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Contact(s)			
	Elizabeth Gagnon	eagagnon@fasb.org	+1 (203) 956-3477
	Glenn Brady	gbrady@iasb.org	+44 20 7246 6460
	Henry Rees	hrees@iasb.org	+44 20 7246 6466
	Kenny Bement	kbbement@fasb.org	+1 (203) 956-5233

Project **Revenue Recognition**

Topic **Background paper: Steps to apply the proposed model**

Purpose of this background paper

1. This paper summarizes the proposed revenue recognition model as developed to date (including decisions both in the discussion paper and those made subsequently).

2. The staff prepared the summary to provide the Boards with an overview of the proposed model and to put into context those parts of the model discussed since the Discussion Paper was issued.

3. The staff does not intend to discuss this background paper at the meeting unless any board members have questions on it.

This paper has been prepared by the technical staff of the FAF and the IASCF for discussion at a meeting of World Standard Setters.

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 U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

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.

Steps to apply the Boards' proposed model

Steps to apply the proposed model		Tentative Board decisions	Outstanding decisions and issues
Step 1: Identify the contract			
1.1	Does the entity have a contract with a customer?	Contract is an agreement between two or more parties that creates enforceable obligations. A customer is a party that has contracted with an entity to obtain an asset (such as a good or service) that represents an output of the entity's ordinary activities.	What is "enforceable"? Does a customer include related parties? What are "ordinary activities"?
1.2	Which contracts (or parts of a contract) should be outside the scope of the proposed model?	DP indicated that scope exclusions may be necessary for: • financial instruments • insurance contracts • leasing contracts. Once a contractual right becomes a receivable (i.e. an unconditional right to cash), it is accounted for in accordance with other standards.	Would the proposed model fail to provide decision-useful information for some contracts (or parts of a contract)? To be determined upon further development of the model. Which fees associated with financial instrument contracts are in the scope of the proposed model?
1.3	Should the contract be combined with other contracts?	Two or more contracts with the same customer should be accounted for as a single net contract position if the prices of those contracts are interdependent.	Are there any situations in which an entity should "look through a renewal option" and account for the additional goods and services as part of the original contract?
1.4	Should the contract be segmented into more than one net contract position?	An entity should account for a single contract with a customer as multiple contracts only if each contract segment is priced independently.	How does segmentation of a contract relate to the identification, separation and measurement of performance obligations?
1.5	Should changes in contract terms and conditions after contract inception be treated as part of the original contract or as a separate contract?	A contract modification should be accounted for as a separate contract if it is priced independently from the original contract. If the prices are interdependent, an entity should combine the original contract and the modification and recognize the effect of the modification on a cumulative catch-up basis.	

Step 2: Identify the performance obligations ("POs")			
2.1	What are the POs in the contract?	An entity's PO is a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer.	Does an entity have a PO if the good or service is transferred to another party? Are standard warranties, returns, sales incentives, and product liabilities POs? What additional examples and guidance are needed to identify POs consistently?
2.2	Which POs should be accounted for separately?	Separate POs are identified based on when the goods and services are transferred to the customer.	Should a PO be accounted for separately only if it has standalone value to the customer? Is guidance needed for perfunctory or inconsequential POs? How should POs be identified when there is continuous transfer of goods/services in a contract?
2.3	What is the PO when other parties are involved in providing goods and services to the customer?	An entity must determine whether its PO is to provide goods and services itself or to arrange for another party to provide those goods and services. The amount of revenue an entity recognizes depends on that assessment.	
Step 3: Determine the transaction price			
3.1	What is the amount to be allocated to the POs?	POs should be measured at the transaction price (i.e. the customer's consideration promised in exchange for goods and services).	Should the amount allocated be adjusted for contract acquisition costs?
3.2	How should the transaction price be determined for the time value of money (i.e. when performance by the entity and the customer occur at different times)?	The transaction price should reflect the time value of money: • Whenever its effect is material. • Using the discount rate that would be reflected in a financing transaction that did not involve the provision of other goods and services.	

