Project **Revenue Recognition**

Topic **Presentation of contracts with customers**

Purpose

1. The discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers* proposes that revenue recognition is based on a single asset or liability – an entity's contract with a customer.

2. The purpose of this paper is to obtain the boards' tentative decisions on the following:

   (a) the staff recommendation that the boards reaffirm the preliminary view expressed in the discussion paper that the unit of account is the remaining rights and obligations in the contract with the customer and the contract position is presented net in the statement of financial position.

   (b) the staff recommendation that no exceptions be made to their preliminary view that the presentation of the contract position should be net.

   (c) finally, the staff recommendation that net contract assets should be shown separately from net contract liabilities.

Structure of the paper

3. The paper is divided into six brief sections:

   (a) Background – the preliminary view in the discussion paper

(b) Initial feedback from respondents to the discussion paper on the proposed accounting for the net contract position

(c) A comparison with types of contracts where the contract position is accounted gross

(d) A summary and staff recommendation to present the contract position net in the statement of financial position

(e) A brief discussion of when it might not be appropriate to present a net contract position

(f) A discussion of the staff's recommendation that net contract assets should be presented separately from net contract liabilities.

Background – the preliminary view in the discussion paper

4. When this subject was discussed at an early stage in the project the boards' view was that for most transactions the remaining rights and obligations in the contract was the unit of account and this was the view expressed in the discussion paper.

> 2.23 A contract with a customer conveys rights to an entity to receive consideration from the customer and imposes obligations on the entity to transfer assets (in the form of goods and services) to the customer. The combination of the rights and obligations (ie the net rights and obligations) gives rise to a **single** asset or liability, depending on the relationship between the entity's rights and obligations. A contract is an asset if the measurement of the remaining rights exceeds the measurement of the remaining obligations. Similarly, a contract is a liability if the measurement of the remaining obligations exceeds the measurement of the remaining rights. That contract asset or contract liability reflects the entity's net position in the contract with respect to its remaining rights and obligations. [emphasis added]

5. The rationale for this proposal was based on two characteristics of contracts with customers.

(a) A contract conveys rights and obligations on both parties to a contract. There is a strong interdependency between the contractual rights (customer consideration) and the contractual obligations (performance obligations.) The right to receive the customer's payment is dependent on the entity's own performance. Similarly, the entity will only perform as long as the customer continues to pay.

(b) This interdependency often means that the rights and obligations under a contract are not readily separable. It is not typically possible to transfer the obligations to another party unless the rights also transfer and the customer's agreement is sought. One or more of the performance obligations may be subcontracted but, in that case, this would represent a further contract between the entity and its subcontractor. The original contract between the entity and the customer is unaffected.

6. Accounting for the combination of the rights and obligations and presenting the contract net is also consistent with some current literature:

(a) Accounting for a forward contract as a net contract position, in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*, reflects the relationship between the promised consideration and the current price of the financial asset.

(b) The IASB's preliminary view in the May 2007 Discussion paper *Preliminary Views on Insurance Contracts* was to present the net contract position. The Board took this position in its preliminary views because it recognised the strong interdependency between the contractual rights (cash inflows) and the expected claims and benefits (cash outflows). At a recent meeting of the Insurance Working Group, some staff noted that the different cash flow components of a contract are closely interrelated; the insurance contract itself is designed and managed on a net basis. Those staff also note that it would seem to be very difficult to transfer only the asset or liability part of the contract without transferring the remaining part as well. Although this project is no longer pursuing a measurement objective based on the notion of a transfer, the fact that it is not possible to transfer only the cash inflows separately from the cash outflows is strong evidence that the two are inseparable. Others, however, hold the view that the different characteristics of the cash flows could be blurred if only the net position is shown. Each cash flow, in their view, represents a different exposure to risk. (The insurance sector itself generally shows a clear preference for accounting for insurance contracts net.)

7. The unit of account proposed in the revenue discussion paper is the remaining rights and obligations of the contract, ie the unperformed rights and obligations. This unit of account is referred to in the UK ASB's *Statement of Principles*, where net presentation is assumed. Paragraph 4.36 states that '… the rights and obligations relating to the unperformed part [of a contract] will together represent a single asset or liability.'

Feedback from respondents

8. Some respondents have found the notion of the net contract position expressed in the discussion paper awkward and confusing. Most, however, made no comment or agreed with the net approach. Those who agreed expressed the view that presenting the rights and obligations gross would distort the statement of financial position and would not provide useful information. They suggested that information could be provided separately for rights and obligations, if required, through disclosure.

9. The few who disagreed made the following points:

   (a) Recognising the net contract position conflicts with IAS 1 *Presentation of Financial Statements* which generally prohibits offsetting. The staff believes that the advice given in paragraph 33 of that standard applies—offsetting can better reflect the substance of the transaction. Offsetting the rights and obligations in a contract with a customer reflects the substance of the transaction by acknowledging the interdependence of the two.

