AGENDA*

8:30-8:40 1. Introductory Remarks and Announcements (Dennis Chookaszian) 10 minutes

8:40-9:00 2. Report of the FASB Chairman, including Status of Certain FASB Projects (Bob Herz) Attachments A-1 and A-2 20 minutes

9:00-9:10 3. Report of the SEC (Jenifer Minke-Girard) 10 minutes

9:10-9:20 4. Report of the PCAOB (Greg Scates) 10 minutes


10:10-10:25 BREAK 15 minutes

10:25-11:55 6. Revenue Recognition Introduction (5-10 minutes) Breakout sessions (65-70 minutes) Summary of key points (15 minutes) (Jeff Wilks, Kenny Bement, Sue Bielstein, and George Batavick) Attachment C 90 minutes

11:55-12:15 7. Statement 133 Projects (Kevin Stoklosa and Tom Linsmeier) Attachment D 20 minutes

12:15-12:30 * Recognition of Departing FASAC Members 15 minutes

12:30-1:15 LUNCH 45 minutes

1:15-2:00 8. Planning FASAC Input on FASB Agenda Setting: Methods and Desired Output (Dennis Chookaszian and Alicia Posta) Attachment E 45 minutes

2:00-2:30 9. Potential Project on Intangible Assets (Ron Bossio and Sue Bielstein) Attachment F 30 minutes

2:30-3:00 10. XBRL Discussion (Dennis Chookaszian and Tom Saleh) Attachment F 30 minutes

3:00 ADJOURNMENT

3:15-5:00 11. Optional Education Session Part 1 of 2: Codification and XBRL (Tom Hoey and Tom Saleh)

* TIMES ARE APPROXIMATE.
FASAC MEETING
DECEMBER 6, 2007
FASB CHAIRMAN’S REPORT

- TECHNICAL ACTIVITIES
- CODIFICATION
- INTERNATIONAL
- WASHINGTON, DC
ITEM 1: TECHNICAL ACTIVITIES

BOARD AND STAFF ACTIVITIES

a. Documents issued:

b. Projects added to the Board’s agenda:
   1. Project to address implementation issues raised by constituents about AICPA SOP 07-1, including its interaction with FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities.
   2. Project to address the need for guidance for not-for-profit organizations concerning donor-restricted endowment funds in response to the model Uniform Prudent Management of Institutional Funds Act of 2006.
   3. Project to clarify the interaction between FASB Statement No. 13, Accounting for Leases, and FASB Statement No. 157, Fair Value Measurements.
   4. Project to address the accounting for convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement).
   5. Project to address disclosures about contingencies (Phase 1) and recognition and measurement of certain nonfinancial liabilities (Phase 2).

c. Projects removed from the Board’s agenda:
   1. The Board decided not to finalize proposed FSP FAS 154-a, “Considering the Effects of Prior-Year Misstatements When Quantifying Misstatements in Current-Year Financial Statements.”
   2. The Board removed from its agenda its separate projects on (a) going concern and liquidation basis of accounting and (b) subsequent events. The Board will address related issues in its codification project.
d. Public Roundtable and other meetings:

1. The Board held a public roundtable with respondents to the FASB Exposure Draft, *Accounting for Financial Guarantee Insurance Contracts*, to discuss significant issues raised in comment letters.

2. Members of the Board met with members of the Joint International Group and the Financial Institutions Advisory Group, the Board’s advisory groups on its financial statement presentation project, to discuss significant issues being addressed in that project.

e. Emerging Issues Task Force (EITF):

1. The EITF reached consensuses for exposure on the following Issues. The comment period ended on October 22, 2007:
   - EITF Issue No. 07-1, “Accounting for Collaborative Arrangements”
   - EITF Issue No. 07-4, “Application of the Two-Class Method under FASB Statement No. 128 to Master Limited Partnerships”
   - EITF Issue No. 07-6, “Accounting for the Sale of Real Estate When the Agreement Includes a Buy-Sell Clause.”

f. Six Board members participated in the September EITF meeting.

g. At the September 26, 2007 Board meeting, the Board ratified the EITF consensuses-for-exposure (reached at the September 11, 2007 EITF meeting on Issues No. 07-1, No. 07-4, and No.07-6. The Board also approved issuance of a draft abstracts for each Issue for public comment.

h. The Board met publicly with representatives of the AICPA Private Companies Practice Section, Technical Issues Committee to discuss matters of mutual interest.

i. The Investors Technical Advisory Committee met in closed session to discuss a number of topics, including fair value of financial instruments, intangible assets, Statement 140, and international convergence issues.

j. Two Board members and staff met in closed session with members of the Financial Institutions Accounting Committee (FIAC) of the Financial Managers Society. FIAC members presented their views and questions on measurement of loans held for sale and other implementation issues related to Statements 157 and 159, the proposed FASB Staff Position on repurchase finance transactions, the Exposure Draft on disclosures about derivative instruments, the financial statement presentation project, and allowances for loan and lease losses.

k. Two Board members met with a representative from Graham Fisher & Co., Inc., to discuss banking regulatory issues.

l. Three Board members and the TA&I director met with representatives from the Center for Audit Quality to discuss matters of mutual interest.
m. Two Board members, the TA&I director, and staff met with Edison Electric Institute and American Gas Association to discuss hedge accounting and Statement 157 fair value measurements implementation issues.

n. Staff members (Financial Statement Presentation team) participated in a web conference call with representatives of PwC to discuss preliminary results of their Performance Statement Survey.

o. Staff members (Financial Statement Presentation team) met with real estate industry representatives to discuss a global real estate financial statement model that is being developed.

p. Staff members held two phone meetings with members of NACUBO’s Accounting Principles Council, representatives from Moody’s Investor Services and Fitch Ratings, a state regulator from New Hampshire, and several other constituents to discuss UPMIFA’s potential ramifications.

q. One staff member had a quarterly meeting with the AICPA NFP Expert Panel in NYC to discuss UPMIFA and to update the panel on the FASB’s activities. In October, they met again for follow-up discussion on UPMIFA, to update the panel on other FASB activities, and to discuss other topics of mutual interest.

r. One staff member updated the AICPA Health Care Expert Panel by phone on the FASB’s current activities.

s. One staff member participated in a roundtable meeting with The Urban Institute Center on Nonprofits and Philanthropy and the Hauser Center for Nonprofit Organizations Harvard University on IRS Form 990 Redesign.

t. One staff member participated in a panel discussion with the International Swaps and Derivatives Association, Inc., on implementation of Statements 157 and 159.

u. One staff member participated in an AICPA webcast to discuss implementation of Statement 157.

v. Staff members had a follow-up phone meeting with representatives from the IRS to discuss reconciliation issues between GAAP financial statements and the IRS Form 990.

w. Staff members met with a subgroup of ITAC to discuss the two revenue recognition models developed over the past year.

INTERNATIONAL ACTIVITIES

a. Six Board members, the MP&T director, and staff members met with the Financial Statement Presentation project’s Joint International Group and Financial Institutions Advisory Group to discuss various issues in that project.
b. The chairman, a Board member, and staff attended the World Standard Setters meeting in London.

c. The PD&S director attended a meeting of the Standards Working Group of the six largest accounting firms in London.

d. Three Board members and the director of MP&T met in closed meetings with members of the Accounting Standards Board of Japan in Norwalk.

e. The FASB and the IASB held a semiannual joint meeting in Norwalk. The Boards discussions included various technical issues on the Boards’ joint projects on financial statement presentation, the conceptual framework, revenue recognition, leasing, and accounting principles for derecognizing financial assets.

f. We are finalizing the arrangements for a secondee from the Accounting Regulatory Department of the Ministry of Finance, China. This person will join the FASB staff in the near future for one year.

OTHER ACTIVITIES

a. The following professional development sessions were presented to the Board and staff:

1. Todd Johnson, FASB Senior Technical Advisor, Ron Bossio, FASB Senior Project Manager, and other FASB staff discussed unit-of-account issues that are to be considered in the conceptual framework project with project managers and fellows that have dealt or are currently dealing with such issues on standard-setting projects and to discern from their experiences whether there are underlying concepts that might be useful tools for standard-setters in addressing those issues. The discussions were conducted in a roundtable format with opportunities for other staff to raise questions and contribute their observations.

2. Bob Wilkins, FASB Senior Project Manager, and Kevin Stoklosa, FASB Project Manager, presented two of three sessions that will provide a basic introduction to the requirements of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities.

3. Dave Cornish, Senior Vice President, Deputy Controller, Financial Accounting and Control; Tom Shilen, Senior Vice President, Deputy Controller, Global Reporting; Kimberly Scardino, Vice President, Global Accounting Policy and Technical Advisory; Michael Nardo, Vice President, Financial Control and Oversight; Chris Wymbs, Vice President, Consumer Business Unit Controller; Alan Demers, Vice President, Quality; Bryan Nazworth, Vice President, External Reporting; and Paul Thompson, Vice President, Consolidations, Standards Implementation, gave an overview of the controllership organization and the accounting standard implementation process at American Express. They explained the overall objectives of the department while focusing on the role that each of them plays in
implementing new standards and complying with existing standards. In addition, they highlighted the efforts currently ongoing in preparing for the adoption of FASB Statement 157, *Fair Value Measurements*. The objective of the presentation was to illustrate the resources required to implement accounting standards in a multinational organization in a well-controlled manner.

4. Jim Leisenring, IASB Board Member, updated the staff on the activities of the IASB and its plans for convergence in both the near and the long terms. He discussed topics that are currently active on the IASB’s agenda and its roadmap for the future.

EXTERNAL CONFERENCES

a. Staff members attended the following conferences:
   1. The 19th Annual Insurance Industry Conference (KPMG)
   2. IFRS/GAAP Issues (KPMG)
   3. FEI’s Global Reporting Conference
   4. 14th Annual Financial Reporting Conference (NYSSA)
   5. FEI’s Current Financial Reporting Issues Conference

ITEM 2: ADMINISTRATIVE AND STRATEGIC ACTIVITIES

a. The Board and one director attended the August FAF Trustees meeting.

b. The FASB Staff Structure Review Committee met numerous times to develop its recommended changes to the staff structure and review drafts of the report. Because some of the Committee’s recommendations relate to interactions with the IASB, members of the committee met with select IASB Board members and directors to get their input prior to proceeding with drafting the final report. A final report with the Committee’s recommendations was delivered to the Board chairman in November.

c. The PD&S director held training sessions with staff members to implement the FASB’s procedures for drafting FASB standards and related project communications, developed through the FASB’s understandability and codification initiatives.

d. The Board, two staff directors, and selected staff members attended the 1.5 day FASAC retreat on international convergence.

e. The Board and the FAF Trustees developed and issued a comment letter to the SEC on its recent releases relating to IFRS.
ITEM 3: WASHINGTON ACTIVITIES

a. The Chairman testified on October 24, 2007, to the Senate Subcommittee on Securities, Insurance and Investment of the Committee on Banking on the international convergence activities of the Board.

b. Staff members met in separate meetings with various staff of Congressional committees and representatives of Washington, DC-based trade associations to discuss the role of the FASB, various current projects, and other matters of mutual interest.

c. The chairman participated as an official observer to the SEC Advisory Committee on Improvements to Financial Reporting. Board members are also acting as observers to the subcommittees of this committee.

d. The chairman participated as an official observer to the U.S. Department of the Treasury’s Advisory Committee on the Auditing Profession. Board members are also acting as observers to the subcommittees of this committee.

e. The chairman, two Board members, the director of TA&I, the director of MP&T, and a staff member held quarterly meetings with the SEC and the PCAOB to discuss current FASB activities and other matters of mutual interest.

f. The TA&I director participated as a senior advisor to the SEC Advisory Committee on Improvements to Financial Reporting.

ITEM 4: SPEECHES DELIVERED

Principal platforms addressed by the Board and staff members during the August 2007 through October 2007 period include:

- AGC/Associated General Contractors of America
- AGC/CFMA
- American Accounting Association Annual Meeting
- American Gas Association Accounting Principles Committee Annual Meeting
- Boston Accounting Research Colloquium (BARC)
- Center for Audit
- Center for Corporate Reporting and Governance
- CICA Financial Reporting Conference
- COBAR Meeting
- College of William and Mary
- Commodity Markets Council
- Council of Institutional Investors
- ELFA Lease Accountants Conference
- Ernst & Young Financial Reporting Conference
- FEI 1st Global Financial Convergence Conference
- Financial Executives International, Connecticut Chapter
ITEM 5: ADDITIONAL COMMUNICATIONS ACTIVITIES

a. On October 22-23, the Communications Department coordinated two key media outreach events in conjunction with the joint meeting of the FASB and IASB in Norwalk. On Monday, October 22, Jennifer Hughes of the Financial Times conducted a sit-down interview with Bob Herz and Sir David Tweedie, who discussed the Boards’ efforts toward international convergence of accounting standards. On Tuesday, October 23, the Department hosted a press conference featuring Bob and Sir David offering views on convergence and a preview of their testimony before the U.S. Senate Banking committee held on that topic the following day. Media attending the press conference included Steve Burkholder of BNA publications, Susan Webster of BNA, and Emily Pickrell of Thomson. Among those who attended the press conference by phone were Ian Katz of Bloomberg, Emily Chasan of Reuters, Ellen Heffes and Edith Orenstein of FEI, Arleen Thomas of AICPA.org, Glenn Cheney of Accounting Today, Tammy Whitehouse of Compliance Week, and Ido Greenboim of KPMG.

b. The FASB, through the Communications Department, also issued three press releases during this period: FASB Issues Invitation to Comment on Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders (08/02/07), FASB Accounting Standards Codification™ Approaches Constituent Verification Phase (10/19/07), and Financial Accounting Standards Board Meets with Accounting Standards Board of Japan to Discuss Global Convergence (10/24/07). A media advisory was also issued to alert the press to the October 23 FASB/IASB press conference.

c. The Department coordinated communications efforts with outside organizations on FASB-related issues. These efforts included working with Bob Herz and FAF staff to provide comment on a draft press release developed by the SEC and XBRL US for an SEC press conference in September; arranging Bob’s participation in press outreach events in conjunction with the September FEI conference; and working with reporter Mary-Jo Kranacher on revisions to a Bob Herz profile to appear in CPA Journal.
d. The Department responded to media inquiries, arranged interviews, and developed
talking points on a number of topics including Statement 48 (Deb Schell, Pittsburgh
Business Times); PCAOB/FASB member salaries (Nick Rummell, Financial Week);
accounting for postretirement benefits; the Codification project (Glenn Cheney,
Accounting Today); off-balance-sheet instruments (Ian Katz, Bloomberg; Andrew
Osterland, Financial Week); FSP APB 14-a (Denise Lugo, BNA); ITAC letter to the
SEC (Sirena Scales of Thomson); Level 3 assets (Peter Eversted, Fortune Magazine;
Liz Moyer, Forbes Magazine); accounting for contingencies (Emily Pickrell,
Thomson); Statement 157 (Wall Street Journal; Herb Lash, Reuters); VEBA
(Catherine Rampell, Washington Post); Conceptual Framework (Emily Pickrell);
FAS 58 (Dow Jones); share-based payments; Statement 140 (Vince Ryan, CFO
Magazine); FASB technical agenda (Glenn Cheney, Accounting Today); SIVs (Chris
Rugaber, AP); Statement 5 (Nick Rummell, Financial Week); Financial Statement
Presentation. The Department also worked with Sarah Johnson of CFO.com to
clarify comments made by Leslie Seidman as part of a Board discussion on whether
to delay Statement 157.

e. Planning for the 2007 Annual Report got under way, with the Department hosting
preliminary planning meetings with representatives from Inergy, the firm that will be
designing this year’s report. Based on these meetings, Inergy submitted its proposed
timeline and budget for the project.

f. The Department worked with Linda MacDonald to finalize the FASB speech
acceptance guidelines for Board and staff members.

g. Two issues of the FASB Report, the FASB’s monthly newsletter, were produced and
distributed. Topics included the FASB’s Invitation to Comment on its “Accounting
for Insurance Contracts” Project Proposal; the Small Business Advisory Council, and
Private Company Financial Reporting Committee; Terri Polley’s appointment as
Interim COO of the FAF; the joint FASB/IASB project on Business Combinations;
and a Q and A with Jim Leisenring, who celebrated 25 years in standard setting. The
Department is currently working with Linda MacDonald and Gerard Carney on
revamping the FASB Report as a quarterly publication, starting with the October
Tech report.

