STAFF PAPER

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Project	**Revenue Recognition**		
Paper topic	Transfers of assets that are not an output of an entity's ordinary activities		
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Purpose of this paper

1. This paper considers possible changes to the consequential amendments related to the transfer of nonfinancial assets that were proposed in the 2011 Exposure Draft *Revenue from Contracts with Customers* ('the 2011 ED'). Those amendments propose that an entity should apply the proposed requirements on control and measurement in the 2011 ED to transfers of nonfinancial assets that are not an output of an entity's ordinary activities to determine:

   (a) *when* to derecognise the asset; and

   (b) *the amount* of the gain or loss on derecognition.

2. This paper does not address whether the transfer of one or more nonfinancial asset(s) would represent a disposal of an entity or a business. The FASB is separately considering that issue as part of an ongoing research project. The outcome of that research project would not affect the analysis about whether to apply the control and measurement requirements in the 2011 ED to transfers of nonfinancial assets; however, it might affect the population to which those proposals would apply.

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Staff recommendation

3. The staff recommend that the Boards:

   (a) confirm the proposed consequential amendments that would require an entity to apply the control and measurement proposals from the 2011 ED to sales of nonfinancial assets; and

   (b) specify in those consequential amendments that the requirements for determining the existence of a contract with a customer (ie paragraphs 13 – 15 in the 2011 ED) would also apply to transfers of nonfinancial assets.

Structure of the paper

4. The remainder of this paper is organised as follows:

   (a) Background (paragraphs 5 – 15)

      (i) Consequential amendments to IFRSs (paragraphs 6 – 8)

      (ii) Consequential amendments to US GAAP (paragraphs 9 – 12)

   (b) Respondent feedback (paragraphs 13 – 15)

   (c) Relevant recent Board decisions (paragraphs 16 – 18)

   (d) Staff analysis (paragraphs (19 – 39)

      (i) Should the accounting for transfers of nonfinancial assets be addressed in a separate project? (paragraphs 19 – 22)

      (ii) Should other aspects of the 2011 ED apply? (paragraphs 23 – 26)

      (iii) Application of the measurement requirements to transfers of nonfinancial assets (paragraphs 27 –32)

      (iv) Fair value as the measurement basis (paragraphs 33 – 37)

Background

5. In developing the 2011 ED, the Boards decided that an entity should apply the control and measurement requirements in the 2011 ED to account for the transfer of a nonfinancial asset that is not an output of an entity's ordinary activities. To give effect to that decision, the Boards proposed consequential amendments to IFRSs and US GAAP as described in the paragraphs below.

Consequential amendments to IFRSs

6. For an entity applying IFRSs, the accounting for a transfer of a nonfinancial asset would be determined by either IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* or IAS 40 *Investment Property*. Those standards require an entity to:

   (a) determine the date of disposal of an item by applying the revenue recognition criteria in IAS 18 *Revenue* (ie that risks and rewards have been transferred, there is no continuing ownership, the amount of revenue and costs incurred can be measured reliably and it is probable that economic benefits will flow to the entity); and

   (b) measure the consideration on disposal at fair value (which is consistent with the measurement principles in IAS 18).

7. Since IAS 18 will be replaced by the revenue standard, the IASB's consequential amendments proposed to replace the cross-references to IAS 18 in IAS 16, IAS 38 and IAS 40 with references to the control requirements in the revenue standard (see paragraphs D17, D22 and D26 of the 2011 ED). This means that an entity would determine the date of transfer for a nonfinancial asset by applying the proposed requirements for determining whether (and when) control has transferred.

8. In determining whether to also amend the requirements in IAS 16, IAS 38 and IAS 40 for the measurement of the consideration on a transfer of a nonfinancial asset, the IASB observed that the measurement principles in those standards were

consistent with that of IAS 18 (ie because both revenue and the consideration receivable is measured at fair value). The IASB also observed that that the notion of 'fair value' in that context was not always applied consistently, particularly when the consideration included variable or contingent amounts. The staff note this may be because often the consideration in a transfer of a nonfinancial asset may not meet the criteria of 'reliably measurable' in paragraph 14(c) of IAS 18. Therefore, to improve the accounting in IFRSs, the IASB decided to amend those standards to require an entity to apply the measurement principles in the 2011 ED to the measurement of the consideration. Those measurement principles would require an entity to apply the requirements of determining the transaction price and the constraint on the cumulative amount of revenue recognised (as specified in paragraphs 81 – 85 of the 2011 ED) in estimating the consideration for a transfer of a nonfinancial asset.

