



Board Meeting Handout

July 16, 2008

Joint Revenue Recognition Project

OVERVIEW OF PAPERS FOR THE MEETING

1. There are two papers for this meeting. The first paper (*Memo 112 / Agenda Paper 6A*) proposes the staff's plan and timetable for completing the revenue recognition project. The objective of the discussion will be to seek the Boards' approval of this plan.
2. The second paper (*Memo 113 / Agenda Paper 6B*) summarises the Boards' decisions in May 2008 about the measurement approach for the general revenue recognition standard. It also seeks to clarify in what circumstances Board members think that performance obligations should be remeasured other than when judged to be onerous.
3. The objective of the discussion will be:
 - a. to ask the Boards to approve the description of the measurement approach and to confirm that it reflects the different reasons for adopting that approach
 - b. to understand whether and how far apart the Boards are on the issue of when performance obligations should be remeasured
 - c. to ask the Boards whether they agree that performance obligations should not be remeasured unless they are judged to be onerous.

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB, the IASB, or their staff members. Official positions of the FASB are determined only after extensive due process and deliberations.

INTRODUCTION AND SUMMARY OF RECOMMENDATIONS

1. This paper sets out a revised plan to issue a general revenue recognition standard by June 2011. The Boards currently plan that this general revenue recognition standard will replace IAS 18 *Revenue*, IAS 11 *Construction Contracts* as well as much of the revenue recognition literature in the US. This plan takes into account the Boards' decision in May to pursue a customer consideration measurement approach.
2. In overview, this revised plan proposes that the Boards:
 - Issue a discussion paper in October/November 2008 explaining the contract-based revenue recognition model and customer consideration measurement approach. The main aim of the paper is to solicit input on whether a single revenue recognition model based on satisfying performance obligations is appropriate for all revenue contracts.
 - Immediately begin developing a draft of the exposure draft (ie before and while the discussion paper is out for comment).
 - Set June 2011 as the deadline (rather than a goal) for issuing the general revenue recognition standard.
3. The remainder of this paper considers the approach and timetable for the main steps in this plan, ie the discussion paper (paragraphs 4–29), exposure draft (paragraphs 30–44) and final standard (paragraph 45). The last section makes some overall observations about the proposed timetable (paragraphs 46–51).

DISCUSSION PAPER

Do the Boards need to issue a discussion paper?

4. Throughout 2006 and 2007, the Boards stated that the objective of the discussion paper (DP) would be to explain and illustrate two contrasting revenue recognition models (ie a customer consideration model and a fair value model). In other words, the original purpose of the DP was to educate ourselves and our constituents, and to seek input from constituents about which of the models should serve as the basis for a new general revenue recognition standard.
5. However, over the last six months, the Boards have coalesced around a single recognition model and, in May, decided to adopt the customer consideration measurement approach. (Appendix A includes a summary of the proposed model developed to date.)

6. In the staff's view, the combination of this recognition model and measurement approach will in many cases result in a pattern of revenue recognition that is similar to current practice. There are two reasons for this. First, we think that much of the current revenue literature is implicitly based on a performance obligation satisfaction model. This is because it often specifies that revenue is recognised only when economic resources (ie goods and services) are transferred to a customer (for instance consider two general standards, SAB 104 *Revenue Recognition* and IAS 18). Secondly, much of the current revenue literature measures the asset or liability arising from a contract by reference to the transaction price.
7. In view of the Boards' recent decisions, the staff reconsidered whether the Boards need to issue a DP or whether they can move straight to developing and issuing an exposure draft (ED).
8. The staff notes that it might be argued that because the proposed model is similar to much of current practice, constituents are less likely to be interested in a general discussion about the proposed model—ie a DP—and more interested in understanding how that model is going to be articulated in a standard and would apply to specific types of contracts—ie an ED.
9. Furthermore, the majority of the detailed input from constituents is likely to arise from the ED rather than the DP. In particular, the Boards will want to know whether they have articulated clear and sufficient principles that can be applied to a wide range of examples, when supported by the appropriate amount of implementation guidance. In other words, the Board will be asking whether the proposed general standard clearly addresses enough of the issues covered by current guidance while also improving weaknesses in existing guidance.
10. However, the staff continues to think that a discussion paper is necessary for two main reasons:
 - a single contract-based recognition principle will be a major change of revenue recognition principle in some cases (see paragraphs 11–17 below);
 - although the customer consideration measurement approach is largely familiar, the Boards are proposing significant changes to US practice (see paragraphs 18–20 below).

Major change to recognition in some cases

11. Although much of the current revenue literature is implicitly a performance obligation satisfaction model, there are other recognition principles in existing literature. In such cases, the proposed model will result in a change in when revenue is recognised.
12. The main area in which the proposed model may differ from current practice relates to construction type contracts. For instance, in IAS 11 revenue is

- recognised ‘in the accounting period in which the work is performed’ (paragraph 26). In accordance with the Boards’ proposed model, revenue on such contracts would be recognised only when a performance obligation is satisfied, which would be when the *customer* has the enforceable rights or other access to the work-in-progress (WIP). In some construction contracts the WIP transfers to the customer continuously throughout the contract so, in accordance with the proposed model, revenue would in effect also be recognised as work is performed. But since a construction contract is defined only as a contract ‘specifically negotiated for the construction of an asset or a combination of assets...’, the staff does not think that *all* contracts within the scope of IAS 11 result in continuous transfer of the WIP. Hence, the proposed model may result in some entities that currently apply IAS 11 being precluded from recognising revenue as ‘work is performed’ under the contract.
13. The same may be true in US GAAP for contracts within the scope of SOP 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. Unlike IAS 11, however, this guidance provides a basis for why revenue is recognised continuously, namely that ‘the business activity taking place supports the concept that in an economic sense performance is, in effect, a continuous sale (transfer of ownership rights) that occurs as the work progresses’ (paragraph 22). This basis is similar to the notion of continuously satisfying a performance obligation through transferring economic resources to the customer and, hence, is consistent with the proposed model. Nonetheless, the staff is not sure that *all* contracts within the scope of SOP 81-1 transfer economic resources continuously to the customer.
 14. In the staff’s view, in construction type contracts in which economic resources are not transferring to the customer throughout the contract, but for which revenue is nonetheless recognised on a percentage-of-completion basis, the asset that determines the recognition of revenue is the *WIP* rather than the contract. In other words, the revenue recognition principle is implicitly focused on a different asset—WIP (or production asset)—compared with the proposed model.
 15. Issuing a DP would give constituents the opportunity to comment on the appropriateness of a single revenue recognition principle for all revenue contracts. It would also help the Boards better understand the types of contracts and industries that might be affected by the change to a single revenue recognition principle. In particular, the Boards would find out more about contracts that currently use percentage-of-completion accounting but which are not ‘continual transfer’ or ‘continual delivery’ contracts.
 16. The staff notes that if constituents argue, and the Boards subsequently agree, that in some cases revenue should be recognised as production assets are enhanced *under contract* (rather than as the contract asset increases or contract liability decreases), the Boards could consider including as part of the general standard a revenue recognition principle that focuses on the asset being created pursuant to the contract (ie., the WIP). The standard would need to explain in what

circumstances an entity would be allowed to recognize revenue according to this principle instead of the recognition principle based on changes in the contract.

17. For completeness, the staff notes that in some limited cases in current practice revenue is recognised even before a contract with a customer exists. For example, existing practice in the US is to recognise revenues from commodities at the completion of the production process if certain criteria are met. The proposed model would therefore alter current practices of revenue recognition if applied to these examples. However, the Boards have already concluded that the scope of the general revenue recognition standard is revenues arising in *contractual* settings. Thus there is currently no plan to change current practice for revenue recognition outside contracts. It is important to clarify this scope decision in a discussion paper to allow constituents in these industries to consider its implications.

