STAFF PAPER

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Project	**Revenue Recognition**
Paper topic	Accounting for contracts that do not meet Step 1 of the revenue model

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Purpose

1. This paper considers the accounting for contracts that cannot qualify to apply the revenue model because they do not meet the criteria in Step 1, *Identify the Contract*, as outlined in paragraph 14 of the 2011 ED (as revised).

Staff recommendation

2. The staff recommend that the Boards provide guidance, in the final revenue standard, for entities when the entity determines that a contract does not meet the criteria in paragraph 14 of the 2011 ED (as revised). This guidance will specify how an entity should account for any consideration received, including when it can be recognised as revenue. However, the guidance will not specify when the related asset will be derecognized, because that guidance exists in IFRS and US GAAP and for sales of nonfinancial assets will be addressed in the US GAAP codification amendments.

Structure of the paper

3. This paper is organised as follows:

   (a) Background (paragraphs 4-7)

   (b) The path forward (paragraphs 8–23)

      (i) Confirm the requirements in the staff draft (paragraphs 12–16)

      (ii) Include only revenue guidance (paragraphs 17 – 23)

   (c) Appendix A – Extract of staff draft requirements, including Example 1

   (d) Appendix B – Paragraphs 14.1 – 14.3 revised, based on the staff recommendation

Background

The staff draft requirements

4. As explained in Agenda Paper 7A/173A, contracts that do not meet the criteria in paragraph 14 of the draft standard are not bona fide contracts, and therefore an entity cannot apply the revenue model to them. This is because when the criteria in paragraph 14 are not met, it is questionable whether the entity and the customer have enforceable rights and obligations and thus whether a revenue-generating transaction has occurred.

5. In the development of the final revenue standard, Board members and a few constituents questioned how a contract should be accounted for when the criteria in paragraph 14 (see Appendix A) are not met. Those Board members and constituents were concerned that, in the absence of specific guidance, entities will seek alternative guidance and potentially apply the revenue model by analogy to contracts that do not meet paragraph 14 of the staff draft, which may not result in appropriate accounting.

6. To address these concerns, the staff draft included paragraphs 14.1-14.3 (see Appendix A) to outline the accounting requirements for contracts that do not meet

the criteria in paragraph 14 of the staff draft. Specifically, the requirements in paragraphs 14.1-14.3 outline how an entity should account for:

(a) any non-refundable cash received for completed performance, and

(b) the derecognition of any asset(s) promised to the customer under the contract (and therefore the cost and profit recognition).

Feedback on the staff draft requirements

7. The staff received feedback on paragraphs 14.1-14.3 in the staff draft. While a few reviewers supported the inclusion of the paragraphs, others raised issues related to the following:

(a) The additional revenue recognition guidance in paragraphs 14.1 & 14.3:

(i) Recognizing revenue when a contract fails to meet the criteria in paragraph 14 seems inappropriate because the contract has failed "Step 1" of the revenue model.

(b) The additional asset derecognition guidance in paragraph 14.2:

(i) Some suggested that it seems inappropriate to include guidance for the derecognition of assets subject to the contract in the revenue standard, particularly for contracts that do not appear to achieve the minimum requirements to apply the revenue standard.

(ii) Some suggested that there did not appear to be sufficient rationale regarding the nature of the asset that is recognized upon transfer (referred to as a 'restricted asset' in paragraph 14.2 of the staff draft) and more specifically, how this asset should be assessed for impairment.

(iii) A few noted that the accounting outcome from applying paragraphs 14.1-14.3 seems more favourable than the accounting outcome that may result when a contract passes the requirements in paragraph 14 and the consideration is variable and is constrained. This is because paragraph 14.2 requires an entity to defer the derecognition of the asset (and consequently the cost recognition) until there is corresponding revenue. As a result, the impact on net income is nil until the cost basis of the asset has been recovered. In contrast, a contract that passes the requirements in paragraph 14 but for which the revenue is constrained might result in a net loss at the time the performance obligation is satisfied if the costs of the related assets derecognised exceed the constrained revenue.

