Project **Revenue Recognition**

Topic **Project Objective and Strategy**

Objective and introduction

1. The objective of this paper is twofold: (a) to affirm the objective of the Boards' revenue recognition project and (b) to agree to a strategy over the next few months to achieve that objective.

2. The project's stated objective is to develop a single revenue recognition model for US GAAP and IFRSs that improves existing standards and can be applied consistently across various industries and transactions.

3. To that end, the Boards issued the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*. In that paper, the Boards propose a revenue recognition model based on the transfer of goods and services to customers. Consistent with the Boards' respective asset definitions, an entity has transferred a good or a service when the customer obtains "control" of the good or service.

Responses to the Discussion Paper

4. Most respondents to the Discussion Paper support the project's objective and a model based on the transfer of goods and services to customers. However, many respondents question whether a single model can provide decision-useful information across various industries and transactions. That concern stems largely from the incomplete nature of the proposed model and uncertainty about how "control" would be interpreted by particular industries.

This paper has been prepared by the technical staff of the FAF and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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5. Respondents are most concerned about the application of the proposed model to the construction industry—i.e. to contracts presently accounted for using a percentage-of-completion method of revenue recognition. In the proposed model, an entity would recognize revenue throughout a construction contract only if goods or services are transferred continuously to the customer. Some respondents think the nature of construction contracts is such that the customer receives the construction services throughout the contract. Hence, an entity would recognize revenue throughout the contract based on continuous transfer to the customer.

6. However, the Discussion Paper was not clear whether, and if so when, entities would recognize revenue throughout construction contracts. Therefore, many respondents support the proposed model but only on the condition that they can apply it consistently with how they apply existing standards for construction contracts (SOP 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*[1] and IAS 11 *Construction Contracts*). That consistency would occur only if the customer controls the work-in-progress throughout the contract.

7. Without clear guidance on "control", many respondents think the proposed model could result in revenue recognition for some construction contracts only upon transfer of legal title or physical possession of the finished asset, which often is upon contract completion. Because those contracts can take many years to complete, respondents think users of financial statements would be deprived of useful information unless revenue is recognized throughout the contract.

8. Therefore, many respondents request that the Boards scope construction contracts out of the proposed model, or change the model to one in which entities recognize revenue based on the activities of the entity in fulfilling the contract rather than the transfer of goods and services.

1 This paper was prepared during the transition to the codification of US GAAP. Therefore, references to US GAAP standards are not based on the codification.

Alternatives for completing the project

9. In the light of responses to the discussion paper, the staff thinks the Boards have the following alternatives for completing the project:

   (a) Alternative 1: create two revenue models and clarify when an entity would apply one versus the other.

   (b) Alternative 2: create a single revenue model and deal separately with those transactions for which the model does not provide useful information.

Alternative 1: Create two revenue models

10. One alternative for completing the project would be to create two revenue models—one for the *transfer* of goods and services to customers and the other based on *activities* of an entity that do not transfer goods and services to customers.

11. Some respondents to the discussion paper recommend that the Boards pursue a two-model approach. Those respondents think that approach would be similar to existing revenue standards—i.e. IAS 18 *Revenue* and IAS 11 in IFRSs, and SAB 104 *Revenue recognition* and SOP 81-1 in US GAAP. They note that those standards resulted from the needs of financial statement users in particular industries. For example:

> TIC believes that although industry-based guidance can sometimes produce revenue recognition patterns that are not consistent with the proposed general revenue recognition principle, certain industry guidance is a necessity and needs to be maintained. Because financial reporting is not an end itself, but rather a tool for financial statement users, the decision-usefulness of the financial reporting must take precedence over any concerns regarding theoretical consistency. TIC believes that industries with unique economic characteristics and existing, well established accounting guidance should be excluded from the general revenue recognition principle. These areas include financial institutions, insurance, and contractor accounting. [Comment Letter No. 211]