Changes to measurement

18. Although the Boards' proposed measurement approach is similar to current practice, it requires the use of estimated standalone prices for goods and services in multiple-element contracts if there are no observable selling prices for those goods and services. This is a significant change to some US practice, particularly EITF 00-21 *Revenue Arrangements with Multiple Deliverables* and SOP 97-2 *Software Revenue Recognition*. These require the use of vendor specific or other objective evidence of prices in order to treat goods or services as a separate unit of accounting.
19. Issuing a DP would allow the Boards to understand whether constituents think that the proposed requirement to use estimated standalone prices is workable or whether it needs to be constrained in any respect. Arguably, unlike questions about the appropriateness of the single revenue recognition model, the Boards could just solicit input on this issue on the ED. Nonetheless, the staff thinks it will be useful to receive constituent feedback as early as possible.
20. Another possible issue on which input might be useful at this stage is whether some types of performance obligations may require remeasurement other than when deemed onerous. This, however, depends on the outcome of the IASB's further discussion of this issue (and is therefore related to Memo 113 / Agenda Paper 6B).

Planned approach

21. The staff thinks that the DP should focus on the significant changes to current practice explained above. This means that the DP should explain the contract-based revenue recognition model, explain where current practice uses other revenue recognition principles and, hence, the changes that the proposed model would entail. The DP should also explain the customer consideration measurement approach and highlight where it is different from current practice

(eg in its use of estimated prices). The Boards can then solicit input from constituents, particularly on the appropriateness of a single revenue recognition principle for all contracts. We think that this is the main issue on which the Boards need input at this stage.

22. We do not think there is any point in including an explanation of the exit price measurement approach, other than to note that it was considered and rejected.
23. An outline of the revised proposed DP is in Appendix B.
24. Assuming the Boards agree with the proposed objective and outline of the DP, the staff will recraft the existing draft DP chapters and develop the additional analysis. Please note that the planned approach does not call for the staff to start from scratch. It is largely a case of refocusing the draft materials that we have already developed. In addition, with the exception of remeasurement, we do not think that the issues to be discussed in the DP require any further Board deliberation.
25. The staff also envisages that a more focused DP can be shorter than the originally planned DP. This should therefore reduce the time taken to finalise the document with the Boards.
26. The proposed timetable for the DP is as follows:

Date	Activity
August 2008	Drafting
September 2008	Pre-ballots to Boards
October-November 2008	Ballot and issue DP
February-March 2009	Comment period end

27. The staff proposes a four-month comment period. We have some reservations about this because constituents are likely to expect a six-month comment period on this major project. Furthermore, the comment period coincides with a holiday period and also many company year ends.
28. However, given the importance of the ED for soliciting constituents' input, the Boards need to maximise the amount of time available *after* issuing the ED to address issues raised on that document. Having a longer comment period for the DP will clearly reduce available time later in the project.
29. The staff also notes that it will be talking to some constituents who we think will be affected by the proposed model during the comment period. Nonetheless, the Boards should note the risk that some constituents who have genuine concerns

about the model may get bypassed in the DP process because of the short comment period.

Q1: Does the Board agree that a DP should be issued? If so, do you agree that the main objective is to solicit comment on the appropriateness of a single revenue recognition principle for all contracts?

Q2: Does the Board agree that a four-month comment period is appropriate?

EXPOSURE DRAFT

30. Whilst the DP is being drafted and finalised, the majority of the staff team will begin work on the ED. In other words, completing the DP and starting the development of the ED will proceed in parallel.
31. Clearly it is important that work on the ED should not pre-empt feedback on the DP. But without in anyway prejudging due process, the staff thinks it unlikely that constituents will object to a contract-based recognition principle for at least a large number of contracts (because this is often current practice) nor that they will object to the measurement approach. Thus work on developing the high-level model in the DP into standards-level guidance can begin immediately. Furthermore, one of the key issues the Board is asking in the DP is whether the proposed model can be applied to all revenue contracts. This largely relates to determining the scope of the general standard rather than the model itself. Of course, for comments received on more detailed aspects of the model, any work done in the earlier stages will be updated to reflect those comments. However, we think our earlier work will be useful regardless.

Planned approach

32. The staff proposes that the first step is to create a working draft of the ED. We acknowledge that some Board members might view this as a somewhat back-to-front approach, especially since we are missing some preliminary conclusions on some critical components of a revenue recognition model (principally relating to measuring the rights in the contract).
33. However, we think that it will be useful to determine how the basic model should be articulated at the standards level at an early stage. This is because developing a draft of the ED will identify which parts of the model need to come back to the Board for further deliberation and should bring more focus to the ensuing discussions. It will also identify any further missing components of the model. (Note that with respect to the missing pieces, the staff has already commenced work identifying these pieces and will bring them to the Boards for consideration as soon as possible.) These missing components can also be highlighted in the DP.

34. Our other rationale for starting with drafting the ED is that we plan to consider which guidance from the existing literature is compatible with the proposed model and could usefully be carried forward into the ED or could at least be used as a starting point for guidance in the ED. In other words, because of the similarity of the proposed model to much of the existing literature, we do not think each of the remaining issues has to be addressed afresh. Accordingly, the staff has already mapped current revenue literature to the list of technical issues that need to be covered in the ED.
35. The technical issues that need to be covered in the ED are listed in Appendix C.

Developing the illustrative examples

36. The other key task to start as soon as possible is the development of the illustrative examples to accompany the general standard. We have two main reasons for front ending this work.
37. First, developing the examples will highlight where the articulation of the model for the standard needs further elaboration. For example, having reviewed the existing examples in IAS 18 and SAB 104 and considered how they would work under the proposed model, we note issues relating to determining when enforceable rights to goods transfer to customer in arrangements such as consignments and layaways. And some of the upfront fee examples are good tests of the notion of a performance obligation: is there a performance obligation for the upfront activity?
38. Secondly, the examples are also needed to act as the starting point for field visits (see below).
39. At present, the staff envisages an amount of illustrative guidance that is more wide-ranging than contained in IAS 18 but, obviously, not as wide-ranging as included across all of US revenue recognition guidance. The examples will also explain how the principles of the model are applied. The lack of explanation is a big weakness in the IAS 18 examples.

Field visits and external consultation

40. The staff thinks that there is a need for field visits in the ED phase of the project. The objective of these is to explore the implications of the proposed revenue recognition model with some of the major industries that will be affected by the proposed model. Amongst these are:
 - *Software industry.* The main issues to discuss are: separating performance obligations and determining standalone selling sales prices for separate goods and services that are never sold separately.
 - *Construction industry.* The main issues to discuss are: determining when resources transfer to customer (eg how does an entity determine whether it or

the customer has the enforceable rights to the WIP) and the role of customer acceptance in construction contracts.

- *Telecomms.* The main issues to discuss are: identifying performance obligations (including for upfront activities), separating performance obligations and determining standalone selling prices.

41. A number of companies have already expressed interest in assisting the staff. Furthermore, we can reach out via contacts on the FASB revenue recognition resource group and through industry groups coordinated by the big accounting firms. Although field visits will consume much staff time, they are a necessary and worthwhile investment that will provide useful input into developing the ED. They will also help the Boards make scope and transition decisions towards the end of deliberations.
42. The staff will need the help of one other group—a group that can advise on the development of the ED’s disclosure requirements. The group should obviously be orientated towards users, but not exclusively so. (Because of this group, the staff does not think it is necessary to obtain input on disclosure from the discussion paper.)

Proposed timetable and sequencing of issues for developing the ED

43. The following table sets out the staff’s proposed timetable for developing the ED (ie it excludes the DP), showing which issues we expect to bring to the Boards for deliberation.

