FASB-IASB Joint Board Meeting
- week beginning 17 May 2010

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Project	**Revenue Recognition**
Topic	**Repurchase agreements**

Introduction

1. This paper seeks the Boards' views on how a seller of an asset should determine whether a buyer obtains control of the asset in a contract with a repurchase agreement.

2. This paper considers only the sale of nonfinancial assets. In addition, when considering the transfer of control of an asset, this paper assumes that the asset cannot be componentized and partially derecognized.

Staff recommendation

3. The staff recommends adding implementation guidance to the forthcoming Exposure Draft to help a seller of an asset determine whether a buyer obtains control of the asset in a contract with a repurchase agreement. That guidance would explain the following:

    (a) If a buyer has the unconditional right to require the seller to repurchase the asset, the buyer obtains control of the asset and the seller should account for the agreement similarly to the sale of a product with a right of return.

(b) If a seller of an asset has an unconditional obligation or unconditional right to repurchase the asset, the buyer does not obtain control of the asset. The seller should account for the repurchase agreement as either:

(i) a lease in accordance with Topic 840 *Leases* or IAS 17 *Leases* if the seller repurchases the asset for less than the original sales price of the asset (i.e. the buyer pays a net amount of consideration to the seller), or

(ii) a financing arrangement if the seller repurchases the asset for more than the original sales price of the asset (i.e. the seller pays a net amount of consideration to the buyer).

(c) If the sale and repurchase agreement is a financing arrangement, the seller should continue to recognize the asset and should recognize a financial liability for any consideration received from the buyer. The seller should recognize the difference between the amount of consideration received from the buyer and the amount of consideration paid to the buyer as interest and, if applicable, holding costs (e.g. insurance).

4. The staff recommends that the FASB propose withdrawing Subtopic 470-40 *Product Financing Arrangements*.

Structure of the paper

5. The paper is organized as follows:

(a) Background information (paragraphs 6–8)

(b) Determining whether a buyer obtains control of an asset in a repurchase agreement (paragraphs 9–33)

(i) a seller's unconditional obligation to repurchase the asset (paragraphs 13–21)

(ii) a seller's unconditional right to repurchase the asset (paragraphs 22–23)

(iii) a buyer's unconditional right to require the seller to repurchase the asset (paragraphs 24–33)

(c) Alternative for improving the proposed model (paragraphs 34–38)

(d) Appendix A – Existing requirements in US GAAP and IFRSs

(e) Appendix B – Definition and indicators of control in the proposed model

Background information

6. At the May 5, 2010 FASB-only Board meeting, the FASB considered the potential effects of the proposed model on the accounting for real estate contracts.

7. During the discussion, the FASB questioned how an entity would determine whether a buyer obtains control of an asset in a contract with a repurchase agreement. The FASB thought that the proposed guidance on control (and the related implementation guidance on repurchase agreements) needed to be developed further.

8. Because an assessment of control is critical to the application of the proposed model, the staff was asked to analyze the issues raised by the FASB and to summarize them for discussion at a joint meeting with the IASB.

Determining whether a buyer obtains control of an asset in a repurchase agreement

9. Sometimes an entity sells an asset and also enters into a repurchase agreement (either in the same contract or in another contract). Repurchase agreements come in three main forms:

(a) a seller's unconditional obligation to repurchase the asset (a forward),

(b) a seller's unconditional right to repurchase the asset (a call option), and

(c) a buyer's unconditional right to require the seller to repurchase the asset (a put option).

10. The repurchased product may be the asset that was originally sold to the buyer, a substantially identical product, or another product of which the asset is a component.

11. The staff thinks the proposed definition of control provides a useful framework to help an entity determine whether a buyer obtains control of an asset in a repurchase agreement. However, the staff thinks the forthcoming Exposure Draft needs additional implementation guidance to explain how an entity would evaluate repurchase agreements within that framework.

12. Therefore, the following sections analyze each type of repurchase agreement to determine whether the buyer obtains control of the asset in accordance with the definition of control in the proposed model (Appendix B).

A seller's unconditional obligation to repurchase the asset (a forward)

13. With this type of repurchase agreement, the buyer is constrained in its ability either to direct the use of the asset, or to receive the benefit from the asset, or both. Because the buyer is obliged to return the asset to the seller, the buyer cannot use up or consume the entire asset. Moreover, the buyer cannot sell the asset to another party (unless that sale is subject to a repurchase agreement in which case the buyer's benefit is constrained).