ITEM 6: GASB LIAISON ACTIVITIES

a. FASB meeting minutes were sent to the GASB RTA director and certain GASB staff.

b. GASB meeting minutes were sent to the FASB chairman and two staff directors.

c. The GASB RTA director and the FASB PD&S director held monthly meetings and
met quarterly with the FASB and GASB chairmen.

d. The FASB staff distributed the following drafts to the GASB for review:

- Proposed FSP SOP 94-3-1 and AAG HCO-a, *Omnibus Changes to Consolidation
  and Equity Method Guidance for Not-for-Profit Organizations*
- Proposed FSP APB 14-a, *Accounting for Convertible Debt Instruments That May
  Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*
Preliminary Views, *Financial Instruments with Characteristics of Equity*.

e. The FASB staff received the following GASB draft for review:

- Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*. 
INTERNATIONAL CONVERGENCE AND THE FINANCIAL REPORTING ENVIRONMENT

Financial Accounting Standards Advisory Council
December 6, 2007

Objective
The objective of this session is to provide an ongoing forum for discussion of strategic-level issues related to convergence.

Materials
Background materials for the international session are:

Attachment B-1: A Press Release from the IASCF about their proposed governance changes.

Attachment B-2: Report for Discussion at the November 2, 2007 Full Committee Meeting of the SEC Advisory Committee on Improvements to Financial Reporting Subcommittee II: Standard Setting.

Note: These materials are provided to facilitate understanding of the issues to be addressed at the December 6, 2007 FASAC meeting. These materials are presented for discussion purposes only; they are not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.
International Accounting Standards Committee Foundation

Press Release

FOR IMMEDIATE RELEASE 6 November 2007

TRUSTEES ANNOUNCE STRATEGY TO ENHANCE GOVERNANCE, REPORT ON CONCLUSIONS AT TRUSTEES’ MEETING

The Trustees of the International Accounting Standards Committee (IASC) Foundation, the oversight body of the International Accounting Standards Board (IASB), today announced, following a strategy review over recent months, proposals to enhance the organisation’s governance arrangements and reinforce the organisation’s public accountability. The Trustees will begin a series of consultations with key stakeholders on these proposals in the build up to the Constitution Review, which is scheduled to start in 2008.

The announcement regarding governance is one of a series of conclusions that the Trustees reached at their meeting on 31 October-1 November held in New York. Details of the enhanced governance proposals and other Trustee decisions are described below.

Governance proposals aimed at enhanced public accountability

Following the last Constitution Review completed in July 2005, the Trustees initiated a number of reforms to improve confidence in the standard-setting process. The Trustees approved amendments to the due process of the International Accounting Standards Board (IASB), increased Trustee engagement with external parties, improved and clarified their oversight responsibilities, and implemented a programme aimed at establishing a broader funding.

With more than 100 countries now using or in the process of adopting International Financial Reporting Standards (IFRSs), the Trustees commenced a strategy review earlier this year in anticipation of the Constitution Review. The Trustees’ objective in launching the review was to begin considering enhanced ways to strengthen public accountability and to fulfil their commitment to the public interest.

To demonstrate clearer public accountability, the Trustees have now adopted the following proposals as a result of their strategy review:

- **Establish a formal reporting link to official organisations:** The Trustees should establish a link to a representative group of official organisations, including securities regulators. This body would approve Trustee appointments and review Trustee oversight activities, including the adequacy of the annual funding arrangements as well as the overall budget.

- **Develop a multi-layered, multi-faceted approach to accountability beyond the formal link to official organisations:** The Trustees should intensify and deepen their engagement with key stakeholder groups and develop mechanisms for the Trustees to receive input outside formalised procedures. This would necessarily include
mechanisms for meeting with official organisations and policymakers and private sector institutions. Furthermore, such accountability would require consideration of the role and structure of the Standards Advisory Council in the organisation’s accountability.

- **Create a mechanism for public input to the Trustees outside regularly scheduled meetings with specific stakeholder groups:** The Trustees should establish enhanced mechanisms for input from interested parties who wish to comment on the IASC Foundation’s and the IASB’s policies, processes, and procedures.

- **Continue efforts towards a sustained, broad-based funding regime:** Having already significantly broadened the funding base through the new approach adopted in 2006, the Trustees should continue their work to broaden the funding base further. The Trustees will begin discussions with key stakeholder groups, including those from the securities regulatory community and other official bodies, regarding the proposals and elements to implement these proposals.

In announcing the enhanced governance strategy, Philip Laskawy, Chairman of the Trustees, stated:

> The use of IFRSs is growing throughout the world, and we are getting closer to our ultimate objective of having a single set of high-quality financial reporting standards used worldwide. My fellow Trustees and I strongly believe that the independence of the standard-setting process and the ongoing convergence work of the IASB have been essential in making this success possible. At the same time, the IASC Foundation, as an independent private sector body, is a unique organisation in the field of international cooperation. We believe that our proposals for enhanced governance are essential in demonstrating our continued commitment to public accountability and the public interest.

Gerrit Zalm, incoming Chairman of the Trustees and former Deputy Prime Minister and Finance Minister of the Netherlands, added:

> I welcome the enhanced governance strategy that the Trustees agreed upon as an important step in addressing challenging issues related to public accountability. One of my leading priorities as Chairman will be to engage interested parties in the Trustees’ strategy in order to reach a well thought-out and broadly supported Constitution Review. As Finance Minister, I recognised the important role that IFRSs and an independent international standard-setter could have for European and global capital markets. The progress of IFRSs throughout the world has gathered pace, and the organisation must continue to adapt to meet this new reality.

**Trustees address funding, convergence, and other oversight issues**

In addition to agreeing to a strategy for enhanced public accountability, the Trustees reviewed a number of issues related to their responsibilities:
• **Broad-based funding regime:** The Trustees assessed the efforts that have been made to establish a broad-based and sustainable regime for 2008, according to the principles agreed in 2006. To date, the Trustees have achieved multi-year financing commitments of more than £12 million of a £16 million annual target.

National funding schemes (either through a levy or national payment) are in place in a number of countries (such as Australia, the Netherlands, New Zealand, and the United Kingdom). Broad-based voluntary programmes in other jurisdictions (such as China, France, Germany, India, Japan, Korea, Luxembourg, South Africa, and Switzerland) are in place or are already agreed. In other countries where fundraising efforts are continuing and are approaching an advanced stage, such as the United States, the Trustees are committed to establishing a broad funding base. The result of these ongoing efforts will bring the sources of funding from less than 200 organisations in 2005 to several thousand by 2008.

The Trustees will enhance their communications on funding arrangements by providing greater information regarding country-specific programmes on the IASC Foundation’s Website and on levels of financing in the annual report.

• **Commitment to convergence, MoU:** The Trustees reviewed the IASB’s current work programme and items being considered as additions to the IASB’s agenda. The Trustees reiterated their support for continuing the convergence work programme described by the February 2006 Memorandum of Understanding between the IASB and the US Financial Accounting Standards Board (FASB), noting that the future work is largely focused on areas in which the objective is to develop a new world class international standard.

The Trustees asked the IASB to report, at the next Trustees’ meeting, on the IASB’s conclusions regarding agenda additions.

• **Expansion of IFRIC to 14 members:** The Trustees approved a proposal to expand the membership of the International Financial Reporting Interpretations Committee (IFRIC) from 12 to 14 members in order to broaden IFRS expertise on the committee. The Trustees will publish the revised Constitutional language and an advertisement for new members shortly.

• **Review of feedback statements, impact assessments:** The Trustees’ Due Process Oversight Committee (formerly the Procedures Committee) will review the IASB’s first feedback statements and impact statements before publication. The Due Process Oversight Committee also reported on its recent meeting with the IASB and indicated that it will schedule regular meetings with the IASB.

**Trustee and IASB appointment matters**

After consultation with the Trustees’ Appointments Advisory Group on issues related to the Trustee selection, the Trustees announced the following:

• Mr Laskawy, the current Chairman of the Trustees, will become Vice Chairman of the Trustees, when Mr Zalm assumes the chairmanship in January 2008. As previously
agreed, Bertrand Collomb will stand down as Vice Chairman at year end and will remain as a Trustee.

- Jeffrey Lucy, former Chairman of the Australian Securities and Investments Commission and incoming Chairman of the Australian Financial Reporting Council, will join the Trustees for a three-year term, beginning January 2008.

- Kees Storm, former Chairman of AEGON, will resign from the Trustees at the end of the year due to other commitments. The Trustees will initiate a public search for his successor shortly.

- The Trustees will consult the Trustees Appointments Advisory Group as part of the Trustees’ efforts to fill the two other Trustee vacancies, created by the retirements of Roberto Teixeira da Costa and William McDonough.

- The Trustees’ Nominating Committee will begin a new search to fill the vacancy on the IASB.

In commenting on Mr Laskawy’s appointment as Vice Chairman, Mr Zalm stated:

   I am delighted that Phil Laskawy will serve as Vice Chairman during an important period for the organisation. Under Phil’s tenure as Chairman, the IASC Foundation made significant progress on issues of governance, funding and due process, and his continued presence on the Trustees will help us advance these issues further. I am looking forward to working with Phil in the coming months.

Regarding Trustee appointments, Mr Laskawy added:

   We are delighted to welcome Jeffrey Lucy to the Trustees. We also appreciate all of the work that our departing Trustees—Richard Humphry, William McDonough, Malcolm Knight, Kees Storm, and Roberto Teixeira da Costa—have undertaken for the cause of IFRSs.

END

For press enquiries:

Mark Byatt, Director of Corporate Communications,
Telephone: +44 (0)20 7246 6472; email: mbyatt@iasb.org

Sonja Horn, Communications Adviser,
Telephone: +44 (0)20 7246 6463; email: shorn@iasb.org

NOTE TO EDITORS

1. The International Accounting Standards Committee (IASC) Foundation, based in London, is the oversight body of the International Accounting Standards Board (IASB). The governance of the organisation rests with 22 Trustees. Six of the Trustees must be selected from the Asia/Oceania region, six from Europe, six from North America, and four from any region. The Chairman is a part-time position.
2. Paul Volcker, former chairman of the US Federal Reserve Board, served as the first Chairman of the Trustees from 2001 to 2005. Tommaso Padoa-Schioppa assumed the chairmanship in January 2006, but stepped down when he became Finance Minister of Italy in May 2006. Philip Laskawy, former Chairman of Ernst & Young International, has served as Chairman since then and will step down from that position when Mr Zalm takes office on 1 January 2008.

3. The IASC Foundation, through the IASB, is committed to developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements.

**About Constitution Reviews**

The IASC Foundation Constitution sets out the governance arrangements of the IASC Foundation, the IASB, and other subsidiary committees. The original Constitution was approved after consultation with international regulatory bodies and the public at large in 2000.

The Constitution requires the Trustees to review the Constitution every five years. The Trustees initiated the first review in November 2003 and following extensive consultation completed the review in June 2005. The current version of the Constitution reflects changes adopted and approved by the Trustees on 21 June 2005 for effect on 1 July 2005. More information on the IASC Foundation Constitution is found at [http://www.iasb.org/About+Us/About+the+Foundation/Constitution.htm](http://www.iasb.org/About+Us/About+the+Foundation/Constitution.htm).

The next Constitution Review must begin no later than July 2008.

**Criteria for selecting Trustees**

The IASC Foundation has adopted the following guidelines for the selection of Trustees, as set out in its Constitution:

5. The Trustees shall be responsible for the selection of all subsequent Trustees to fill vacancies caused by routine retirement or other reason. In making such selection, the Trustees shall be bound by the criteria set forth in Sections 6 and 7 and in particular shall undertake mutual consultation with international organisations as set out in Section 7, for the purpose of selecting an individual with a similar background to that of the retiring Trustee, where the retiring Trustee was selected through a process of mutual consultation with one or more international organisations.

6. All Trustees shall be required to show a firm commitment to the IASC Foundation and the IASB as a high quality global standard-setter, to be financially knowledgeable, and to have an ability to meet the time commitment. Each Trustee shall have an understanding of, and be sensitive to the challenges associated with the adoption and application of high quality global accounting standards developed for use in the world’s capital markets and by other users. The mix of Trustees shall broadly reflect the world’s capital markets and a diversity of geographical and professional backgrounds. The Trustees shall be required to commit themselves formally to acting in the public interest in all matters. In order to ensure a broad international basis, there shall be
(a) six Trustees appointed from North America;
(b) six Trustees appointed from Europe;
(c) six Trustees appointed from the Asia/Oceania region; and
(d) four Trustees appointed from any area, subject to establishing overall geographical balance.

7 The Trustees shall comprise individuals that as a group provide an appropriate balance of professional backgrounds, including auditors, preparers, users, academics, and other officials serving the public interest. Two of the Trustees shall normally be senior partners of prominent international accounting firms. To achieve such a balance, Trustees should be selected after consultation with national and international organisations of auditors (including the International Federation of Accountants), preparers, users and academics. The Trustees shall establish procedures for inviting suggestions for appointments from these relevant organisations and for allowing individuals to put forward their own names, including advertising vacant positions.

8 Trustees shall normally be appointed for a term of three years, renewable once: in order to provide continuity, some of the initial Trustees will serve staggered terms so as to retire after four or five years.

The Trustee Appointments Advisory Group

This is a high level and broadly representative advisory group to help the Trustees in discharging their responsibility for nominating and appointing highly qualified and interested people as Trustees.

The use of the Advisory Group is aimed at increasing consultation between the Trustees and official international and regional organisations with an interest in accounting standard-setting. The Advisory Group’s terms of reference are set out below.

The members of the Trustee Appointments Advisory Group are:

- Jane Diplock, Chairman of the Executive Committee, International Organisation of Securities Commissions
- Mario Draghi, Chairman, Financial Stability Forum
- Donald Kaberuka, President, African Development Bank
- Haruhiko Kuroda, President, Asian Development Bank
- Luis Alberto Moreno, President, Inter-American Development Bank
- Managing Director, International Monetary Fund (to be confirmed following appointment)
- Jean-Claude Trichet, President, European Central Bank
- Paul Volcker, Chairman of the Appointments Advisory Group and former Chairman of the Trustees
- Robert Zoellick, President, World Bank
Terms of reference and operating procedures of the Trustee Appointments Advisory Group

Mandate

1. The Trustees of the IASC Foundation shall consult the Trustee Appointments Advisory Group on nominations to the IASC Foundation Trustees before a final decision is made regarding appointments.

2. Members of the Advisory Group are free to suggest candidates who they believe would be well-qualified Trustees.

3. The ultimate decision on appointments will remain with the Trustees, consistently with the need to maintain organisational independence. However, the Trustees will explain to the members of the Advisory Group the rationale for any decision contrary to reservations expressed by members of the Advisory Group.

Membership

4. The Advisory Group shall comprise five to eight leaders of official international and regional organisations that have an interest in the development of a single set of rigorous, internally consistent, and enforceable international accounting standards, faithfully and consistently applied throughout the world’s capital markets.

5. The organisations selected for representation should reflect a geographical balance.

6. The membership of the Advisory Group shall also reflect the different perspectives of the official community with an interest in accounting standard-setting, including, but not limited to, securities regulators, banking supervisors, and development organisations.

Operations

7. The Advisory Group shall meet at least once annually, either in person or by conference call. Additional meetings may be necessary in the event of extraordinary appointments.

8. The Chairman of the Trustees of the IASC Foundation shall chair the meetings of the Advisory Group. The Chairman of the Trustees shall determine whether other Trustees and the secretariat shall attend meetings of the Advisory Group.

9. The secretariat of the IASC Foundation shall be responsible for handling administrative arrangements for meetings of the Advisory Group, including the preparation of meeting materials. Such materials shall be sent to members of the Advisory Group at least seven days in advance of the meetings.
Introduction

Subsequent to the August 2, 2007 meeting of the Securities and Exchange Commission (SEC) Advisory Committee on Improvements to Financial Reporting (Advisory Committee), committee members have formed four subcommittees to address the issues raised in Robert Pozen’s discussion paper dated July 31, 2007 (Discussion Paper).

This report summarizes the efforts of the Standard Setting subcommittee thus far and reflects only tentative thinking in each area. After receiving input from the full committee, the subcommittee intends to continue to seek input from various constituencies in the financial reporting community in preparation for full committee consideration of certain interim recommendations in January 2008.

Members:
David Sidwell, Chair
Dennis Beresford
Scott Evans
James Quigley

Observers:
Robert Herz, FASB
Mark Olson, PCAOB

Scope of Work Plan

The subcommittee has been tasked with examining the standard setting process in the U.S. in order to make recommendations for the full committee to consider to improve the quality of financial information delivered to investors and reduce undue complexity in the financial reporting system. The Discussion Paper recommended that the subcommittee evaluate the following:

- The U.S. GAAP hierarchy.
- Characteristics of the Financial Accounting Standards Board (FASB).
- The FASB standard setting process.
- Interpretive guidance from the Emerging Issues Task Force (EITF).
- Interpretive guidance from the SEC.
- Interpretive guidance from other sources.
- The use of cost-benefit analyses in standard setting and the review of the analyses performed for particular standards.

