IASB Agenda ref **7C**

FASB Agenda ref **164C**

STAFF PAPER

FASB | IASB Meeting

Week of 19 November 2012

FASB Education Session 14-15 November 2012

Project	**Revenue Recognition**		
Paper topic	Constraining the cumulative amount of revenue recognised – placement of constraint (Step 3 v Step 5)		
CONTACT(S)	Gary Berchowitz	gberchowitz@ifrs.org	+44 20 7246 6914
	Brian Schilb	bjschilb@fasb.org	+1 203 956 3447

Purpose of this paper

1. This paper considers the following two issues related to the proposals in the 2011 ED:

    (a) whether the constraint should continue to apply to constrain the cumulative amount of revenue recognised when an entity satisfies a performance obligation (Step 5) or whether the constraint should apply to constrain the transaction price (Step 3); and

    (b) how the constraint should apply if the consideration promised by a customer includes both fixed and variable amounts.

Staff view and recommendation

2. The staff's view is that the location of the constraint (ie either in Step 5 or in Step 3) should not affect the amount of revenue that an entity would recognise when it satisfies a performance obligation. For that reason, the staff recommend that a decision on the location of the constraint in the revenue standard should be

made as part of the drafting process. The staff prefer moving the constraint back into Step 3, but ultimately the staff think that the location of the constraint should be determined on the basis of where it will be most easily understood by those applying the revenue standard.

Structure of the paper

6. This paper is organised as follows:
   - (a) Background (paragraphs 7 – 9)
   - (b) Feedback on the 2011 ED proposals (paragraphs 10 – 12)
   - (c) Location of the constraint (paragraphs 13 – 22)
   - (d) Implications of moving the constraint to Step 3 (paragraphs 23 – 27)
   - (e) Implications of retaining the constraint in Step 5 (paragraphs 28 – 33)
   - (f) Staff recommendation (paragraphs 34 – 35)

Background

7. In the 2011 ED, the Boards proposed that an entity should:
   - (a) determine the transaction price (Step 3 of the model) using either an expected value or most likely amount approach, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled. In other words, the transaction price would be determined without consideration of the requirements related to the constraint (ie on an unconstrained basis);
   - (b) allocate the transaction price to the separate performance obligations identified in the contract with the customer (Step 4 of the model); and
   - (c) recognise revenue when (or as) the entity satisfies a performance obligation (Step 5 of the model), but only to the extent that the

constraint does not apply to the cumulative amount of revenue that the entity will recognise.

8. The proposal in the 2011 ED to apply the constraint at Step 5 of the model was a change from the proposal in the 2010 ED to apply the constraint in determining the transaction price at Step 3 of the model.

9. The Boards decided to move the constraint to Step 5 so that it applies to constrain the cumulative amount of revenue recognised because:

   (a) constraining the transaction price at Step 3 would result in some performance obligations being incorrectly identified as onerous. This is because, in determining whether a performance obligation is onerous, amounts of variable consideration might be excluded from the amount of consideration that is compared with the cost of fulfilling a performance obligation; and

   (b) there were unintended revenue recognition patterns for some types of service arrangements where the consideration is uncertain at contract inception, but that uncertainty progressively resolves over the service period. For instance, this is a common occurrence in contracts in the asset management and hotel management industries (the staff consider this in more detail later in this paper and provide an example to illustrate the issue in paragraph 24).

Feedback on the 2011 ED proposals

10. This paper concentrates on the following issues raised by respondents:

   (a) The location of the constraint—Some respondents highlighted the apparent complexity of assessing the constraint in Step 5 of the model. They commented that the complexity arises because, in principle, an entity would be required to estimate variable consideration in order to determine the transaction price (in Step 3), only for the entity to be constrained from recognising as revenue those amounts of variable consideration when the entity satisfies the related performance obligation. Specifically, these respondents think that the constraint should be assessed in Step 3 of the model because an entity would be considering the variability in the transaction price when determining the measurement of the transaction price.

(b) The constraint could produce patterns of revenue recognition that would not seem to make sense—A few respondents noted that the proposed constraint could produce a pattern of revenue recognition that might not faithfully depict period-to-period performance under the contract if the consideration promised by a customer includes both fixed and variable amounts. That is because the proposals in the 2011 ED could result in the amount of revenue recognised hitting a ceiling, so that even though the entity continues to perform, no more revenue would be recognised until the uncertainty is resolved. We have included an example later in paragraph 28 to help illustrate the issue further.

