

# STAFF PAPER

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Project	Revenue Recognition		
Paper topic	Scope		
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## Purpose of this paper

1. The objective of this paper is to consider potential improvements to the scope guidance of the 2011 exposure draft *Revenue from Contracts with Customers* (the ‘2011 ED’), based on feedback received from respondents.

## Staff recommendation

2. The staff recommend the Boards do not modify the scope proposals in the 2011 ED, including the Boards’ definition of a customer, and make the following improvements:
  - (a) For collaboration arrangements:
    - 1) clarify that a collaborative arrangement is not limited to the development and commercialization of a product; and
    - 2) clarify that a transaction with a collaborator or a partner can be within scope of the model if the collaborator or partner is a customer in a transaction.
  - (b) For financial services contracts – improve the application guidance, potentially include an example, to clarify the application of paragraph 11.

## Structure of the paper

3. This paper is organized as follows:
  - (a) General feedback (paragraph 4);
  - (b) Collaborative arrangements (paragraphs 5-10);
    - (i) Feedback
    - (ii) Staff analysis
    - (iii) Staff recommendation
  - (c) Application to financial services contracts (paragraphs 11-19);
    - (i) Feedback
    - (ii) Staff analysis
    - (iii) Staff recommendation
  - (d) Appendix A: Suggested changes

## General feedback

4. The Boards did not ask a question on scope in the 2011 ED but some respondents nonetheless asked for clarification on applying the scope proposals or suggested improvements to ensure consistent application. Overall, the staff conclude that because there were relatively few comments on the scope proposals, most constituents are supportive of the Boards' scope as proposed in the 2011 ED. The feedback received on scope has been grouped into the following two categories:
  - (a) Collaborative arrangements; and
  - (b) Application to financial services contracts.

## Collaborative arrangements

### ***Feedback***

5. Paragraph 9 of the 2011 ED requires “an entity to apply this proposed guidance to all contracts with customers ...” Paragraph 10 of the 2011 ED proceeds to define a

customer as a “party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities” and clarifies that for some contracts “the counterparty to the contract might not be a customer but rather a collaborator or a partner that shares with the entity the risks and benefits of developing a product to be marketed.”

6. A few respondents, focused on the paragraph’s description of a collaborator or partner and requested certain clarification and/or improvements as follows:

- (a) some questioned if a transaction with a collaborator or partner could ever be within scope of the model;
- (b) others questioned if the Boards intended to narrow the population of collaborative arrangements to only those that develop a marketable product. A couple of respondents noted that this clarification is important for not-for-profit entities that receive grants and sponsorship for research activity. In these situations, the grantor or sponsor does not usually expect anything in return other than perhaps periodic status update reports on the use of the monies provided (ie no commercial product is developed). Grants received by higher education institutions are described as follows by the National Association of College and University Officers (CL #249):

Grants from governmental entities (and other sponsors) received by independent institutions are agreements under which funds are provided to the institution to fulfill mutually agreeable goals that are in keeping with the institution's mission. As discussed in our comments on the original exposure draft, the objective of these arrangements is the performance of the research, not the creation of an output with commercial value.

- (c) a few respondents asked for further guidance to distinguish between a customer and a collaborator or a partner.

7. A few respondents also asked what guidance should be followed if a transaction or contract is outside of the scope of the model (eg for a collaborative arrangement) and if analogy could be made to the model’s guidance in absence of other applicable guidance.

**Staff analysis**

8. The Boards excluded collaborative arrangements from the scope of the model because these contracts typically have objectives and features not consistent with the counterparty obtaining the “output of the entity’s ordinary activity.” That said, the Boards explain in paragraph BC37 of the 2011 ED that transactions with partners or participants in a collaborative arrangement *can* be within scope of the model if the counterparty meets the definition of a customer. The Boards decided against providing guidance about when a counterparty could be a customer in different types of transactions due to differing terms and conditions of specific arrangements across industries. Accordingly, “an entity would need to consider all relevant facts and circumstances in assessing whether the counterparty meets the definition of a customer.” (paragraph BC37 of the 2011 ED)
9. The staff think it was not the Boards’ intent to limit the definition of collaborative arrangements to those that result in a marketable product, thereby excluding certain not-for-profit grants or other activities. Importantly, the staff observe that the definitions of a *customer* and of *revenue* are not predicated on the profit-making ability of the transaction, but rather on whether the transaction involves part of the entity’s ordinary activities. The staff also observe that the Boards did not intend to preclude the ability to analogize but did not intend to provide guidance on the transactions to which the revenue model could be applied by analogy.