The subcommittee agreed that all of the topics in the Discussion Paper will be included within its scope but decided to organize its evaluation of each within the following broad categories:

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SEC Advisory Committee on Improvements to Financial Reporting
Subcommittee II: Standard Setting
Report for Discussion at November 2, 2007 Full Committee Meeting

- Governance.
- Agenda and standard setting processes.
- Proliferation of accounting interpretations.
- Design of standards.
- International considerations.

Each category is described below, together with our related preliminary hypotheses concerning recommendations for the full committee designed to improve the quality of financial reporting and reduce undue complexity. The subcommittee acknowledges that certain of its proposals for how to improve the usefulness of the current financial reporting system may be partially or substantially addressed by actions recently taken or in the process of being taken by the FASB and SEC.

To finalize the scope of its work plan and obtain input on its preliminary hypotheses, the subcommittee intends to continue to seek input from various constituencies in the financial reporting community. In its future deliberations, the subcommittee will also reflect in its work the potential impact on the FASB’s agenda associated with any recommendations from the full committee.

Questions for the Full Committee:

1) Does the full committee agree with the subcommittee’s approach and preliminary scope? What areas, if any, would the full committee recommend adding or removing?

Deliberations and Preliminary Hypotheses

OVERVIEW

U.S. GAAP has evolved over many years and its basic principles have become obfuscated by detailed rules, bright lines, exceptions and regulations, which reduces the transparency and usefulness of the resulting financial reporting. In addition, interpretative guidance proliferates from a variety of sources and becomes, intentionally or not, an additional source of GAAP that can add to the complexity in the financial reporting system, especially when there are conflicts between interpretations. The fear of being second-guessed sometimes causes auditors and preparers to ask for more rules and interpretations, which further exacerbate the problem. The FASB has taken recent actions intended to reduce the proliferation of formal interpretative guidance from different bodies, including establishing itself as the sole private-sector standard setter and interpretive body in the U.S. The FASB has also undertaken a significant project to develop a comprehensive, integrated codification of existing accounting literature.

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organized by subject matter that would become an easily retrievable single source of GAAP, but the codification by itself will not resolve the root causes of complexity. The SEC is also a source of GAAP, including through non-authoritative processes such as comment letters and staff speeches that are perceived in the marketplace to be authoritative. In addition, informal interpretations continue to be issued by other bodies (e.g., the Center for Audit Quality), which also have the perception of being authoritative. 

It is the opinion of the subcommittee that the fear of having good faith judgments be second-guessed significantly influences the behavior of participants in the financial reporting community and is a key driver of much of the undue complexity in the financial reporting system. If the full committee’s recommendations have the ability to defuse the fear of second-guessing by replacing it with a willingness to respect reasonable, good faith judgments made following an agreed-upon professional judgment framework, the Advisory Committee will have met its mandate. Such a change in behavior would enable a simplification in the design of standards and would reduce the proliferation of interpretive guidance. Without such a change in behavior, meaningful improvements to financial reporting will be difficult.

In its deliberations of how the standard setting and interpretive processes in the U.S. may be improved, the subcommittee developed a number of preliminary hypotheses covering a broad spectrum of issues, many of which are inter-related. There are a few central issues that complement each other that the subcommittee would like to briefly highlight for the full committee, as follows:

1. Additional user involvement in the standard setting and regulatory processes is central to improving financial reporting. Only if user perspectives are properly considered will the output of the financial reporting process meet the needs of those for which it is intended. Additional user participation on the FAF and FASB, together with making FASB user advisory committees more effective, will help provide this perspective.

2. The SEC and FASB should work together to clarify roles and responsibilities in the standard setting and interpretive processes, which would reduce uncertainty in the financial reporting community. They should provide a roadmap of the standard setting and interpretive processes going forward that should clarify the following:
   - The FASB (and the EITF as its delegate) should be the primary issuer of broadly-applicable authoritative accounting guidance. The number of parties interpreting GAAP must be reduced by addressing the root causes of interpretations.
   - The SEC should issue registrant-specific accounting guidance and refer broadly-applicable issues to the FASB whenever possible.
   - When the SEC deems it appropriate to issue broadly-applicable authoritative accounting guidance, it should be done with appropriate due process to the extent

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practicable. Furthermore, the SEC should implement internal procedures to ensure that all sources of accounting guidance emanating from various Divisions and Offices within the SEC are reviewed and approved by a single Chief Accountant.

- All other sources of accounting guidance should be considered non-authoritative and should not be given more credence than any other non-authoritative sources that are evaluated using well-reasoned, documented professional judgment. To accomplish this, the FASB’s codification project should be completed in a timely manner to clarify which guidance is authoritative versus non-authoritative and to bring to the maximum extent practicable all of U.S. GAAP into a single location.

3. A formal process should be implemented to actively manage the priorities of the standard setting and interpretive processes in the U.S. that includes representation from the regulatory, standard setting, user, preparer, and auditor communities.

4. The use of reasonable judgment should be further promoted in the way standards are both written and implemented, which would allow a reasonable amount of diversity in practice, as follows:
   - Accounting standards should be written in a manner that reflects the premise that there is trust and confidence in efficient markets through the respect of professional judgment, rather than by attempting to prevent abuse. They should not strive to answer every question and close every loop-hole, but rather, should be written with clearly-stated objectives and principles that may be applied to broad categories of transactions.
   - Standard setters should provide extended implementation periods for all new standards, which may allow the SEC to regulate compliance with new standards without forcing unwarranted restatements as long as the requirements in GAAP are followed.
   - Formal post-adoption effectiveness reviews of new standards should be conducted within 2-3 years of implementation. By identifying divergence that developed during the implementation period that is perceived to be too great, the standard setters may take corrective action to reduce diversity through the authoritative amendment process, with appropriate transition provided to avoid unwarranted restatements.

The subcommittee believes that an appreciation of the complementary nature of the preliminary hypotheses above would provide insight into the importance of the same preliminary hypotheses described more fully, but individually, below.

**GOVERNANCE**

The subcommittee considered the potential ways in which (1) the SEC’s delegation of standard setting authority to the FASB, and (2) the governance structure provided by the
Financial Accounting Foundation (FAF) may be improved. The subcommittee believes that the SEC’s delegation of standard setting to the FASB with oversight from the FAF (1) is appropriate, (2) is functioning as designed, and (3) does not contribute to complexity in a meaningful way. However, the subcommittee does have preliminary hypotheses regarding how the SEC and FASB should clarify roles and responsibilities going forward that will reduce uncertainty in the marketplace (see Preliminary Hypotheses 14-19).

**Preliminary Hypothesis 1:** The standard setting and regulatory processes need more individual user perspectives, which may be accomplished with more user representation, especially on both the FAF and the FASB. The subcommittee recognizes that user involvement is central to the issue of improved financial reporting, yet the intricacy of certain accounting matters and the complexity of the debate makes it difficult to attract individual users to participate in the standard setting and regulatory processes, which in turn reduces the perceived usefulness of financial statements themselves. However, it is important to strike an appropriate balance between the perspectives of users, preparers, and auditors. The subcommittee believes that the objective in the near-term should be to improve that balance by increasing consideration of the users’ perspectives in the process, so that what results is an end product that meets the needs of those for which it is intended.

**Future Considerations:** The subcommittee will consider the role of sponsoring organizations in influencing the composition of the FAF, although the subcommittee recognizes that the sponsoring organizations currently serve in a vital nominating capacity. The subcommittee will also further consider whether and how individual FASB members represent particular constituencies and whether changes should be recommended that would increase their user focus. The subcommittee also plans to reflect on the preliminary findings of an external review of the FASB being sponsored by the FAF to determine if additional analysis of broad governance issues is justified.

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**AGENDA AND STANDARD SETTING PROCESSES**

Due Process: The FASB’s activities are open to public participation and observation as part of its due process procedures and the FASB actively solicits the views of its various constituencies on accounting issues. This process was designed to provide constituents with significant input into the decisions of the Board. The subcommittee believes that the
FASB’s approach to obtaining significant input through due process is fitting, although the subcommittee recognizes the difficult trade-off between due process and expediency. Therefore, the subcommittee is considering a number of additional preliminary hypotheses, as described below, to further enhance the standard setting process in the U.S. and improve its timeliness.

**Agenda:** Critics in the financial reporting community argue that the standard setting process in the U.S. is slow and they point to projects that have been on the Board’s agenda for a number of years (e.g., the conceptual framework project, the revenue recognition project, the liabilities & equity project, etc.) to illustrate that there are fundamental standard setting issues that are routinely given a low priority. These critics also argue that standards that are issued are not always cohesive and may be based on several different principles. This may be due to the lack of a complete, current conceptual framework, competing priorities placed on the Board, and the evolutionary nature of standard setting in the U.S.

The FASB receives many requests for action on various financial accounting and reporting topics from all segments of its diverse constituency, including the SEC. The Board also turns to many other organizations and standing advisory committees for advice regarding its agenda, but these groups act solely in advisory capacities. There is no body that brings together the key stakeholders in the regulatory, standard setting, user, preparer, and auditor communities to actively manage priorities in the standard setting and interpretive processes. **Preliminary Hypothesis 2:** A formal Agenda Committee that includes representation from the SEC, the FASB, users, preparers, and auditors should be created to provide advice on the standard setting agendas of the FASB, EITF, and SEC, while at the same time maintaining an appropriate focus on user needs. A framework should be developed that may assist the Agenda Committee with making agenda setting and prioritization decisions, including what projects to advise adding and removing from the agenda, and short-term priorities for active projects. **Future Considerations:** The subcommittee will further explore (1) the structure of and representation on the Agenda Committee, including how to ensure that the SEC has a strong voice regarding the agenda (see Preliminary Hypothesis 17), (2) how to ensure that the scope of new projects is clear prior to commencing work, (3) whether to require a supermajority for adding projects to the FASB’s agenda, which may encourage addressing only standard setting and interpretive issues with widely acknowledged needs, and (4) the impact of the existence of an Agenda Committee on the activities of various other FASB advisory groups.

**Preliminary Hypothesis 3:** Although highly dependent upon the conclusions reached in International Considerations as described below, the subcommittee is exploring a recommendation for the full committee to consider that the FASB re-prioritize its existing agenda, which may include the following:

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1. Consider the full committee’s recommendations and the potential prioritization of those recommendations.
2. Finalize the codification of U.S. GAAP on a timely basis.
3. Continue efforts towards international convergence.
4. Complete the conceptual framework (jointly with the IASB).
5. As phase II of the codification project, consider whether GAAP should be systematically revisited, as follows:
   - To be more coherent post codification.
   - To remove redundancies.
   - To be less complex, where possible.
   - To be more principles-based.
   - To readdress frequent practice problems (as identified by restatement volumes, input from the SEC, recent interpretations, and frequently-asked questions).
   - To readdress outdated standards (i.e., sunsetting).
6. Create a disclosure framework that may be used by the FASB in the future when assessing what types of disclosures are necessary based upon the type of information being conveyed.
7. Address emerging issues that urgently require attention (either directly or through the EITF as its delegate).

**Preliminary Hypothesis 4**: In addition, the subcommittee may also recommend that the full committee consider recommending that the SEC work with the FASB to:
1. Remove any redundancy between SEC disclosure requirements and other sources of GAAP.
2. Consider taking steps so that the SEC guidance to be included in the codification will conform to the extent possible with the rest of the format of the codification.
3. As phase II of the codification project, consider whether SEC literature should be systematically revisited and integrated with FASB guidance.

**Conceptual Framework**: The subcommittee believes that the completion of the conceptual framework, and a reconsideration of conflicts between the revised framework and U.S. GAAP, will be an important step to reduce inconsistencies in GAAP and improve the coherence of the reporting framework. Specifically, Board members should have such a framework that they may refer back to over time when standard setting to ensure cohesiveness and consistency in GAAP. The subcommittee acknowledges that many of the issues currently being addressed by the Board as part of the conceptual framework project are challenging and will have a pervasive impact on U.S. GAAP. Therefore, it will be important that constituents agree with the direction of the FASB and to do so, there may be opportunities during Board deliberations to further clarify what the specific impact of recommended changes to the conceptual framework will have on the full body of GAAP.
Objectives: The subcommittee reflected on the FASB’s published objectives and precepts for standard setting. The subcommittee plans to evaluate possible changes to the FASB’s objectives and precepts that may provide guidance to the Board when balancing competing priorities in the future. **Preliminary Hypothesis 5:** Two possible recommendations for the full committee to consider may be that (1) certain objectives should be given more emphasis, and (2) an objective should be added that accounting models should not introduce unnecessary complexity (i.e., not be more complex than the underlying transactions).

Advisory Groups: As noted above in Preliminary Hypothesis 1, the subcommittee believes that there is a need for greater individual user involvement throughout the standard setting process. The FASB has a number of standing advisory groups and committees that it consults on technical issues on the Board’s agenda, project priorities, matters likely to require the attention of the FASB, selection and organization of task forces, and other matters. **Future Considerations:** The subcommittee is in the process of considering (1) whether the FASB makes effective use of its advisory groups, and (2) what other mechanisms may be effective in ensuring that sufficient input is received by appropriate parties and at the right time during the standard setting process. The subcommittee will also further consider how user involvement may be more effectively managed and made more transparent so that interested parties know when and how to engage the FASB and its staff to assist in standard setting.

Staffing: The subcommittee is also concerned that the organization and composition of its staff may constrain the FASB. **Preliminary Hypothesis 6:** The FASB should consider an alternate staffing model that makes use of preparers, users, and auditors either directly or through task forces and resource groups (perhaps on a rotational basis) to bring additional subject matter expertise and recent business experience to each standard setting activity. Such resources might be leveraged to do original thinking on new projects, assist in field testing, estimate the costs of implementing new standards, or serve as subject matter experts to the FASB’s staff.

**Preliminary Hypothesis 7:** The FASB’s Major Projects and Technical Analysis & Interpretations groups should be combined and organized by subject matter expertise to:

- Ensure that major projects are led by subject matter experts.
- Ensure that interpretive issues are addressed by the same group involved in setting the standards.
- Facilitate inclusion of interpretive accounting guidance in the codified standards.
- Increase the interaction with relevant financial reporting constituents, resource groups, and alternate staff who have the same subject matter expertise.
Field Testing and Cost Benefit Analysis: The FASB evaluates whether the benefits of each new standard justify its costs by determining that a proposed standard will meet a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the perceived overall benefits. However, participants in the standard setting process have long acknowledged that reliable, quantitative cost-benefit calculations may seldom be possible, in large part because of the lack of available information on the costs and the difficulty in quantifying the benefits. Further, the magnitude of the benefits and costs are difficult to assess prior to preparers using the standard in the preparation of financial statements, auditors auditing that information, and users assessing the benefits of the resulting accounting and disclosure. Preliminary Hypothesis 8: The subcommittee is considering a recommendation to the full committee that the FASB improve its procedures for field testing, field visits, and cost-benefit analyses, such that:

- Field tests and field visits should be required to be integrated into the standard setting process for all new standards.
- Cost-benefit analyses should be required to be performed as part of the field tests.
- This additional work should leverage the alternate staffing model described above. Specifically, the FASB should leverage work already being done by preparers, auditors, task forces, and user groups to assess the impact, operationality, and auditability of proposed standards to help inform its views.

The Discussion Paper proposed the review of previously-issued standards to understand cost-benefit analyses performed by the FASB, but the subcommittee decided that sufficient information regarding the efficacy of cost-benefit analyses may be obtained without performing a detailed review with reference to specific standards. Future Considerations: The subcommittee intends to also consider guidance from economists regarding whether there are other opportunities for the FASB to improve its cost-benefit analyses.

Fatal Flaw Reviews: Preliminary Hypothesis 9: The review of near-final standards immediately prior to final release (sometimes referred to as fatal flaw reviews) should be more formalized. Such a formalized review may identify unintended consequences of changes made since the previously-exposed drafts and may provide an additional opportunity for user involvement, given the near-final nature of the standard or interpretation. Currently, the IASB posts near-final exposure drafts to its website to facilitate such reviews by interested parties.

