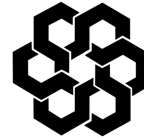

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **March 2009, London**

Project: **Revenue recognition**

Subject: **Noncash consideration (Agenda paper 6C)**

OBJECTIVE

1. In developing the proposed revenue recognition model to date, the Boards have considered only contracts in which customer consideration is in the form of cash. However, customer consideration might be in the form of goods, services, or other noncash consideration.

2. The objective of this paper is to consider how an entity would determine the transaction price when the customer promises noncash consideration. This paper does not consider the effects of the time value of money or other issues associated with measuring the rights in a contract. In other words, it assumes that the noncash consideration is due when the entity satisfies its performance obligation.

3. The paper also covers the related issue of whether some contracts involving the exchange of goods and services should generate revenue.

SUMMARY OF RECOMMENDATIONS

4. The staff recommends:

   a. An entity should measure its right to noncash consideration at the fair value of the promised consideration unless the fair value of the promised consideration cannot be measured reliably or the contract lacks commercial substance.

   b. If the fair value of the noncash consideration cannot be measured reliably, but the contract has commercial substance, the entity should measure the promised

consideration indirectly by reference to the fair value of the goods and services promised in exchange for the consideration.

c. A contract in which goods or services are exchanged for goods or services that are of a similar nature is not a revenue generating contract if that contract lacks commercial substance.

d. A new revenue standard should not provide specific guidance for particular exchanges involving noncash consideration (e.g. barter credit transactions, exchange of advertising services).

5. Fair value will be as defined by the boards' respective standards, i.e. FAS 157 *Fair Value Measurements* and the standard contemplated by the IASB's Fair Value Measurement project. Hence, this paper does not discuss what is meant by fair value.

6. The basis for the staff's recommendations is organized as follows:

a. a measurement basis for noncash consideration (paragraphs 7 – 10)

b. potential modifications of the measurement basis (paragraphs 11 – 30)

i. fair value is not determinable

ii. exchange transaction to facilitate sales to other customers

iii. exchange transaction lacks commercial substance

c. application of the measurement basis to barter transactions (paragraphs 31 – 33).

A MEASUREMENT BASIS FOR NONCASH CONSIDERATION

7. When an entity receives cash from a customer upon delivery of the goods and services promised in a contract, the entity measures the customer's consideration at the amount of cash received, i.e. at the value of the inbound asset. To be consistent with that approach when the customer pays noncash consideration, the entity also should measure noncash consideration at the value of the asset received. In other words, the staff thinks that the basis for measuring rights should be the same whether the form of the customer consideration is cash or noncash.

8. IAS 18 *Revenue* paragraphs 9-12 state that the basis for measuring revenue is the fair value of the consideration received (regardless of the form of that consideration). IFRIC 18 *Transfers of Assets from Customers* similarly requires an entity to measure an asset received from a customer at fair value. Hence, applying the measurement basis of IAS 18 and IFRIC 18 to the boards' proposed model would result in an entity measuring a right to noncash consideration at the fair value of the promised consideration.

9. U.S. GAAP similarly requires that an entity measure noncash consideration at the fair value of the promised consideration. APB Opinion No. 29 *Accounting for Nonmonetary Transactions* paragraph 18 states that an entity should measure an asset received at fair value if the fair value of the asset received is more clearly evident than

the fair value of the asset surrendered (if not, then that principle would be modified as this paper discusses starting in paragraph 11). Applying that principle to the boards' proposed model would result in an entity measuring the right to noncash consideration at the fair value of the promised consideration.

10. The staff agrees with measuring noncash consideration at fair value and recommends that basis for the boards' proposed revenue recognition model.

Question

1 In principle, should an entity measure its right to noncash consideration at the fair value of the promised consideration?

MODIFICATIONS OF THE MEASUREMENT BASIS

11. If the boards decide that companies should measure a right to noncash consideration at fair value, the boards must decide whether to modify that basis in some circumstances—as existing standards do. Existing standards modify the measurement basis for noncash consideration if:

    (a) fair value cannot be measured reliably (paragraphs 12 – 18)

    (b) the exchange transaction facilitates a sale to another customer (paragraphs 19 – 25) or

    (c) the exchange transaction lacks commercial substance (paragraphs 26 – 30).