12. However, other respondents to the Discussion Paper think that creating more than one model would maintain some of the issues of existing standards that the revenue project seeks to resolve. According to one respondent:

> Some argue that the existing approaches in IAS 11 and IAS 18 have worked quite well and that the existing revenue literature works for the vast majority of transactions. In other words, if a change needs to be made, it does – according to those supporting this position – not need to be a big one, so it is not necessary to ask fundamental questions about revenue; instead it is necessary only to ask what 'add-ons' and exceptions need to be made to the existing material.
>
> We do not share this view, because this would mean that different standards would still be based on different revenue accounting principles. That in turn would mean there would still be boundaries between principles that will be problematic and it would still be difficult to extrapolate the existing material to address new types of transactions that will emerge in the future. In addition different views of what revenue is and of how financial statements should portray an entity's revenue-related activities would continue. In other words, such a 'keep but improve current standards' approach would provide only temporary relief. [Comment Letter No. 178]

Alternative 2: Create a single model

13. Another alternative is for the Boards to create a single model. In that case, they would need to decide whether that model should be an activities model or a transfer model. The following analysis of an activities model reflects the staff's views and not necessarily those of respondents to the Discussion Paper who request that the Boards develop an activities model.

Activities model

14. An activities model recognizes revenue on the basis of an entity's activities, regardless of whether those activities transfer goods and services to a customer when performed. The asset giving rise to revenue in an activities model is inventory. As an entity's activities enhance the value of its inventory, it recognizes revenue.

15. Existing accounting for agricultural and extractive industries arguably is consistent with an activities model. In those industries, entities sometimes recognize revenue (or a gain) from increases in inventory if the value of the

inventory can be determined reliably and the costs of selling the inventory can be estimated (or are insignificant).

16. An activities model does not require a contract because the contract position is not the asset or liability giving rise to revenue recognition. Nevertheless, an activities model could defer the recognition of activities-based revenue until a contract exists. However, that would result in revenue being recognized at contract inception for any activities completed to date. (Appendix A illustrates that consequence and provides further information about an activities model.)

17. Proponents of an activities model cite the following advantages:

    (a) The relevance of information provided by a model that recognizes revenue continuously throughout long-term construction or other services contracts, regardless of whether goods and services are transferred to customers.

    (b) The focus on the entity's perspective of performance during a reporting period rather than the customer's perspective.

    (c) Consistency with agricultural and extractive industries that recognize revenue for activities, regardless of the existence of a contract with a customer.

    (d) The FASB's conceptual framework and IAS 18 define revenue more broadly than a transfer of goods and services. For example,

    > Revenues are inflows or other *enhancements of assets* of an entity or settlements of its liabilities (or a combination of both) from delivering or *producing goods*, rendering services, or other activities that constitute the entity's ongoing major or central operations. [CON 6 paragraph 78, emphasis added]

18. However, disadvantages of the Boards pursuing an activities model include:

    (a) The need for the Boards to rethink the main principles of revenue recognition and perhaps issue another discussion paper.

    (b) Results for some contracts that the staff thinks many constituents would consider unacceptable (see Appendix A).

(c) Potential for abuse—an entity could accelerate revenue recognition by increasing its activities (e.g. production) at the end of a reporting period.

Transfer model

19. Alternatively, the Boards could continue to develop a transfer model based on the Boards' preliminary views in the Discussion Paper and feedback on those views.

20. Arguments in favour of that approach include:

    (a) Arguably, the use of percentage-of-completion contract accounting in existing standards is consistent with a transfer model. That argument is stronger perhaps in US GAAP because of the basis of SOP 81-1.

    > …the business activity taking place supports the concept that in an economic sense performance is, in effect, a continuous sale (transfer of ownership rights) that occurs as the work progresses. [paragraph .22]

    Hence not as many entities should be affected by the proposals as feared by most respondents to the Discussion Paper. Many long-term construction and service entities are likely to be able to continue to recognize revenue continuously throughout the contract.