**Staff recommendation**

10. The staff recommend the Boards:
- (a) affirm the definition of a customer in the 2011 ED;
  - (b) improve paragraph 10 of the 2011 ED by clarifying that a collaborative arrangement is not limited to developing a product to be marketed; and
  - (c) reinforce that some transactions with a collaborator or a partner may be within the scope of the model if the collaborator or partner meets the definition of a customer.

## Application to financial services contracts

11. Financial services contracts typically include one or more transactions within the scope of the financial instruments guidance and may also include goods or services that could qualify for accounting under the proposed revenue model (hereafter referred to as “hybrid” contracts).

### **Feedback**

12. Some respondents requested clarification and/or application guidance on how the transaction price would be determined for hybrid financial services contracts and then allocated between the financial instrument component and the services component.

As expressed by one respondent:

For example, banks may provide treasury services to clients including lock box services, check clearing, and account reconciliations. Fees related to these services may be reduced or eliminated depending on the level of deposits that the business maintains in a financial institution. Under the guidance it is unclear how or whether fees would be allocated between the deposit, which would be a financial instrument outside of the scope of the Proposals, and the service provided, which would be within the scope of the Proposals. We believe the accounting for the deposit would not be changed, and therefore any fees would be allocated to the services provided. However, we believe that an example related to identifying and allocating the transaction price to separate performance obligations embedded within certain common financial services transaction[s] would be helpful. (CL #298, Bank of America)

13. Other respondents commented on the difficulty of applying the model’s requirements to customer relationship contracts (a common type of financial services contract) because under these contracts, the customer can engage at their discretion in a number of different services over an extended/unspecified period of time. Respondents particularly identified contract combinations, identification of separation performance obligations (as compared to activities), customer options for additional goods or services and allocation of the transaction price as particularly challenging application concepts. As explained in CL #209, JPMorgan:

... the model assumes that any required revenue allocations or deferrals are based on a comprehensive view of the economics of the arrangement. In contrast, certain revenue arrangements in the financial services industry may include many related services that vary in timing, frequency or pricing based on future market conditions, and therefore it is not clear how to apply the Revised ASU to determine which transactions should be combined. A requirement to combine only those individual transactions occurring in a reporting period may result in arbitrary revenue allocations that do not reflect a complete view of the underlying revenue arrangement.

. . It is not clear if the Revised ASU intends to combine a series of transactions over time that are linked under an overall account but occur at the customer's direction, or how such combination should be accomplished.

### **Staff analysis**

14. The 2011 ED proposes that if contractual rights and obligations are accounted for under other, specified standards, then the related revenue would continue to be accounted for under those other standards. These other standards include Topic 825, *Financial Instruments*, Topic 860, *Transfers and Servicing*, and Topic 310, *Receivables* for U.S. GAAP and IFRS 9, *Financial Instruments*, for IFRS. If a contract with a customer comprises some contractual rights and obligations that are within scope of these other standards and some that are within scope of the model, the Boards did not believe it would be appropriate to account for the entire contract under one or the other standard. As explained in paragraph BC44, accounting for an entire hybrid contract within one standard “could result in different accounting outcomes, depending on whether the goods or services were sold on a standalone basis or together with other goods.”
15. Paragraph 11 of the 2011 ED specifies that if a contract is only partially within scope of the model, then the model can only be applied to that part of the contract. To allocate contract consideration between the part of the contract within scope and the part outside of scope, the guidance directs entities to follow the separation and/or measurement requirements in the *other* standard, if it exists. If none exists, then an entity is directed to apply the model's separation and/or initial measurement guidance. The Boards emphasize that the 2011 ED's guidance is the “default

approach for separating a contract and allocating consideration” (paragraph BC45 of the 2011 ED). The more specific standard takes precedence in accounting for a part of a contract (paragraph BC46 of the 2011 ED).