Post-Adoption Effectiveness Reviews: After a new accounting standard has been in place for multiple financial reporting cycles, more data may be available to evaluate its cost, efficacy, utility, and/or relevance in the current environment. However, currently the FASB does not have a process in place to do post-adoption effectiveness reviews of new standards. As a result, standards may miss important matters, not properly consider
implementation issues, have unintended consequences, and as a result, may lose their relevance and effectiveness. As such, useful financial information might not be made available to the users of financial statements. Preliminary Hypothesis 10: The FASB should conduct formal post-adoption effectiveness reviews of new standards within 2-3 years of implementation to:

- Ensure that the accounting that is being produced is what the FASB intended and is useful to readers of the financial statements.
- Re-assess the cost-benefit analyses.
- Deal with interpretive matters that arise.
- Ensure that only an acceptable amount of diversity in practice exists.

As noted in Preliminary Hypotheses 3 and 4, Preliminary Hypothesis 11: A review of all of U.S. GAAP should be performed periodically by the SEC and the FASB and should formally consider (1) restatement activity, (2) practice problems identified by the SEC, (3) the number of interpretations required since that last post-adoption effectiveness review, and (4) opportunities for simplification and sunsetting.

Promoting Reasonable Interpretations: The subcommittee also noted that one of the significant complexities of the current financial reporting and regulatory environment is that preparers, auditors, and other participants are sometimes penalized for improving their understanding and interpretations of accounting standards over time. This issue is especially problematic for new standards. Preliminary Hypothesis 12: The FASB should provide 2-3 year extended implementation periods for all new standards prior to the first formal post-effectiveness review, during which time preparers may benefit from authoritative or non-authoritative implementation guidance to learn about how the standard is being interpreted and implemented without being forced to restate (except in egregious cases at the SEC’s discretion in which the registrant clearly fails to apply the requirements of the standard). Such an extended implementation period would likely require the FASB to adopt standard transition guidance applicable to all new standards and may have the effect of allowing the SEC to satisfy its regulatory mandate of investor protection and capital formation in a more flexible manner. This complements Preliminary Hypotheses 2, 10, 11, and 17. Issues arising during this process that are of an interpretive nature (other than clear violations of the standards, as determined by the SEC) would be re-considered by the FASB either during or at the end of the implementation period and authoritative amendments would be completed by the FASB to clarify the standard and reduce diversity in practice, as necessary.

The subcommittee does not mean to imply that it is considering recommending a move away from comparability in financial reporting; on the contrary, such post-adoption effectiveness reviews after an extended 2-3 year implementation period would actively manage comparability. By identifying divergence that developed during the implementation period that is perceived to be too great, the FASB may take corrective
action to reduce diversity though the authoritative amendment process, with appropriate transition provided to avoid unwarranted restatements. Therefore, the subcommittee’s preliminary thinking represents a shift in attitude away from the stark emphasis on comparability at any cost towards a careful evaluation of when diversity in practice becomes too great that it must be reigned-in. This is one reason why enhanced individual user involvement in Preliminary Hypothesis 1 is central to the subcommittee’s other preliminary hypotheses.

Future Consideration: The subcommittee will further consider whether the standard implementation and transition guidance noted above should have a bias towards prospective or retrospective application.

**Questions for the Full Committee:**

1) Does the full committee agree with the subcommittee’s approach and preliminary hypotheses? What revisions, if any, would the full committee suggest?

### PROLIFERATION OF ACCOUNTING INTERPRETATIONS

**Codification:** The subcommittee believes that there are too many sources of authoritative accounting guidance in U.S. GAAP. Interpretations of U.S. GAAP have proliferated over a number of years from a variety of sources. Often interpretive accounting guidance that is not formally authoritative is erroneously perceived by participants in the financial reporting and legal communities to be additional sources of authoritative GAAP. This adds to complexity in the financial reporting system, especially if there are conflicts between these accounting interpretations. With that in mind, the subcommittee is considering **Preliminary Hypothesis 13:** The FASB’s codification project should be completed in a timely manner so that the flattening of the GAAP hierarchy into authoritative and non-authoritative accounting guidance will be completed as quickly as practical. As part of the codification validation process, the SEC should ensure that all accounting guidance it deems to be authoritative is included in the codification to the extent practicable. The completion of the codification project (which will (1) flatten the GAAP Hierarchy to two levels, and (2) clarify explicitly those sources that are authoritative and those that are not) is an important aspect of Preliminary Hypotheses 14-19.

**Clarify Roles and Responsibilities:** The subcommittee hypothesizes that certain changes that clarify how the SEC and FASB should interact will further improve financial reporting, as follows:
• **Preliminary Hypothesis 14:** Authoritative accounting guidance that is broadly applicable is best issued by a single, private-sector standard-setter (e.g., the FASB and the EITF as its delegate) such that the guidance may be immediately updated in the codified version of GAAP. This hypothesis is based upon the presumption that the SEC will continue to be judicious when determining when to issue its own guidance (see Preliminary Hypotheses 17-18).

• **Preliminary Hypothesis 15:** Authoritative accounting guidance that is applicable only to specific registrants should be given solely by the SEC and should not be required to be applied more broadly. This will require more formal coordination within the SEC, as noted below.

• **Preliminary Hypothesis 16:** All precedent-setting accounting guidance applicable either broadly or to specific registrants (e.g., staff interpretations, speeches, information posted to its website, etc.) should be reviewed and approved by a single Chief Accountant. This will help to ensure consistency in the accounting conclusions that drive regulatory actions taken by various Divisions and Offices within the SEC. In future deliberations, the subcommittee will also consider the impact of caveat language commonly included on SEC staff guidance stating that it is either non-authoritative or does not represent the views of the SEC on the perception in the marketplace that it is non-authoritative.

• **Preliminary Hypothesis 17:** The SEC and the FASB should establish a formalized mechanism in which the SEC may refer agenda topics to the FASB such that the FASB (or the EITF as its delegate) can deliberate and issue authoritative accounting guidance that is broadly applicable, thereby reducing the need for the SEC to do so. Such a process would leverage the Agenda Committee described above in Preliminary Hypothesis 2, and the post-adoption effectiveness reviews described above in Preliminary Hypotheses 10 and 11, but may also require an additional ongoing communication process, to be further considered by the subcommittee. This would have the effect of specific registrant matters that have broad applicability being formally referred from the SEC Division of Corporation Finance to the SEC Office of the Chief Accountant to the FASB. Such a formal, transparent feedback loop would identify and prioritize issues with broad applicability that require immediate, authoritative accounting guidance from the FASB (or the EITF as its delegate) directly in the codified version of GAAP.

• There may continue to be instances, albeit rare, when the FASB and EITF are unwilling or ineffective at addressing practice issues raised by the SEC. **Preliminary Hypothesis 18:** Any accounting guidance issued by the SEC that is broadly applicable should to the extent practicable be (1) subject to due process, including public comment, and (2) easily integrated into the GAAP codification.

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Preliminary Hypotheses 8-12 would also apply to the SEC when issuing such standards or interpretations.

- **Preliminary Hypothesis 19:** All non-authoritative accounting guidance (including that which has historically been communicated in industry guides, SEC speeches, accounting firm guidance, etc.) should be clarified to be non-authoritative (by virtue of the fact that it will not be included in the codification) and would therefore not have more credence than well-reasoned, documented conclusions based on other, potentially-conflicting non-authoritative accounting guidance applied using a professional judgment framework. Although the FASB codification initiative will help alleviate some of the proliferation of accounting interpretations by including only authoritative accounting guidance, making meaningful improvements in financial reporting will be difficult if non-authoritative accounting guidance continues to have the perception it has today of pseudo-authority in the marketplace.

In summary, Preliminary Hypotheses 14-19 reflect the subcommittee’s tentative thinking that roles and responsibilities in the standard setting process could be clarified in such a way as to reduce uncertainty in the financial reporting community by:

1. Flattening the GAAP Hierarchy.
2. Providing a roadmap of the standard setting process going forward that clarifies that:
   - The FASB (and the EITF as its delegate) should be the sole issuer of broadly-applicable authoritative accounting guidance.
   - The SEC should issue registrant-specific accounting guidance and refer broadly-applicable issues to the FASB whenever possible.
   - When the SEC deems it appropriate to issue broadly-applicable authoritative accounting guidance, it should be done with appropriate due process to the extent practicable.
   - All other sources of accounting guidance would be considered non-authoritative and need not be given any more credence than any other non-authoritative sources that are evaluated using well-reasoned, documented professional judgment.

The subcommittee does not intend for the SEC’s authority to (1) oversee the private-sector standard setting body, (2) set standards, or (3) regulate the capital markets be usurped in any way. Rather, Preliminary Hypotheses 14-15 will improve the clarity around what standard setter should provide guidance and what that guidance should ideally include. The SEC will continue to have ultimate authority, but Preliminary Hypothesis 18 is based upon the presumption that the SEC will continue to be judicious when determining when to issue its own guidance. Preliminary Hypothesis 16 will enhance the consistency of accounting guidance provided by the SEC to reduce the
instances of mixed messages being communicated in the marketplace. Preliminary Hypothesis 17 recommends that the SEC continue to improve its oversight of the FASB by implementing a formal, transparent feedback loop. And Preliminary Hypothesis 19 clarifies that non-authoritative guidance should not be used to force restatements when other reasonable views exist. Taken together, this would be a significant change in practice.

Further Considerations: The subcommittee will further consider how to make these preliminary hypotheses operational. In its future deliberations, the subcommittee will evaluate other root causes of the proliferation of accounting interpretations to identify whether there are other changes that are necessary in the regulatory environment to reduce the need for multiple parties to informally interpret GAAP.

Questions for the Full Committee:

1) Does the full committee agree with the subcommittee’s approach and preliminary hypotheses? What revisions, if any, would the full committee suggest?

DESIGN OF STANDARDS

Some participants in the financial reporting community believe that accounting standards do not clearly articulate the objectives and principles upon which they are based. The subcommittee believes the objectives and principles inherent in existing U.S. GAAP are obfuscated by detailed rules, examples, scope exceptions, safe harbors, cliffs, thresholds, and bright lines. This makes it difficult for preparers and auditors to apply the standard’s underlying objectives and principles, causing difficulty and uncertainty in application, because rules cannot cover all possibilities and create additional risk that the appropriate rule is not identified and considered. This, in turn, may drive requests from preparers, auditors and regulators to answer every question in the form of more prescriptive rules, examples and additional guidance. The result is an accounting system that is overly complex, has little room for professional judgment, and can engender a check-the-box approach. As such, the subcommittee is considering Preliminary Hypothesis 20: Accounting standards should be written in a manner that reflects the premise that there is trust and confidence in efficient markets through the respect of professional judgment, rather than by attempting to prevent abuse.

Similarly, the FASB’s codification project is progressing at a rapid pace, yet participants in the U.S. financial reporting community have not built consensus about what standards should look like. As part of its deliberations, the subcommittee is considering what an ideal accounting standard should look like and whether a framework should be created that the standard setter may refer back to over time to ensure that these ideals are
Preliminary Hypothesis 21: Characteristics for the potential framework that are being evaluated include that accounting standards should:

- Faithfully represent the economic consequences of transactions.
- Be decision-useful and promote transparency.
- Be consistent with the FASB’s conceptual framework.
- Have an appropriately-defined scope that addresses a broad area of accounting.
- Be written clearly and concisely in plain language.
- Have an appropriate balance between principles, explanations, examples, and other guidance based on the complexity of the transactions.
- Minimize rules, exceptions to the scope and principles, safe harbors, cliffs, thresholds, and bright lines.
- Allow for the use of well-reasoned, documented professional judgment, where appropriate, with transparent disclosure.

Future Consideration: Once the subcommittee’s perspectives about the design of standards is more complete, the subcommittee will further consider the approach that should be taken to migrate the codified version of U.S. GAAP to this ideal.

Questions for the Full Committee:

1) Does the full committee agree with the subcommittee’s approach and preliminary hypotheses? What revisions, if any, would the full committee suggest?

INTERNATIONAL CONSIDERATIONS

Future Considerations: The subcommittee has deferred full discussion of international considerations until comments have been received and evaluated by the SEC on (1) the proposal to remove the U.S. GAAP reconciliation for foreign-private issuers reporting under IFRS as promulgated by the IASB, and (2) the concept release on the possibility of allowing domestic issuers to report under IFRS as promulgated by the IASB. The subcommittee believes that international considerations should be included within its scope, because:

- It would be difficult to address standard setting in the U.S. without discussing convergence matters, especially given that the FASB’s agenda is heavily influenced by convergence efforts.
- Convergence matters have in the past created conflicts in the Board’s priorities.
- Differences between U.S. GAAP and IFRS are an additional source of confusion.
- Allowing domestic issuers to report under IFRS as promulgated by the IASB would be a significant change from today’s process.
The subcommittee believes that many of the preliminary hypotheses contained herein are equally applicable to the International Accounting Standards Board (IASB), with minor modifications. Therefore, international considerations are already implicit in the subcommittee’s deliberations. Nevertheless, the subcommittee will defer in-depth discussion of international considerations until 2008.

Questions for the Full Committee:

1) Does the full committee agree with the subcommittee’s intention to defer deliberations of international considerations associated with standard setting until 2008?

Current Status and Further Work

The subcommittee will continue to meet on a frequent basis with a goal of finalizing certain of its preliminary hypotheses for full committee consideration in January 2008 and publication as interim recommendations. The subcommittee is also planning to obtain further input on its preliminary hypotheses from various constituents in the financial reporting community. As noted above, international considerations will impact these recommendations and will be further deliberated in early 2008.

Coordination with Other Subcommittees

The subcommittee wishes to refer to the Audit Process and Compliance subcommittee work regarding a framework for professional judgment.
FINANCIAL ACCOUNTING STANDARDS ADVISORY COUNCIL
REVENUE RECOGNITION
December 6, 2007

REVENUE RECOGNITION: COVER

1. We plan to discuss the revenue recognition project at the December FASAC meeting and to visit the revenue recognition topic again in more depth at the March 2008 FASAC meeting. The purpose of those sessions is to discuss the proposed models and to invite FASAC members’ comments and reactions to those models. In particular, input will be sought on:
   a. the internal consistency of the models
   b. whether the models are sufficiently described to invite comments in a discussion paper and
   c. if and how participants think the proposed models would improve current practice.

2. The revenue recognition team has prepared four memos in preparation for the December 2007 FASAC meeting. The first two memos provide brief summaries of the proposed revenue recognition models—the Measurement model and the Customer Consideration model. The third memo provides a tabular comparison of the two models to highlight the key features of both. The final memo applies the proposed models to three revenue recognition situations. This memo also illustrates how U.S. GAAP and IFRS would be applied to these same situations.

3. The session will consist of the following parts:
   (5-10 minutes) Description of the current status of the project
   (65-70 minutes) Breakout into two groups to facilitate interactive discussions of the proposed models and

Note: These materials are provided to facilitate understanding of the issues to be addressed at the December 6, 2007 FASAC meeting. These materials are for discussion purposes only; they are not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.
examples. *Participants will need to familiarize themselves with the materials beforehand so that we can invite as many comments and questions as possible in the breakout discussions.*

(15 minutes) Reconvene as a group to discuss the key points raised in each of the breakout sessions.
INTRODUCTION

Overview

1. This paper summarises the measurement model of revenue recognition. In this model, revenue arises from recognising and explicitly measuring increases in specified assets and decreases in specified liabilities, rather than from a separate evaluation of how much performance occurred in a period. In other words, the amount of revenue to be recognised is determined by considering how much assets and liabilities change in a period. Because the model is predicated on explicit measurements of the assets and liabilities, it is described as the measurement model.

2. The specified assets and liabilities in this model are those that arise directly from enforceable contracts with customers. The contract asset or liability is measured at its current exit price. This is the price that a market participant would pay (or require) to obtain (or assume) the remaining rights and obligations in the contract. The contract is measured this way at inception and subsequently. [Paragraphs 17–24]

3. Because the model focuses on the contract asset and liability, revenue is defined as an increase in a contract asset or a decrease in a contract liability that results from the
provision of goods and services to a customer. [Paragraph 6] Hence, revenue is recognised when:

- an entity obtains a contract in which the underlying rights exceed the underlying obligations (because this would result in a new contract asset). [Paragraphs 27–32]

- the entity subsequently satisfies its obligations in the contract by providing goods or services to the customer (because this would either increase a contract asset or decrease a contract liability). [Paragraphs 33–46]

4. The amount of revenue that is recognised is derived from the increase in the exit price of the contract asset or decrease in the exit price of the contract liability. [Paragraph 36]

A cautionary note

5. In illustrating the measurement model, simple examples are often used. However, if this model was adopted in practice, it would not alter the current accounting for many straightforward revenue transactions. For instance:

- the model would not affect many point-of-sale contracts unless those contracts result in material obligations to customers that are not satisfied at the point of sale, such as return rights or warranties;

- no revenue would be recognised until the entity had an enforceable contract. Hence, in the case of an executory contract that can be cancelled without penalty by either party before the entity performs, no assets or liabilities would be recognised, and, thus, no revenue would be recognised either.

