is recognised.