Project **Revenue Recognition**

Topic **Noncash Consideration**

Background and objective

1. At the March 17, 2009 and April 1, 2009 Board meetings, the Boards tentatively decided that an entity should measure noncash consideration at fair value. If an entity cannot reliably estimate the fair value of noncash consideration, it should measure the consideration indirectly by reference to the selling price of the promised goods and services. The Boards tentatively decided that some exchange transactions should not be transactions that generate revenue but did not decide on which exchange transactions should be excluded from revenue. The Boards also asked the staff to seek user input on this matter.

2. The objective of this paper is to consider how the proposed model should address exchange transactions that the Boards think should not be considered transactions that generate revenue. This paper also considers whether a new revenue standard should provide specific guidance for particular exchanges involving noncash consideration (for example, barter credit transactions and exchange of advertising services).

Summary of recommendations

3. The staff recommends that:

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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.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

(a) An exchange transaction should not be regarded as a transaction that generates revenue if the purpose of the transaction is to facilitate sales of an asset to another customer in the ordinary course of business.

(b) The revenue standard not provide guidance on how to account for contracts whose purpose is to facilitate sales to customers.

(c) An exchange transaction should have commercial substance for it to be considered revenue generating.

(d) Either the selling price of the asset surrendered or the fair value of the asset received in an exchange transaction should be reliably determinable for the transaction to be considered revenue generating.

(e) Specific guidance should not be included within the revenue standard to address barter transactions.

Exchange Transactions

4. At the March 17 and April 1 Board meetings, the staff recommended that an exchange transaction that has commercial substance be accounted for at the fair value of the consideration received or indirectly by reference to the selling price of the asset exchanged if an entity cannot estimate reliably the fair value of the noncash consideration. The staff's recommendation was based on the premise that such a transaction would qualify as a transaction with a customer in the proposed model. The Boards define a *customer* as 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. Therefore, a fellow market participant who swaps inventory with the entity would be considered a customer of the entity because it contracts with the entity to obtain an output of the entity's ordinary activities.

5. The Boards disagreed with the staff's recommendation and tentatively decided that some exchange transactions should not be revenue-generating transactions but did not decide on which exchange transactions should be excluded from revenue. The staff was also asked to obtain user input into how they view such

transactions and to determine what information relating to these transactions would be useful for them.

Outreach

6. The staff reached out to six users primarily from the oil, gas, and chemical industries because exchange transactions are common in those industries. All of the users stated a preference for retaining the existing model whereby exchange transactions are not reflected in revenue and the inventory received is recorded at the carrying value of the exchanged inventory. The primary reason was that they believed this approach best reflected the nature of the transaction that they believed to be procurement of inventory to fulfill a transaction with the entity's true end customer. Some were concerned that recognizing revenue for such transactions would result in a gross-up of activity in the income statement that would make it more difficult to assess the entity's operating performance during the period and distort gross margins. Others expressed concerns that recognizing the transaction at fair value, either through revenue or as a gain, could result in greater potential for management manipulation or earnings management. Simply put, the users believed that the current model worked well, was reflective of the transaction economics, and that there was no reason to change the approach.

7. The staff also discussed this matter with several industry practitioners in the oil and chemical industries to gain an industry perspective. The feedback received was consistent with that from the users and stated that the current model seemed to work well and reflected how the industry viewed such transactions. It appears that the industries generally use these transactions to maximize the efficiency of the supply chain in delivering their goods to their end customers; that is, they generally view the counterparty as a supplier not a customer.

Alternative Approaches

8. The staff believes that the Boards disagreed with the staff's recommendation because Board members do not view the other party to the exchange as a

customer. Some Board members were concerned that allowing revenue for exchange transactions of similar assets would result in the entity recognizing revenue twice: once for the exchange and then again for the ultimate sale of the inventory to the end customer. Some Board members viewed these transactions to be more supply chain oriented rather than customer oriented. The staff believes that a new revenue standard could address this issue in two ways. The first is to modify the definition of a *customer*. The second is to explicitly exclude some contracts from the scope of the revenue standard.

9. One way to modify the definition of a customer would be by reference to the markets in which an entity transacts, for example as follows: A customer is a party that has contracted with an entity in a market in which an entity normally transacts to obtain an asset (such as a good or a service) that represents an output of the entity's ordinary activities. For example, if an oil company normally sells oil in the retail market then an exchange of inventory in the wholesale market would not be considered a transaction with a customer. Such a model would not treat transactions that are conducted in the same market differently just because of the form of consideration (ie similar goods or services). However, this approach may not work well when an entity commonly transacts in different markets. If the oil company has both retail and wholesale customers, then this approach would result in revenue for exchange transactions in both of those markets.