Month	Summary of activity
2008	
Aug-Oct	Staff develop working draft of ED Staff devise and begin development of illustrative example Staff develop papers on issues relating to measuring rights in the contract
Oct	<i>Discussion with Board advisers:</i> Input on articulation of the model at the standards level and discussion of issues arising in working draft; input on appropriateness of the set of examples. <i>Board discussion:</i> Measuring rights I: reflecting time value of money and credit risk; variable consideration; contingent consideration; non-cash consideration

Nov	<p><i>Board discussion:</i></p> <p>Measuring rights II: revenue recognition when consideration is uncertain</p>
Dec	<p><i>Board discussion on issues from draft ED:</i></p> <p>Confirm guidance on identifying and combining performance obligations (ie multiple-element arrangements)</p>
2009	
Jan	<p><i>Board discussion on issues from draft ED:</i></p> <p>Treatment of typical stand-ready obligations arising from contracts (eg returns; guarantees; statutory warranties; promotional promises; fixed price and availability guarantees)</p>
Feb	<p><i>Board discussion on issues from draft ED:</i></p> <p>Confirm guidance on determining when performance obligations are satisfied and consideration of problematic examples</p> <p>Onerous contracts (specifying when a performance obligation is deemed onerous).</p>
Mar	<p><i>Board discussion:</i></p> <p>Display issues (should revenue be reported for performance by third parties; are there any cases in which the rights and obligations in a contract should be reported gross; reporting the effects of a remeasurement)</p> <p>Disclosure requirements</p>
Apr	<p><i>Board discussion:</i></p> <p>Discuss DP comment letter analysis. The main issue to consider will be whether some contracts should be out of scope of the general standard. In particular the Boards will need to consider the potential effect on current accounting for construction type contracts.</p>
May	<p><i>Board discussion:</i></p> <p>Follow up on comments on DP on measurement.</p>
Jun	<p><i>Board discussion:</i></p> <p>Scope and transition (in particular transition from the many pieces of US literature)</p>

Jul-Aug	Finalise draft of ED for Board comment
Sep	Discussion of any sweep issues arising
Oct	Ballot and Issue ED

44. The staff proposes a six-month comment period for the ED. The staff views the ED as being a critical step. The Boards will need to know whether they have articulated clear and sufficient principles, supported by the right level of guidance and illustrative examples, that can be applied to a wide range of contracts.

Q3: Does the Board agree with the approach?

Q4: Does the Board have any comments on the approach or timetable?

FINAL STANDARD

45. Assuming the project is on track at the end of the ED phase, the staff envisages a timetable along the following lines. Clearly, the amount of redeliberation required will depend on the comments received.

Month	Activity
Oct 2009-Mar 2010	ED comment period
Mar 2010	Roundtable discussions (if needed)
Mar-Apr 2010	Staff analysis of comment letters
May 2010	Board discussion of comment letters
June 2010-Feb 2011	Redeliberations
Mar-May 2011	Finalise, ballot and publish standard.

TIMETABLE

46. The Boards will already have noted in the above timelines that the staff proposes that the Boards complete this project by June 2011. The staff has previously noted the challenge of meeting the MOU deadline of June 2011 with this project. However, having reflected further, we now feel confident about this deadline.

47. First, we think the Boards' decision to pursue the customer consideration approach allows us to refocus and streamline the DP so it is focused on the main issues on which we need input at this stage. This should speed up the process of finalising the document with the Board. Furthermore, it means that work can start immediately on the ED, which reduces the time required between the DP and ED.
48. Secondly, the decision to pursue the customer consideration approach means that the proposed model is similar to much of the current literature. As noted, we think that this should allow the Boards to use some solutions from existing literature when developing the ED, rather than starting afresh. In addition, it should also mean that we can adopt the 'life-boat' theory. That is to say, we focus on addressing the fundamental weaknesses with the existing literature first. For other issues, the Boards may need to accept adopting solutions from the current literature, even if ideally they would like to deliberate that issue to reach an improved solution.
49. Indeed, the staff now think the Boards should be clear that June 2011 is a deadline rather than a goal for this project. We note that this project started in 2002. We do not think that it is unreasonable for constituents to expect the Boards to deliver at least some improvements in revenue accounting within nine years of the start of the project, even if those improvements do not fulfil all of the Boards' initial objectives.
50. More importantly, unless the Boards issue a new standard by June 2011, many more constituents are going to be adopting IAS 18 as they transition to IFRSs. The proposed revenue recognition model as developed to date could already be used to make worthwhile improvements to IAS 18 by addressing some of its fundamental weaknesses and internal inconsistencies.
51. Clearly as with other MOU projects, the June 2011 deadline will impose a tight project timetable. Nonetheless, it will force the staff and Boards to focus on the fundamental weaknesses with current revenue recognition guidance. It also requires the staff and Boards to drive on with the decisions already reached and not go over old ground. For instance, we note that some IASB members (and staff) are attracted to a measurement approach in which the transaction price *less* some direct contract origination costs is allocated to the performance obligations. However in the staff's view, the consequences of recognising 'day 1 losses' under the customer consideration approach have been fully illustrated to the Boards and, in this project, not thought to be troubling to the majority of Board members. Hence, we do not think this issue should be debated until the Boards have received input from constituents.

Q5: Does the Board agree that June 2011 is the deadline for completing the project?

Appendix A

SUMMARY OF BOARD DECISIONS TO DATE

- A1. The Boards' proposed revenue recognition model can be summarised as follows:
- a. The model addresses the recognition of contractual revenues, ie the revenues that arise when recognised contract assets increase or contract liabilities decrease (ie the net position in a contract increases).
 - b. At inception, a contract consists of rights and performance obligations. The rights are measured at the value¹ of promised consideration. This amount is allocated to the individual performance obligations in the contract based on the entity's observed or estimated selling prices of the goods or services underlying those performance obligations at contract inception.
 - c. In principle, any good or service that is promised to the customer in accordance with the explicit or implicit terms of the contract constitutes a performance obligation. In practice, for the purpose of allocating the value of the promised consideration, goods or services need to be treated as individual performance obligations only if they are transferred to the customer at different times.
 - d. As the entity satisfies each performance obligation in the contract, the entity recognises the corresponding increase in the contract asset or decrease in the contract liability (ie increase in the contract's net position) as revenue. The amount of revenue recognised is the amount of the consideration allocated to the satisfied performance obligation at contract inception.
 - e. The initial measurement of a performance obligation is locked in at inception and is not subsequently updated unless it is deemed onerous, at which point it is remeasured.² The IASB has indicated that there may be other circumstances in which performance obligations might be remeasured.

- A2. These decisions mean that:

¹ By using the word 'value', the staff is acknowledging the possibility that the Boards may conclude that the nominal amount of the consideration should be discounted for the time value of money and the customer's credit risk. The Boards have not yet discussed this nor how the effects of any discounting should be reported in profit or loss over the contract life. The staff assumes that the unwinding of the discounting would be recognised as financing or interest revenue.

² The Boards have not confirmed when a contract is onerous, nor have the Boards discussed the unit of account for determining when a contract is onerous. The staff's working assumption is that a contract is onerous when an individual performance obligation is onerous. That is to say, the performance obligation itself is the unit of account for any onerous test.

- a. An entity recognises revenue only when a performance obligation is satisfied, ie when it transfer economic resources (ie goods and services) to the customer under the contract. Revenue is not recognised when a contract is obtained, although it may be recognised immediately after contract inception if a performance obligation is satisfied.
- b. At contract inception, neither a contract asset nor liability is recognised (except in the unusual circumstances that performance obligations are deemed onerous at contract inception). A contract asset or liability is recognised only when one party begins to perform in accordance with the contract (ie when the entity satisfies a performance obligation or the customer pays).
- c. The total amount of revenue recognised over the life of a contract is the amount of the customer consideration.
- d. The measurement approach of the proposed model differs from the prospective measurement approaches in the IASB's insurance model discussed in the 2007 paper *Preliminary Views on Insurance Contracts*. The insurance and revenue recognition project teams need to consider the interaction of the two projects.