WHAT IS REVENUE?

6. Revenue is an increase in a contract asset or a decrease in a contract liability (or some combination of the two) that results from (a) obtaining an enforceable contract with a customer to provide goods and services and (b) providing those goods and services to the customer.
7. This definition of revenue is linked to changes in a narrow set of assets and liabilities: those arising directly from an enforceable contract with a customer to provide goods and services. These assets and liabilities are discussed below in paragraphs 8–16. Revenue is not affected by changes in assets such as inventory. Said simply, revenue reflects the increase in the entity’s net position in an enforceable contract with a customer from obtaining that contract and subsequently providing goods and services to customers.

HOW ASSETS OR LIABILITIES ARISE FROM AN ENFORCEABLE CONTRACT

8. When an entity enters into an enforceable contract with a customer, it exchanges promises with the customer. The promises impose obligations on the entity to transfer economic resources (in the form of goods and services) and convey rights to receive consideration from the customer in exchange.

9. The rights and obligations in the contract are inextricably linked because neither would be enforced without the other also being enforced. As a result, the combination of the rights and obligations is treated as a single (that is, net) asset or liability, depending on the relationship between the underlying rights and obligations. Thus, at any given point in time, a contract is treated as an asset if the remaining rights exceed the remaining obligations. Similarly, a contract is treated as a liability if the remaining obligations exceed the remaining rights. This asset or liability reflects the entity’s net position in the contract with respect to the remaining rights and obligations in the contract.

10. Accordingly, if the customer performs first by prepaying in full, then the entity has a contract that is a liability to it. This is because it only has contractual obligations remaining. In this case, as the entity satisfies its obligations by transferring economic resources to the customer, the contract liability decreases. In other words, the entity’s net position in the contract increases.

Suppose Engineering Co enters into a contract to deliver and install a machine. If the customer prepays, then immediately after contract inception Engineering Co has no remaining contractual rights. Therefore, the remaining contractual obligations give rise to a contract liability.
After transferring the machine to the customer, Engineering Co’s remaining obligations have decreased, because it needs only to install the machine. Therefore, the contract liability decreases, i.e., Engineering Co’s net position in the contract increases.

11. If the customer does not prepay, then the remaining rights and obligations may result in the entity having a contract that is an asset or a liability to it. This will in part depend on the measurement of those rights and obligations (see paragraphs 17–24). In this case, as the entity satisfies its obligations, the asset will increase or the liability decrease (or the contract that was a liability will become an asset). This is because the rights remain unchanged but the obligations have decreased. In other words, the entity’s net position in the contract increases.

Suppose that in the above example payment is due on completion of the installation of the machine. In this case, on contract inception Engineering Co has both remaining rights and obligations. Suppose that the combination of these rights and obligations initially results in a contract asset, because the value of the rights is greater than the obligations. After transferring the machine to the customer, the remaining rights in the contract remain unchanged. However, Engineering Co’s remaining obligations have decreased, because it needs only to install the machine. Therefore, the contract asset (which is the combination of the remaining rights and obligations) increases. As in the above example, Engineering Co’s net position in the contract increases.

**Relationship of the contract asset or liability to work in progress or inventory**

12. The contract asset or liability arising from the remaining contractual rights and obligations is separate and distinct from any underlying assets to be sacrificed by the entity and transferred to the customer (e.g., an item of inventory). Hence it is not the production of goods and services that results in the satisfaction of an obligation; rather it is the transfer of those goods and services to the customer.

**Which rights and obligations are included in the contract asset or liability?**

13. The rights include the enforceable rights to consideration under the contract or the enforceable rights to the customer’s promise to pay that consideration that is contingent upon the entity’s performance under the contract.
14. The obligations include all of the obligations to the customer that arise from entering into the contract. This includes explicitly stated obligations to transfer economic resources to the customer. It also includes those obligations stemming from the promises that are implied by the entity’s customary business practices if a court would enforce those promises. For instance, these may include obligations to accept returns that are not required under the explicit terms of the contract.

15. Obligations to transfer economic resources to customers include obligations that require the entity to stand ready to perform. For instance, an entity that is providing a guarantee on a loan is providing a service (of guaranteeing the loan) to its customer for the duration of the guarantee, even though ultimately it might not have pay any cash if the borrower does not default.

16. Note that the contractual obligations include those obligations that are sometimes referred to as ‘post-performance’ obligations, such as a manufacturer’s standard warranty and a return or cancellation right (ie the remaining obligations that an entity has after providing the main deliverable in the contract). In other words, all obligations (explicit or implicit) that would require the entity to transfer an economic resource to the customer as a result of entering into a contract with the customer would result in contractual obligations.

**HOW IS THE CONTRACT MEASURED?**

17. The contract asset or liability (that is, the combination of the entity’s remaining contractual rights and obligations) is measured at its current exit price. This is the amount that the entity would expect to receive or pay to transfer its remaining contractual rights and obligations to a market participant at the reporting date.

*Why use a current exit price attribute?*

18. A current exit price measure provides several benefits:

- It reflects the contractual rights and obligations that remain at the reporting date, no more or less. This is because an exit price is the price that the entity would have to
• It reflects the circumstances that exist on the reporting date. A current exit price reflects these circumstances by depicting what the entity would have to pay market participants to assume the entity’s remaining contractual rights and obligations at the reporting date. It therefore depicts how real world events (such as changes in prices and circumstances) affect the contract and reports the effects of those events when they occur. This provides relevant information about the amount and timing of the cash flows that will arise from the contract, which is particularly important in contracts of a longer duration. In particular,
  
  o it should provide more immediate reporting of loss-making or onerous contracts. This is because unfavourable changes in circumstance are reported immediately in profit or loss rather than in future periods.
  
  o it results in subsequent measurements that are more neutral. This is because both favourable and unfavourable changes in circumstances are reported as they arise.

• It explicitly requires a margin on all of the remaining obligations, including ‘post-performance’ obligations such as a return right, because a market participant would require a margin for fulfilling an obligation. Therefore (assuming the contract is profitable) profit is reported over the entire duration of the contract (and not, for instance, just on delivery of the main deliverable in the contract).

• It would improve the comparability of reported information. A current exit price attribute reports economically similar obligations the same regardless of how the entity incurred those obligations. For instance, when an entity sells warranties to its own retail customers and also assumes identical warranties from other retailers for
less money, a current exit price would measure those identical warranties at identical amounts.

- Although an entity may not intend (or may not be able) to transfer the contract to a third party, a current exit price attribute provides a clear objective for measuring the rights and obligations that is based on economic attributes of those rights and obligations. Therefore, a current exit price attribute makes it easier to answer the question ‘how much revenue (and profit) to recognise’ by explicitly determining how much the asset or liability has actually changed in the period (particularly in contracts in which obligations are satisfied over time rather than discretely).

19. The above measurement approach treats the transaction price as an input into the measurement of the rights in the contract asset (or liability). This transaction price does not override the determination of the price a market participant would charge to assume the remaining rights and obligations in the contract. Two potential drawbacks about this measurement approach should be noted:

- It relies on a complete identification of all of the obligations in the contract. This is because if obligations that are present in the contract are not identified, they obviously will not be included in the measurement. This will therefore result in errors in the amount of revenue and profit recognised in profit or loss until such time as the omitted obligations are satisfied. In that regard, there is no ‘cushion’ against the possibility of omitting obligations on initial recognition of the contract asset or liability as there is with many current revenue recognition models.

- Any errors in the initial measurement of the contract will be reported in profit or loss. In other words, any revenue and profit or loss recognised on contract inception will include the effects of any errors in the initial measurement of the contract.

What is included in the measurement?

20. If the customer has prepaid in full, the measurement of the contract liability reflects the price that the entity would have to pay to transfer its remaining contractual obligations to a market participant at the reporting date. In other words, it is the amount that the entity
would have to pay to lay off its obligations. Said simply, it is the price a market participant would charge to fulfil all of the remaining obligations in the contract with no anticipated payments from the customer. This price would reflect any express or implied rights of return and refund, allowances, rebates, discounts, and credits, etc.

21. The exit price will not typically be observable, so it will need to be estimated. The objective is to arrive at the price a market participant would charge, so inputs into the estimate should be consistent with that objective. However, an entity could use its own inputs if it has no evidence to suggest that they would be inconsistent with those that a market participant would use.

22. For example, in some cases, the amount may be derived from the price a subcontractor would currently charge for providing the goods and services underlying the obligations in the contract. This price would then need to be adjusted for the estimated amount a market participant would demand for managing the contract and the price for guaranteeing the performance of the subcontractor.

23. The exit price can also be estimated by using a ‘building block’ approach. In this approach, the price is estimated by considering the following three components:

- the cash flows a market participant would expect to incur in providing all of the goods and services in the contract (ie the direct and indirect costs involved in fulfilling the obligations). When there is uncertainty about the cash flows, the estimate reflects the full range of possible outcomes, weighted by their respective probabilities.
- the margins a market participant would demand for providing the goods and services (including the margin for bearing uncertainty about the future cash flows).
- the time value of money.

24. If the customer has not prepaid, the measurement of the contract asset (or liability) also reflects the enforceable expected cash flows from the customer, taking into account the effects of credit risk and the time value of money.
ACCOUNTING FOR THE CONTRACT WITH THE CUSTOMER

Before contract inception

25. Revenues cannot arise before a contract with a customer exists.

26. This may seem self-evident, but it is important to emphasise that under the definition in paragraph 6 above, revenues could not arise until a contract, which by definition is enforceable, exists. Before a contract exists, the entity does not have any contractual rights or contractual obligations. It is these contractual rights and obligations that are fundamental to the existence of contract assets and liabilities and hence revenue.

At contract inception

27. When an entity becomes party to a contract with a customer to provide goods and services, the entity recognises a contract asset or a contract liability from the combination of its rights and obligations in the contract.

28. If the entity recognises a contract asset that increase in contract assets is recognised as revenue. If the entity recognises a contract liability that increase in contract liabilities is recognised as a loss.

29. In a contract in which the exit price of the underlying contractual rights exceeds the exit price of the underlying contractual obligations, the entity recognises a contract asset when it becomes party to the contract. That increase in the contract asset meets the definition of revenue in paragraph 6. If the exit price of the underlying contractual obligations exceeds the exit price of the underlying contractual rights, the entity recognises a contract liability when it becomes a party to a contract. That increase in the contract liability does not meet the definition of revenue in paragraph 6 and would be recognised as a contract loss.

30. In some contracts, immediately after contract inception, the customer pays in advance in full. Hence, the rights in the contract are satisfied, but obligations still exist, so that the entity’s net position in the contract immediately becomes a liability. Although two events have occurred (the entity has obtained a contract and then the customer has performed
fully), it typically would not be necessary to separately account for these events. Instead, the amount of any revenue to be recognised at contract inception could effectively be determined as the excess of the cash (or other consideration) obtained from the rights in the contract over the current exit price of the entity’s contract liability. Conversely, if the exit price of the contract liability is more than the cash (or other consideration) obtained from the rights in the contract, the entity recognises the excess as a contract loss.

31. Revenue recognised at contract inception is the revenue that arises from obtaining a contract with a customer. This revenue does not necessarily result in reporting a corresponding amount of profit. This is because the entity will have incurred expenses in obtaining the contract (although some of these may have been recognised in prior reporting periods). Note that in this model there is no need to defer pre-contract expenses such as sales commissions or other direct costs of obtaining a contract. This is because some revenue would potentially be recorded at contract inception.

32. Recognising the value attributable to obtaining the contract does not mean that the entire profit expected from the contract is recognised at contract inception. Profit that a market participant would require for providing the goods and services in the contract will be recognised only as those goods and services are provided. Put another way, the revenue that is recognised at contract inception reflects the fact that if the contract was immediately transferred to a market participant, that market participant would not need to obtain the customer; it would need only to fulfil the contract.

Suppose Retailer enters into an enforceable contract with a customer on 30 June for the sale of a good for CU150. The customer prepays and the good will be provided to the customer on 10 July.

All things being equal Retailer would expect to pay less than CU150 at 30 June to transfer the contract liability to a market participant. This is because Retailer incurs expenses in obtaining the contract, ie all of the (direct and indirect) expenses associated with its selling activities (sales commission, staff wages, rent of retail facilities, etc). Retailer implicitly charges the customer for all of these activities. In other words, the customer pays for more than just the good itself. Therefore Retailer would expect to be compensated by the market participant for these activities if it transferred its contractual obligations. And the market participant would be prepared to compensate Retailer because it would not need to incur those costs itself: the customer is in place, it would only need to fulfil all of the contractual obligations.
After contract inception

Changes in the contract from providing goods and services

33. Revenue is recognised after contract inception as the entity satisfies the obligations in the contract with the customer, thus increasing the contract asset or decreasing the contract liability (or a combination of the two).

34. If the customer has prepaid, the contract liability decreases as the entity satisfies the obligations in the contract by providing goods and services to the customer. This is because, all things being equal, as the entity satisfies its obligations, the price that the entity would have to pay a market participant to assume the remaining obligations in the contract would decrease. The resulting decrease in the contract liability meets the definition of revenue.

Suppose Engineering Co enters into a contract to deliver and install a machine. The customer prepays the contract price of CU1,000. Immediately after contract inception the exit price of the contract liability is CU900 and hence revenue of CU100 is recognised.

Suppose that after transferring the machine to the customer, the exit price of Engineering Co’s contract liability decreases to CU200, representing the amount a market participant would charge to install the machine. The decrease in the contract liability of CU700 (ie CU900 – CU200) is recognised as revenue.

35. If the customer has not prepaid, the contract asset increases as the entity satisfies the obligations in the contract by providing goods and services to the customer. This is because, all things being equal, as the entity satisfies its obligations, the price that the entity would expect to receive from a market participant to transfer the remaining rights and obligations in the contract would increase. The resulting increase in the contract asset meets the definition of revenue.

Suppose that in the above example payment is due on completion of the installation of the machine. The exit price of the contract asset on inception is CU100 and hence revenue of CU100 is recognised.
Suppose that after transferring the machine to the customer, the exit price of Engineering Co’s contract asset increases to CU800, representing the amount a market participant would pay for the customer’s promise of CU1,000 less the amount it would charge to install the machine of CU200. The increase in the contract asset of CU700 (ie CU800 – CU100) is recognised as revenue.

36. The amount of revenue recognised is derived from the increase in the exit price of the contract asset or the decrease in the exit price of the contract liability (or combination of the two). Revenue therefore reflects the value of the goods and services that have been provided to the customer at the date they are provided.

When are contractual obligations satisfied?

37. In the usual situation in which an entity satisfies its obligations by providing goods and services to the customer, a contractual obligation cannot be considered satisfied until the entity cedes control of the economic resources called for in the contract. This will be when the entity no longer has the ability to direct the use and benefit of those resources.

38. Contractual obligations are satisfied when an entity no longer has a present obligation to transfer an economic resource in the future. This occurs when the entity either transfers the economic resources called for in a contract (whether a good, service, or refund of the original consideration), when the entity is forgiven or otherwise relieved of the obligation by the customer or court action, or when the entity legally lays off the obligation whereby the customer no longer has any claim against the entity. Typically, an entity will satisfy its obligations to a customer by transferring the goods and services called for in the contract, thereby ceding control of those economic resources.

39. In that regard, there is often a direct connection between the point at which an entity’s obligation is satisfied and the point at which the entity derecognises an asset. This is because in some cases the obligation is satisfied by transferring an economic resource to the customer that was previously a recognised asset of the entity.

40. Generally an obligation to provide a good is satisfied when the entity passes possession of the good to the customer. This is because the entity cedes control of the good so that it
is no longer the entity’s asset. In some cases, the entity may retain physical possession of
the good even though the good no longer is an asset of the entity. For instance, in a
‘genuine’ bill and hold arrangement, the customer might be regarded as controlling the
asset because it controls the right to use the asset, even though it does not currently have
physical possession of the asset. In contrast, the entity might be regarded as having ceded
control of the asset because it no longer has the ability to direct the use and benefit of the
good. The entity cannot, for instance, use the good to fulfil other contracts. In effect, the
entity would be providing custodial services to the customer over the customer’s asset.

41. In the case of many contracts to provide services, an obligation is satisfied continuously
as the entity renders the services. This is because the entity is continuously transferring
economic resources (in the form of services) to its customer.

| Suppose that on 31 December 2007, Cleaning Co enters into a contract that requires it to
clean a customer’s offices each work day for a year.

