Project **Revenue Recognition**

Topic **Sales of assets that are not an output of an entity's ordinary activities**

Introduction

1. This paper seeks the Boards' views on whether an entity should apply the recognition and measurement requirements of the proposed revenue model to contracts for the sale of the following assets that are not an output of the entity's ordinary activities:

    (a) Intangible assets in the scope of Topic 350 *Intangibles* or IAS 38 *Intangible Assets,* and

    (b) Property, plant and equipment in the scope of Topic 360 *Property, Plant, and Equipment* or IAS 16 *Property, Plant and Equipment* or IAS 40 *Investment Property*.

2. Throughout this paper, these assets are referred to as "nonfinancial assets".

Staff recommendation

3. The staff recommends that an entity should apply the recognition and measurement principles of the proposed revenue model to contracts for the sale of nonfinancial assets that are not an output of the entity's ordinary activities. Consequently, the entity would:

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

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) Derecognize the asset when the buyer obtains control of the asset, and

(b) Recognize a gain or loss at the date of transfer for the difference between the transaction price and the carrying amount of the asset (the transaction price would be limited to amounts that can be reasonably estimated at the date of transfer).

Structure of paper

4. The paper is organized as follows:

   (a) Background information

   (b) Existing requirements in US GAAP and IFRSs

   (c) Alternatives for the Boards

   (d) Staff recommendation

Background information

5. US GAAP currently provides detailed guidance for recognizing profit on all real estate transactions regardless of the nature of the seller's business. That is, the guidance applies equally to a financial services entity selling its corporate headquarters as it does to a commercial real estate developer selling a recently completed home or a real estate investment trust selling a building.

6. At the May 5, 2010 FASB-only Board meeting, the FASB considered the potential effects of the proposed model on real estate transactions, including real estate transactions when real estate is not an output of the entity's ordinary activities.

7. During the discussion, the FASB noted the lack of guidance for gain transactions in US GAAP and questioned whether the proposed revenue model should be applied to all contracts for the sale of nonfinancial assets. The FASB did not reach a decision at this meeting and asked the staff to bring the issue to the joint FASB-IASB meeting.

Existing requirements in US GAAP and IFRSs

Existing US GAAP requirements

General Principle

8. Current US GAAP requirements on the recognition of revenues and gains specify that they generally are not recognized until realized or realizable and earned. FASB Financial Statements Concepts highlight the difference between revenues and gains by noting that ‘‘revenues…result from an entity’s ongoing major or central operations and activities…’’while ‘‘gains...result from entities’ peripheral or incidental transactions”.

Real Estate Transactions

9. In addition to the general concepts, US GAAP provides detailed guidance with respect to all real estate transactions and specifies that profit is recognized in full when the real estate is sold, if both of the following conditions are met:

   (a) The profit is determinable; that is, collectability is reasonably assured or the uncollectable amount can be estimated, and

   (b) The earnings process is virtually complete and the seller is not obligated to perform significant activities after the sale to earn profit.

10. Recognition of all or part of the profit is deferred if both conditions are not met.

11. In assessing whether collectability is reasonably assured, the real estate guidance prescribes detailed rules by requiring a specified amount of initial investment from the buyer in order for the seller to conclude that collectability is reasonably assured. For example, some types of real estate sales must have a minimum 20 percent cash down payment if all of the profit on the sale is to be recognized immediately. The cash down payment does not include marketable securities, or a note receivable, backed by the full faith and credit of a significant creditworthy entity.

12. If collectability is not reasonably assured, full profit recognition at the time of sale is precluded and the entity must use the deposit, instalment, cost recovery or

reduced profit methods. For example, an entity can elect to use the instalment or cost recovery method if recovery of property cost is reasonably assured even if the buyer defaults.

13. With respect to the second criteria on the earning process to be virtually complete, the transaction cannot be considered a sale under US GAAP if the seller has continuing involvement. In those circumstances, the seller would account for the transaction as a financing, leasing or profit sharing arrangement. For example, a transaction in which the buyer has the right to force the seller to repurchase the property is not a sale for accounting purposes. Such a transaction is a financing or leasing transaction depending on whether the repurchase price is above or below the initial sale price.

Gain Contingencies

14. The staff notes that the predominant practice prior to the issuance of Topic 810, *Consolidation* (originally issued as Statement 160, *Noncontrolling Interest in Consolidated Financial Statements*) was to recognize contingent consideration from the transfer of nonfinancial assets when the contingency is resolved, applying the guidance in Topic 450, *Contingencies* (originally issued as Statement 5, *Accounting for Contingencies*). Subsequent to the issuance of Topic 810, the staff believes that practice is mixed with respect to gain recognition when the sale of nonfinancial assets involves contingent consideration. Entities either:

    (a) recognize a gain for the fair value of all the consideration (including the contingent consideration) less the carrying amount of the asset when the seller transfers the significant risks and rewards of ownership of the asset; or

    (b) recognize a gain:

        i. for the fair value of the noncontingent consideration less the carrying amount of the asset when the seller transfers the significant risks and rewards of ownership; and

        ii. for contingent consideration when the contingency is resolved.