   (b) Amounts due from the customer should be shown as a financial instrument, a customer receivable, accounted for in accordance with IAS 39. The staff view is that the rights in the net contract position are typically not financial instruments – they are not unconditional rights to cash. They are conditional on the entity's performance. As discussed in the board paper on collectibility in May 2009, once the entity has unconditional rights to cash, the resulting receivable could be accounted for in accordance with IAS 39 and would no longer be part of the net contract position.

(c) Recognising the net contract position will obscure information about the rights and performance obligations in the contract that would be useful to users. The staff notes that any such information could be disclosed in the notes to the financial statements.

Comparison with types of contracts presented gross

10. Two areas of current literature discuss the presentation of a contract position as gross assets and gross liabilities.

Leases

11. In the Discussion Paper *Leases Preliminary Views*, the obligation to pay rentals and the right-of-use asset are presented separately by the lessee in the statement of financial position. The right-to-use asset is presented in accordance with the characteristics of the underlying asset and the obligation to pay as a financial liability.

12. The discussion paper proposes two possible applications of the right-to-use model to lessors.

13. Under the first lessor application proposed, the lessor transfers a component of the leased asset to the lessee at initiation. The lessor derecognises part of that leased asset. It has entirely performed at that stage so it has no remaining contractual obligation to the lessee.

14. Because it has performed it now has an unconditional right to receive the lessor's payment – recognised as a separate financial asset. Therefore, the lessor has no remaining contractual rights or contractual obligations after initiation and

so has no contract position to depict. It presents a separate receivable and recognises revenue to recognise satisfaction of its contractual obligation. This is consistent with the revenue recognition discussion above.

15. The second application to lessors proposed in the lease discussion paper does not assume transfer of the right-to-use asset at initiation and the lessor continues to recognise the leased asset in its entirety. Instead, the lessor recognises a new contractual right and a new contractual obligation. The obligation is satisfied over the period of the lease as the right to use the asset transfers. The right to the lessee's consideration under the contract is described in the discussion paper as an unconditional right to cash.

16. The rights and obligations of the lessor described in this model do not appear to be exactly analogous to the rights and performance obligations in contracts with customers. As noted above, contracts with customers are characterised by rights and obligations which are conditional on each other. In the leasing project the lessor's right to receive rentals appears to be unconditional at initiation.

17. At a recent board meeting, the second lessor model seemed to be preferred. Presentation of the lessor's contract rights and obligations under this model will be discussed at July board meetings.

Financial guarantee insurance contracts

18. The FASB have discussed a further type of contract which is accounted for gross —a financial guarantee insurance contract. FAS 163 *Accounting for Financial Guarantee Insurance Contracts* requires the guarantor to account for these contracts as gross assets and gross liabilities. The present value of the premiums receivable is shown separately from the obligation. These guarantees are often pre-funded. Where guarantee premiums are paid by the borrower throughout the period of the loan this is, in effect, a financing choice.

19. The staff believes financial guarantee insurance contracts can be distinguished from other insurance contracts that are presented net by a number of characteristics:

(a) The *right* (to payment) is exercised against the issuer, but the *obligation* is to the beneficiary of the guarantee, generally the holder of the security.

(b) The guarantor's expected or potential contractual cash flows are, therefore, with different counterparties. The inflow is from the issuer; the beneficiary is the holder of the security.

(c) The loan transaction cannot proceed until the guarantee is in place; it is a pre-condition of the lending contract. It is non-cancellable.

20. The inflows and outflows are not interdependent after contract initiation nor are they to the same party. This contrasts with contracts with customers where the rights and obligations are interdependent and the counterparties the same.

Summary and staff recommendation

21. In accounting for contracts with customers the rights and obligations are intertwined and interdependent. The right is dependent upon the obligation and the obligation on the right—neither becomes unconditional until the party performs. The accounting, therefore, needs to be done for the contract in its entirety to depict the net combination of the rights and obligations that it contains.

22. In addition, in contracts with customers the cash inflows (customer consideration) and outflows (goods and services) are both between the same parties. The customer pays the entity and the entity transfers goods or services to the customer. There is a net flow of resources between the entity and its customer. The net contract asset or liability depicts that future net inflow or outflow. A common counter-party to the rights and to the obligations is, in the staff view, a requirement of netting rights and obligations.

23. This can be summarised:

Net	Gross
Rights and obligations are	Rights and obligations are not

interdependent.	interdependent.
Rights and obligations are with same counterparty or subject to legal offset.	Right and obligation are to different parties, with no right of offset.

Question 1
The staff recommend the boards reaffirm the preliminary view expressed in the discussion paper that the unit of account is the remaining rights and obligations in the contract with the customer and the contract position is presented net in the statement of financial position. Do the boards agree with that recommendation?