This contractual obligation is satisfied continuously as Cleaning Co provides the cleaning
services. For instance on 31 March 2008, Cleaning Co has an obligation to provide
cleaning services for nine months rather than an obligation to provide services for a year.
Hence, the contractual obligation is satisfied continuously over 2008. |

42. Some of the more troublesome examples in revenue recognition are contracts in which an
entity is creating an asset for a customer under contract. In some cases, the entity is
producing the asset (eg manufacturing a good) for eventual transfer to the customer. In
such cases, the entity does not cede control of the asset until the asset is actually
transferred to the customer. This is because the entity is largely free to direct the use and
benefit of the good until it delivers the good to the customer.

| Suppose that on 1 May Engineering Co enters into a contract with a customer for the
provision of a machine. The contract specifies that the machine will be transferred to the
customer on 1 August, which is when payment is due. Engineering Co manufactures the
machines to fulfil specific customer orders, and has partly completed the manufacturing
on 30 June.

On 30 June, Engineering Co has:

- a contract asset from its remaining unperformed rights (to the customer’s promise of
  payment) and obligations in the contract (to provide a machine) |
43. The point to note in this example is that Engineering Co’s production process does not in itself satisfy its contractual obligation. Therefore, when the machine is partly constructed, the obligation is not partly satisfied. The obligation is satisfied only when Engineering Co cedes control or otherwise ceases to direct the use and benefit of the machine by transferring it to the customer on 1 August.

44. In other cases, assets transfer to the customer throughout the production process so that the contractual obligation is satisfied continuously.

Suppose that on 1 May Builder enters into a contract to build an extension to a building on the customer’s land. The contract is expected to be completed on 30 September. The customer is required to prepay.

On 30 June, Builder has:

- a contract liability from its remaining unperformed obligations in the contract.

In this case the outputs from Builder’s production processes are transferred continuously to the customer because they become the customer’s property as they are installed on its land. Therefore, the contractual obligation changes continuously. For instance, the contract liability at 30 June arises from Builder’s obligation to provide the remaining construction materials and services.

45. The point to note in this example is that, in contrast to the previous example, Builder cedes controls of assets (construction materials and services) throughout the period of 1 May to 30 September. Hence, its obligation is satisfied continuously.

46. The foregoing paragraphs have only briefly discussed the issue of when a contractual obligation is satisfied. Nonetheless, they highlight the importance of this issue in a contract-based revenue recognition model and therefore that a prerequisite to implement this model would be guidance to assist entities in determining when contractual obligations are satisfied.
Non-performance changes in the contract

47. Changes in the exit price of the contract asset or liability for reasons other than the entity providing goods and services to the customer are reported outside of revenue.

48. At each reporting date, the contract asset or liability is measured at its current exit price. This measure can change for reasons other than the entity providing goods and services to the customer (i.e., satisfying the obligations). For instance, the exit price of the contract asset or liability may change because of a change in the price of the underlying goods and services yet to be provided to the customer. To assist users in understanding the reasons for changes in the exit price of contract assets and liabilities, such changes are reported outside of revenue.

Suppose Retailer enters into a contract with a customer to provide a widget in three months time for which the customer prepays in full CU100. Suppose that the initial measurement of the contract liability is CU90 and hence revenue of CU10 (i.e. CU100 – CU90) is recognised.

Suppose that after one month there is an increase in the price of widgets and that as a result, a market participant would now require CU95 to assume Retailer’s obligation to provide a widget. Retailer increases the contract liability to CU95 and recognises the resulting loss of CU5 in profit or loss outside of revenue.

When Retailer satisfies its obligation by providing the widget to the customer, it extinguishes its contract liability. The resulting decrease in the contract liability of CU95 is recognised as revenue. This revenue reflects the value of the good being provided to the customer at the date that it is provided.

Note that in this example because the amount of revenue was derived from the decrease in the exit price of the contract liability, the total amount of revenue recognised over the duration of the contract was CU105 (i.e. CU10 + CU95), which is greater than the payment actually received from the customer.

49. There are a number of options for displaying the changes in the contract asset and liability in the financial statements. Some of these display options can accommodate reporting an additional revenue line that reports the amount of the customer consideration as revenue. However, discussion and illustration of these options are outside the scope of this summary.
ACCOUNTING FOR A BROADER SET OF ASSETS AND LIABILITIES

50. The revenue recognition model described above only accounts for a narrow set of assets and liabilities, namely those that arise from an enforceable contract with a customer. However, in some cases, the profit or loss (and statement of financial position) that results from such a narrow focus on the contract might fail to faithfully represent the economic circumstances of an entity. There are two main situations in which this might occur.

Accounting mismatches arising in profit or loss

51. After contract inception, but before fulfilment of the contract, the market price of a contractual obligation to provide a good to a customer may increase. This will decrease (increase) the measurement of the contract asset (liability) and result in the recognition of a contract loss. If the entity has already acquired or manufactured the good that will be used to satisfy the obligation (thereby having effectively hedged its position), but this good is not remeasured to reflect its current value, then recognising the increased market price of the obligation will result in an incomplete and potentially misleading depiction of how the price change has affected all the entity’s assets and liabilities.

Suppose Oil Co enters a fixed-price contract on 1 January with a customer to deliver 1000 gallons of oil in four equal instalments starting on 31 March. Suppose the customer pays in full in advance and Oil Co recognises a contract liability of CU3,000. Oil Co purchased all of the oil required to fulfil this contract on 1 January and measures its oil inventory at cost.

On 1 March 2007, the price of oil increases by 10%. Suppose that this increase in the price of oil results in the exit price of the contract liability increasing to CU3,300 and therefore that Oil Co recognises a contract loss of CU300. If Oil Co does not reflect any corresponding increase in the carrying amount of its oil inventory, then profit or loss depicts Oil Co as if it was economically identical to an entity that had not obtained any oil to fulfil the contract. In other words, it depicts Oil Co as if it was fully exposed in its contract to changes in market prices of oil.

Incomplete depiction of the changes in the entity’s assets and liabilities throughout the contract

52. An entity may create an asset under an enforceable contract for eventual transfer to the customer. In such a contract, until the asset (eg an item of inventory) is transferred to the
customer, there will be no change in the entity’s contractual obligation and, hence, no revenue will arise. Furthermore, if the asset is measured at accumulated cost, profit or loss will not reflect any increase in the entity’s assets from creating the asset until it is transferred to the customer. Hence, profit or loss may give an incomplete depiction of the changes in the entity’s assets and liabilities throughout the contract.

Homebuilder is developing an estate of 10 houses. On 31 March 2007, it enters into a contract with a customer for the sale of House 2 of the development for the fixed price of CU250,000. At the time the contract is entered into, Homebuilder has not commenced work on House 2 (ie the house is sold to the customer ‘off plan’).

On entering into the contract the customer pays Homebuilder a non-refundable deposit of CU25,000. The remaining amount of the consideration (CU225,000) is due when the Homebuilder transfers the completed house to the customer. Assume that this occurs on 31 January 2008. Assume that the exit price of the obligations on 31 March is CU240,000 and the initial measurement of the contract liability is CU15,000 (ie remaining rights of CU225,000 – remaining obligation of CU240,000).

Following the principles in paragraphs 25–49, revenue of CU10,000 is recognised on 31 March (ie cash obtained of CU25,000 less contract liability incurred of CU15,000) and revenue of CU240,000 recognised on 31 January 2008.

Between 31 March 2007 and 31 January 2008, Homebuilder recognises its costs in building House 2 as an item of inventory. House 2 is derecognised and an expense is recognised on 31 January 2008. Homebuilder’s margin attributable to building House 2 is therefore not reported in profit or loss until 31 January 2008 when revenue and the building expenses are recognised in profit or loss.

53. Some think that the second situation described above highlights a weakness with the proposed definition of revenue in paragraph 6. They think that the source of an entity’s revenues is the activities it undertakes in producing goods and services for customers rather than the contract itself. In other words revenue can arise from producing goods (eg from creating or enhancing inventory assets) even if this revenue is then precluded from recognition until a contract with a customer exists. They would therefore broaden the definition of revenue to capture increases (decreases) in assets (liabilities) that arise from the entire process of producing, selling, and delivering goods and services to customers.

54. To address these concerns, an alternative revenue recognition model might focus on a broader set of assets and liabilities beyond those that arise directly from the contract.
alone. In particular, it also might include inventory assets (when they are the subject of a contract).

55. However, instead of broadening the definition of revenue, the model described in paragraphs 6–49 could be extended as follows. In a contract in which an entity is creating or enhancing an asset to fulfil contractual obligations, the increase in the exit price of that asset over the costs incurred in bringing the asset to its present location and condition could be reported in profit or loss as a separate component of income—production income. Hence, in such contracts an entity would recognise:

- production income as it created or enhanced assets
- revenue when it transferred those assets to the customer.

56. The profit attributable to creating or enhancing the asset would be recognised as those activities occur. The profit that would be recognised when revenue is recognised would relate only to contract completion activities (because the assets would be carried at their exit price at the date of transfer to the customer).

Continuing with the Homebuilder example in paragraph 52.

Suppose that Homebuilder incurs costs of CU175,000 in building House 2 and that the exit price of House 2 on completion is CU240,000. Applying paragraph 55, Homebuilder would recognise production income of CU65,000 (i.e., CU240,000 – CU175,000) over the period 31 March 2007 to 31 January 2008. And the carrying amount of House 2 immediately before the contract liability is satisfied would be CU240,000.

When Homebuilder satisfies its obligation and recognises revenue of CU240,000 on 31 January 2008, it also derecognises House 2 and recognises a corresponding expense of CU240,000. Therefore no margin is reported on 31 January 2008 because the margin attributable to building House 2 was recognised as production income over the construction period.
INTRODUCTION

1. This paper summarises the customer consideration model of revenue recognition. In this model, revenue arises from recognising increases in specified assets and decreases in specified liabilities rather than from a separate evaluation of how much performance occurred in a period. In other words, the amount of revenue to be recognised is determined by how much assets and liabilities change in a period. The specified assets and liabilities in this model are those that arise directly from enforceable contracts with customers.

2. To measure the contract, the underlying rights in the contract are measured at inception at the amount promised by the customer (often referred to as the customer consideration). That amount is then allocated to the separate performance obligations identified within the contract based on the sales price of the good or service underlying each performance obligation. Therefore, the sum of the identified performance obligations always equals the customer consideration at inception. Because the model is predicated on this allocation of customer consideration to the performance obligations, it is described as the customer consideration model.
3. Because the customer consideration amount is allocated to the identified performance obligations, the sum of these performance obligations and the measure of the rights are equal at inception. Thus, the measure of the contract at inception is typically zero—neither an asset nor a liability arises at contract inception.

4. As each performance obligation identified in the contract is satisfied, the resulting decrease in the contract liability or increase in the contract asset results in the recognition of revenue.

WHAT IS REVENUE?

5. Revenue is an increase in a contract asset or a decrease in a contract liability (or some combination of the two) that results from the satisfaction of performance obligations to provide goods or services to a customer.

6. Performance obligations are the enforceable promises an entity makes within a contract to provide goods and services to a customer. The change in the contract asset or liability that results from the satisfaction of these performance obligations gives rise to revenue. This satisfaction takes place when the goods and services specified by the contract are transferred to the customer.

WHAT ASSETS AND LIABILITIES ARISE FROM AN ENFORCEABLE CONTRACT?

7. When an entity enters into an enforceable contract with a customer, it exchanges promises with the customer. The promises convey rights to the entity and impose obligations on it.

8. The entity’s rights under the contract represent the customer’s promise to pay the consideration specified in the contract. The entity’s obligations under the contract represent the customer’s rights to goods or services from the entity.

9. The combination of the rights and obligations gives rise to a contract asset (where the value of the remaining unperformed rights exceeds the value of the remaining unperformed obligations) or a contract liability (where the value of the remaining unperformed obligations exceed the value of the remaining unperformed rights) that
reflects the entity’s net position in the contract. Increases in this asset or decreases in this liability, which result from the satisfaction of performance obligations, give rise to revenue as a residual.

*Identifying the performance obligations in a contract*

10. **The contract with the customer should be disaggregated into its separate performance obligations based on the goods and services being transferred under the contract.**

11. A good or service promised represents a potentially separate performance obligation if it could be bought and sold separately. Hence, if a contract requires the provision of a number of goods, each good potentially represents a separate performance obligation if that good could be bought or sold separately. Similarly, where a range of services is promised, each service potentially represents a separate performance obligation if it could be bought or sold separately.

12. The settlement of the obligations within a contract can occur at different times over the period of the contract. Separation of the obligations allows recognition of revenue when each separate obligation is satisfied. To be identified as a separate performance obligation, the underlying good or service must be transferred at a different time from other goods or services promised in the contract. That is, the risks and rewards associated with a good or service must transfer to the customer at a different time than other goods and services. There will be situations in which a potential performance obligation is not separately satisfied because the risks and rewards of the underlying good or service are not transferred separately.

13. For example, an entity may contract with a customer to deliver a particular gravel. To fulfil its obligations, the entity must find the specific type of gravel for the customer and wash and grade it prior to delivery. While finding, washing, and grading the gravel are all services that could be sold separately as finding services, washing services, or grading services, *in this particular contract*, these services do not transfer any separate benefit to the customer. They all transfer upon delivering the gravel to the customer. Therefore, in
this example, there is only a single performance obligation (or unit of account): delivery of special, washed and graded gravel.

*Which obligations are not performance obligations?*

14. Under this model performance obligations are restricted to those obligations agreed upon by the entity and its customer, or those that are imposed on the arrangement by the operation of law. For example, a customer loyalty program that is affected by a transaction with a customer would be treated as a performance obligation in that contract. This is because the entity and the customer have previously agreed to the terms of the customer loyalty program and how it applies to future transactions. As another example, a statutory warranty imposed by the operation of law would be treated as a performance obligation even though it is not mentioned in the terms of the customer contract.

15. In contrast, other obligations may be incurred at the same time as a customer contract that would not be treated as performance obligations. The primary class of obligations that would not be treated as performance obligations are those related to future transactions with the customer. These include offers for discounts on future transactions and other similar options granted to customers. These offers are typically outside of the contract with the customer, which is to say, their terms are not part of the negotiations between the entity and the customer. Such offers are also typically unrelated to the good or service being provided in the contract. Because these offers are meant only to entice the customer to transact in the future, and generally the customer will be providing new consideration in those transactions, such offers are not treated as performance obligations. They may give rise to liabilities, but these liabilities would not be treated as a performance obligation under this model.

16. Another class of obligations that would not be treated as performance obligations are promises to allow customers to return merchandise for a refund. Granting such a promise is equivalent to recognising that some sales to customers will ultimately fail. Permitting the customer to return a good or service for a refund is not on its own a separate performance obligation, but instead a reversal of a sale. Although these promises may
result in recognition of a liability, those liabilities would represent refund obligations and would not be treated as separate performance obligations.

17. These classes of obligations are referred to as ancillary obligations in this model. If recognised as liabilities, they would follow the prescribed guidance in IAS 37 Provisions, Contingent Assets and Contingent Liabilities or FAS 5 Accounting for Contingencies in accordance with local practice.

MEASUREMENT OF THE RIGHTS AND OBLIGATIONS

18. The contract rights are measured at the amount of contract consideration stated in the contract. This takes into account the customer’s credit risk as well as the time value of money. This amount is referred to as the customer consideration.

19. The contractual obligations are not measured directly. Instead, the customer consideration is allocated to the individual performance obligations pro rata based on the separate selling prices of each underlying good or service. As a result, the total remaining performance obligations at contract inception are measured at an amount equal to the customer consideration.

Why allocate the customer consideration amount to performance obligations?

20. In any exchange between two willing, rational parties, it is assumed that the parties are giving and receiving items of equal value. This is the assumption with this model. However, some of what the entity gives, and the customer receives, occurs before contract inception. In the exchange with the customer, the entity provides benefits both before (for example, through knowledgeable sales demonstrations) and after contract inception. The amount of consideration promised by the customer takes into account these services because the selling price includes an amount to recover pre-contract costs and post-contract overhead costs (even if the customer is unaware of this fact).

21. However, this consideration is not allocated to any of the pre-contractual activities because it is difficult to determine a reliable selling price for which these activities might be sold separately. Moreover, it is not clear which pre-contractual activities actually
provide a benefit to the customer. For example, a sales demonstration service might be a clearly identified pre-contractual service, but would the design of a sales brochure also represent a separate service? Given these difficulties, the customer consideration amount is allocated only to the performance obligations that arise from the contract.

Allocation of consideration

22. The allocation of consideration should be based on the most reliable information available of how a selling price is or would be calculated for the separate performance obligations. The purpose of the allocation exercise is to allocate the customer consideration to performance obligations based on the entity’s own sales price for each separate underlying good or service.