Consequential amendments to US GAAP

9. There is currently no guidance in US GAAP on accounting for the transfer of nonfinancial assets other than real estate. For those assets within the scope of Topic 350, *Intangibles- Goodwill and Other* and Subtopic 360-10, *Property, Plant, and Equipment*, the staff understand that an entity generally records a gain or loss at the date of transfer in the amount of the difference between the fixed portion of the consideration and the asset's carrying value. The entity typically does not attribute value to any variable and/or contingent consideration until uncertainty about the consideration is resolved (ie by analogy to Topic 450, *Contingencies* and/or a 'fixed or determinable' assessment under SAB 104).

10. Since Subtopic 360-20, *Real Estate Sales* (formerly FAS 66) specifies how to account for all sales of real estate, the FASB needed to propose a consequential amendment to Subtopic 360-20 to exclude sales of real estate that are an output of an entity's ordinary activities (ie because those sales would be within the scope of the revenue standard). The FASB observed that this would mean sales of real estate would be accounted for differently depending on whether or not the sale

was an output of the entity's ordinary activities. The FASB viewed this outcome as undesirable because (as noted in paragraph BC346):

> ...economically there is little difference between the sale of real estate that is an output of the entity's ordinary activities and the sale of real estate that is not. Hence, the difference in accounting should relate only to the presentation of the profit or loss in the statement of comprehensive income—revenue and expense or gain or loss.

11. Consequently, as part of their consequential amendments, the FASB tentatively decided to withdraw Subtopic 360-20 and amend Subtopic 360-10 and Topic 350 so that all assets within the scope of those topics (ie including real estate that is not an output of an entity's ordinary activities) would be accounted for using the control and measurement requirements from the 2011 ED. The primary reasons for those decisions were:
    (a) to align the outcomes for sales of real estate regardless of whether real estate is an output of the entity's ordinary activities; and
    (b) to provide clear guidance about accounting for the transfer of other nonfinancial assets (eg equipment and intangible assets) under Topic 350 and Subtopic 360-10.
12. Despite the different starting points for accounting for transfers of nonfinancial assets, the consequential amendments proposed to IFRSs and US GAAP in the 2011 ED ensure consistency between IFRSs and US GAAP in recognising and measuring gains/losses on transfers of those assets.

Respondent feedback

13. Question 6 in the 2011 ED asked respondents for feedback on the Boards' proposal to amend other standards that would require entities to apply the control and measurement requirements in the 2011 ED to transfers of nonfinancial assets that are not an output of an entity's ordinary activities. About half of the

respondents to the 2011 ED commented on this issue, and a clear majority agreed with the proposals. Many noted that the amendments would ensure consistency between the accounting for sales of similar assets, even if those assets are classified differently across entities.

14. Some respondents raised concerns that the proposed requirements in the revenue standard should not be applied or could not be applied to transfers of nonfinancial assets. Those concerns were as follows:

    (a) whether the accounting for transfers of nonfinancial assets should be addressed as part of its own separate project;

    (b) whether the requirements for determining contract existence (ie paragraphs 13 – 15 in the 2011 ED) in the revenue proposals should be applied; and

    (c) potential negative consequences of applying the measurement requirements (ie including application of the constraint) to transfers of nonfinancial assets.

15. The staff has described and analysed the ramifications of each of those concerns in the 'staff analysis' section below.

Relevant recent Board decisions

16. The Boards have redeliberated two aspects of the 2011 ED proposals that the staff think are relevant to the discussion of the aforementioned proposed consequential amendments:

    (a) the criteria for determining the existence of a contract; and

    (b) the constraint on revenue recognised.