Appendix B

PROPOSED STRUCTURE OF THE DISCUSSION PAPER

- I. Project objective and purpose for discussion paper
- II. Revenue and a focus on assets and liabilities
 - Perceived problems with existing literature
 - Explanation of focus on assets and liabilities
- III. Proposed contract-based revenue recognition principle
 - Rationale for proposing a single contract-based revenue recognition principle
 - Contractual rights and obligations
 - Changes in contractual rights and obligations
- IV. Proposed measurement approach
 - Measurement of performance obligations in the customer consideration approach
 - Invitation to comment on the use of estimated standalone selling prices
 - [Invitation to comment on whether there are types of performance obligations that call for remeasurement other than when deemed onerous]
- V. Effect of the proposed revenue recognition model on current practice
 - Description of the various assets and liabilities that underlie the different revenue recognition principles today (contracts, inventory, or cash).
 - Comparison to current practice in major areas
 - Invitation to comment on the appropriateness of a single revenue recognition principle for all contracts

Appendix: Other issues to be addressed in the exposure draft

- Brief explanation of main issues not covered in the paper but that will be addressed in the exposure draft
 - Boundary of the contract
 - Measurement of rights (eg contingent and uncertain consideration)
 - Display
 - Disclosure

Appendix C

ISSUES STILL TO BE ADDRESSED FOR A GENERAL REVENUE RECOGNITION STANDARD

- C1. This list is organised according to the headings used in most accounting standards: scope, recognition, measurement, display, disclosure, implementation guidance and illustrations, effective date, and transition guidance.

Scope

- C2. The Boards have already limited the scope of the standard to the recognition of revenues arising in contracts (for example, revenues from producing commodities are not in scope). The Boards have not considered whether any industries or types of contracts would be exempted from this general standard. (At this point, it is likely that insurance, leases, and financial instruments will be excluded.) The staff thinks that this will be the main issue to discuss when considering the comments on the DP. In particular, at this stage, the staff thinks that the Boards will need to consider the potential effect on some contracts accounted for under IAS 11 and SOP 81-1.

Recognition

- C3. *Contracts and enforceability.* Under the customer consideration approach, the contract is not recognised until one party to the contract performs. This approach places less stress on the issue of determining when a contract exists for accounting purposes compared with the exit price measurement approach. However the Boards still need to answer the following questions in relation to this issue:
- a. Is an agreement within the scope of the proposed model if the customer can effectively back out of or unwind the agreement with little or no consequence?
 - b. How should renewal (or cancellation) options be treated in the recognition of a contract? For instance, how should a three-year warranty contract that allows the customer to cancel at any point be treated?
 - b. When and how should contracts entered into (or contemplated) at the same time be combined?
 - d. How should contract modifications and scope changes be accounted for?
- C4. *Defining and identifying performance obligations.* Identifying performance obligations in a contract is an issue that requires further clarification. **The treatment of multiple-elements arrangements is one of the major problem**

areas in current literature that must be fixed in the new standard. The Boards will need to answer the following questions in relation to this issue:

- a. What (if any) guidance would be needed to assist in identifying performance obligations?
 - b. What (if any) guidance would be needed to assist in combining performance obligations into single units of account?
 - c. Do rights of return represent performance obligations? Do other similar stand-ready obligations represent performance obligations, such as (1) performance guarantees, (2) residual value guarantees, (3) non-patent-infringement guarantees, (4) minimum revenue guarantees, (5) obligations to dispose of electronic waste on behalf of the customer, (6) promotional promises, and (7) fixed-price guarantees?
 - d. How does the definition of performance obligations clarify gross versus net and agency issues in the current literature? Does an entity always recognize revenue when performance obligations are satisfied, even when those performance obligations are satisfied by a third party?
- C5. *Changes in a contract that lead to revenue recognition* (ie satisfaction of performance obligations). The Boards will need to answer the following question in relation to this issue:
- a. What constitutes satisfaction of a performance obligation? How much (if any) guidance will be required to make the notion of control or enforceable rights operable? Will the standard rely on the notion of control to determine when a performance obligation is satisfied, and will risks and rewards of ownership be ignored when they conflict with the notion of control?

Measurement

- C6. The Boards have expressed a preliminary view in favor of a customer consideration measurement approach. In other words, most Board members think performance obligations should be measured at inception at a proportion of the transaction price and it is the transaction price that should be reported as revenue over the life of the contract. Nonetheless the May discussions highlighted divergent views about the extent to which performance obligations would need to be remeasured to reflect changes other than the entity's performance. For instance, the majority of FASB members indicated that performance obligations would need to be measured *only* if deemed onerous. However, the majority of IASB members indicated that remeasurement would be required beyond just onerous contract cases. In addition, the Boards have not considered issues relating to measuring the rights in the contract. The treatment of contingent and uncertain consideration is a problematic area in current literature.

C7. Hence, the Boards need to answer the following questions in relation to measurement:

Rights

- a. How are rights measured? Does the measurement of rights take into account the time value of money? The customer's credit risk? How is non-cash consideration measured (eg if the customer pays with a fixed asset, trade credit, right to use an intangible asset, or even the right to use the customer's human resources)? How are barter transactions treated?
- b. How are variable and contingent rights measured? Are variable and contingent amounts ignored until they are no longer uncertain, or is there some form of expected weighting calculation or even an exit price measure of those rights?
- c. How are contract price adjustments reflected in the measurement of the contract and how do these affect recognised revenue? For example, consider (1) rebates (cash, eg based on annual credit card purchases, or product/other assets) (2) volume discounts, and (3) other sales incentives.
- d. If the time value of money affects the measurement of rights and performance obligations, is interest accrued on those rights and performance obligations? How is the interest reported?

Performance obligations

- e. What guidance will be required on estimating standalone selling prices when a good or service is never sold separately?
- f. For (a) and (b) above, what effect does the measurement (and potential remeasurement) of the rights have on the measurement of the performance obligations (given that in the customer consideration approach to date, the measurement of the performance obligations is deemed equal to the measurement of the rights)?
- g. When and how would a performance obligation be measured other than at an allocated amount? When would an allocated measure need to be updated (ie remeasured) after initial recognition (ie other than for performance)? For instance, when would a performance obligation be deemed to be onerous?³ If some types of performance obligations are required to be remeasured other than when onerous, how would they be remeasured? Might it be appropriate to measure some performance obligations at fair value?

³ The staff proposes that if a contract is deemed onerous it is measured in accordance with current requirements for onerous contracts.

Display

- C8. The Boards need to consider some issues related to how contracts, remeasurement of contracts, and revenue are displayed on the face of the financial statements:
- a. Should contracts that are net assets be reported separately from contracts that are net liabilities on the statement of financial position?
 - b. Should the rights and the obligations be reported separately in the statement of financial position, with a subtotal representing the net position of the contract, or should the contract simply be reported net? Are there situations in which the rights and obligations should be reported gross (for example, when a contract would require specific performance)?
 - c. How should remeasurements (eg due to onerous contract situations) be displayed on the statement of comprehensive income? When the related performance obligations are finally satisfied, is the full remeasurement amount reported as revenue, or only the original amount attributed to that performance obligation?

Disclosure

- C9. Inadequate disclosure is a weakness in current revenue accounting. The Boards need to deliberate this issue from scratch and the following questions:
- a. What is the overall objective of disclosures relating to contracts with customers and changes in those contracts?
 - b. What disclosures within the framework of the proposed model would meet the need users?
 - c. How would a disclosure requirement be crafted that would require entities to report their goods and services in meaningful segments?

Implementation guidance and illustrations

- C10. The Boards will need to craft some implementation guidance and illustrations to accompany this general standard.