14. In theory, the buyer is not constrained in its ability to direct the use of the asset or to receive the benefit from the asset if the seller agrees to repurchase, at the prevailing market price, a substantially identical product that is readily available in the marketplace. However, the staff cannot envisage why a seller would enter into this transaction.

15. Therefore, the buyer does not obtain control of an asset if the seller has an unconditional obligation to repurchase the asset (a forward). Consequently, the seller would neither derecognize the asset nor recognize revenue for satisfying a performance obligation to transfer the asset. Rather, the seller would account for the contract as either a lease or as a financing arrangement as follows:

(a) *Lease*—the seller would account for the contract as a lease if the price at which the seller repurchases the asset is less than the original sales price of the asset. In that case, the buyer pays a net amount of consideration to the seller in exchange for allowing the buyer to use the product for a period of time. In other words, the seller's performance obligation was to allow the buyer to use the product for a period of time. If an agreement is a lease, an entity would apply existing requirements to account for the lease (i.e. Topic 840 or IAS 17).

(b) *Financing arrangement*—the seller would account for the contract as a financing arrangement if the price at which the seller repurchases the asset is more than the original sales price of the asset. In that case, the seller pays a net amount of consideration to the buyer in exchange for financing. The seller would not have an obligation to provide a good or a service.

16. When comparing the repurchase price to the sales price, an entity would adjust the prices for the time value of money.

17. If a repurchase agreement is a financing arrangement, an entity applying US GAAP could apply Subtopic 470-40 *Product Financing Arrangements*. IFRSs do not have an equivalent standard (the implementation guidance of IAS 18 acknowledges the possibility of a financing arrangement but does not specify the accounting). A summary of existing requirements on repurchase agreements is in Appendix A.

18. To converge US GAAP and IFRSs for a financing arrangement that arises from a contract with a customer, the staff thinks the Boards should specify, in the implementation guidance of the forthcoming Exposure Draft, that the seller should:

(a) continue to recognize the asset,

(b) recognize a financial liability for any consideration received from the buyer, and

(c) recognize the difference between the amount of consideration received from the buyer and the amount of consideration paid to the buyer as interest and, if applicable, holding costs (e.g. insurance).

19. The staff's recommended implementation guidance is consistent with Subtopic 470-40 which states:

> If a sponsor sells a product to another entity and, in a related transaction, agrees to repurchase the product (or a substantially identical product) or processed goods of which the product is a component, the sponsor shall record a liability at the time the proceeds are received from the other entity to the extent that the product is covered by the financing arrangement. The sponsor shall not record the transaction as a sale and shall not remove the covered product from its balance sheet.

20. Consequently, the FASB could withdraw that guidance in Subtopic 470-40. The remaining guidance in Subtopic 470-40 addresses situations in which an entity arranges for another party to purchase products on its behalf and agrees to purchase those products from the other party. In those cases, the entity is required to recognize the products as an asset and to recognize a related liability when the product is purchased by the other party. The staff thinks that the proposed model would result in similar accounting when the other party acts as an agent of the entity (i.e. the other party does not obtain control of the products). The staff observes that there could be a change in practice if the other party is not acting as an agent.

21. The staff thinks the proposed model, with the added implementation guidance recommended in this paper, addresses the issues in Subtopic 470-40. Moreover, the issues are addressed in the framework of control which the staff thinks will provide a clearer objective for evaluating financing agreements. Therefore, the staff recommends withdrawing Subtopic 470-40.

A seller's unconditional right to repurchase the asset (a call option)

22. With this type of repurchase agreement, the buyer is obliged to stand ready to return the asset to the seller. Therefore, the buyer's position is constrained just as it would be with a seller's unconditional obligation to repurchase the asset.

23. Therefore, the buyer does not obtain control of an asset if the seller has an unconditional right to repurchase the asset (a call option). Hence, the seller would account for the repurchase agreement either as a lease or as a financing arrangement (as discussed above).

A buyer's unconditional right to require the seller to repurchase the asset (a put option)

24. This type of repurchase agreement could be viewed as either:

View A: the sale of an asset with a right of return (although an entity might not recognize any revenue upon the sale of the asset), or

View B: the sale of an asset with a right of return except when the put option economically is similar to a forward.

View A

25. Under View A, the buyer of the asset obtains control of the asset and also receives a put option. Because the buyer is neither unconditionally obliged to return the asset nor is obliged to stand ready to do so, it has the present ability to direct the use of and receive the benefit from the asset. That is, the buyer can sell, use up, or consume the entire asset and choose to not exercise the put option. View A is consistent with the Boards' decision on the accounting for the sale of a product with a right of return. When discussing the accounting for the sale of a product with a right of return, the Boards concluded that a put option does not preclude the transfer of control of an asset.