10. The other approach to address this issue is to explicitly exclude some transactions from the scope of the revenue standard because they are not considered contracts with a customer. This would be similar to the approach that exists under current standards. Paragraph 12 of IAS 18, *Revenue,* states the following with regard to those types of transactions:

> When goods or services are exchanged or swapped for goods or services which are of a similar nature and value, the exchange is not regarded as a transaction which generates revenue. This is often the case with commodities like oil or milk where suppliers exchange or swap inventories in various locations to fulfill demand on a timely basis in a particular location.

11. Similarly, APB Opinion No. 29, *Accounting for Nonmonetary Transactions,* requires that an entity measure noncash consideration received in a transaction to facilitate sales to customers at the carrying amount of the asset surrendered (paragraph 20). This precludes an entity from recognizing a gain on the exchange. Opinion 29 does not specifically address whether classification as revenue is precluded, but in practice these exchange transactions are generally not recognized in the income statement if they are not accounted for at fair value.

12. The staff recommends an explicit scope exception similar to that in Opinion 29, focusing on the entity's reason for entering into the transactions. Specifically, an exchange transaction should not be regarded as one that generates revenue if the purpose of the transaction is to facilitate sales of an asset to another customer in the ordinary course of business. The staff has focused this scope exception on nonmonetary exchanges involving goods because the staff believes it is rare that an exchange of services would exist that would not be treated as a revenue-generating contract unless it was deemed not to have commercial substance. The staff believes that nonmonetary exchanges of services are barter transactions. See paragraphs 20-24 of this memo for discussion and analysis of barter transactions.

13. At the prior Board meetings, some Board members indicated that they might support a model that would recognize the inventory acquired in an exchange to facilitate sales to customers at its fair value with any corresponding gain recognized in earnings (i.e. other income) but not in revenue. The staff believes there is conceptual support for recognizing these transactions at fair value. If these transactions are not considered revenue generating, then they are inherently being viewed as procurement transactions. When an entity acquires a good it generally will recognize that good at its cost, which in an exchange transaction would be the fair value of the asset surrendered.

14. Notwithstanding the conceptual merits of recognizing these transactions at fair value, the staff recommends that the Board not provide guidance on how to account for these transactions within the revenue standard because those transactions are not considered to be within its scope as a contract with a

customer. Under this approach, transactions would continue to be accounted for in accordance with other existing guidance such as Opinion 29 which would result in the good acquired being recognized at the carrying value of the good surrendered. The staff believes that recognizing these exchanges at fair value would increase complexity in the financial statements by excluding some of the profit from the gross margin on the ultimate product sale thereby making evaluation of an entity's performance more difficult. The staff believes that these concerns outweigh the conceptual benefits of recognizing the transaction at fair value on the balance sheet. This is consistent with the input that was received from both users and practitioners who believed that the existing model appropriately displayed the economics of the entity's activities.

Questions 1 and 2	
1	Do the Boards agree that an exchange transaction whose purpose is to facilitate sales to another customer in the ordinary course of business should not be a contract that generates revenue?
2	Do the Board agree with the staff recommendation that the revenue standard not include guidance on how to account for such transactions?

Commercial substance

15. The staff had previously recommended that the new revenue standard include a commercial substance test when evaluating exchange transactions. Opinion 29 defines commercial substance as follows:

> An exchange transaction has commercial substance if the entity's future cash flows are expected to significantly change as a result of the exchange. The entity's future cash flows are expected to significantly change if either of the following criteria are met:
>
> a. The configuration (risk, timing, and amount) of the future cash flows of the asset(s) received differs significantly from the configuration of the future cash flows of the asset(s) transferred.
>
> b. The entity specific value of the asset(s) received differs from the entity-specific value of the asset(s) transferred, and the difference is significant in relation to the fair values of the assets exchanged. [Paragraph 21; footnote references omitted.]

The guidance in IAS 16 *Property, Plant and Equipment* is similar.

16. Some Board members were concerned about basing the exchange transaction accounting solely on the commercial substance notion because they were uncertain whether the commercial substance concept had been adequately tested in practice. The staff was asked to discuss this matter with auditors to determine how frequently this assessment was encountered and if there were any difficulties in applying the concept. The staff discussed this matter with several major accounting firms. The feedback was fairly consistent and most of the auditors stated that it did not appear there was substantial difficulty in applying the concept and that commercial substance issues did not occur very frequently. They did note, however, that they had encountered transactions that were determined not to have commercial substance and that retaining this concept would be useful.