    (b) IFRIC 15 *Agreements for the Construction of Real Estate* provides guidance that arguably is consistent with the proposed transfer model.

    > The entity may transfer to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. In this case, if all the criteria in paragraph 14 of IAS 18 are met continuously as construction progresses, the entity shall recognise revenue by reference to the stage of completion using the percentage of completion method. The requirements of IAS 11 are generally applicable to the recognition of revenue and the associated expenses for such a transaction.
    >
    > The entity may transfer to the buyer control and the significant risks and rewards of ownership of the real estate in its entirety at a single time (eg at completion, upon or after delivery). In this case, the entity shall recognise revenue only when all the criteria in paragraph 14 of IAS 18 are satisfied. [paragraphs 17-18]

    Many respondents note that they like that clarification in IFRIC 15.

(c) Consistency with many other existing standards (e.g. IAS 18 and SAB 104).

(d) For most short-term contracts, a transfer model is both practical and provides useful information.

21. The primary disadvantage of a transfer model is that it is a critical-event model that would fail to report some information about some entities' activities. However, recognizing revenue based on an exchange between an entity and a customer (i.e. the critical event) is intuitive to many people. Moreover, information about an entity's activities could be provided to users through disclosures or another project on inventory.

22. Many respondents to the Discussion Paper note that the transfer model, as articulated in the Discussion Paper, is not practical for continuous-delivery contracts. For example, a construction contract has a seemingly endless number of performance obligations to which an entity could not practically allocate the transaction price on a relative standalone selling price basis. Therefore, a transfer model would require application guidance for continuous-delivery contracts. That guidance would be separate from the application guidance for discrete-delivery contracts. Some might think of that different guidance as different revenue models.

Staff recommendations

Maintain the project objective and further develop the proposed model

23. Responses to the Boards' Discussion Paper suggest that the proposed model needs further development and clarification. However, the staff thinks the objective of the project (paragraph 2) can still be achieved by developing that model.

24. The Boards acknowledge in the Discussion Paper that the proposed model might not provide decision-useful information for all industries (e.g. financial instruments and insurance). Whether additional industries (e.g. construction) should be scoped out depends on how "control" is clarified.

25. Hence, the staff thinks the Boards need to further consider control before assessing for which industries the proposed model would provide decision-useful information. Only then would the Boards be able to properly consider whether to also develop an activities model.

26. The staff plans on further analyzing the notion of control and bringing that analysis for the Boards' discussions in September. (Appendix B contains some of the staff's preliminary thinking on control.)

27. Once the transfer model is further developed and control is clarified, the staff thinks that many of the concerns raised in the comment letters will be mitigated. That is, the staff thinks that many long-term construction contracts will result in continuous revenue recognition.

28. After further developing the recognition principle of the proposed model (i.e. control), the Boards should then consider a key measurement issue in the proposed model. That issue relates to the segmentation of margins in a contract.

29. In some contracts, the allocation of the transaction price results in different margins being recognized for each component of a contract. For example, if a company typically sells hardware at a 15% margin and maintenance services at a 40% margin, the company would recognize higher margins when the services are provided than when the hardware is delivered. However, some respondents suggest that all the components of a contract should be recognized at the composite contract margin. For example, construction contracts often do not segment margins even though the margin for one component of the contract (e.g. the engineering design) may differ from the margin of another component (e.g. the foundation work).

30. The staff plans on analyzing that measurement issue and discussing it with the Boards in October. Appendix C contains a summary of the staff's proposed timeline for addressing other issues.

Hold roundtable discussions of the proposed model

31. Once the model is further developed as discussed above, the staff thinks the Boards should consider holding roundtables. The staff thinks that roundtables would:

    (a) allow the Boards to better explain the transfer model, in particular for service contracts.

    (b) facilitate an inter-sector discussion of the proposed model—so far outreach has largely been to individual sectors. It would be good for different sectors to hear the perspective of others.