23. In some rare cases this sales price will be separately available outside the entity. This will occur, for example, in the case of a commodity traded in an active market. The entity’s sales price, and that of all other participants, does not need to be estimated; it is the market fair value of the commodity.

24. Where a separate sales price needs to be determined for a performance obligation, an entity should rely on the following hierarchy of entity-specific entry prices, from most reliable to least reliable:

   • Level 1 - Current sales price charged by the entity itself in an active market
   • Level 2 - Current sales price charged by the entity in an inactive market
   • Level 3 - Current sales price of competitors in an active market
   • Level 4 - Estimates of sales prices using entity inputs that reflect the entity’s own internal assumptions

25. Once the sales price of each performance obligation is assessed, any difference between the sum of the obligations and the total contract value needs to be allocated across the obligations. This residual amount is allocated to each performance obligation pro rata based on the estimated sales price of the performance obligation as a proportion of total customer consideration. Obligations to provide commodities for which a sales price has already been determined are measured at fair value and no residual is allocated to them.
26. As the full amount of customer consideration is fully allocated to the identified performance obligations, there is no initial unallocated customer consideration. Therefore, no contract asset or liability is recognised, and no revenue arises at contract inception.

No re-measurement of performance obligations

27. Performance obligations are subsequently reported at the amount of the customer consideration allocated to them at contract inception. They are not re-measured, except when the contract is onerous.

28. The customer consideration amount is only observable at contract inception. After that point, the price for the remaining obligations in the contract would rarely be observable and, therefore, could not be ascertained.

Loss making contracts

29. Both at inception and where economic circumstances have changed, there would need to be an onerous contract test to ensure that the performance obligations are not understated.

ACCOUNTING FOR THE CONTRACT WITH THE CUSTOMER

At contract inception

30. At contract inception the contract as a whole is measured at zero.

31. At inception, the rights and obligations are both equal to the total customer consideration amount, so no contract asset or contract liability is recorded at contract inception unless the contract is judged to be onerous.

After contract inception

32. Revenue is recognised when the contract liability decreases, or the contract asset increases, as a result of the entity satisfying its performance obligations.
33. As the contract progresses, sales invoices are issued in line with the terms of the contract. The contract right is converted into a receivable or debtor, which is, in turn, converted into cash as the invoices are paid. These changes in this right do not give rise to revenue.

34. The performance obligations identified in the contract are satisfied individually as the contract progresses. At each reporting period, the entity will need to ascertain whether the obligations have been satisfied or not. As these obligations are satisfied, the resulting decrease in the contract liability or increase in the contract asset results in the recognition of revenue.

*Identifying when goods and services transfer*

35. **The performance obligations are satisfied when goods and services transfer from the entity to the customer.**

36. The obvious, clear indicator that transfer has taken place occurs when legal title transfers. This is an absolute indicator that the rights and obligations of ownership have transferred. However, for many transactions the risks and rewards of a particular good will transfer in advance of legal title.

37. To assess whether the risks and rewards of a good or service have transferred to the customer, an entity needs to consider the following questions:
   
   a. Who has physical possession?
   b. Who has the ability to use?
   c. Who can control or direct the benefit?
   d. Who bears the insurance risk?
   e. Who has the ability to pledge?
   f. Who bears technical or obsolescence risk?
   g. Who bears the risk of loss or destruction?
   h. Who bears the risk of price changes?

38. Generally speaking, the risks and rewards alluded to in these questions reflect an everyday idea of ownership or control. The answers to these questions will form the basis to judge whether the risks and rewards of a particular good or service have passed to the
customer. Where the majority of risks and rewards of a good or service has transferred to the customer, the performance obligation will have been satisfied. Where the balanced view is that the majority has not transferred to the customer, the good or service has not transferred and the performance obligation has not been satisfied. In this situation, no revenue is recognised.

39. **Goods.** A principal indicator of the transfer of a good to the customer is physical delivery of the good to the customer’s premises. At this stage the customer usually acquires physical control of the good, the ability to use it, pledge it, and resell it. The entity, in turn, can be seen as having satisfied its performance obligation.

40. **Services.** The benefit of a service provided to the customer transfers as the service is rendered by the entity.

41. Where a service is rendered on the customer’s goods, the transfer of benefit is immediate and revenue is recognised as the obligation is progressively satisfied by performance. In a building construction contract on the customer’s site, a small increment of the obligation is satisfied as each brick is laid. The performance obligation is not being re-measured as it is satisfied, but rather may be thought of as a series of tiny, identical obligations, each of which is measured at inception at the same amount and satisfied separately as the benefit transfers.

42. However, where the service is not performed on the customer’s good or directly for the customer, the question arises—is the entity supplying *its good* to a customer or is it providing *a service* to the customer to create the customer’s own asset?

43. Indications that a service is being provided, rather than a finished good delivered, would include:

- The customer controls the unfinished inventory (work in progress or WIP).

  Indicators that the entity has transferred control include:

  a. The asset is constructed on land owned by the customer.
b. The customer has the right to take over the WIP.

c. In the event of termination, the customer retains the WIP and the entity has the right to be paid for it.

d. Title passes as the asset is built.

- Further indicators that a service is being provided may arise from customisation. It is not customisation per se, however, that suggests the good is the customer’s from the outset. It is the fact that the operation of law or an explicit statement in the contract makes the good the customer’s from the beginning. In the absence of such a statement or operation of law, an entity retains the preponderance of the risks and rewards associated with the customised good.

44. Where a construction service is provided, it will normally be expressed as a number of separate performance obligations, representing how the service as a whole is performed. The construction of a house will include laying the foundations, building the frame, cladding the frame, and fitting the electrics and plumbing. All of these services could be sub-contracted or sold separately. Each is a potential separate performance obligation. As each is satisfied, revenue is recognised.

45. The level of separation the entity goes to will depend on both the sensitivity of timing (for example does the contract span a year end) and on its method of control and management of the contract. Where costing structures and responsibilities are segregated, the disaggregation of performance obligations will reflect that level of separation.

46. In practice, the identification of separate performance obligations and ascertaining their satisfaction will not be burdensome for many contracts. Satisfaction takes place instantaneously in many transactions. For example, in the case of a retail transaction, the transfer of the goods and services and the satisfaction of the obligation is both simultaneous and instantaneous. The existence of the performance obligation is not noted by observers nor is it recorded separately by the retailer.
## REVENUE RECOGNITION: SUMMARY OF THE KEY FEATURES OF THE MEASUREMENT AND CUSTOMER CONSIDERATION MODELS

<table>
<thead>
<tr>
<th></th>
<th>Measurement Model</th>
<th>Customer Consideration Model</th>
</tr>
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<tbody>
<tr>
<td><strong>What is revenue?</strong></td>
<td>An increase in a contract asset or a decrease in a contract liability (or some combination of the two) that results from (a) obtaining an enforceable contract with a customer to provide goods and services and (b) providing those goods and services to the customer.</td>
<td>An increase in a contract asset or a decrease in a contract liability (or some combination of the two) that results from the satisfaction of performance obligations to provide goods or services to a customer.</td>
</tr>
<tr>
<td><strong>Contract Inception</strong></td>
<td><strong>Measurement of contract at inception</strong> Measure the remaining rights and performance obligations in the contract at their current exit price.</td>
<td>Measure the rights in the contract at the amount of consideration received or receivable. The amount of consideration received or receivable is then allocated to the identified performance obligations based on the separate selling price of the underlying good or service.</td>
</tr>
</tbody>
</table>

**Note:** These materials are provided to facilitate understanding of the issues to be addressed at the December 6, 2007 FASAC meeting. These materials are for discussion purposes only; they are not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.
<table>
<thead>
<tr>
<th><strong>Identifying the separate performance obligations</strong></th>
<th><strong>Measurement Model</strong></th>
<th><strong>Customer Consideration Model</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>At any reporting date, the entity measures all of the remaining performance obligations in the contract.</td>
<td>All obligations to a customer arising from the contract are included in the measurement of the contract (including obligations such as warranties and return rights).</td>
<td>The identified performance obligations are restricted to those obligations agreed upon by the entity and its customer, or those that are imposed on the arrangement by the operation of law. ‘Ancillary obligations’ (such as discount offers on future transactions or rights of return) may arise directly from the contract, but these are not considered performance obligations. No consideration is allocated to ancillary obligations.</td>
</tr>
</tbody>
</table>

<p>| <strong>Can some revenue arise at contract inception?</strong> | Yes (if current exit price of rights obtained &gt; current exit price of obligations incurred). | No |
| <strong>Can some profit arise at contract inception?</strong> | Yes (if current exit price of rights obtained less current exit price of obligations incurred &gt; contract acquisition expenses). | No |
| <strong>Can some loss arise at contract inception?</strong> | Yes (if the contract acquisition expenses &gt; current exit price of rights obtained less current exit price of obligations incurred; or if current exit price of obligations incurred &gt; current exit price of rights obtained). | Yes (for all the contract acquisition expenses. An additional loss will also arise if the contract is judged to be onerous.) |</p>
<table>
<thead>
<tr>
<th>After Contract Inception</th>
<th>Measurement Model</th>
<th>Customer Consideration Model</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Measurement of contract after inception</strong></td>
<td>Measure remaining rights and obligations in the contract at their current exit price.</td>
<td>Measure remaining rights at the amount of remaining consideration receivable. Measure remaining obligations at the amount of consideration that was allocated to those obligations at contract inception unless those obligations are judged to be onerous. If onerous, recognise an additional liability.</td>
</tr>
<tr>
<td><strong>If there is a change in price for goods and services still to be provided, does the carrying amount of the performance obligations change?</strong></td>
<td>Yes, if there is a change in the current exit price of the goods and services to be provided.</td>
<td>Yes, but only if the contract is determined to be onerous.</td>
</tr>
<tr>
<td><strong>When is revenue recognised?</strong></td>
<td>As performance obligations are satisfied (i.e. as goods and services transfer to customer).</td>
<td>As performance obligations are satisfied (i.e. as goods and services transfer to customer).</td>
</tr>
<tr>
<td><strong>How is the amount of revenue determined</strong></td>
<td>By reference to the current exit price of the obligations that have been satisfied—i.e. current price of goods and services provided in the period.</td>
<td>By reference to the contract consideration that was initially allocated to the obligations that have been satisfied—i.e. amount of contract consideration attributed to goods and services provided in the period.</td>
</tr>
</tbody>
</table>
1. This paper illustrates the Measurement and Customer Consideration models relative to current practice using the following four examples:

   • A television sold with an extended warranty
   • A house painting arrangement
   • The purchase of a boat
   • A widget sold with a right of return.

2. The first three examples are similar to those presented to the Boards for the October 2007 joint Board meeting with the FASB and the IASB. The principal difference, however, is that a section has been added for comparison to current practice.
TELEVISION WITH AN EXTENDED WARRANTY

3. Consider the following facts and assumptions:

On December 31, 2007, 20 customers purchase the same model of television from an electronics retailing entity (Retailer) for CU2,300 cash each. Retailer includes a one-year warranty with the sale of all its televisions, as required by consumer protection laws in the country in which Retailer operates. However, each of the customers also chooses to buy an extended two-year warranty (i.e. to increase the warranty period to a total of three years).

Retailer normally sells the television (inclusive of the statutory one-year warranty) for CU2,000 and the extended two-year warranty for CU400. As part of a year-end sale, however, it offers its customers the option of buying the television and extended warranty at the reduced price of CU2,300.

When a warranty claim arises, Retailer processes the claims and repairs or replaces the television itself. Its prior experience with this type of television suggests a 20 percent likelihood that a claim will be filed during the three years of warranty coverage. Hence, Retailer expects four claims to arise from these 20 contracts, with one of these claims being filed in Year 1, another in Year 2, and two of them in Year 3. Actual claims filed during 2008, 2009, and 2010 were one, two, and two, respectively. The total cost of servicing and administering each claim was CU400. All claims were serviced in the same year they were filed and processed.

Retailer incurs various costs for activities to obtain the contracts, including a direct sales commission of CU30 per extended warranty. Retailer also incurs costs in administering the warranties; however, these are not directly attributable to the contracts and are excluded from the illustration. The carrying amount of each television in Retailer’s inventory immediately prior to sale was CU1,600.

To simplify the example, assume that the customers do not have the right to return the televisions and cannot cancel the warranties. The time value of money is ignored for simplicity. Retailer reports annually.

4. The staff chose this example for the following reasons:

- A warranty is a common feature of many contracts and accounting for warranties is often cited as an example of inconsistency in current revenue recognition guidance.

- A warranty contract is analogous to many other service contracts in that it features a continuous transfer of economic resources to the customer over multiple reporting periods. In other words, the contractual obligation is partially extinguished on a daily
basis, which highlights the need for an entity to identify and measure remaining contractual obligations each reporting period.

- Warranties are often long-term contracts and the circumstances surrounding the warranties can change substantially over the contract term. It is important to explore how the two models address these changes in those circumstances.

**Measurement model**

*Period ended December 31, 2007*

5. During the period ended December 31, 2007, Retailer performs various activities to obtain 20 contracts. Shortly after inception of each contract, the customer performs by paying the full amount of consideration (thus extinguishing Retailer’s contractual rights). At the same time, Retailer satisfies part of its obligations by delivering the television to the customer. Therefore, Retailer has a contract liability because the remaining obligations to provide three years of warranty coverage exceed the rights that are fully extinguished upon prepayment by the customer.

6. The contract liability is measured at the amount a market participant would require to assume *all* of Retailer’s remaining obligations in the contract. This measurement reflects any attributes of the particular contract. For example, a market participant would require a higher price if Retailer has a higher-than-industry average number of warranty claims because of its poor inventory-handling procedures. Suppose that insurance companies will legally assume Retailer’s warranty obligations for CU120 per warranty, so that CU2,400 is the current exit price for the portfolio of all 20 warranty contracts.

7. In this example, revenue can be determined as the excess of cash obtained (CU46,000, i.e., CU2,300 × 20) over the current exit price of Retailer’s remaining contract liability (CU2,400). This revenue arises from obtaining the contract (in which the rights obtained exceeded the obligations incurred) and from partially satisfying an obligation under the contract (by delivering the television). Given the shortness of time over which the customer performs and Retailer partially performs, however, it is not necessary to
determine revenue for these events separately. Revenue can instead be recorded as follows:

\[
\begin{align*}
\text{Dr Cash} & \quad 46,000 \\
\text{Cr Contract liability} & \quad 2,400 \\
\text{Cr Revenue} & \quad 43,600
\end{align*}
\]

8. Retailer derecognizes the television inventory when the televisions are transferred to the customer (20 × CU1,600 = CU 32,000).

\[
\begin{align*}
\text{Dr Cost of sales (expense)} & \quad 32,000 \\
\text{Cr Inventory} & \quad 32,000
\end{align*}
\]

9. Retailer also recognizes the direct selling costs incurred of CU30 per television (20 × CU30 = CU600).

\[
\begin{align*}
\text{Dr Selling expenses} & \quad 600 \\
\text{Cr Cash} & \quad 600
\end{align*}
\]

*Period ended December 31, 2008*

10. During the period ended December 31, 2008, a single television claim is serviced under warranty. Retailer incurs direct and indirect costs of servicing and administering the claim of CU400.

\[
\begin{align*}
\text{Dr Warranty expenses} & \quad 400 \\
\text{Cr Cash} & \quad 400
\end{align*}
\]

11. To determine revenue for the period, Retailer needs to measure the contract liability at its current exit price. This price is not directly observable because the current prices available from the insurance companies are for warranty coverage on new televisions, not on one-year-old televisions.

12. Because directly observable prices for the warranty obligations are not available, Retailer estimates the amount it would need to pay a market participant to assume those obligations. In this case, that price reflects:

a. The number of claims expected to arise under the warranty contracts
b. The direct and indirect costs of satisfying those claims
c. The direct and indirect costs of administering the warranties (e.g. resolution of customer questions and processing of claims)
d. The margin required on warranty work

e. The margin required for bearing uncertainty about the number of claims that might arise and the cost of fulfilling those claims

f. The likelihood of having to refund the consideration due to non-performance.

13. In concept, Retailer should make its estimates from the perspective of a market participant. In practice, however, Retailer could use its own estimates if it does not have reason to believe they would significantly differ from those of other market participants.

14. Retailer estimates a 15 percent chance of a claim arising over the remaining two years of warranty coverage and expects the total cost per claim to be CU400. The total expected cost per contract is therefore CU60 (CU400 × 15%). The required margin per contract (for the warranty work and for bearing uncertainty), is CU35 per contract. The measurement of each warranty obligation is therefore estimated at CU95 (CU60 + CU35), so that the contract liability for all 20 contracts is measured at CU1,900 (CU95 × 20).