17. Accordingly, the staff recommends that the Boards retain the commercial substance notion in the revenue standard as previously recommended to be applied to those exchange transactions that are not facilitating sales to customers.

Question 3	
3.	Do the Boards agree with the staff's recommendation that an exchange transaction should have commercial substance for it to be recognized as revenue?

Barter Transactions

18. Many contracts involving noncash consideration relate to exchanges of advertising services or other barter credits. For example, a company might promise to transfer a good or a service in exchange for advertising time or barter credits from the customer (or a network of advertisers to which the customer belongs). Or a technology company might promise to provide advertising services to its customer in exchange for advertising services. Historically, companies applied Opinion 29 and IAS 18 to account for those transactions. However, additional application guidance has been issued in EITF Issue No. 93-

11, "Accounting for Barter Transactions Involving Barter Credits," EITF Issue No. 99-17, "Accounting for Advertising Barter Transactions," and SIC Interpretation 31, *Barter Transactions Involving Advertising Services*.

19. That additional application guidance was deemed necessary because of diversity in practice whereby for similar transactions some entities would recognize revenue at the fair value of the goods or services received, others based on the fair value of the goods or services transferred, and others based on the historical cost of the goods or services transferred. The following subparagraphs summarize that guidance:

    (a) Issue 93-11 provides explicit guidance in U.S. GAAP for accounting for barter credit transactions. In effect, Issue 93-11 presumes that the fair value of the asset provided can be measured more reliably than the fair value of the barter credits received. That standard also presumes that the fair value of the asset surrendered does not exceed its carrying value (after evaluation for impairment). Those presumptions can be overcome if there is persuasive evidence supporting a higher value for the surrendered asset, if the barter credits could be converted into cash in the near term, or if independent quoted market prices exist for items to be received upon exchange of the barter credits. In IFRS, entities would account for those transactions in accordance with IAS 18.

    (b) Issue 99-17 and SIC 31 provide guidance on exchanges of advertising, which addresses issues similar to those in Issue 93-11. Issue 99-17 provides additional guidance to determine whether such an exchange is of similar or dissimilar advertising services while SIC 31 only addresses exchanges of dissimilar services. Judgment is used to determine whether the advertising is similar or dissimilar. Both Issue 99-17 and SIC 31 conclude that such exchanges are accounted for at fair value if the fair value of the advertising services provided can be determined or reliably measured. In other words, they presume that the fair value of the advertising services received cannot be measured reliably. Each provides similar guidance to assist in making that evaluation. Issue 99-17 also specifies that if the fair value of the

services provided cannot be determined or reliably measured then the transaction would be accounted for using the carrying amount of the services provided, which would often be zero.

20. The staff believes that barter transactions would generally be considered to have commercial substance and the concerns that triggered the specific issues previously were focused more on whether the value of the assets exchanged could be reliably determined. For example, assume a manufacturing company has obsolete inventory for which demand is limited. The manufacturing company enters into an agreement with a barter company for advertising credits that the manufacturer can use to obtain discounts on future advertising it purchases. Determining the value of the credits can oftentimes be very difficult. Sometimes a company's marketing department may be able to negotiate similar pricing for similar advertising without entering into the exchange transaction. Other times, the agreement may contain limitations on when and how frequently the manufacturer can use the credits and there is risk that the manufacturer may not be able to use some or perhaps all of the credits. One can see how determining the value of either the obsolete inventory or the credits in these situations could be problematic.

21. Another example is an Internet company that has excess capacity on its website. The company enters into an agreement with another Internet company that also has excess capacity. The agreement states that the two companies will provide advertising on each other's website. If the exchange had not occurred, neither company would have purchased the advertising at the counterparty's selling price, if at all. Determining the selling price of the advertising provided or value of the advertising received can be very difficult in such situations.

22. Because of the practice issues encountered previously with these transactions and the difficulty in determining the value of the assets or services exchanged in some of these transactions, the staff recommends that the new revenue standard require that the selling price of either the asset surrendered or the asset received be reliably estimable in order for the transaction to generate revenue. The staff thinks that recommendation is consistent with the boards' recent decision on uncertain consideration—i.e. that an entity would include in its probability-

weighted estimate of total consideration only those amounts that can be estimated reliably.

Questions 4 and 5	
4.	Do the Boards agree with the staff's recommendation that either the selling price of the asset surrendered or fair value of the asset received in an exchange transaction needs to be reliably estimable for the transaction to be considered a transaction that generates revenue?
5.	Do the Boards also agree that the proposed standard should not include specific guidance for barter transactions?