		The effect of financing should be presented separately from revenue from other goods and services.	
3.3	How should the transaction price be determined if the amount of promised consideration is variable or uncertain?	The transaction price is the probability-weighted estimate of customer consideration, unless that amount cannot be estimated reliably. • That amount should be updated subsequently and any change allocated to all POs. • Amounts allocated to satisfied POs would be recognized as revenue immediately.	What is meant by a "reliable estimate"?
3.4	How should the transaction price be determined if the customer promises noncash consideration?	The transaction price is the fair value of the noncash consideration or, if fair value cannot be reliably estimated, the selling price of the promised goods and services. If neither of those amounts can be estimated reliably, the transaction would not generate revenue. An entity should recognize revenue for a nonmonetary exchange only if the transaction has commercial substance. An entity should not recognize revenue from a nonmonetary exchange if the purpose was to facilitate a sale to another party.	
3.5	How to adjust the transaction price if collectibility is uncertain?	The measurement of a net contract position should reflect the customer's credit risk. Hence, uncertainty of collectibility because of the customer's credit risk would affect the amount of profit or loss recognized when a PO is satisfied, rather than whether a profit or loss is recognized (IASB only, no FASB decision).	IASB: How should the effects of uncertainty of collectibility be presented in profit or loss? FASB: Should uncertainty of collectibility affect recognition or measurement of revenue?

Step 4: Allocate the transaction price to the separate POs			
4.1	How should the transaction price be allocated to the POs?	The transaction price should be allocated relative to the standalone selling price of the goods and services underlying the POs. If that price is not observable, it would be estimated.	What methods are appropriate for estimating selling prices? When, if ever, should the allocation be on another basis (e.g. cost, residual method)? Should the Boards specify a hierarchy for allocating the transaction price?
Step 5: Determine when POs are satisfied and revenue is recognized			
5.1	When are POs satisfied?	A PO is satisfied when an entity transfers the promised good or service to the customer. An entity has transferred the promised asset when the customer obtains control of it.	
5.2	When is control of a good or service transferred to a customer?	An entity should consider various factors to determine when an asset is transferred to a customer including: • Physical possession • Customer payment • Customer acceptance • Customer intent • Customization	How should the definition of control be clarified and what indicators of control would be needed? How would the notion of control be applied by various industries (specifically construction, services and intangibles)?
5.3	Is revenue recognized if POs are settled other than by transfer of goods and services to the customer?	If an entity transfers a PO to another party so that the entity is no longer obliged to provide the underlying good or service, the entity should not recognize revenue for that PO.	
Step 6: Determine the subsequent measurement of POs			
6.1	When should the initial measurement of a PO be updated?	The measurement of a PO should be updated only when it is deemed onerous. A PO is deemed onerous when the entity's expected costs of satisfying the PO exceed its carrying amount.	At what level should the onerous test operate (e.g. individual POs, remaining POs, whole contract, or portfolio of POs)? When, if ever, would an onerous remeasurement be reversed?

6.2	How should an onerous PO be measured?	An onerous PO should be measured at the entity's expected costs of satisfying the PO. That remeasurement does not affect the amount of revenue recognized.	What costs should be included in the onerous test and measurement?
Step 7: Determine how to account for contract costs			
7.1	How should contract acquisition (and other) costs be accounted for?	Costs would be recognized as expenses when incurred unless eligible for capitalization in accordance with other standards.	Are there any instances in which revenue should be recognized to cover contract acquisition costs? Should any contract acquisition or other upfront costs be deferred? Which cost guidance in existing revenue standards should be retained?
Step 8: Determine presentation and disclosure			
8.1	How should the net contract position be presented?	The net contract position is the combination of remaining rights and obligations in the contract, and therefore is presented net in the statement of financial position.	Are there any instances in which rights and obligations should be presented gross in the statement of financial position? Should net contract assets be presented separately from net contract liabilities?
8.2	What disclosures are required?	An entity should disclose separately revenue in the same line of business from: • Providing goods and services itself • Arranging for the provision of goods and services. An entity should disclose the basis for its assessment and any significant judgment in identifying POs when other parties are involved in providing goods and services to the entity's customer.	What disclosures would provide decision-useful information to users? In particular, what disclosures are required for contracts with uncertain consideration and the use estimates used in determining revenue?