17. At the September 2012 joint Board meeting, the Boards tentatively decided to amend the requirements for determining the existence of a contract as part of their discussions about 'collectibility'. The Boards clarified that paragraph 14 of the 2011 ED ('existence of a contract') should be considered before recognising revenue from a contract with a customer. Furthermore, the Boards tentatively

decided to provide additional guidance for determining the existence of a contract that will focus on assessing whether the customer is committed to perform its obligations under the contracts.

18. The Boards' tentative decisions on the constraint on revenue recognised are as follows:

    (a) the objective of the constraint on revenue recognised is for an entity to recognise revenue at an amount that the entity does not expect to be subject to significant revenue reversals (ie to any downward adjustment) that might arise from subsequent changes in the estimate of the amount of variable consideration to which the entity is entitled;

    (b) when the constraint applies, an entity should recognise revenue up to the amount where it does not expect a significant revenue reversal (ie there is a minimum amount of revenue that should be recognised). This minimum amount should be reassessed at each reporting period and updated for changes in circumstances. In some cases, this minimum could be zero; and

    (c) to delete paragraph 85 of the 2011 ED which constrains the amount of revenue that can be recognised for licences of intellectual property when the consideration varies on the basis of the customer's subsequent sales of a good or service. Instead, for all licences of intellectual property, an entity should rely on the general principles of the constraint.

Staff analysis

Should the accounting for transfers of nonfinancial assets be addressed in a separate project?

19. A few respondents suggested that the Boards make no consequential amendments to IFRSs or US GAAP for the transfer of nonfinancial assets; and instead the Boards should consider whether to amend existing guidance as part of a separate

project about those transfers. Those respondents noted that the proposed consequential amendments may have a more than insignificant effect on some transactions; and, therefore, a separate project is warranted.

20. The staff note that undertaking a separate project about transfers of nonfinancial assets would mean that changes to existing guidance would not be made until that project is completed and becomes effective. Given the Boards' other standard setting priorities and the timeframes to complete all relevant due process steps for the issuance of a standard, it could be several years before the existing guidance is replaced. The staff observe that the implications of not proceeding with the proposed consequential amendments would be as follows:

    (a) the IASB would need to amend IAS 16, IAS 38 and IAS 40 to include the revenue recognition criteria from IAS 18 and retain the fair value measurement requirement that currently exists in those standards. This would result in different recognition and measurement guidance for transfers of nonfinancial assets as compared to contracts with customers;

    (b) US GAAP would include two sets of recognition and measurement guidance for real estate sales. That is because sales of real estate that are an output of an entity's ordinary activities would be accounted for in accordance with the revenue proposals, whereas other sales of real estate to parties that do not meet the definition of customer would continue to be accounted for using the existing recognition and measurement guidance in Subtopic 360-20; and

    (c) there would continue to be no specific guidance in US GAAP for transfers of nonfinancial assets (other than real estate) within the scope of Subtopic 360-10 (eg equipment) or Topic 350 (eg intangible assets).

21. As a result of these negative implications, the staff think the FASB and the IASB should confirm the proposed consequential amendments for transfers of nonfinancial assets (ie as opposed to undertaking separate projects). Applying the

control and measurement requirements from the 2011 ED to transfers of nonfinancial assets would also:

(a) create consistency for the accounting for the transfers of nonfinancial assets between:

  (i) US GAAP and IFRSs generally;

  (ii) sales of real estate that are not an output of an entity's ordinary activities and similar sales arising from a contract with a customer (without that consistency, the staff note that there would be increased pressure on the assessment of a customer within the revenue proposals) under US GAAP; and

  (iii) transfers of nonfinancial assets and contracts with customers under IFRS;

(b) eliminate the delay for guidance about the accounting for transfers of nonfinancial assets in US GAAP (because there currently is no guidance other than for sales of real estate); and

(c) eliminate any possible complexities that may result from retaining separate recognition criteria for transfers of nonfinancial assets (ie because the recognition criteria from IAS 18 would be retained for transfers of nonfinancial assets).

22. Therefore, the staff recommend that the Boards do not take on a separate project, and the Boards should confirm the proposed consequential amendments that would require an entity to apply the control and measurement requirements from the 2011 ED to transfers of nonfinancial assets.