(iv) Others stated that there would be operational challenges in determining the method under which the related asset would be derecognised when there was only a partial receipt of the consideration and therefore a partial derecognition of the restricted asset.

(c) Reassessment, specifically, whether the evaluation of the criteria in paragraph 14 is a one-time assessment or whether those criteria should be reassessed?

The path forward

8. The staff think that it is appropriate to include some guidance in the final revenue standard for contracts that do not meet the criteria in paragraph 14 of the staff draft. This is because, without this guidance, as mentioned above, entities may try to apply the revenue model by analogy, which is inappropriate. The staff think that the question for the Boards is what guidance should be included if an entity does not meet the criteria in paragraph 14 of the staff draft.

9. Throughout this memo we refer to revenue recognition in the context of contracts with customers. However, at the January 2013 Board meeting, the Boards tentatively decided that the requirements in paragraphs 13-15 of the 2011 ED (as revised) should also apply to transfers of non-financial assets that are not an output of an entity's ordinary activities. Consequently, the decision that the Boards reach on this issue will also apply to the transfer of non-financial assets

that are not an output of an entity's ordinary activities and the resulting gain/loss recognized.

10. The staff think that there are two alternatives for the Boards to consider for the level of guidance to be provided:

    (a) ***Alternative A – staff draft with clarifications***: This alternative would largely retain the wording from the staff draft (see Appendix A) while attempting to address the concerns raised through the feedback process by including clarifications.

    (b) ***Alternative B – address only the revenue related aspects in the revenue standard***: This alternative would result in requirements in the final revenue standard that state how an entity should account for consideration received in cases where the criteria in paragraph 14 are not met. However, the revenue standard would not prescribe the asset derecognition requirements (and cost recognition), these would be dealt with by existing IFRSs and US GAAP and will be addressed in the codification amendments for US GAAP for transfers of nonfinancial assets (see Appendix B for proposed drafting changes to the revenue standard).

11. Regardless of the alternative that the Boards choose, the staff think that the criteria in paragraph 14 should be reassessed if they are initially not met. However, once the criteria have been met and an entity determines that a contract meets the criteria in paragraph 14, the entity should not reassess that conclusion unless a contract modification has occurred. The staff has improved the drafting to make this reassessment requirement clearer by adding paragraph 14.4 in Appendix B.

Alternative 1 – Confirm the requirements in the staff draft

12. This alternative would confirm the requirements in the staff draft, ie include the requirements for both the revenue recognition and asset derecognition in paragraphs 14.1-14.3.

13. This may seem to be an appropriate level of guidance from a FASB perspective, because under US GAAP, there are two Subtopics that address some aspects of asset derecognition and cost guidance that are proposed to be deleted as a result of the revenue standard:

    (a) Subtopic 605-10, *Revenue Recognition – Overall* – Paragraphs 605-10-25-3 to 25-5 include references to the installment and cost-recovery methods (formerly ARB 43 Chapter 1A paragraph 1 and APB 10 paragraph 12), specifically 605-10-25-4 defines these methods as follows:

    > As defined in 360-20-55-7 through 55-9, the **installment method** apportions collections received between cost recovered and profit. The apportionment is in the same ratio as total cost and total profit bear to the sales value. Under the **cost recovery method**, equal amounts of revenue and expense are recognized as collections are made until all costs have been recovered postponing any recognition of profit until that time. [emphasis added]

    (b) Subtopic 360-20 includes detailed guidance on both the revenue and cost recognition for sales of real estate (for example, deposit, cost recovery, installment, or reduced profit methods).

14. Conversely, under IFRS, there is no specific guidance in IAS 16 *Property, Plant and Equipment* regarding the sale of real estate. IAS 16 (and IAS 38 *Intangible Assets* and IAS 40 *Investment Property*) include general derecognition guidance that requires an entity to derecognise the asset when the sale criteria in IAS 18 *Revenue* are met. To date the staff are not aware of practice issues that arise under IFRS as a result of the existing derecognition guidance.