Effective date and transition guidance

- C11. The staff notes that transition and consequential amendments are likely to be a significant issue in the US because of the large amount of current literature.

INTRODUCTION

1. The purpose of this paper is twofold:
 - a. to summarize the Boards' decisions in May 2008 regarding the measurement approach for a general standard on revenue recognition. The staff will ask the Boards to affirm these decisions and the rationale(s) supporting them so that they can be included in the discussion paper that will be published in the coming months.
 - b. to clarify the circumstances in which the Boards would remeasure performance obligations after contract inception. The FASB expressed a preliminary view in which performance obligations would be remeasured *only* if they are deemed to be onerous. The IASB agreed that performance obligations should be remeasured if deemed to be onerous, but also suggested other circumstances in which a performance obligation might be remeasured. This paper seeks to clarify what those additional circumstances are in order to gauge how far apart the two Boards are on this issue. The information gathered in this month's meetings will help the staff determine how much time to allot for additional deliberations on this matter as the Boards move toward an exposure draft.

MEASUREMENT AT CONTRACT INCEPTION

2. From an entity's perspective, a contract represents inflows of payments from the customer (rights) and outflows of goods and services to the customer (obligations). To recognize a contract with a customer, the entity must measure those rights and obligations. The Boards have not discussed how to measure the rights in a contract, but the staff plans to ask the Boards to consider the issue in the third quarter of 2008.
3. Although the Boards have not discussed the measurement of rights, they have reached a tentative decision on the measurement of performance obligations. At contract inception (i.e., before either party has performed), performance obligations are measured equal to the transaction price in the contract.¹ This amount is often referred to as the customer consideration amount. Because both the rights and the performance obligations in the contract are measured equal to the transaction price, the contract is recognized at a net nil position at inception. Neither an asset nor a liability is recognized at the inception of the contract.

¹ The transaction price would likely be adjusted for the time value of money (if payments are made over an extended period of time) and customer credit risk. These adjustments relate to the measurement of rights, which the Boards have not yet deliberated.

Because there is no increase in a contract asset or decrease in a contract liability, no revenue is recognized at contract inception.

4. Although the Boards agreed to recognize a contract at a net nil position at inception, two different views exist as to *why*.

View A

5. Some Board members think that performance obligations (i.e. the outflows of goods and services) should be measured equal to the transaction price (i.e. the inflows of consideration) because the transaction price represents the negotiated price between a willing buyer and a willing seller. That is to say, because the transaction price represents the amount the customer is willing to pay for the goods and services to be provided in the contract, that price serves as a meaningful measure of the performance obligations in the contract.
6. These Board members also think an entity should not recognize revenue before it has provided a good or service promised in the contract—that is to say, before a performance obligation is satisfied. These Board members acknowledge that a contract with a customer may be an asset to the entity, but they do not think an entity should recognize revenue for the obtaining of a contract. The decision to measure performance obligations at the transaction price precludes revenue from being recognized for the obtaining of a contract.

View B

7. Other Board members agree that performance obligations should be measured at the transaction price in the contract, but for a different reason. Ideally, these Board members think that a performance obligation should be measured directly at the price to satisfy the performance obligations (i.e., a fulfillment price). This is because a fulfillment price (whether an exit price or an entity's own fulfillment price) measures only the remaining economic resources the entity is required to transfer to the customer. Said differently, they think that measuring the outflows in a contract should ideally be done by focusing directly on those future outflows rather than on the inflows, which they think are intended to cover both past and future outflows.
8. These Board members acknowledge that a fulfillment price measure for the performance obligations will typically lead to the recognition of a contract asset at the inception of a contract with a customer. Conceptually, this makes sense to these Board members because the focus of the proposed model is on contracts with customers. In concept, they think that revenue should be recognized when a contract asset increases (from the obtaining of a contract or the satisfaction of a performance obligation) or a contract liability decreases (from the satisfaction of a performance obligation).
9. However, although these Board members prefer a fulfillment price for these conceptual reasons, they think the costliness and complexity of estimating such a

price is unjustified given that the transaction price in the contract is a relatively straightforward, observable, and reasonable proxy for a fulfillment price. Moreover, these Board members worry that any mistake in identifying and measuring performance obligations at contract inception would affect the amount of the contract asset and revenue that would be recognized. As a result, these Board members reject a fulfillment price measurement approach and conclude that at contract inception, the rights and the performance obligations should be measured equal to the transaction price in the contract.

The need to distinguish between View A and View B

10. Distinguishing between these two views is important to standard setters because the basis for this conclusion will serve as the basis for applying the resulting standard to new situations in the future. View A suggests that no matter how observable or costless to obtain a fulfillment price measurement might be, the Boards would still not favor the recognition of a contract asset and revenue at contract inception. This is because no performance obligation in the contract has been satisfied at contract inception.
11. In contrast, View B suggests that the Boards might decide at some future point that in situations in which a fulfillment price is observable and relatively inexpensive to obtain, that price would be used to measure the bundle of performance obligations—especially if the fulfillment price for those obligations materially departs from the transaction price. As a result, a contract asset would likely be recognized at contract inception in these situations with a corresponding amount of revenue also being recognized.
12. The staff is not asking the Boards to vote for one of these two views in this meeting. It is only asking whether the two views have been expressed accurately. At this point, the staff intends to include both views in the discussion paper to explain why the Boards have tentatively decided that performance obligations should be measured at the transaction price in the contract.
13. In summary, for two fundamentally different reasons, the Boards have expressed a preliminary view in favor of measuring both the rights and the performance obligation in a contract equal to the transaction price at contract inception. As a result, neither a contract asset or liability is recognized at contract inception, nor is any revenue recognized at that point.

Q1: Does the Board agree with the description of the measurement approach for performance obligations at contract inception? If not, what changes need to be made?

Q2: Does the Board agree that paragraphs 5-9 faithfully reflect the two views supporting the decision to measure performance obligations equal to the rights at contract inception? If not, what changes need to be made?

Q3: Does the Board agree that both views should be included in the discussion paper?

SUBSEQUENT MEASUREMENT

14. After contract inception, revenue is recognized when the entity satisfies a performance obligation in the contract. This is because when a performance obligation is satisfied, either the entity's contract asset increases or its contract liability decreases (or both). Hence, after contract inception, the point at which performance obligations are satisfied determines *when* revenue is recognized. However, the *amount* of revenue recognized depends on the amount of the increase in the contract asset or the decrease in the contract liability. Effectively, this amount is determined by how much the measure of remaining performance obligations decreases when a given performance obligation is satisfied.

Allocation approach

15. The Boards have expressed a preliminary view in favor of an allocation approach to measure how much performance obligations decrease when an entity satisfies a given performance obligation. According to this view, the transaction price used to measure the bundle of performance obligations at contract inception is allocated to individual performance obligations based on the entity's separate selling prices of the promised economic resources (i.e., goods and services). The amount allocated to each performance obligation at inception is then recognized as revenue when that particular performance obligation is satisfied. This approach negates the need to remeasure the remaining performance obligations in subsequent periods to determine how much revenue to recognize in those periods.
16. The following example illustrates this approach:

On 1 February, EngineeringCo enters into a contract to provide and install a machine. The enforceable rights to the machine transfer on its delivery to the customer on 31 March. The machine is installed in the first two weeks of April. The customer pays the contract price of CU100,000 on delivery of the machine.

Suppose EngineeringCo sells the machine separately for CU95,000. It sells installation services separately for CU10,000. Based on these separate selling prices, the CU100,000 transaction price would be allocated to the two performance obligations as follows:

	<i>Observed selling price</i>	<i>Allocation of discount</i>	<i>Measurement of performance obligation</i>
Machine	95,000	4,524	90,476

Installation	10,000	476	9,524
	<u>105,000</u>	<u>5,000</u>	<u>100,000</u>

At 31 March, the remaining performance obligation would be measured at CU9,524 and revenue of CU90,476 would be recognized. When the obligation to provide installation service is satisfied, the remaining performance obligations would be measured at CU0 and revenue of CU9,524 would be recognized.