Fair value cannot be measured reliably

12. In some contracts, an entity might not be able to measure reliably the fair value of the promised noncash consideration. In those cases, IAS 18 requires that an entity refer to the fair value of the goods and services provided to the customer to measure noncash consideration indirectly. Paragraph 12 of IAS 18 states:

> When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up…

13. In US GAAP, APB 29 similarly requires an entity to measure the fair value of the asset received indirectly by reference to the fair value of the asset surrendered (unless the fair value of the asset received is more clearly evident).

14. In other words, existing standards constrain the use of estimates when measuring rights at the fair value of promised noncash consideration. One reason for that constraint is to minimize the risk that management of a company might overestimate the fair value of promised noncash consideration and recognize revenue in excess of the revenue that would be recognized if the customer paid in cash.

15. Some might think that constraining estimates of the fair value of noncash consideration conflicts with the boards' proposal to increase the use of estimates of standalone selling prices when allocating the transaction price to performance obligations. However, the complexity of estimating standalone selling prices affects

the basis of an allocation in the boards' proposed model rather than the total amount to be allocated. In other words, estimates of standalone selling prices affect the timing of revenue recognition in the boards' proposed revenue recognition model, but not the total *amount* of revenue recognized.

16. Some argue that the fair value of the promised consideration always can be measured reliably, in the sense understood by Concepts Statement 2 *Qualitative Characteristics of Accounting Information*, paragraph 59. Namely that an entity can determine a measure that faithfully represents what it purports to represent and that provides an assurance for the user, through verification, that the measure has that representational quality.

17. However, the staff notes that IFRS 2 *Share-based Payment* and FAS 123(R) *Share-based Payment* state that if the fair value of the goods or services received cannot be estimated reliably, then the entity measures them indirectly by reference to the fair value of the granted equity instrument. It also assumes that the fair value of the employee services cannot be measured reliably directly. Furthermore, some of the asset standards that specify the accounting for the noncash consideration in a revenue contract such as IAS 16 *Property, Plant and Equipment* require the asset received to be reliably measureable. Therefore, if the revenue recognition standard is to dovetail with those standards, it needs a reliable measurement criterion.

18. Accordingly, the staff recommends that if an entity cannot reliably measure the fair value of the promised noncash consideration directly, it should measure the consideration indirectly by reference to the fair value of the goods and services exchanged for the noncash consideration.

Questions

2 If an entity cannot reliably measure the fair value of the noncash consideration directly, should it measure the promised consideration indirectly by reference to the fair value of the goods and services exchanged for the noncash consideration?

3 Should a revenue standard include guidance on when the fair value of an asset received can be measured reliably in the absence of comparable market transactions?

Exchange transaction to facilitate sales to other customers

19. In some cases, the parties to a contract exchange assets of a similar nature to facilitate sales to their own end customers. An example of that type of transaction is an oil supplier that swaps inventory with another oil supplier to reduce transportation costs, meet immediate inventory needs, or otherwise facilitate the sale of oil to the end consumer. In those cases, APB 29 requires that an entity measure noncash consideration received at the carrying amount of the asset surrendered (paragraph 20). That requirement precludes an entity from recognizing a gain on the exchange.

20. IAS 18 paragraph 12 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.

21. In contrast to existing standards, the boards' revenue recognition model as developed to date would not preclude an entity from recognizing revenue (or gains) in an exchange of similar goods or services.

22. Some might think that the proposed model should preclude revenue recognition if inventory is swapped with a fellow market participant. However, the fellow market participant would meet the boards' proposed definition of a customer. 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. Hence, 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.

23. The staff notes a couple consequences of an entity recognizing revenue for an exchange of similar assets. First, if the noncash consideration received becomes inventory of the entity and is measured at fair value, it might be measured on a basis different from other inventory of the entity. (Although it should be noted that fair value is the price in the wholesale market, not the retail market.) Secondly, allowing an entity to recognize revenue for an exchange of similar assets might entice companies to artificially inflate (or 'manufacture') revenue by swapping assets when there is no commercial substance to that swap.

24. Despite those consequences, the staff recommends that the boards' proposed model allow an entity to recognize revenue if, in a substantive contract, the customer promises noncash consideration that is similar in nature and value to the goods and services the entity provides to the customer. The staff thinks that a contract with a customer (as defined in the discussion paper) generates revenue for an entity. If the boards decide that revenue recognition should be precluded in an exchange of similar assets, the staff thinks the boards should modify the definition of a contract or a customer, or constrain the model in some way other than measurement of the noncash consideration.