15. Consequently, the staff observe that the introduction of the revenue standard will result in a loss of existing asset derecognition and cost recognition guidance under US GAAP for sales of real estate (and some other revenue related transactions) whereas it will not result in a loss of existing guidance under IFRS.

16. The staff think that if the Boards decided to proceed with the proposed requirements in the staff draft, the concerns raised by respondents to the asset derecognition and cost requirements would need to be addressed. The staff think that most of these concerns can be addressed by:

    (a) Specifying that the restricted asset is tested for impairment in accordance with the financial instrument guidance.

    (b) Clarifying that any derecognition of the restricted asset is always equal to the non-refundable cash received (the cost recovery method as defined under US GAAP).

    (c) Clarifying that the restricted asset should be presented as a separate class of asset (if material).

    (d) Providing a clear rationale for the inclusion and measurement of the restricted asset.

Alternative 2 – Include only revenue related guidance

17. The staff think that another alternative would be to include guidance that only specifies when revenue or a liability should be recognized when a contract does not meet the criteria in paragraph 14 but the entity receives consideration. However, the revenue standard would not specify the related asset derecognition (and cost recognition) guidance, existing US GAAP and IFRS standards would address this (refer to Appendix B for a draft of what the possible revenue standard requirements might be). In addition, the FASB would make codification amendments to Topics 350 and 360 to specify that in a transfer of a non-financial asset that does not meet the criteria in paragraph 14 of the revenue guidance, the asset is not derecognized. The staff think that this would address the majority of the concerns which focused on the asset derecognition requirements in the staff draft.

18. However, the staff think that if this alternative is followed by the Boards, paragraph 14.1 of the staff draft should be amended to specify that no revenue should be recognized until such time that both the entity and the customer have no

remaining rights or obligations under the arrangement. In other words, the only way an entity may recognize revenue for a contract that does not meet the requirements in paragraph 14 is to conclude that there are no remaining obligations the entity has to perform under the contract (that is, the entity's performance is complete) and either:

(a) *all* of the promised consideration in the arrangement has been collected and is non-refundable; or

(b) the contract is cancelled and the consideration received is non-refundable.

19. Therefore, in an installment sale that does not meet the criteria in paragraph 14, in which an entity transfers an asset at contract inception and the consideration is non-refundable, an entity would not recognize any revenue until such point that all promised consideration has been received or the contract is cancelled (the customer defaults) . The contract would however be reassessed and might in some subsequent period meet the criteria in paragraph 14.

20. This approach is similar to the deposit method in US GAAP (Paragraphs 360-20-55-17 through 20). The deposit method in US GAAP is applied when there is no consummation of a sale. The staff think that this is consistent with the Boards' intent of paragraph 14, which is to filter out contracts that are not bona fide transactions. This "failed sale" accounting would preclude the entity from recognizing any revenue until a subsequent reassessment indicates that the contract meets all of the criteria in paragraph 14.

21. As a result of relying on other standards for asset derecognition (including the consequential amendments proposed by the FASB), the staff think that it would not be appropriate to include guidance in the revenue standard that would permit an entity to recognise revenue for partial (ie installment) payments. This is because the related asset derecognition guidance in other standards may not always permit a partial derecognition of the asset and therefore may result in inappropriate profit recognition.

22. Specifically, under IFRS the derecognition requirements under IAS 2 paragraph 34 only require inventory to be recognized as a cost when the related revenue is recognized. In addition, the staff think that the consequential amendments to IAS 16, IAS 38 and IAS 40 would require an entity to meet the criteria in paragraph 14 and paragraph 37 (ie control has transferred) before the related asset is derecognized. In other words, the asset derecognition guidance under IFRS would be clear in cases where an entity did not meet the criteria in paragraph 14.