16. The staff think that a challenge in applying paragraph 11 of the 2011 ED to financial services contracts is the unit of account under financial instrument guidance and the Boards’ proposed revenue model. Financial instrument guidance under both U.S. GAAP and IFRS focuses on the financial instrument as compared to the revenue model’s focus on the contract and its performance obligations.
17. Given the challenge of different revenue recognition approaches, when evaluating the separation guidance in paragraph 11 of the 2011 ED, the staff think that it is important to emphasize the model’s focus on applying the guidance in *other* standards first. Thus, financial instrument guidance would be looked to first for determining the premise on which parts of a financial services contract are separated (eg fair value, transaction price). Upon applying this premise to the financial instrument components of the contract, the components within scope of the revenue model would be ascribed any residual amount. That is, any amount of customer consideration remaining after subtracting the amount determined attributable to the financial instrument components would be applied to performance obligations within scope of the revenue model. The staff think that in some cases there may be immaterial or no amounts left allocable to components of a hybrid financial services contract within scope of the model.
18. The staff think that the question about combining transactions under a financial services contract to get a comprehensive view of the economics of an arrangement in order to apply the model is effectively addressed by the paragraph 11 separation assessment discussed above. The 2011 ED’s proposals are not intended to supersede the guidance in financial instruments standards and require that revenue for financial instruments is recognized on a contract basis (as opposed to a financial instrument basis). The staff think that the important evaluation point is determining the components in the contract and the measurement requirements of those respective components using either guidance outside of the revenue model or within. Any consideration allocated to a service component within scope of the revenue model

would become the transaction price for identified separate performance obligations and hence would be recognized into revenue in accordance with the model's guidance.

### **Staff recommendation**

19. The staff acknowledge the challenges raised in the above feedback regarding financial services contracts and, in addition to any improvements to the standard, recommend providing implementation guidance or examples to assist entities in performing the required scoping and subsequent separation and measurement requirements.

#### **Question for the Boards**

Do the Boards agree with the staff recommendations to:

- (a) confirm the scope as proposed in the 2011 ED, including the definition of a customer
- (b) include the following clarifications and improvements in the final standard:

For collaborative arrangements: clarify that a collaborative arrangement is not limited to the development and commercialization of a product, and clarify that a transaction with a collaborator or a partner can be within scope of the revenue model if the collaborator or partner is a customer in a transaction.

For financial services contracts: improve the application guidance, potentially including an example, to clarify the application of paragraph 11.



## Appendix A: Suggested changes

A1. The following table lists the proposed requirements from the exposure draft that relate to the guidance on financial instruments and identifies what might change as a result of the staff recommendations in this paper.

Proposals from 2011 Exposure Draft	Suggested changes
<p>9 An entity shall apply this proposed guidance to all contracts with customers, except the following:</p> <p>(a) Lease contracts within the scope of Topic 840 on leases</p> <p>(b) Insurance contracts within the scope of Topic 944 on insurance</p> <p>(c) Contractual rights or obligations within the scope of the following Topics:</p> <p>(i) Topic 310 on receivables</p> <p>(ii) Topic 320 on debt and equity securities</p> <p>(iii) Topic 405 on liabilities</p> <p>(iv) Topic 470 on debt</p> <p>(v) Topic 815 on derivatives and hedging</p> <p>(vi) Topic 825 on financial instruments</p> <p>(vii) Topic 860 on transfers and servicing.</p> <p>(d) Topic 460 on guarantees (other than product or service warranties) within the scope of Topic 460 on guarantees</p> <p>(e) Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers, or to potential customers, other than the parties to the exchange (for example, an exchange of oil to fulfill demand on a timely basis in a specified location).</p>	<ul style="list-style-type: none"> <li>No change recommended</li> </ul>
<p>10 A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities. An entity shall apply this proposed guidance to a contract (other than a contract listed in paragraph 9) only if the counterparty to the contract is a customer. For some contracts, the counterparty to the contract might not be a customer but rather a collaborator or a partner that shares with the entity the risks and benefits of developing a product to be marketed. Such contracts are not in the scope of this proposed guidance.</p>	<ul style="list-style-type: none"> <li>The staff recommend improvements in paragraph 10 of this paper. Specifically, the staff recommend clarifying that a collaborative arrangement is not limited to the development and commercialization of a product; and that a transaction with a collaborator or a partner can be within scope of the model if the collaborator or partner is a customer in a transaction.</li> </ul>

<p>11 A contract with a customer may be partially within the scope of this proposed guidance and partially within the scope of other standards.</p> <p>(a) If the other standards specify how to separate and/or initially measure one or more parts of the contract, then an entity shall first apply those separation and/or measurement requirements.</p> <p>(b) If the other standards do not specify how to separate and/or initially measure one or more parts of the contract, then the entity shall apply this proposed guidance to separate and/or initially measure the part(s) of the contract.</p>	<ul style="list-style-type: none"><li>• The staff do not recommend a change to this paragraph but recommend improving application guidance, potentially including an example, see paragraph 19 in this memo.</li></ul>
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