26. To account for the sale of a product with a right of return, the Boards concluded that an entity would:

(a) recognize a refund liability at the amount of the expected (probability-weighted) consideration to be paid to the customer,

(b) allocate consideration to the performance obligation to transfer the product at an amount equal to the difference between the amount of the refund liability and the amount of consideration received from the customer,

(c) recognize an asset for its right to receive any returned products upon fulfillment of its refund liability.

27. Consequently, the Boards could require an entity to account for other put options in a similar manner. A benefit of applying that approach is that the likelihood of the buyer exercising the put option affects the amount of the consideration allocated to the performance obligation to transfer the asset and to the liability to repurchase the asset. If the buyer is not likely to exercise the put option, the seller would recognize relatively more revenue for the transfer of the asset but would still allocate some amount to the liability to repurchase the asset. The seller would measure the asset for its right to receive the repurchased asset at a relatively lower amount.

28. Conversely, if the buyer is likely to exercise the put option, then the seller would recognize relatively little revenue for the transfer of the asset and would allocate a greater amount to the liability to repurchase the asset. The seller also would measure the asset for its right to receive the repurchased asset at a relatively greater amount.

29. If the terms of the agreement and the surrounding facts and circumstances indicate that the buyer is virtually certain to exercise the put option, then the seller would:

(a) not recognize revenue upon sale of the product,

(b) recognize an asset for its right to receive the repurchased asset at the previous carrying amount of the asset sold, and

(c) recognize a liability at the amount of consideration received from the buyer.

View B

30. Under View B, in most cases, the buyer also obtains control of the asset and receives a put option. Therefore, the seller would account for the repurchase agreement similar to a right of return as described above.

31. However, in some cases, the terms of the agreement and the surrounding facts and circumstances economically constrain the buyer so that the buyer neither directs the use of, nor receives the benefit from, the asset. For example, consider an arrangement in which an asset with a market value of CU90 is sold for CU100 and the buyer has the right to require the seller to repurchase the asset for CU110 (when the market value is expected to be unchanged). Although the buyer is not obliged to exercise its put option, it would incur a loss if it did not exercise its right. Hence, the buyer neither directs the use of, nor receives the benefit from, the asset. Economically, the transaction is similar to a forward and would be accounted for either as a lease or as a financing arrangement (as described above).

Staff recommendation

32. As discussed above, View A and View B result in the same accounting for most put options (those similar to a right of return). Moreover, both views result in similar accounting outcomes even when View B views the option as similar economically to a forward. For example, if the buyer is virtually certain to exercise the put option, neither view would result in the recognition of revenue at the point of sale. Both views would result in the recognition of an asset and a liability. Moreover, the asset would be measured at the same amount under both views as would the liability. An advantage of View A is that the Boards would not need to specify when a put option is similar economically to a forward. Rather, the proposed revenue model would account for all put options consistently and would address the likelihood of the buyer exercising the put option through measurement.

33. Therefore, the staff recommends View A.

Questions for the Boards

Repurchase agreements
Question 1 Do the Boards agree with the staff's recommendation to add implementation guidance to explain how an entity would determine whether the buyer obtains control of the asset in accordance with the definition of control in the proposed model? **Question 2** Do the Boards agree that all put options in the scope of the proposed revenue model should be accounted for consistently with a right of return? (i.e. View A) **Question 3** Do the Boards agree with the proposed guidance on financing arrangements in paragraph 18? **Question 4** Does the FASB agree with the staff's recommendation to withdraw Subtopic 470-40 *Product Financing Arrangements*.

Alternative for improving the proposed model

34. If the Boards disagree with the staff's recommendation to use the proposed definition of control (with additional implementation guidance) to help an entity evaluate a contract with a repurchase agreement, the Boards could modify the proposed definition and/or indicators of control.

35. The Boards could modify the definition of control as follows:

> Control of a good or service is the present ability to direct the use of and receive <u>substantially all</u> the <u>risks and</u> benefit<u>s</u> from that good or service (additions to existing definition are underlined).

36. Modifying the proposed definition of control in this way would change the proposed model to one based on risks and rewards of ownership. It might be more consistent with current practice but the staff thinks it would not be consistent with the Boards' proposals in the Discussion Paper. For example, if an entity promises to

deliver a product to a customer and cover the risk of loss during the product's shipment, the existing definition of control would result in the entity identifying two performance obligations—one for the product and another one for the risk coverage service. Assuming control of the product is transferred to the customer upon shipment, some revenue would be recognized at that time.