- 17. In this example, the entity sells both the machine and installation services separately, so the transaction price of the entire contract is allocated to the promised good and service based on the separate selling prices of each. In many situations, the entity may not actually sell a promised good or service separately. When this is the case, the entity must estimate the price at which it would sell the good or service separately so that the transaction price can be allocated to all performance obligations in the contract.
- 18. When estimating the price at which it would sell a good or service that it currently does not sell separately, an entity should use the price a competitor would charge separately in the same market for the identical good or service as a starting point for its own estimate. If the identical good or service is not sold separately by the entity or others, the entity must still estimate a selling price.
- 19. The following example illustrates an approach to estimating a separate selling price when neither the entity nor its competitors sell a particular good or service separately:

On 2 January, SoftwareCo enters into a contract to create a software program for the sole use of the customer and to provide two years of post contract support (PCS) to the customer. This software is not sold by any other competitor, nor is PCS for this particular software sold by any other competitor. The enforceable rights to the software transfer to the customer on June 30 (at the point of delivery), while the benefit of the PCS transfers to the customer over the ensuing two years. The customer pays the entire contract price of CU400,000 on delivery of the software.

Because neither SoftwareCo nor any other entity sells this particular software separately, SoftwareCo must estimate a separate selling price for the software. Similarly, because no entity sells PCS for this particular software separately, SoftwareCo must estimate a separate selling price for the PCS.

SoftwareCo decides that a reasonable approach to determine the separate selling prices of the software and the PCS is to estimate the cost-weighted labor hours needed to create the software and provide PCS. (Of course, other costs might also be included in this estimation process, but in this situation, these costs are

relatively insignificant and likely would not affect the allocation of transaction price to the performance obligations.)

SoftwareCo estimates 2,000 hours of programmer time at an hourly labor cost of CU100 to create the software (for a total of CU200,000). Although the number of hours is not observable, the hourly labor cost is observable on internal records and corroborated by industry trade reports on current programmer salaries.

SoftwareCo estimates 600 hours of PCS in year one and 400 hours in year two and an hourly labor cost of CU70 to provide this support (for a total of CU42,000 in year one and CU28,000 in year two). Again, the number of hours is not observable, but the hourly labor cost for PCS is observable on internal records and corroborated by industry and trade reports on PCS personnel salaries.

Because SoftwareCo has never sold software programming separately from PCS, it has no entity-specific data to suggest that margins for software programming are different from margins for PCS. However, industry reports suggest that margins on programming and PCS are roughly the same when they are sold separately. As a result, SoftwareCo assumes that margins on its programming and PCS are the same. This leads to the following allocation of the contract transaction price across the three performance obligations in the contract:

	<i>Estimated labor cost</i>	<i>Percentage of total labor cost</i>	<i>Measurement of performance obligation</i>
Software	CU200,000	74	CU296,296
PCS-Year 1	42,000	16	62,222
PCS-Year 2	28,000	10	41,482
	<u>CU270,000</u>	<u>100</u>	<u>CU400,000</u>

At 30 June, the remaining PCS performance obligations would be measured at CU103,704 and revenue of CU296,296 would be recognized. When the obligation to provide the first year of PCS is satisfied (probably continually throughout that year), the remaining obligation of PCS would be measured at CU41,482 and revenue of CU62,222 would have been recognized. Finally, when the obligation to provide the last year of PCS support is satisfied, revenue of CU41,482 would have been recognized.

20. This example illustrates just one way in which an entity might reasonably determine separate selling prices for the individual performance obligations in a contract. Moreover, this estimation approach is necessary only when neither the entity nor its competitors sell a particular good or service separately. When the entity sells the identical good or service separately, the separate selling price of

that good or service should be used as the basis on which to allocate the transaction price.

21. It is important to note that the fact that a particular good or service is not sold separately by the entity or any other entity does not preclude the allocation of transaction price to the related performance obligation in the contract. This represents a significant departure from current US literature for contracts subject to EITF 00-21 *Revenue Arrangements with Multiple Deliverables* and SOP 97-2 *Software Revenue Recognition*. These standards generally require vendor-specific evidence or other forms of objective evidence to substantiate the selling price of a particular good or service.

An exception to the allocation approach

22. Some Board members have suggested a limited exception to the allocation approach described above. This exception would apply when goods or services identical to those promised in a contract are traded in an active market (to which the entity has access) with pricing information available on an ongoing basis. In this situation, the promise to transfer such a good or service should be measured at the quoted price in the active market. Any remaining balance of the contract transaction price is allocated to all other performance obligations in the contract on a relative selling-price basis.
23. The staff questions the usefulness of this exception for two reasons. First, the exception appears to apply to a very limited set of circumstances—principally those in which an entity promises to transfer a commodity or a financial instrument to a customer. Given that many of these promises are already covered by literature dealing with derivatives and financial instruments, the staff questions the usefulness of including this exception in a general standard on revenue.
24. Second, the staff thinks this exception is not likely to provide information that is any more useful than the information already provided by the allocation approach. In settings in which an entity is promising to transfer a commodity or financial instrument (or other similar resource traded on an active market), the entity typically is also promising to provide other services such as broker services. Although the broker services and the commodity or financial instrument are distinct economic resources, they transfer to the customer at the same time. As a result, they would be treated as a single performance obligation in the proposed model. Measuring the commodity or financial instrument obligation at a market quoted price and allocating any excess consideration to the broker service obligation would not provide any more useful information than simply measuring the combined obligations at the transaction price.
25. Given these arguments, the staff recommends that an exception to the allocation approach not be permitted simply because a promised good or service is traded on active markets with quoted prices that are available on an ongoing basis.

Rejected alternatives

26. The Boards considered the possibility of remeasuring the contract after each performance obligation is satisfied (using either a current selling price or exit price for the remaining bundle of goods and services) instead of using a locked-in allocation approach. Any increase in the remeasured contract asset or decrease in the remeasured contract liability would lead to the recognition of revenue. However, the Boards rejected this remeasurement approach in favor of an allocation approach for two primary reasons.
27. First, the Boards think there are few circumstances in which remeasurement would provide significantly more useful information to users than the locked-in allocation approach described in this section. In other words, the Boards do not think a remeasurement of the remaining performance obligations at each reporting date would provide significantly more useful information than a locked-in allocation that is determined at contract inception.
28. Second, remeasuring the contract as each performance obligation is satisfied would almost always require some form of estimation. Board members did not think that continually revising these estimates would be worth the cost. Although the allocation approach at contract inception sometimes requires estimation of selling prices, this estimation process is required much less frequently than would be needed to remeasure the contract at each reporting date.
29. In summary, the Boards have expressed a preliminary view in favor of an allocation approach because it provides a straightforward, cost beneficial means of determining the change in the contract asset or liability when a performance obligation is satisfied and hence the amount of revenue to be recognized. This means that after initial recognition, the remaining performance obligations in a contract are measured at the amount of the transaction price allocated to those obligations at contract inception.

Q4: Does the Board agree with the description of the allocation approach in this section, including the recommendation not to allow any exceptions to the allocation approach? If not, what changes need to be made?

Q5: Does the Board agree that the example of estimating a separate selling price in this section is a reasonable illustration of a potential estimation process? If not, what changes need to be made?

Q6: Does the Board agree that paragraphs 26-28 faithfully reflect the basis for choosing the allocation approach? If not, what changes need to be made?