11. The first issue is analysed in the next section of the paper, which considers whether the constraint should be located in Step 5 (as per the 2011 ED proposals) or in Step 3 (as per the 2010 ED proposals).

12. The second issue is analysed in the section of the paper that considers the implications of retaining the constraint in Step 5 (paragraphs 28 – 33).

Location of the constraint

13. In considering whether the constraint should form part of Step 3 of the model (determining the transaction price) or Step 5 of the model (recognising revenue when (or as) the entity satisfies its performance obligations), the main factors to be considered are:

(a) whether the constraint is a recognition and/or a measurement issue; and

(b) whether the location of the constraint could potentially affect the timing and amount of revenue recognition.

Is the constraint a measurement or recognition hurdle?

14. In discussions with constituents and Board members, some think that the constraint should be located in Step 3 if it is a measurement consideration and, in contrast, located in Step 5 if it is a recognition consideration.

15. The staff note that there are several areas in the model where there are recognition considerations (ie not all recognition issues are exclusively in step 5 of the model). For example, there must be a contract in Step 1 of the model.

16. The staff think that the constraint is a concept that includes both measurement and recognition considerations. That is, the constraint acts as a threshold to revenue recognition, but it uses measurement uncertainty as the basis for determining if (or how much) revenue should be recognised.

17. Consequently, the staff thinks that the determination of whether or not the constraint is a measurement or recognition issue is not the critical decision when considering which step should include the constraint.

Effect on the pattern of revenue recognition

18. The staff think that the location of the guidance related to the constraint should not affect the outcome from applying what the staff thinks is the objective of the constraint (ie that an entity should recognise revenue for a satisfied performance obligation only if it does not reasonably expect there to be a significant revenue reversal). The objective of the constraint is discussed in more detail in Agenda Paper 7B/164B.

19. The constraint objective can be achieved in Step 3 by limiting the transaction price if the entity reasonably expects a significant reduction of the estimated transaction price; or the objective can be achieved in Step 5 by limiting the cumulative revenue recognised if the entity reasonably expects a significant reversal of the cumulative revenue that would be recognised. In other words, the outcome would be the same, but there may be some changes to the wording to

ensure that the terminology is consistent with the step in the model in which the constraint assessment is performed.

20. As explained in Agenda Paper 7B/164B, one of the concerns raised by preparers in the construction industry was that the scope of revenue contracts subject to the constraint would expand if the constraint was assessed at the transaction price level, as compared to an assessment of the constraint on the cumulative amount of revenue recognised.

21. The staff think that considering the constraint at the transaction price or at the cumulative amount of revenue recognised should not impact the assessment of whether the constraint will apply because the constraint is assessed on a relative basis, not an absolute basis. For example:

> An entity provides a service over a two year period. The service is determined to be a single performance obligation satisfied over time. The transaction price is made up of a fixed amount of CU1,000 and a variable amount of CU500. At the end of year 1, the entity measures its progress to completion at 50%.
>
> *Assessment at the transaction price level:*
>
> When considering the possible transaction price of CU1,500, the entity considers the possibility of a reduction in the transaction price of CU500. This is potentially a significant reduction because the variable portion represents 33% of the transaction price.
>
> *Assessment at the cumulative amount of revenue recognised level:*
>
> When considering the cumulative amount of revenue that could be recognised at the end of year 1 of CU750 ((CU1,000+CU500) × 50%), the entity considers the possibility of a revenue reversal of CU250 (CU500 × 50%). This is potentially a significant revenue reversal because the variable portion represents 33% of the cumulative revenue recognised to date on the contract.

22. However, there are other factors that may influence the Boards' decision on where the constraint should be located. These are discussed in the paragraphs below.

Implications of moving the constraint to Step 3

23. As discussed above in paragraph 9(a), one of the reasons the Boards moved the constraint from Step 3 (in the 2010 ED proposals) to Step 5 (in the 2011 ED proposals) was due to the implications for the onerous test. However, due to the Boards' July 2012 tentative decision to remove the onerous test from the revenue standard, the onerous test no longer presents a concern for considering whether to locate the constraint in Step 3 of the model.