    (c) allow the Boards to engage with more constituents at a higher level—this project affects the top line of companies all over the world.

    (d) provide more input from users of financial statements.

32. Moreover, if roundtables are held after the Boards have made tentative decisions on control and margin segmentation, those meetings would:

    (a) alleviate the concern of some respondents that the Boards need to issue another Discussion Paper.

    (b) enable the Boards to discuss with constituents the implications of some of their tentative decisions since issuing the DP, in particular those relating to measurement of rights.

33. If the Boards agree in principle to roundtables, the staff could schedule them for November/December 2009. The staff thinks it would be necessary to have at least three roundtables: one each in North America, Europe, and Asia.

34. The staff also is thinking about a possible webcast after the October Board meetings to update constituents on the project.

Draft the Exposure Draft

35. Once the model is further developed, the staff thinks the Boards could make much use of existing standards to draft an Exposure Draft. Some respondents note how particular aspects of existing standards are consistent with the proposed model and could be used as useful application guidance for the model.

36. At that time, the Boards can then consider whether the model still might not provide useful information for some contracts. If the Boards still have some concerns about those contracts, then the staff thinks that the Boards should not obscure the principles of a transfer model by modifying the model to incorporate an activities model. Instead the Boards could develop, for specified transactions, an activities model that recognizes revenue based on increases in inventory subject to a contract. That could be done in another project or a follow-up phase to this project.

Questions for the Boards
Question 1: In the light of responses to the Discussion Paper, do the Boards agree with the project's objective (paragraph 2) to develop a single revenue recognition model? *Question 2*: Do the Boards agree with the staff's recommendation to focus first on developing a transfer model, and then on determining the scope of that model? *Question 3*: Do the Boards agree with the staff's recommendation to hold roundtables during November/December 2009? If so, do the Boards agree with the proposed locations (i.e. North America, Europe, Asia)?

Appendix A: Consequences of an activities model

A1. The purpose of this appendix is (a) to illustrate how the activities model differs conceptually from the transfer model proposed in the Discussion Paper and (b) to highlight some revenue consequences of an activities model.

A2. Consider the following example.

> On 1 January Homebuilder enters into a contract with a customer for the sale of House 1 on a new development for CU1m. At that time, Homebuilder has not started building the house. Under the terms of the contract, the customer is required to pay a 10 per cent deposit with the balance due when it obtains ownership of the house (and related land), expected to be 30 June. The customer is able to select some of the fixtures and fittings in the property from a limited range of options, but cannot specify any major structural changes. In this particular jurisdiction, the customer obtains no rights to the underlying real estate until it obtains ownership of the house.
>
> Assume that the cost of the land is CU175,000 and the costs of labour and materials, incurred evenly over the construction period, are CU450,000. The customer obtains ownership of the house on 30 June.

A3. The accounting would be as follows:

	Activities model		*Transfer model*	
	31 Mar	30 Jun	31 Mar	30 Jun
WIP	640 [(a)]	-	400	-
Cash	(300)	375	(300)	375
Contract liability	(100) [(b)]	-	(100)	
Revenue	640	360	-	1,000
Expenses	(400)	(225)	-	(625)
Margin	240	135	-	375

(a) the CU400,000 costs incurred to 31 March (land of CU175,000 and labour and materials of CU225,000) plus a margin of CU240,000. For simplicity, the margin is assumed to accrue in proportion to costs, so the CU240,000 margin in the period to 31 March is CU375,000 expected total margin × (CU400,000 actual costs ÷ CU625,000 expected total costs)
(b) remaining rights of CU900,000 less performance obligations of CU1,000,000

A4. The obvious difference between the two models is that revenue is recognised throughout the contract in the activities model but only on 30 June in the transfer model. Revenue in the activities model arises from the increase in the WIP asset throughout the contract, i.e. as Homebuilder creates value. In the

transfer model revenue is recognised when the performance obligation is satisfied on 30 June. Note that there is no difference in the accounting for the *contract* in both models: the performance obligation is satisfied in both cases on 30 June. In particular, the performance obligation in the activities model is *not* satisfied as the house is constructed because there is no transfer of assets to the customer. The different pattern of revenue recognition arises because the activities model accounts for a broader set of assets and liabilities.