25. In the staff's view, the risk that companies might artificially inflate revenue should be mitigated by a commercial substance test (as discussed below). That is, the staff thinks that a commercial substance test is a better way of excluding nonsubstantive contracts than simply excluding all contracts in which there is an exchange of assets of a similar nature.

Question

4 In principle should an entity be allowed to recognize revenue in a contract for an exchange of similar goods or services?

Exchange transaction lacks commercial substance

26. Neither U.S. GAAP nor IFRS allow an entity to measure noncash consideration at fair value if the transaction lacks 'commercial substance'[1]. In those transactions, the asset acquired is measured at the carrying value of the asset transferred (i.e. no profit is recognized). The idea behind a commercial substance test is to capture the

[1] Opinion 29 par 21-22, IAS 16 par. 24-25, and IAS 38 par 45-46

transactions in which an entity swaps one asset for another similar asset, but the attributes of that asset are different. Hence, the configuration (risk, timing, and amount) of the cash flows differs.

27. The staff thinks that a new revenue standard should also have a commercial substance test. Noncash consideration is an area of significant financial reporting abuse in the past. One such example is "round-tripping" whereby companies transfer goods and services back and forth to each other (often with little or no cash consideration) with the purpose of artificially inflating revenue. That rationale was included in paragraph BC21 of IAS 16 as a basis for requiring a commercial substance assessment in that standard. Therefore, the staff proposes to carry forward the commercial substance test of existing U.S. GAAP and IFRS and apply it to revenue transactions as a filter to exclude nonsubstantive exchange contracts from giving rise to revenue.

28. Hence, a contract, in which goods or services are exchanged or swapped for goods or services which are of a similar nature, would not be regarded as a revenue-generating contract if that contract lacks commercial substance.

29. Both IAS 16 and FAS 153 *Exchange of Nonmonetary Assets* provide guidance on commercial substance. The staff proposes carrying forward the guidance in FAS 153 because that guidance incorporated improvements to the notion of commercial substance introduced in IAS 16. As a result, an entity that enter into an exchange contract that lacks commercial substance would measure the asset received (consideration) based on the carrying amount of the assets surrendered, which in the case of many service contracts would be nil.

30. To illustrate the consequence of carrying forward the commercial substance test, consider the example of two companies that swap oil to facilitate sales to an end customer. If the companies are in the same geographic area and exchange oil for sale to end customers, then arguably the transaction lacks commercial substance and revenue would not recognized. That is because the risk, timing and amount of the future cash flows from the asset received and given up do not differ significantly. Said another way, location can be attribute of an asset. Hence, in this example, because there was no substantive change of location, the attributes of the assets exchanged are nearly indistinguishable. So in effect, the asset received under the swap is the same as the asset given up and there was, in substance, no exchange contract. However, if those companies are in different countries and swap oil, then the transaction would have commercial substance and would result in revenue recognition. In this example, the asset received and given up under the swap are different because their cash flow configuration is different.

Question

5 Do the boards agree that a new revenue standard should have a commercial substance test to exclude nonsubstantive exchange contracts from generating revenue?

APPLICATION OF THE MEASUREMENT BASIS TO BARTER TRANSACTIONS

31. 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 93-11, *Accounting for Barter Transactions Involving Barter Credits*, EITF Issue 99-17*, Accounting for Advertising Barter Transactions, and* SIC-31*, Barter Transactions Involving Advertising Services*.

32. That additional application guidance was deemed necessary because of diversity in practice whereby for similar transactions some companies 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 paragraphs summarize that guidance:

    a. *EITF 93-11* provides explicit guidance in U.S. GAAP for accounting for barter credit transactions. In effect, EITF 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, or 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. *EITF 99-17 and SIC 31*: Exchanges of advertising present similar issues. EITF 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 EITF 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. EITF 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 based on the carrying amount of the services provided, which would often be zero.

33. The staff thinks that a new revenue standard should not contain specific guidance on those types of arrangements. Hence, in a barter transaction involving advertising services, an entity would recognize revenue based on the fair value of the services received if that fair value is reliably measureable. If it is not, the entity would recognize revenue based on the fair value of services provided. If the contract lacked commercial substance, no revenue would be recognized and the entity would recognize the service received based on the carrying amount of the assets surrendered (which is likely to be nil).