15. The Emerging Issues Task Force deliberated this issue but was unable to reach a consensus. As a result, this issue was added to the financial instruments project, but was subsequently scoped out of that project.

Existing IFRSs requirements

16. The IASB's *Framework* defines income as ''increases in economic benefits during the accounting period in the form of inflows or enhancements of assets and decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.'' The *Framework* goes on to distinguish between the two main components of income—revenue and gains. Revenue arises ''in the course of the ordinary activities of an entity.'' In contrast, gains are ''other items that meet the definition of income and *may or may not* arise in the course of the ordinary activities of an entity.'' The framework goes on to explain that because gains are not different in nature from revenues, they are not regarded as a separate element. However, IAS 16, *Property, Plant and Equipment* and IAS 38, *Intangible Assets* specify that gains recognized under those standards on derecognition of an asset shall not be classified as revenue.

17. The existing requirements under IAS 40, *Investment Property,* IAS 38 and IAS 16 refer to IAS 18 recognition guidance on sale of a nonfinancial asset to determine the timing of gain recognition. Those standards require the consideration receivable on disposal of an item of nonfinancial asset to be measured initially at its fair value. If payment for the item is deferred, then interest revenue is recognized in accordance with IAS 18, reflecting the effective yield on the receivable.

Gain Contingencies

18. The staff believes that just as in US GAAP, there is diversity in practice when the sale of nonfinancial assets involves contingent consideration. Entities either:

    (a) recognize a gain for the fair value of all the consideration less the carrying amount of the asset, with subsequent changes in the fair value of the consideration recognized in profit or loss, or

(b) recognize a gain:

   i. for the fair value of the noncontingent consideration less the carrying amount of the asset, and

   ii. for contingent consideration, when the realization of income is virtually certain.

Alternatives for the Boards

19. The staff thinks that the Boards have the following alternatives to address accounting for sale of nonfinancial assets that are not an output of the entity's ordinary activities:

    (a) ***Alternative A***: Apply the recognition and measurement principles of the proposed revenue model for all contracts that involve a sale of a nonfinancial asset.

    (b) ***Alternative B***: Apply the recognition principle of the proposed revenue model to determine the date of derecognition of the nonfinancial asset. However, an entity would measure the gain or loss based on the fair value of the consideration (that is, without limiting it to amounts "reasonably estimated" as in the proposed revenue model) less the carrying amount of the asset.

20. The main difference between Alternative A and Alternative B relates to the determination of consideration to be received from the buyer. If the consideration from the buyer is a fixed amount at the date of the transaction, both alternatives would result in the same accounting. However, if the amount of consideration from the buyer were variable, the transaction price determined in Alternative A would include only amounts that an entity can reasonably estimate rather than the fair value of all the consideration under Alternative B. Additionally, the staff believes that a difference could arise because the proposed revenue model does not measure

consideration at fair value, although it would require adjustments for the time value of money and credit risk.

21. Proponents of Alternative A think that the principles for revenue and gain transactions involving contracts are similar and highlight that the difference between revenue and gains is a matter of presentation on the statement of comprehensive income. They believe that this approach would result in similar transactions being accounted for similarly. They believe that a "reasonably estimated" constraint on the transaction price should also apply to the sale of nonfinancial assets because entities face similar challenges when the asset is not an output of the entity's ordinary activities. Additionally, they believe that this alternative would eliminate the diversity in practice in accounting for contingent consideration. Moreover, they view this alternative as merely a consequential amendment to IAS 16, IAS 38 and IAS 40 to ensure that the measurement of the consideration in those standards remains consistent with the proposed revenue model.

22. Alternative B is the existing requirements in IFRSs. Thus, if the Boards decide this alternative it will not change IFRSs. However, it would change US GAAP (as would Alternative A).

Staff recommendation

Sales of nonfinancial assets
The staff recommends that an entity should apply the recognition and measurement principles of the proposed revenue model to contracts for the sale of nonfinancial assets that are not an output of the entity's ordinary activities. Consequently, the entity would: (a) Derecognize the asset when the buyer obtains control of the asset, and (b) Recognize a gain or loss at the date of transfer for the difference between the transaction price and the carrying amount of the asset (the transaction price would be limited to amounts that can be reasonably estimated at the date of transfer). Do the Boards agree with the staff recommendation?