24. However, if the constraint is moved to Step 3 of the model, the issue identified in the 2010 ED would need to be addressed (ie service arrangements where the consideration is uncertain at inception but is progressively determined over the service period). For example:

> On 1 January, an entity enters into a contract with a customer to provide fund management services for a period of one year. As payment for services, the entity will receive a quarterly non-refundable fee of 1% of the assets under management (AUM) of the fund at the end of each quarter. The entity determines that the contract contains one performance obligation that is satisfied over time.
>
> The entity concludes that its experience with similar contracts is not relevant to the contract because the amount of consideration is highly susceptible to external factors (ie market risk) and there are a large number of possible consideration amounts. Consequently, the transaction price is limited to zero at inception of the contract.
>
> At the end of the first quarter, the entity's quarterly fee is determined to be CU10,000. Because the constrained transaction price is now CU10,000, the entity recognizes revenue based on its measure of progress. Assuming that the entity determines that it is 25% of the way to completing its performance obligation (one quarter of the year contract), it would recognise CU2,500 (CU10,000 × CU25%) at the end of the first quarter, even though its performance for the first quarter is more appropriately represented by the CU10,000.

25. The staff think that the basis of allocation in paragraph 76 of the 2011 ED could help to address the above issue. Paragraph 76, which was added to the revenue proposals in the 2011 ED, states:

> If the transaction price includes an amount of consideration that is contingent on a future event or circumstance (for example, an entity's performance or a specific outcome of the entity's performance), the entity shall allocate that contingent amount (and subsequent changes to the amount) entirely to a distinct good or service if both of the following criteria are met:
>
> a) the contingent payment terms for the distinct good or service relate specifically to the entity's efforts to transfer that good or service (or to a specific outcome from transferring that good or service); and
>
> b) allocating the contingent amount of consideration entirely to the distinct good or service is consistent with the allocation principle in paragraph 70 when considering all of the performance obligations and payment terms in the contract.

26. Thus, if a variable transaction price allocated to a partially satisfied service has not been recognised due to the constraint, but subsequently is no longer subject to the constraint (for example, because a portion of the transaction price is no longer subject to uncertainty), the entity would allocate that portion entirely to the services that have transferred to the customer if it is clear that, in accordance with the basis of allocation in paragraph 76 of the 2011 ED, the consideration relates to those services. For example:

> The facts are the same as those in the example in paragraph 24.
>
> At the end of the first quarter, the entity updates its estimate of the transaction price to CU10,000. The entity determines that, in accordance with the allocation principle in paragraph 76 of the 2011 ED, the change in the transaction price, as a result of updating the constraint assessment, is allocated completely to the satisfied portion of the service.

> Consequently, the entity would recognise CU10,000 at the end of the first quarter.

27. Assuming that the issue from the 2010 ED is resolved as explained above, there may be merit in moving the constraint back into Step 3 for the following reasons:

    (a) the constraint uses *measurement uncertainty* as the basis for constraining the recognition of revenue, so proponents of moving the constraint to Step 3 think it makes more sense to think about the constraint when measuring the transaction price at Step 3 of the model;

    (b) if the constraint was applied at the transaction price level, there would be no need to explain that the constraint applies only to 'variable' consideration. In other words, the constraint would automatically capture variable consideration when applied at the transaction price level; and

    (c) it introduces complexity into the model to require an entity to apply all of the other steps in the model, only to prohibit revenue recognition at Step 5 (ie when a performance obligation has been satisfied) because the constraint applies.

Implications of retaining the constraint in Step 5

28. As described in paragraph 10(b) above, a few respondents noted that the proposed constraint could produce a pattern of revenue recognition that might not faithfully depict period-to-period performance under the contract in some cases where the consideration promised by a customer includes both fixed and variable amounts. For example:

> An entity agrees to provide a single service in exchange for a fixed fee of CU1,200 and a possible contingent bonus of CU800 (which is considered likely to be received, but assume it is subject to the constraint and therefore cannot be recognised until the end of the contract). The entity estimates that the costs to complete the contract will be CU1,000.

> The entity estimates the transaction price in Step 3 using the most likely amount, so the transaction price would be CU2,000. When 55% of the work is complete, revenue of CU1,100 is recognised.
>
> After the entity has performed 60% of the work, the constraint will apply as the total unconstrained amount (CU1,200) has been recognised as revenue. The entity will recognise further costs, but no corresponding revenue until the end of the contract if the bonus is obtained (assuming no subsequent changes in assessing the constraint as progress continues in the contract).