Are there any circumstances when netting would not be appropriate?

24. When the question of gross versus net presentation was discussed in 2003, the boards tentatively decided that for most contracts net presentation was appropriate. The boards tentatively decided, however, that an exception should be made for contracts requiring specific performance. These contracts would be presented gross.

25. The arguments in support of this view were:

    (a) Most contracts, if breached, would be net settled, ie there would be a one-way flow of resources between the contracting parties. Contracts subject to specific performance, however, would require each party to the contract to perform as required by the contract, ie there would be a two-way flow of resources between the entities. Each party would provide what was defined as their deliverable by the contract.

    (b) Contracts for which the legal remedy of breach is specific performance are akin to financial contracts that are settled physically. The units of account for physical settlement are the individual assets and liabilities arising from the contractual rights and obligations.

26. The staff do not recommend making such an exception for contracts requiring specific performance.

(a) When considering a contract with a customer, it is the staff's view that the accounting should be based on the contract itself and the rights and obligations defined by the contract. To base the proposed accounting for any contract on what would happen were that contract to be set aside by either party seems counter-intuitive because entities do not enter into contracts with the expectation that they will be breached.

(b) Specific performance is only one of a number of possible remedies that could be awarded by a court if legal action were taken for breach of contract. At contract inception, neither party could predict what remedy would be awarded by the court if such litigation did take place in the future. It is difficult to see what useful guidance could be provided to assist preparers in identifying at inception those contracts that should be accounted for gross from those that should be accounted for net.

(c) The equitable remedy of specific performance is relatively rare and is not available in all jurisdictions.

(d) If accounting for contracts with customers were gross, the boards might need to reconsider how the rights and obligations should be measured. In particular, how would the fact that the entity's right is conditional upon the entity's successful performance be reflected in the measurement of the asset?

(e) While the boards' tentative decision in 2003 had conceptual merit, the staff think it is unnecessary to create an exception to the net principle that would only lead to diversity in practice. It would result in additional cost disproportionate to any benefit and would, in all probability, apply to very few contracts.

Question 2
The staff recommends the boards decide tentatively that no exceptions be made to their preliminary view that the accounting and presentation of the contract position should be net. Do the boards agree with the staff's recommendation?

Should net contract assets be presented separately from net contract liabilities?

27. Under the boards' proposed model a contract with a customer can be either a (net) contract asset or a (net) contract liability. It will be a net contract liability where the customer performs (pays) in advance of the supply of goods or services. It will be a net contract asset where the entity performs first and bills later.

28. In the simplest contracts, payment will be exchanged simultaneously for goods and services and the contract position would be a net nil. This is often the position, for example, for retail transactions. However, industry practice or the creditworthiness of the entity or its customer might dictate that one party habitually performs first.

29. Many entities will typically have similar contract terms with all customers and consequently all their contract positions will be either (net) contract assets or (net) contract liabilities. For example, contracts for many services are invoiced in advance as there are no tangible assets to retrieve in the event of subsequent non-payment. Other sectors habitually invoice in arrears once goods and services have been provided.

30. In some cases, a contract might switch from being either a contract asset or a contract liability over time when there is no direct relationship between the billing schedule and the company's actual satisfaction of performance obligations. A contract may, for example, schedule monthly or quarterly payments at inception irrespective of the actual performance to date. Whether an entity's contractual positions are a net contract asset or a net contract liability, therefore, provides users of financial statements with useful information.

31. Similarly, where the entity has both contract assets and contract liabilities this too provides useful information. Contract assets are different from contract liabilities. The former typically depicts a future cash inflow which will arise from the entity's past performance. The latter typically represents an obligation to supply goods or services in the future. IAS1 (paragraph 32) states that an entity should report assets and liabilities separately. This presentation helps

users understand the transaction and enables them to assess the entity's future cash flows.

32. At present the discussion paper, *Preliminary Views on Financial Statement Presentation*, is about to be re-deliberated. The discussion paper proposed that assets and liabilities should be categorised by nature of function. Both net contract assets and net contract liabilities would be expected to be business operating assets and liabilities under this proposal and the examples given in the discussion paper suggest that operating assets and operating liabilities would continue to be presented separately.

33. In addition IAS 1 currently further analyses assets and liabilities based on an assessment of their liquidity and recommends showing short-term elements separately from long-term elements when material. The discussion paper above proposes that this distinction between short-term and long-term within each functional category of assets and liabilities be maintained.

34. Accordingly:

Question 3

The staff recommends that the boards tentatively decide that, where material:

- net contract assets be presented separately from net contract liabilities
- short-term contract assets be presented separately from long-term contract assets
- short-term contract liabilities be presented separately from long-term cpntract liabilities

Do the boards agree with the staff's recommendation?