REMEASUREMENT OF PERFORMANCE OBLIGATIONS

30. The Boards rejected the approach in which the contract would be remeasured to determine by how much a contract asset has increased or a contract liability has decreased after each performance obligation is satisfied, and hence how much revenue should be recognized. Instead, the Boards selected a locked-in allocation approach as a way of determining by how much a contract asset has increased or a contract liability has decreased after a performance obligation is satisfied.
31. Although this approach is arguably less complex than a remeasurement approach, the Boards acknowledge that a locked-in allocation approach sometimes will not provide a faithful depiction of the obligation to transfer economic resources to a customer. For example, if the estimated remaining costs to satisfy a performance obligation exceed the original amount allocated to that performance obligation (i.e. the performance obligation is deemed “onerous”), the allocated amount may significantly understate the economic resources required to satisfy that obligation.
32. In the May Board meetings, both Boards decided tentatively that performance obligations that are deemed onerous should be remeasured upward with a loss recognized in the statement of comprehensive income.² When that performance obligation is later satisfied, the Boards decided that the original allocated amount for that performance obligation would be recognized as revenue, and the upward adjustment due to the onerousness of the obligation would be reversed and recognized as a gain in the statement of comprehensive income. In other words, remeasurement of the performance obligation due to the onerousness of that obligation affects comprehensive income, but does not affect recognized revenue.
33. Although both Boards decided tentatively to remeasure performance obligations when onerous, they differed in their willingness to remeasure performance obligations for other reasons. The FASB decided that performance obligations would be remeasured *only* if they are deemed to be onerous. The IASB noted that performance obligations *might* be remeasured for circumstances beyond the onerousness of the performance obligation. This section of the paper seeks to clarify what those additional circumstances are in order to gauge how far apart the two Boards are on this issue.

Availability of observable current exit prices

34. Some Board members have suggested that remeasurement might be justified when an observable current exit price exists for a particular performance obligation and the entity can lay off the performance obligation at that price. These Board members think that a regularly observable exit price for an identical performance obligation on the market should be used.

² The Boards have not determined the specific details of what an onerous contract test would entail (e.g., is it based on a loss trigger or a minimum margin trigger). The Boards intend to deliberate this issue at a future point in the project.

35. When such an exit price is observable at contract inception, some Board members have already suggested that this price should be used instead of an allocation (see paragraphs 22-25). If an observable current exit price for these same performance obligations exists after contract inception, these Board members think it should be used instead of locking in the original measurement for that obligation.
36. The staff questions how often a regularly observable current exit price would be available, even for performance obligations that have an exit price at contract inception. In fact, it is difficult to think of any examples in which an observable current exit price is available except in the case of commodities and some financial instruments. Given that current exit prices are not observable after contract inception for most performance obligations other than for commodities and some financial instruments, the staff questions whether it is worth complicating the model by including a remeasurement approach for this small set of circumstances.

Q7: Does the Board agree that there are very few (if any) performance obligations aside from promises to transfer commodities and some financial instruments that have a regularly observable exit price? If not, what other performance obligations come to mind?

Q8: Does the Board agree that the existence of observable current exit prices for performance obligation after contract inception is not sufficient cause to remeasure performance obligations?

Uncertain, long-term performance obligations

37. Another situation in which some Board members have suggested they would remeasure performance obligations rather than locking in the original measurement is when a performance obligation spans many reporting periods and the economic resources necessary to satisfy the obligation are highly uncertain or unpredictable. Some have suggested long-term insurance and construction contracts give rise to just such performance obligations. Even if an updated measure of these performance obligations is not observable, these Board members think some form of updated measurement would be more useful than a locked-in measurement.
38. Given that the Boards have already agreed that remeasurement is required for performance obligations that are deemed onerous, the concern in measuring these uncertain, long-term performance obligations must rest on *when* a remeasurement is triggered. A number of Board members have expressed this very concern—that remeasurement for onerous obligations can lead to surprises. Supposedly, an obligation that is not yet loss making but is headed that direction is invisible to financial statement users. However, the moment that obligation becomes loss

- making, a loss is immediately recognized in the statement of comprehensive income because the obligation is remeasured upward.
39. One of the reasons such surprises happen is that management has some discretion in estimating expected remaining costs when comparing those costs to the locked-in measure of the performance obligation. If management decides that they want to take more losses in a particular reporting period, they can increase their estimates of remaining costs and trigger the onerous obligation adjustment. The fact that remeasurement may require that a margin be added to any remaining costs only exacerbates the potential surprise and increases the subjectivity in the remeasurement of the performance obligation.
 40. Board members who suggest that uncertain, long-term performance obligations should be remeasured at each reporting date think that such an approach will decrease the number of surprises that would result under the more limited onerous-test approach. To the extent that a remeasurement approach would be applied more frequently than an onerous test approach, fewer surprises are likely to occur. That said, the staff questions whether a cost-beneficial improvement in the information provided to users would result from a remeasurement approach.
 41. Another difficulty with the suggestion to remeasure long-term, uncertain performance obligations is defining what those obligations are. It is not as simple as saying that all stand-ready obligations should be remeasured because many stand-ready obligations are not long-term and their outcomes are reasonably predictable. Even some longer term stand-ready obligations, for instance some three-year warranties and some long-term life insurance contracts, are reasonably predictable. Given the difficulty of defining this class of obligations to be remeasured, the staff again questions whether such an exception can be articulated.
 42. The staff recommends that a remeasurement approach not be sought for uncertain, long-term obligations. Aside from the fact that such obligations would be difficult to define and identify in a principled way, it is likely that an improved onerous test that is based on a more conservative trigger (e.g., one that requires an adjustment when, say, 50 percent of the originally anticipated margin is wiped out instead of 100 percent being wiped out) might address Board members' concerns about surprise losses related to these obligations.
 43. The staff notes that this recommendation for a general standard on revenue recognition has implications for the IASB's deliberations on insurance. On that project, the IASB decided that insurance contracts, which often include long-term uncertain obligations, should be remeasured.

Staff recommendations on remeasurement

44. Given the arguments in this section and the examples that Board members have raised in the past, the staff recommends that the Boards not remeasure any

performance obligations after contract inception unless the obligation is deemed onerous. In the near future, the staff will ask the Boards to consider if and how they would want to apply an onerous test to performance obligations in a general revenue recognition standard. This discussion will consider both the trigger for an onerous adjustment and the extent to which existing literature provides adequate guidance on how to remeasure obligations that are deemed onerous.

Q9: Does the Board agree that the primary concern with a locked-in allocation approach for uncertain, long-term performance obligations is that the approach sometimes leads to significant, negative surprises when an onerous adjustment is triggered? If not, why do some Board members want to continuously remeasure these types of performance obligations?

Q10: Does the Board agree that a reconsideration of onerous tests has the potential to resolve Board members' concerns about the surprises that can happen in a locked-in allocation approach?

Q11: Is there any other circumstance not mentioned in this section for which Board members would want to remeasure performance obligations at each reporting date?

Q12: Assuming the answer to the previous question is no, does the Board agree that performance obligations should be remeasured *only* if they are deemed onerous?

CONCLUSION

45. The purpose of this paper has been to summarize and clarify the Boards' recent decisions on measuring contracts with customers. In particular, the staff is seeking the Boards' affirmation of their decision to measure performance obligations equal to the transaction price at contract inception and then not to remeasure those performance obligations unless they are deemed onerous. The staff is also seeking clarification of the circumstances (beyond an onerous obligation) in which some of the IASB Board members would want to remeasure performance obligations. Based on an initial analysis of what the staff thinks those circumstances are, the staff is recommending that the Boards decide not to remeasure performance obligations unless they are deemed to be onerous.