A5. In the staff's view, conceptually there is no reason why a contract is required for revenue recognition in the activities model. The revenue arises from the activities (or value creation) of the entity which are independent of a contract with a customer. However, other than perhaps for biological assets and readily marketable commodities, most would not recognise revenue in the absence of a contract, because of uncertainties about whether an increase in an asset has in fact occurred and the amount of that increase. In other words, in an activities model, the contract typically is a recognition criterion.

A6. But if activities have been undertaken before the entity obtains a contract, then revenue would arise at contract inception in an activities model for those activities. Consider again the example above.

> Suppose that Homebuilder starts building another similar house, House 2, on 1 January without a contract and construction of House 2 progresses in parallel with House 1 so that at 31 March the two houses are at the same stage of completion. Further suppose Homebuilder enters into a contract with a customer on 31 March for the sale of House 2 with exactly the same terms as for the sale of House 1.

A7. In that case, Homebuilder would recognise revenue and margin of CU640,000 and CU240,000 respectively on 31 March with respect to House 2—for the activities undertaken between 1 January and 31 March. That is, Homebuilder would recognize revenue at contract inception on a cumulative catch-up basis. Its WIP and contract liabilities with respect to the two contracts are then measured at the same amounts. Homebuilder then recognises revenue continuously over the remainder of the contracts.

A8. Conceptually that means that the activities model results in a very different pattern of revenue recognition for the sale of goods compared with existing standards. Consider the following example:

> WidgetCo manufactures widgets for inventory. On 1 January it enters into a contract for the sale of a widget for CU9,500, for delivery on 31 January. The cost of manufacturing each widget is CU5,000. Customer also purchases optional delivery services for CU500 and prepays in full on 1 January.

A9. In the activities model, WidgetCo would recognise revenue of CU9,500 and margin of CU4,500 on 1 January on obtaining the contract. That revenue conceptually arises from manufacturing the widget but it is not recognised until a contract is obtained. The widget would continue to be recognised on WidgetCo's statement of financial position at CU9,500 until the performance obligation is satisfied on 31 January. (Although on 1 January customer has a right to receive a widget on 31 January, it has no present rights to a widget itself.) The remaining revenue of CU500 would be recognised on 31 January when the delivery services are provided.

A10. Of course, an activities model could be supported by additional recognition criteria to deal with contracts such as the above in which the benefits to users of recognising revenues as they arise would probably not justify the costs.

Appendix B: Staff's preliminary thoughts on control

B1. This appendix contains some of the staff's preliminary thinking on the definition of control along with potential indicators of control and factors to consider carefully when applying those indicators.

B2. Most respondents to the Discussion Paper think the proposed model needs to be clearer about control because control is the tool for determining the transfer of goods and services to the customer (and recognition of revenue). The staff agrees with that view and thinks the proposed model needs a definition of control such as:

> Control is an entity's ability to direct the use of and receive the benefit of a particular good or service.

B3. Regardless of the definition of control in the Revenue Recognition project, the Boards will need to consider carefully how that notion of control relates to notions of control in other projects such as derecognition of financial assets, consolidations, the conceptual framework, and leases.

B4. The staff agrees with many respondents to the Discussion Paper that the proposed model needs indicators of when control of a good or service is transferred to the customer. The Boards will need to consider from whose perspective (i.e. the entity's or the customer's) those indicators should be articulated and whether that makes a difference. In other words, should an entity recognize revenue when it relinquishes control of a good or service or when the customer obtains control?