29. Paragraphs 81 and 84 of the 2011 ED explain that the constraint applies only to the portion of the transaction price allocated to satisfied performance obligations to which the entity is not reasonably assured to be entitled. In other words, the constraint establishes a ceiling up to which revenue can be recognised. The staff think that it was not the Boards' intention that the inclusion of a threshold should result in a revenue recognition pattern as illustrated in the example in paragraph 28. Instead, the staff think that in the example, revenue of CU660 should be recognised when the entity has performed 55% of the work (CU1,200 × 55%).

30. The staff think that the revenue standard could address that concern by clarifying that, when the consideration includes a variable component, an entity should split the transaction price into a 'fixed' and 'variable' portion when it determines the transaction price at Step 3 in the model. The 'variable' portion of the transaction price would be subject to the requirements of the constraint, whereas the 'fixed' portion would not be. For example:

> An entity agrees to provide a single service in exchange for a fixed fee of CU1,200 and a possible contingent bonus of CU800 (which is considered likely to be received, but assume it is subject to the constraint and therefore cannot be recognised until the end of the contract).
>
> The entity estimates the transaction price in Step 3 using the most likely amount, so the transaction price would be CU2,000. Because the transaction price includes a fixed and variable component, the entity splits the transaction price into CU1,200 that is not subject to the constraint and CU800 which is subject to the constraint.

> After the entity has performed 55% of the work, the entity would recognise CU660 (CU1,200 × 55%).

31. This is consistent with the measurement objective for revenue as explained in Agenda Paper 7B/164B. Specifically, the staff think that the objective of the constraint is to ensure that when a performance obligation has been satisfied but there is a reasonable expectation that the ultimate amount of revenue for the satisfied performance obligation could be significantly less than the entity's best estimate, the entity should recognise revenue only up to the amount that the entity is confident will not be subject to significant revenue reversals. This amount could be classified to effectively be a 'fixed' minimum amount of consideration.

32. If the constraint was retained in Step 5 of the model and a clarification was made to split the transaction price into what is effectively a 'fixed' minimum portion and a 'variable' portion at Step 3 for the purposes of applying the constraint at Step 5, the revenue standard would also need to specify how an entity should account for changes in that 'fixed' portion. The staff think that this could be achieved in a similar way to the explanation regarding Step 3 in paragraph 25 above. In other words, the standard would need to clarify that if that 'fixed' portion of the transaction price changes, the entity would allocate that change entirely to those distinct goods or services that have transferred to the customer if it is clear that, in accordance with the allocation principle in paragraph 76 of the 2011 ED, the consideration relates to those distinct good or services. For example:

> The facts are the same as those in the example in paragraph 24 (the asset management example).
>
> At the end of the first quarter, the entity updates its estimate of the 'fixed' portion of the transaction price to CU10,000. The entity determines that, in accordance with the allocation principle in paragraph 76 of the 2011 ED, the change in the 'fixed' portion of the transaction price, as a result of updating the constraint assessment, is allocated completely to the satisfied portion of the performance obligation. Consequently, the entity would recognise CU10,000 at the end of the first quarter.

33. There is some caution against moving the constraint back into Step 3 because:

    (a) there is concern that at this stage of the project, there may be other unintended consequences of moving the constraint back into Step 3;

    (b) the constraint remains viable as a recognition hurdle (part of Step 5 in the model). In other words, although the constraint uses measurement as the hurdle for recognition, proponents of retaining the guidance in Step 5 state that it is still a *recognition* constraint which is not what Step 3 of the model deals with; and

    (c) in practice, preparers may not need to go through Steps 1 – 5 for transactions where it is obvious that the constraint applies.

Staff recommendation

34. The staff's view is that the location of the constraint (ie either in Step 5 or in Step 3) should not affect the amount of revenue that an entity would recognise when it satisfies a performance obligation. For that reason, the staff recommend that a decision on the location of the constraint in the revenue standard should be made as part of the drafting process.

35. The staff prefer moving the constraint back into Step 3, but ultimately the staff think that the location of the constraint should be determined on the basis of where it will be most easily understood by those applying the revenue standard.

Question for the Boards
The staff recommends that a decision on the location of the constraint in the revenue standard should be made as part of the drafting process. Do the Boards agree?