Board Meeting Handout
FAIR VALUE PRACTICABILITY EXCEPTION

July 16, 2008

PURPOSE

The purpose of this meeting is to discuss whether to retain the practicability exception for measuring fair value in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

ISSUE

Statement 140 requires that a **transferor** initially recognize and measure all assets obtained and liabilities incurred at fair value, if practicable. When it is not practicable to estimate fair value, no gain on the transfer can be recognized by the transferor. Statement 140 also requires that a **transferee** recognize and initially measure all assets obtained and any liabilities incurred at fair value. However, the Statement does not provide a fair value practicability exception for the transferee.

FASB Statement No. 157, *Fair Value Measurements*, retained the practicability exceptions for fair value measurements in certain accounting pronouncements within the scope of Statement 157, including the one provided in Statement 140. As discussed in the basis for conclusions in Statement 157, the Board acknowledged that practicability exceptions would create inconsistencies but decided for practical reasons not to address those inconsistencies at that time. However, the Board indicated that issues related to some practicability exceptions would be addressed in other agenda projects.

STAFF RECOMMENDATION

The staff recommends that the fair value practicability exception be removed from Statement 140 in its entirety.

Q1. Does the Board agree with the staff's recommendation to remove the fair value practicability exception in Statement 140 in its entirety?



Board Meeting Handout

POSTRETIREMENT BENEFIT OBLIGATIONS INCLUDING PENSIONS

July 16, 2008

PURPOSE

The purpose of this meeting is to begin redeliberations for the proposed FSP FAS 132(R)-a, *Employers' Disclosures about Postretirement Benefits Plan Assets*, and to address significant issues raised in comment letters to the proposed FSP relating to the disclosures about categories of plan assets and concentrations of risk.

BACKGROUND

Proposed FSP FAS 132(R)-a was issued March 18, 2008, with a 45-day comment period ending May 2, 2008. We received 45 comment letters which are summarized in the comment letter summary and available on the FASB website.

The objective of the proposed FSP is to improve transparency about the types of assets held in postretirement benefit plans by amending FASB Statement No. 132(R), *Employers' Disclosures About Pensions and Other Postretirement Benefits*, to include the following:

- a. A principle for disclosing the fair value of categories of plan assets based on the types of assets held in postretirement benefit plans
- b. Examples of significant categories of plan assets
- c. Disclosure of the nature and amount of concentrations of risk arising within or across categories of plan assets
- d. Disclosures about fair value measurements, similar to those required by FASB Statement No. 157, *Fair Value Measurements*.

CATEGORIES OF PLAN ASSETS

Respondents raised several issues relating to the disclosure of categories of plan assets that warrant further consideration by the Board. Those are:

Issue #1: Should investment vehicles (for example, mutual funds, hedge funds, and investment trusts) or their underlying holdings be disclosed as categories of plan assets?

Issue #2: The examples of categories of plan assets listed in the proposed FSP should be changed.

Issue #3: Materiality guidance should be provided for identifying significant plan asset categories.

Issue #1

The proposed FSP requires disclosure of categories of plan assets based on the types of assets held in postretirement plans. Some respondents concluded that the principle of disclosing categories based on the type of plan asset should be clarified to indicate whether a plan's ownership interest in an investment vehicle should be disclosed as a category (for example, "mutual funds"), or if the underlying holdings of those investment vehicles should be disclosed as categories (a "look through" principle). The staff thinks the alternatives are as follows:

Alternative A: Modify the current principle by requiring companies to "look through" to the underlying holdings of investment vehicles (such as mutual and hedge funds) in determining the types of assets to disclose as categories. For indirect investments, asset types would be based on the underlying holdings of investment vehicles.

Alternative B: Retain the current principle of disclosing categories of plan assets based on asset type, but modify the list of categories in the proposed FSP to include other types of investment vehicles, such as mutual funds (see Issue #2). For indirect investments, asset types would be based on the plan's interest in the investment vehicles themselves and not the underlying investments.

Alternative A would result in disclosure of more detailed categories of plan assets that would be more responsive to users' concerns about what types of assets are held in postretirement benefit plans, such as mortgage backed securities and collateralized debt obligations. However, Alternative A would be more costly to implement.

Alternative B would be less costly for employers to implement than Alternative A. Alternative B would result in broad categories of plan assets for companies that do not make direct investments because they would disclose the type of investment fund as a category (for example, mutual funds). Alternative B would not provide any information about the underlying holdings of investment vehicles unless the Board chooses to retain the concentrations of risk disclosures (see Concentrations of Risk section below).

Question 1:

Should Alternative A or B be used as the principle for disclosing categories of plan assets?

Issue #2

The proposed FSP listed several examples of categories of plan assets that should be disclosed based on the principle of disclosing categories by asset type. Some respondents preferred additional or different categories, while others thought there should be fewer categories.

The categories listed in the proposed FSP complement the principle, are similar to those listed in other FASB Statements (for example, the derivatives categories listed in the proposed FSP are the same as those listed in FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*), and emphasize that employers should disclose categories that are specific and not too broad. However, the list should be modified based on the Board's decision in Issue 1 as follows:

Alternative A: Eliminate the categories listed in the proposed FSP for private equity, hedge, and venture capital funds (this corresponds with Alternative A in Issue 1 above).

Alternative B: Modify the categories of plan assets listed in the proposed FSP to clarify that other types of funds (such as mutual funds) should be disclosed as categories and not their underlying assets (this corresponds with Alternative B in Issue 1 above).

Question 2:

Should the list of categories of plan assets in the proposed FSP be modified in accordance with Alternatives A or B?

Issue #3

Respondents requested more guidance on how to determine whether a category of plan assets is significant and suggested that the proposed FSP include a category for disclosing plan assets identified as insignificant.

Alternative A: Include a de minimis or immaterial category within the list of categories in the standards section and in the illustration.

Alternative B: Do not provide guidance on how to disclose insignificant plan asset types.

Question 3:

Does the Board prefer Alternative A or B?

CONCENTRATIONS OF RISK

Respondents raised several significant issues relating to the disclosures about concentrations of risk in plan assets that warrant further consideration by the Board. Those are issues with:

Issue #4: Understandability,

Issue #5: Applying the disclosures to the underlying assets of certain funds.

Issue #4

The proposed FSP would require employers to disclose the nature and amount of a concentration of risk arising within or across categories of plan assets. Examples of concentrations of risk include, but are not limited to, significant investments in a single entity, industry, country, commodity, or investment fund.

Some respondents concluded that this requirement is too vague, while others suggested using the requirements in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, instead. Those respondents noted that they are already familiar with Statement 107's requirements to disclose concentrations of credit risk. On the other hand, some respondents concluded that the proposed FSP's language is understandable because it is similar to Statement 107. Therefore, the alternatives are:

Alternative A: Retain the disclosures as proposed in the FSP

Alternative B: Require the disclosures about concentrations of credit risk in Statement 107 and eliminate the requirement to disclose concentrations of risk in the proposed FSP.

Question 4:

Does the Board prefer Alternative A or B?

Issue #5

Some respondents were concerned about their ability to disclose concentrations of risk within investments in certain funds, such as hedge, pooled, or mutual funds. They noted that it would be difficult to obtain the information at a level of detail necessary to determine whether a concentration of risk exists because the information is not currently obtained on a timely basis, or is not available due to proprietary reasons.

Alternative A: Retain the existing disclosures for concentrations of risk.

Alternative B: Require that employers disclose:

- (i) the types of funds (for example, hedge funds) for which they are unable to make a concentrations of risk assessment,
- (ii) the fair value of their interest in those funds,
- (iii) the reason why they are unable to make an assessment of concentrations of risk for those funds (for example, for proprietary reasons), and
- (iv) concentrations of risk in investment strategies for those funds. For example, if a company invests in 20 hedge funds, and 15 of them follow the same strategy, a description of the strategy and the amount of plan assets dedicated to that strategy would need to be disclosed.

Alternative C: Do not require disclosures about concentrations of risk.

Question 5:

Does the Board prefer Alternative A, B, or C?