37. In contrast, the modified definition in paragraph 35 could result in the entity identifying one performance obligation because the entity retains some of the risks (i.e. the risk of loss) associated with the product during its shipment. Consequently, an entity might not recognize any revenue at the time of shipment even though the customer has obtained control of an asset. Similar situations arise with sales of products with a warranty.

38. Another alternative would be to introduce additional indicators (or contra indicators) of control. The staff has considered doing so but notes the following:

    (a) *Loss of focus on the principle of control*—some external reviewers of the draft Exposure Draft think that the indicators of control take the focus away from the principle. There is a concern about the indicators becoming a checklist rather than helpful factors to consider when assessing control. The staff thinks it would be more useful to focus on the definition of control to evaluate repurchase agreements.

    (b) *Confusion with identification of performance obligations*—if the Boards were to add an indicator of control of a product such as "the seller does not have an obligation, or option, to repurchase the product", the staff thinks it would confuse the satisfaction of performance obligations with the identification of performance obligations. For example, although it is true that in some cases, a seller's repurchase obligation indicates that the buyer does not obtain control of a *product*, the buyer still might obtain control of a *service* from using the product over time (if the agreement is a lease).

    (c) *Overlap with other requirements in the proposed model*—if the Boards were to add a contra indicator of control such as "the seller has continuing involvement with the asset" (similar to existing requirements in US GAAP on real estate), the staff thinks that indicator would overlap with other aspects of the proposed model that address related issues (e.g. determining whether a contract exists, identifying performance obligations, and determining the transaction price).

Appendix A – Existing requirements in US GAAP and IFRSs

A1. This appendix contains a summary of existing requirements in US GAAP and IFRSs on the sale and repurchase of a product.

US GAAP

A2. Subtopic 470-40 on product financing arrangements states the following:

> *Glossary*
>
> A product financing arrangement is a transaction in which an entity sells and agrees to repurchase inventory with the repurchase price equal to the original sale price plus carrying and financing costs, or other similar transactions.
>
> *Scope*
>
> 15-2 The guidance in this Subtopic applies to product financing arrangements for products that have been produced by or were originally purchased by the sponsor or purchased by another entity on behalf of the sponsor and have both of the following characteristics:
>
> a. The financing arrangement requires the sponsor to purchase the product, a substantially identical product, or processed goods of which the product is a component at specified prices. The specified prices are not subject to change except for fluctuations due to finance and holding costs. This characteristic of predetermined prices also is present if any of the following circumstances exist:
>
> 1. The specified prices in the financing arrangement are in the form of resale price guarantees under which the sponsor agrees to make up any difference between the specified price and the resale price for products sold to third parties.
>
> 2. The sponsor is not required to purchase the product but has an option to purchase the product, the economic effect of which compels the sponsor to purchase the product; for example, an option arrangement that provides for a significant penalty if the sponsor does not exercise the option to purchase.
>
> 3. The sponsor is not required by the agreement to purchase the product but the other entity has an option whereby it can require the sponsor to purchase the product.
>
> b. The payments that the other entity will receive on the transaction are established by the financing arrangement, and the amounts to be paid by

the sponsor will be adjusted, as necessary, to cover substantially all fluctuations in costs incurred by the other entity in purchasing and holding the product (including interest). This characteristic ordinarily is not present in purchase commitments or contractor-subcontractor relationships.

Recognition

25-1 This Subtopic requires that a product financing arrangement be accounted for as a borrowing rather than as a sale. The sponsor is in substance the owner of the product and the sponsor shall, therefore, report the product as an asset and the related obligation as a liability.

25-2 Product and obligations under product financing arrangements that have both of the characteristics described in paragraphs 470-40-15-2 through 15-3 shall be accounted for by the sponsor as follows:

a. If a sponsor sells a product to another entity and, in a related transaction, agrees to repurchase the product (or a substantially identical product) or processed goods of which the product is a component, the sponsor shall record a liability at the time the proceeds are received from the other entity to the extent that the product is covered by the financing arrangement. The sponsor shall not record the transaction as a sale and shall not remove the covered product from its balance sheet.

b. If the sponsor is a party to an arrangement whereby another entity purchases a product on the sponsor's behalf and, in a related transaction, the sponsor agrees to purchase the product or processed goods of which the product is a component from the entity, the sponsor shall record the asset and the related liability when the product is purchased by the other entity.