23. Under US GAAP, Topic 330, Inventory, there is limited guidance; however, in paragraph 330-10-10-1 notes that the "accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues." As a result of providing the revenue recognition guidance suggested in Appendix B (that is, in an instalment sale, no recognition of partial receipts of non-refundable consideration) it may be presumed that no costs should be recognized. Currently, there is no guidance in Topics 350 or 360 regarding derecognition and the FASB proposed amendments in the 2011 ED. The staff think that this guidance in Topic 330 and the new guidance in Topics 350 and 360 could be further amended for the avoidance of doubt that if the criteria in paragraph 14 are not met any asset(s) subject to the contract shall not be derecognized consistent with a deposit method as currently described in 360-20-55-17.

Staff recommendation

24. The staff recommend, Alternative 2, that the Boards provide guidance, in the final revenue standard, that entities should apply when a contract does not meet the criteria in paragraph 14; however, this guidance should be limited to the revenue recognition aspect of the arrangement. The staff have included, in Appendix B to this paper, what the possible wording might look like should the Boards agree with the staff recommendation. The final wording in the revenue standard may be different and the wording included in Appendix B is only intended to help Board members better visualise what the staff recommendation would require.

Questions for the Boards
Do the Boards agree that the final revenue standard should provide guidance for entities to apply when a contract does not meet the criteria in paragraph 14, but that guidance should be limited to addressing revenue recognition?

Appendix A – extract from the staff draft

14 An entity shall apply this guidance to a contract with a customer (or to a modification of the contract) only when all of the following criteria are met:

a. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).

b. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices).

c. The entity can identify each party's rights regarding the goods or services to be transferred.

d. The entity can identify the payment terms for the goods or services to be transferred.

e. The parties are committed to perform their respective obligations and they intend to enforce their respective contractual rights. To assess this criterion, an entity shall consider all relevant facts and circumstances including, but not limited to, the following:

   1. Whether the contractual terms and conditions (for example, payment terms that have the effect of providing financing to the customer and/or any collateral offered) are commensurate with the uncertainty, if any, about the customer performing in accordance with the contract.
   2. Whether there is experience about the customer (or class of customer) not fulfilling its obligations in similar contracts under similar circumstances.
   3. Whether the entity has previously chosen not to enforce its contractual rights in similar contracts with the customer (or class of customer) under similar circumstances.

14.1. If a contract with a customer does not meet the criteria in paragraph 14 and an entity receives consideration from the customer, the entity shall recognize the consideration received as revenue only when both of the following conditions are met:

a) The entity has no remaining obligations to transfer goods or services to the customer.

b) The consideration is nonrefundable.

14.2. If both of the conditions in paragraph 14.1 are met, the entity shall derecognize any asset(s) subject to the contract and recognize another asset (for example, a restricted asset). The asset is measured initially at the carrying amount of the derecognized asset and the carrying amount of the asset is subsequently reduced as and when the entity receives nonrefundable consideration (including any interest received) from the customer.

14.3 If either (or both) of the conditions in paragraph 14.1 are not met, the entity shall not derecognize any asset(s) subject to the contract and shall recognize the consideration received as a liability (for example, a liability for the entity's obligation to either transfer goods or services in the future or to refund the consideration received). The liability shall be measured at the amount of consideration received from the customer.

Excerpt from Illustrative Examples

Example 1—Seller–based financing of real estate

An entity, a real estate developer, enters into a contract with a customer for the sale of a building for $1 million. The customer intends to open a restaurant in the building. The customer pays $50,000 (5 percent of the promised consideration) at inception of the contract and enters into a financing agreement with the entity for the remaining 95 percent of the contract consideration. The financing arrangement is provided on a nonrecourse basis, which means that if the customer defaults the entity can seize the building but cannot seek further compensation from the customer, even if the collateral does not cover the full value of the amount owed. The entity's cost of the building is $600,000.

The customer obtains control of the building at contract inception. Accordingly, the customer has the ability to direct the use of and obtain substantially all of the remaining benefits from the asset, and the customer can also prevent other entities from directing the use of or obtaining the benefits from the asset. This restriction applies to the entity, provided the customer continues to meet its obligations under the contract and, as such, the entity does not have the present right to repossess the asset.