Question 1- confirmation of consequential amendments
Do the Boards agree to confirm the proposed consequential amendments that would require an entity to apply the control and measurement requirements from the 2011 ED to transfers of nonfinancial assets?

Should other aspects of the 2011 ED apply?

23. A few respondents (ie primarily US banks commenting about the accounting for sales of repossessed real estate) suggested that, in addition to the requirements on control and measurement in the 2011 ED, an entity should also consider the requirements for determining the existence of a contract (ie paragraphs 13 - 15 in the 2011 ED) for transfers of nonfinancial assets. Some respondents thought that those criteria would be relevant for all transfers of nonfinancial assets, but some respondents explained that they would be particularly important for sales of real estate, because often in those transactions it may be unclear if a contract exists (ie because the buyer may not be committed to perform). Furthermore, those respondents thought that if the contract existence criteria is relevant for sales of real estate that are an output of the entity's ordinary activities, they should also be relevant for sales of real estate that are not.

24. The staff note that the Boards tentatively decided to amend the requirements for determining the existence of a contract at the September 2012 joint Board meeting. At that meeting the Boards tentatively decided to provide additional guidance for determining the existence of a contract with a customer that will focus on assessing whether the customer is committed to perform its obligations under the contract.

25. The staff think that the requirements for the existence of a contract (ie paragraphs 13 - 15 in the 2011 ED) should also apply to transfers of nonfinancial assets. This is because the contract existence criteria would be equally relevant for transfers of nonfinancial assets, in particular because economically they are often very similar.

26. Consequently, the staff recommend that the requirements for determining the existence of a contract in the revenue standard (ie paragraphs 13 – 15 of the 2011 ED) should apply to transfers of nonfinancial assets that are not an output of an entity's ordinary activities.

Question 2 – contract existence requirements
Do the Boards agree that the requirements for determining the existence of a contract (ie paragraphs 13 – 15 in the 2011 ED) should apply to transfers of nonfinancial assets?

Application of the measurement requirements to transfers of nonfinancial assets

27. As explained above, most respondents agreed with the Boards' proposed consequential amendments for transfers of nonfinancial assets, including the proposal to apply the measurement requirements from the 2011 ED to those transfers. However, some respondents raised concerns about applying those measurement requirements because they noted that it will result in the following:
    (a) recognising a loss on the transfer (ie disposal) as a result of applying the constraint on revenue recognised to the consideration; and
    (b) economically similar arrangements may be measured differently.

Recognising a loss on the transfer

28. The concern raised by some respondents about applying the measurement requirements from the 2011 ED to transfers of nonfinancial assets was that, in some situations, an entity might recognise a loss upon transfer solely as a result of applying the constraint on revenue recognised to the consideration. This may occur when the transfer includes variable consideration that might be constrained because the amount is subject to a significant revenue (or gain) reversal and the carrying value of the nonfinancial asset is at or near fair value. Common examples of this situation would be:
    (a) recently acquired intangible assets (ie in a business combination) that may be carried at or near fair value; and
    (b) investment properties carried at fair value under IAS 40.

Removing the constraint for transfers of nonfinancial assets

29. To address the concern that an entity might sometimes recognise a loss upon transfer of a nonfinancial asset as a result of applying the constraint on revenue recognised, the Boards could consider removing the requirement for an entity to apply the constraint to transfers of nonfinancial assets. This would mean that an entity would only be required to apply the measurement requirements in the 2011 ED for determining the transaction price (ie estimating variable consideration and accounting for the effects of time value of money). Application of only those pieces of the measurement requirements in the 2011 ED might be considered appropriate because gains and losses on transfers of nonfinancial assets are viewed by users very differently than that of revenue. This is because those gains and losses are often nonrecurring and therefore they generally would not be used to predict net income and/or estimate the value of an entity.

30. However, in removing the requirement to apply the constraint, the Boards would create a measurement basis that is inconsistent with neither the measurement principles in the revenue standard nor any existing standards. Therefore, this approach would not address concerns that economically similar arrangements should be measured similarly. In addition, in specifying that an entity should apply only a part of the measurement requirements in the 2011 ED, the revenue model would become more complex.