25-3 Costs of the product, excluding processing costs, in excess of the sponsor's original production or purchase costs or the other entity's purchase costs represent financing and holding costs. The sponsor shall account for such costs in accordance with the sponsor's accounting policies applicable to financing and holding costs as those costs are incurred by the other entity. For example, if insurance costs ordinarily are accounted for as period costs by the sponsor, similar costs associated with the product covered by financing arrangements shall be expensed by the sponsor as those costs are incurred by the other entity.

25-4 Interest costs associated with the product covered by financing arrangements shall be identified separately and accounted for by the sponsor in accordance with Topic 835 as those costs are incurred by the other entity.

A3. Subtopic 360-20 on real estate states the following:

>>> Seller Option or Obligation to Repurchase

> 40-38 If the seller has an obligation to repurchase the property, or the terms of the transaction allow the buyer to compel the seller or give an option to the seller to repurchase the property, the transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement rather than as a sale. A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. See paragraph 360-20-55-21A for implementation guidance related to evaluating a buy-sell agreement in cases where the seller of the real estate has otherwise met the criteria to recognize a partial sale.
>
> 40-39 Land sale agreements sometimes contain antispeculation clauses that require the buyer to develop the land in a specific manner or within a stated period of time. Antispeculation clauses may also prohibit certain uses of the property. If the buyer fails to comply with the provisions of the sales contract, the seller has the right, but not the obligation, to reacquire the property. The seller's contingent option described would not preclude recognition of a sale if the probability of the buyer not complying is remote. A number of factors might lead one to conclude that buyer noncompliance is remote, including the economic loss to the buyer from repurchase and the buyer's perceived ability to comply with the provisions of the sales contract. A probability test would not be appropriate if the seller's repurchase option is not contingent upon compliance by the buyer.

IFRSs

A4. An illustrative example of IAS 18 states the following:

> *Sale and repurchase agreements (other than swap transactions) under which the seller concurrently agrees to repurchase the same goods at a later date, or when the seller has a call option to repurchase, or the buyer has a put option to require the repurchase, by the seller, of the goods.*
>
> For a sale and repurchase agreement on an asset other than a financial asset, the terms of the agreement need to be analysed to ascertain whether, in substance, the seller has transferred the risks and rewards of ownership to the buyer and hence revenue is recognised. When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to revenue. For a sale and repurchase agreement on a financial asset, IFRS 9 Financial Instruments and IAS 39 Financial Instruments: Recognition and Measurement apply.

Appendix B – Definition and indicators of control in the proposed model

B1. The current draft of the forthcoming Exposure Draft includes the following definition and indicators of control:

Definition

Control of a good or a service is an entity's present ability to direct the use of and receive the benefit from a good or service. Control includes the present ability to prevent other entities from directing the use of and receiving the benefit from a good or service.

Indicators

An entity shall consider the transfer of control of goods or services for each separate performance obligation. Indicators that the customer has obtained control of a good or service include, but are not limited to, the following:

(a) the customer has an unconditional obligation to pay—if a customer is unconditionally obliged to pay for a good or service, typically that is because the customer has obtained control of the good or service in exchange. An obligation to pay is unconditional when nothing other than the passage of time is required before the payment is due.

(b) the customer has legal title—legal title often indicates which party has the present ability to direct the use of and receive the benefit from a good. Benefits of legal title include the ability to sell a good, exchange it for another asset, or use it to secure or settle debt. Hence, the transfer of legal title often coincides with the transfer of control. However, in some cases, possession of legal title is a protective right and may not coincide with the transfer of control to a customer (for example, when a seller retains title solely as protection against the customer's failure to pay).

(c) the customer has physical possession—in many cases, the customer's physical possession of a good gives the customer the ability to direct the use of that good. In some cases, however, transfer of physical possession does not coincide with the transfer of control of a good. For example, in some bill-and-hold arrangements, the entity may have physical possession of a good that the customer controls. Conversely, in some consignment arrangements, an entity may have transferred physical possession of a good but retained control of it.

(d) the design or function of the good or service is customer-specific—a good or service with a customer-specific design or function might be of little value to an entity because the good or service lacks an alternative use. For instance, if an entity cannot sell a customer-specific product to another customer, it is likely that the entity would require the customer to obtain control of the product (and pay for any work completed to date) as the it is created. A customer's ability to specify only minor changes to the design or function of the good or service or to choose from a range of standardized options specified by the entity typically would not indicate a customer-specific good or service. However, a customer's ability to specify major changes to the design or function of the good or service might indicate a continuous transfer of goods or services.