In assessing whether the contract meets the criteria in paragraph 14, the entity considers the following factors:

a. The buyer plans to open a restaurant in a highly competitive market.
b. New restaurants in the area generally close within two years of opening.
c. The buyer has little previous experience in the restaurant industry.
d. The buyer has limited financial resources and is relying on income from the restaurant to pay the remaining 95 percent of consideration promised under the contract.
e. The entity expects that the customer will likely need to return the building to the entity in exchange for settlement of its loan. The entity expects this to happen within a short period of time because of the riskiness of the restaurant industry. The entity's experience also indicates this is likely because the entity has transferred similar buildings to other restaurateurs in the region during the last five years. The previous buyers defaulted on their mortgages and control of the properties transferred back to the entity.

f. The buyer has a poor credit history.

g. The entity's mortgage note contains customary payment terms, payable monthly over twenty years, a market rate of interest, and is secured by the property.

h. The entity intends to enforce its contractual rights.

The entity concludes that the criteria in paragraph 14 are not met because the customer does not appear to be committed to the contract. Because the entity has no remaining goods or services to transfer under the contract and the $50,000 down payment is nonrefundable, the entity derecognizes the asset and records an asset subject to restriction at $600,000 (the cost basis of the asset prior to derecognition). The $50,000 received is recorded as revenue, cost of sales, and a reduction of the asset subject to restriction, in accordance with paragraph 14.2. Future payments of principal and interest received from the customer reduce the asset subject to restriction and result in the recognition of revenue and cost of sales.

Appendix B– Paragraph 14.1 – 14.3 revised, based on the staff recommendation

Clean version of staff recommendation

14.1. If a contract with a customer does not meet the criteria in paragraph 14 and an entity receives consideration from the customer, the entity shall recognize the consideration received as revenue only when the entity has no remaining obligations to transfer goods or services to the customer and either of the following conditions are met:

(a) all of the promised consideration in the arrangement has been collected and is non-refundable or

(b) the contract is cancelled and the consideration received is non-refundable.

14.2 [Not used]

14.3 If the conditions in paragraph 14.1 are not met, the entity shall recognize the consideration received as a liability (for example, a liability for the entity's obligation to either transfer goods or services in the future or to refund the consideration received). The liability shall be measured at the amount of consideration received from the customer.

14.4 If a contract does not meet the criteria in paragraph 14, then an entity shall reassess, at each reporting period, whether the criteria in paragraph 14 are met.

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Marked change version of staff recommendation

NOTE: Changes are marked from the staff draft (Appendix A) additions are <u>underlined</u> and deletions are ~~struck through.~~

14.1. If a contract with a customer does not meet the criteria in paragraph 14 and an entity receives consideration from the customer, the entity shall recognize the consideration received as revenue only when ~~both~~ <u>the entity has no remaining obligations to transfer goods or services to the customer and either</u> of the following conditions are met:

(a) ~~The entity has no remaining obligations to transfer goods or services to the customer~~.

(a) ~~The~~ <u>all of the promised</u> consideration <u>in the arrangement has been collected and</u> is non-refundable <u>or</u>

(b) <u>the contract is cancelled and the consideration received is non-refundable</u>.

14.2 ~~If both of the conditions in paragraph 14.1 are met, the entity shall derecognize any asset(s) subject to the contract and recognize another asset (for example, a restricted asset). The asset is measured initially at the carrying amount of the derecognized asset and the carrying amount of the asset is subsequently reduced as and when the entity receives nonrefundable consideration (including any interest received) from the customer.~~

14.3 If ~~either (or both of)~~ the conditions in paragraph 14.1 are not met, the entity ~~shall not recognize any asset(s) subject to the contract and~~ shall recognize the consideration received as a liability (for example, a liability for the entity's obligation to either transfer goods or services in the future or to refund the consideration received). The liability shall be measured at the amount of consideration received from the customer.

14.4 <u>If a contract does not meet the criteria in paragraph 14, then an entity shall reassess, at each reporting period, whether the criteria in paragraph 14 are met.</u>