B5. Arguably, taking the customer's perspective on the transfer of control would be more conservative. Moreover, the customer perspective often is used in existing standards. On the other hand, the entity's perspective is the perspective of financial reporting. For this appendix, the staff briefly discusses various indicators from both the entity's and customer's perspective.

B6. Typically, an asset has been transferred from an entity to a customer when:

(a) *the entity has an unconditional right to cash*—in an exchange transaction, if an entity has an unconditional right to cash, presumably it is because the customer has received a good or service in exchange.

Unconditional means that nothing other than the passage of time is required before the payment is due.

(b) *the customer can pledge or sell the asset*—if a customer can pledge an asset as collateral or sell the promised asset, that would suggest that the asset has been transferred to the customer. Conversely, if the customer can pledge or sell the asset, then the entity probably would not be able to direct that asset to another customer.

(c) *legal title has passed to the customer*—legal title serves as evidence of which party owns an asset. However, in some cases, possession of legal title is a protective right and may not coincide with the transfer of an asset to a customer (e.g. cases in which a seller retains title of a product as protection against the customer's failure to pay for the product).

(d) *the customer has physical possession of the asset and can restrict* the *access of others*—in many cases, physical possession of a good indicates the owner of the good. In other cases, however, it may not. For example, in many construction contracts, the contractor has physical possession of an asset that is the customer's. In some bill and hold arrangements, the entity also has physical possession of a product that belongs to a customer. Conversely, in a consignment arrangement, an entity may have transferred physical possession of a good, but clearly retains ownership (i.e. control) of the good.

(e) *the customer specifies the design of the promised good or service*—if the customer specifies the design of a promised good or service (i.e. the promised asset is customized for a particular customer's needs), that may indicate that the entity is providing a service on the customer's asset and hence, control of an asset would be transferred continuously to the customer. Moreover, if an entity is not responsible for the design of a particular asset, that asset likely is of little value to the entity (for instance, it could not be sold to another customer) which may indicate that the asset is the customer's.

(f) *the customer has managerial involvement throughout the contract*—if a customer has managerial involvement throughout a contract (including the ability to change the design of an asset under construction), that may indicate that the asset is the customer's throughout the contract. Hence, control of an asset would be transferred (and revenue recognized) continuously throughout the contract.

(g) *the customer can take possession of the asset throughout the contract*—an indicator that an asset is being transferred throughout a contract is if the customer can take possession of the asset throughout the contract.

B7. The staff notes that instead of defining control and providing indicators of control, some respondents to the Discussion Paper suggest focusing on the distinction between goods and services. A good could be defined as an asset transferred at a point in time and a service could be defined as being transferred continuously. For construction contracts, some respondents then think that whether a contact is for a good or a service could be determined primarily by whether the underlying item is customized for the customer.

Appendix C: Project timetable and issues to deliberate

Developing the Exposure Draft	
Sep 2009 – Jan 2010 (redeliberation of main issues in DP)	September • Recognition and control: when are goods and services transferred to the customer? • Options: sales incentives and renewal/cancellation options
	October • Allocation of the transaction price / margin segmentation • Determining the transaction price
	November • Contract acquisition and other upfront costs (including non-refundable fees) • Treatment of existing cost guidance in revenue standards • Determining the amount of revenue each period in continuous-delivery contracts • Remeasurement
	November/December • Possible roundtable discussions
	December • Contract issues: contract existence; returns and refunds; loss leaders • Identifying performance obligations • Scope of standard
	January • Presentation • Disclosure • Transition • Consequential amendments
Feb 2010 – May 2010	• Drafting of Exposure Draft • Publishing of Exposure Draft
June – Sep 2010 (comment period)	During this 4-month comment period the staff will undertake field visits with various companies and industry groups.
Developing the final standard	
Sep – Oct 2010	Comment letter analysis
Oct 2010	Possible roundtable discussions on Exposure Draft
Nov 2010 – Mar 2011	Redeliberate issues included in the Exposure Draft
Mar – June 2011	Drafting and publishing of a standard