Economically similar arrangements may be measured differently

31. Other respondents noted that the result of applying the measurement principles in the 2011 ED to transfers of nonfinancial assets may result in different measurement principles from other economically similar transactions, such as transfers of ‘businesses’. This is because in disposing of a ‘business’, any variable and/or contingent consideration would be measured at fair value under both IFRS 10, *Consolidated Financial Statements* and Topic 810, *Consolidation*.

32. The staff observe that the majority of respondents agreed with the proposals and, therefore, the Boards could confirm the consequential amendments without

modifications for the measurement concerns above. However, the staff think that the Boards could address the concerns above by modifying the consequential amendments as follows:

(a) remove the requirement for an entity to apply the constraint on revenue recognised to the measurement of the consideration for transfers of nonfinancial assets; or

(b) specify that an entity should measure the consideration in those transactions at fair value.

Fair value as the measurement basis

33. Both of the concerns identified above (ie in paragraphs 28 and 31) could be addressed if the Boards specify that an entity should measure the consideration in a transfer of a nonfinancial asset at fair value instead of by applying the measurement requirements in the 2011 ED. This would mean that the consideration would be measured using the converged standards of IFRS 13, *Fair Value Measurement* and Topic 820, *Fair Value Measurement*.

34. This alternative may limit the risk of the recognition of a loss on the transfer of a nonfinancial asset because the measurement of the consideration would be measured on the same basis (ie fair value) as any asset that may be carried at or near its market value, or with a carrying value that is determined using fair value (eg investment properties in IAS 40). In addition, it would also result in the same measurement basis (ie fair value) for transfers of a business and a transfer of financial assets. Furthermore, the staff note that fair value is the required measurement basis for transfers of nonfinancial asset in IFRSs (ie in IAS 16, 38 and 40).

35. However, the staff acknowledge that there is diversity in practice today in applying fair value as the measurement basis for transfers of nonfinancial assets. The staff understand that this diversity sometimes results from the judgement of whether fair value amounts can meet the criterion in IAS 18 of being ‘reliably measurable’ but also because estimating the fair value of the consideration can be

difficult. This is because estimating the fair value of consideration received in a transfer of nonfinancial assets could require an entity to make subjective estimates (ie level 3 fair value measurements) relating to variable and/or contingent consideration.

36. As a result of these challenges, the staff observe that an entity could be required to make significant adjustments (ie both positive and negative) to the recognised gain/loss as additional information becomes available. Those adjustments might be required, for example, when a nonfinancial asset is transferred in exchange for a stream of future royalties. In those cases, adjustments to the gain/loss on the transfer of the nonfinancial asset would result in increased volatility and the loss of trend information in the entity's statement of comprehensive income. Some would argue against introducing those potentially negative consequences specifically as they relate to transactions that are often non-recurring.

37. The staff also note that requiring transfers of nonfinancial assets to be measured at fair value would represent a fairly significant change for those applying US GAAP because there is currently no guidance for the transfer of nonfinancial assets (other than real estate). In addition, the staff observe that fair value was not proposed as the measurement basis for the transfers of nonfinancial assets in the FASB's proposed consequential amendments.

Staff recommendation

38. The staff recommend that the Boards confirm their consequential amendments proposed as a result of the 2011 ED that would require an entity to apply the measurement principles from the 2011 ED to transfers of nonfinancial assets. The staff think the benefits of applying a fair value measurement basis to transfers of nonfinancial assets do not outweigh the challenges. Furthermore, the staff think that it is helpful to measure consideration consistently for all transfers of an entity's assets, whether or not those assets are outputs of the entity's ordinary activities.

39. The staff observe that existing differences in IFRSs and US GAAP may support the IASB and the FASB reaching different conclusions on the measurement basis for transfers of nonfinancial assets (because it may be easier for the IASB to maintain existing requirements to measure the transfers at fair value than for the FASB to introduce those concepts into US GAAP). However, the staff think it would be preferable to achieve a converged solution that also is less challenging to apply.

Question 3: measurement of consideration
Do the Boards agree with the staff recommendation to confirm the consequential amendments proposed as a result of the 2011 ED that would require an entity to apply the measurement principles (including the constraint) from the 2011 ED to transfers of nonfinancial assets?