15. The decrease in the contract liability from CU2,400 at inception to CU1,900 at December 31, 2008, is recognized as revenue.

\[
\begin{array}{ccc}
\text{Dr Contract liability} & 500 \\
\text{Cr Revenue} & 500 \\
\end{array}
\]

Period ended December 31, 2009

16. During the period ended December 31, 2009, two television claims are serviced under warranty. The total costs of servicing and administering the claims are CU800.

\[
\begin{array}{ccc}
\text{Dr Warranty expenses} & 800 \\
\text{Cr Cash} & 800 \\
\end{array}
\]

17. At contract inception, Retailer expected to service 4 televisions during the life of these 20 warranty contracts. Retailer serviced three televisions during the first two years, which, based on the original expectation, suggests that at the end of 2009 only one claim would

---

1 The cost estimate has been simplified in the example for illustrative purposes. In practice, this estimate would likely use a probability weighted average calculation to reflect the likelihood of different cash flow scenarios. The calculation would also estimate the cash flows associated with administering the warranties and the possibility of having to refund amounts to the customer.
be expected to arise in the third year (i.e. there would be a 5 percent probability of a claim arising). However, Retailer determines at December 31, 2009, that the probability of servicing a claim during the third year is 10 percent due to an unexpected increase in the number of claims filed for this particular television model.

18. Hence, in estimating the amount a market participant would now require to assume the remaining obligations, Retailer updates the probability of a claim arising. Since it does not expect the total cost per claim to change, the total cost per contract is CU40 (CU400 × 10%). The required margin per contract (for the warranty work and for bearing uncertainty) decreases to CU20 per contract because there is now only one year of coverage remaining.\(^2\) The measurement of each warranty obligation is therefore CU60 (CU40 + CU20), so that the total contract liability for all 20 contracts is CU1,200 (CU60 × 20).

19. The contract liability has therefore decreased from CU1,900 at December 31, 2008, to CU1,200 at December 31, 2009. The full amount of this decrease (CU700) could be recognized as revenue. However, there are two reasons for the decrease in the contract liability.

20. First, Retailer provided warranty coverage and service repairs in the period (i.e. the obligation was partly extinguished in the period). Secondly, there has been a change in the expected amount of claims and that affects the price a market participant would demand for assuming the remaining obligations. Separately identifying these two effects may provide more useful information to users. For instance, suppose Retailer estimates that the contract liability would have been measured at CU800 if there had been no change in future anticipated repairs. One way in which the decrease in the contract liability could be presented is as follows:

\[
\begin{align*}
\text{Dr Contract liability} & \quad 700 \\
\text{Dr Contract loss} & \quad 400 \\
\text{Cr Revenue} & \quad 1100 \\
\end{align*}
\]

\(^2\) Note that this margin has not reduced proportionately. Although there has been no change in the price demanded for bearing risk since December 31, 2008, the amount of risk in the contracts does not reduce evenly over the life of the contracts. In other words, there is more uncertainty about the number of claims that might arise in the later periods of the contract than during the earlier periods.
21. The income statement would therefore display the loss from the change in circumstances during the period separately from the value of services provided to the customer during the period.

**Period ended December 31, 2010**

22. During the period ended December 31, 2010, two television claims are serviced under warranty. The total costs of servicing and administering the claims are CU800.

<table>
<thead>
<tr>
<th>Dr Warranty expenses</th>
<th>800</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr Cash</td>
<td>800</td>
</tr>
</tbody>
</table>

23. Retailer measures its remaining contract liability at zero because it has fulfilled its obligations under the 20 contracts. The CU1,200 decrease in the contract liability during the period is recognized as revenue.

<table>
<thead>
<tr>
<th>Dr Contract liability</th>
<th>1,200</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr Revenue</td>
<td>1,200</td>
</tr>
</tbody>
</table>

24. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>43,600</td>
<td>500</td>
<td>1,100</td>
<td>1,200</td>
<td>46,400</td>
</tr>
<tr>
<td>Cost of sales (expenses)</td>
<td>(32,000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(32,000)</td>
</tr>
<tr>
<td>Warranty expenses</td>
<td>-</td>
<td>(400)</td>
<td>(800)</td>
<td>(800)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Contract loss</td>
<td>-</td>
<td>-</td>
<td>(400)</td>
<td>-</td>
<td>(400)</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>(600)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(600)</td>
</tr>
<tr>
<td>Margin</td>
<td>11,000</td>
<td>100</td>
<td>(100)</td>
<td>400</td>
<td>11,400</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>45,400</td>
<td>45,000</td>
<td>44,200</td>
<td>43,400</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td></td>
</tr>
<tr>
<td>Contract liability</td>
<td>2,400</td>
<td>1,900</td>
<td>1,200</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>11,000</td>
<td>11,100</td>
<td>11,000</td>
<td>11,400</td>
<td></td>
</tr>
</tbody>
</table>

25. As a result of the remeasurement in 2009 (Year 2), total revenue does not equal the contract consideration. This is because revenue reflects the value of the goods and services provided to the customer at the date they were provided, rather than at contract inception. Various options exist for presenting the changes in the contract liability arising from the changes in price and circumstances. Some of these would result in Retailer reporting revenue of CU46,000 (i.e. the amount of the contract consideration). However, illustration of these options goes beyond the objective of this paper.
Customer Consideration model

Period ended December 31, 2007

26. Under the Customer Consideration model, no contract asset or liability is recognized at inception because the measurement of the rights is allocated to the performance obligations. The amount of rights changes throughout the contract according to the contractual billing terms, but it is the satisfaction of the performance obligations that gives rise to revenue.

27. The television and both warranties represent potential performance obligations because they are goods and services capable of separate delivery or benefit to the customer. The total customer consideration amount must therefore be allocated among these performance obligations based on their relative selling prices at contract inception.

28. The observable prices at contract inception are CU2,000 for the television (inclusive of the statutory warranty) and CU400 for the extended warranty. Because the statutory warranty was not priced separately, Retailer uses its own estimate to determine that CU25 of the television’s CU2,000 selling price was for the statutory warranty. That is, CU25 is the entity’s best estimate of a standalone selling price for the statutory warranty. This estimate would be built up by projecting future cash flows and adjusting them for the margins required by the entity. The CU100 discount is then allocated to each performance obligation according to their relative prices as follows (rounded to the nearest whole dollar):

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Base Price</th>
<th>Weighted Average Discount</th>
<th>Allocated Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Television</td>
<td>1,975</td>
<td>(82)</td>
<td>1,893</td>
</tr>
<tr>
<td>Statutory warranty coverage</td>
<td>25</td>
<td>(1)</td>
<td>24</td>
</tr>
<tr>
<td>Extended warranty coverage</td>
<td>400</td>
<td>(17)</td>
<td>383</td>
</tr>
<tr>
<td>Total</td>
<td>2,400</td>
<td>(100)</td>
<td>2,300</td>
</tr>
</tbody>
</table>

29. Once the performance obligations are identified and the total customer consideration is allocated to them, revenue is then recognized as each obligation is satisfied. For the television, the obligation is satisfied upon delivery to the customer when the rights and benefits associated with the television transfer. The statutory warranty obligation is satisfied over the first year and the extended warranty obligation is satisfied over the
following two years. Revenue is not necessarily recognized on a straight-line basis, however, because the increments of time may be quantified differently to better approximate the selling price of each increment based on its relative risk and cost.

*Period ended December 31, 2007*

30. During the year ended December 31, 2007, Retailer recognizes the cash consideration received from the customers (CU46,000). This total amount is then allocated to each performance obligation in the contract. Based on this allocation, CU37,860 (CU1,893 per television × 20 televisions) is allocated to the obligation to deliver the television, CU480 (CU24 × 20) to the statutory warranty, and CU7,660 (CU383 × 20) to the extended warranty.

\[
\begin{align*}
&\text{Dr Cash} & 46,000 \\
&\text{Cr Contract liability – televisions} & 37,860 \\
&\text{Cr Contract liability – statutory warranty} & 480 \\
&\text{Cr Contract liability – extended warranty} & 7,660
\end{align*}
\]

31. At December 31, 2007, Retailer has fulfilled its obligation to deliver the television and recognizes revenue in the amount of consideration originally allocated to that obligation.

\[
\begin{align*}
&\text{Dr Contract liability – televisions} & 37,860 \\
&\text{Cr Revenue} & 37,860
\end{align*}
\]

32. In practice, the entries shown in paragraphs 30 and 31 are likely combined into a single entry. The entries are shown separately here to illustrate the process of identifying the relevant rights and obligations in an arrangement and allocating the customer consideration to the performance obligations.

33. Retailer also derecognizes the television inventory when the televisions are delivered to its customers.

\[
\begin{align*}
&\text{Dr Cost of sales (expense)} & 32,000 \\
&\text{Cr Inventory} & 32,000
\end{align*}
\]

34. Finally, Retailer recognizes the direct selling costs incurred of CU30 per warranty.

\[
\begin{align*}
&\text{Dr Selling expenses} & 600 \\
&\text{Cr Cash} & 600
\end{align*}
\]
Period ended December 31, 2008

35. In the period ended December 31, 2008, Retailer satisfies the statutory warranty obligation which gives rise to revenue in the amount of customer consideration allocated to that obligation at contract inception.

\[
\begin{align*}
\text{Dr Contract liability – statutory warranty} & \quad 480 \\
\text{Cr Revenue} & \quad 480
\end{align*}
\]

36. During the period ended December 31, 2008, Retailer incurs direct and indirect costs of CU400 for servicing and administering one television under the statutory warranty. These costs are charged to warranty expenses as incurred.

\[
\begin{align*}
\text{Dr Statutory warranties expense} & \quad 400 \\
\text{Cr Cash} & \quad 400
\end{align*}
\]

Periods ended December 31, 2009 and 2010

37. In these periods, Retailer recognizes extended warranty services revenue of CU2,553 and CU5,107 based on the satisfaction of the performance obligation to provide warranty coverage during these years. Retailer also incurs actual warranty expenses each year of CU800. The revenue amounts represent the satisfaction of the performance obligation as determined at contract inception by the allocation of customer consideration to each time period. In other words, the consideration allocated to the extended warranty was CU7,660, of which one third was recognized in Year 2 and two thirds in Year 3 (due to the original expectation of servicing one of the three additional warranty claims in Year 2 and the remaining two claims in Year 3).

38. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>37,860</td>
<td>480</td>
<td>2,553</td>
<td>5,107</td>
<td>46,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(32,000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(32,000)</td>
</tr>
<tr>
<td>Warranty costs</td>
<td>-</td>
<td>(400)</td>
<td>(800)</td>
<td>(800)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>(600)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(600)</td>
</tr>
<tr>
<td>Margin</td>
<td>5,260</td>
<td>80</td>
<td>1,753</td>
<td>4,307</td>
<td>11,400</td>
</tr>
<tr>
<td>Cash</td>
<td>45,400</td>
<td>45,000</td>
<td>44,200</td>
<td>43,400</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td></td>
</tr>
<tr>
<td>Statutory warranties liability</td>
<td>480</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Contract liability – Extended warranties</td>
<td>7,660</td>
<td>7,660</td>
<td>5,107</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>5,260</td>
<td>5,340</td>
<td>7,093</td>
<td>11,400</td>
<td></td>
</tr>
</tbody>
</table>
Current practice (U.S. GAAP and IFRS)

39. The principles of revenue recognition under IFRS are similar to revenue recognition principles of U.S. GAAP and therefore often results in the same accounting treatment. However, significant differences in practice may arise for various reasons such as the fact that IFRS is generally not as prescriptive as U.S. GAAP. Differences may also arise in terms of the means by which the same outcome is achieved. The objective of this paper is not to explore these differences between U.S. GAAP and IFRS but rather to illustrate the Measurement and Customer Consideration models relative to the underlying principles of current practice. For this reason, these examples assume that the results are the same under U.S. GAAP and IFRS. All paragraphs in this paper under the Current practice (U.S. GAAP and IFRS) section should be read with this objective in mind.

40. Under current practice, revenue recognition is based largely on the criteria that revenue must be realized or realizable and earned (that is, the earnings process must be complete or substantially complete). Because the customer pays in advance for the television and warranty, the realization criterion has been met. Revenue is then recognized as the earnings process is completed. Assessing completion of the earnings process, however, is complicated by the existence of multiple deliverables in the same arrangement.

41. Multiple deliverables in a single arrangement require an analysis to identify the unit (or units) of account. In this case, Retailer allocates the CU100 contract discount between the television (including the statutory warranty) and the additional warranty. Current practice would likely use a relative fair value method to do this allocation.

42. When identifying the separable units of account, current practice looks for objective and reliable evidence of a standalone selling price in order to recognize revenue for each deliverable independently of the others.\(^3\) In this case, the statutory warranty does not have an observable selling price on a standalone basis because it is never sold separately from the television. In other words, the statutory warranty is considered to be an integral

---

\(^3\) EITF Issue No. 00-21 addresses this topic under U.S. GAAP. IFRS does not have comparable literature dealing with revenue arrangements with multiple deliverables but does often follow similar principles when determining the unit of account.
part of the television and is not therefore accounted for separately. But the television and the additional warranty are priced and sold separately and are therefore treated as separate units of account. The standard selling prices of the television (CU2,000) and warranty (CU400) serve as the basis to determine revenue associated with each deliverable. Hence, the CU100 discount is applied to the deliverables of each contract as follows:

<table>
<thead>
<tr>
<th></th>
<th>Base Price</th>
<th>Weighted Average Discount</th>
<th>Allocated Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Television (and statutory warranty)</td>
<td>2,000</td>
<td>(83.33)</td>
<td>1,917</td>
</tr>
<tr>
<td>Extended warranty coverage</td>
<td>400</td>
<td>(17.67)</td>
<td>383</td>
</tr>
<tr>
<td>Total</td>
<td>2,400</td>
<td>(100)</td>
<td>2,300</td>
</tr>
</tbody>
</table>

43. Based on the above allocation and the relevant guidance for each deliverable, revenue for the television and statutory warranty is recognized once the television is delivered to the customer while revenue for the warranty is recognized over the period in which the warranty coverage is provided. Warranty coverage revenue is recognized on a straight-line basis over the contract period except when sufficient historical evidence indicates that the costs of performing services under the contract are incurred on another basis. At the commencement of the warranty, Retailer expects to service one television under statutory warranty, one television in the first year of the extended warranty, and two televisions in the last year of the extended warranty. This expectation is based on previous experience with similar warranties on similar products. Revenue for the extended warranty would follow this expected pattern of claims servicing over only the last two years of the total warranty coverage period (i.e. one third of the extended warranty revenue in Year 2 and two thirds in Year 3).
Period ended December 31, 2007

44. During the period ended December 31, 2007, Retailer receives full payment of CU46,000 and delivers the televisions. Based on the allocation of contract consideration, television revenue of CU38,340 (CU1,917 × 20) is recognized along with deferred revenue of CU7,660 (CU383 × 20). This deferred revenue represents the realization of customer consideration in excess of the revenue Retailer has earned.

\[
\begin{align*}
\text{Dr Cash} & \quad 46,000 \\
\text{Cr Revenue} & \quad 38,340 \\
\text{Cr Deferred revenue} & \quad 7,660
\end{align*}
\]

45. At inception of the contract, Retailer recognizes a liability for the statutory one-year warranty obligation. Suppose this amount is CU400.

\[
\begin{align*}
\text{Dr Warranty expenses} & \quad 400 \\
\text{Cr Warranty liability - statutory} & \quad 400
\end{align*}
\]

46. Retailer recognizes cost of sales for the televisions delivered to the customers.

\[
\begin{align*}
\text{Dr Cost of sales} & \quad 32,000 \\
\text{Cr Inventory} & \quad 32,000
\end{align*}
\]

47. Retailer recognizes the direct selling expenses incurred of CU30 per warranty. Assume these expenses are not eligible for deferral.

\[
\begin{align*}
\text{Dr Selling expenses} & \quad 600 \\
\text{Cr Cash} & \quad 600
\end{align*}
\]

Period ended December 31, 2008

48. In the period ended December 31, 2008, Retailer does not recognize any revenue because no revenue has been deemed to be earned. Retailer does, however, service one television under the statutory warranty and thereby extinguishes its liability that was set up at contract inception.

\[
\begin{align*}
\text{Dr Warranty liability - statutory} & \quad 400 \\
\text{Cr Cash} & \quad 400
\end{align*}
\]

Periods ended December 31, 2009 and 2010

49. During Years 2 and 3, Retailer recognizes extended warranty services revenue of CU2,553 (one third of CU7,660) and CU5,107 (two thirds of CU7,660) and incurs
warranty expenses of CU800 (CU400 × 2) and CU800 (CU400 × 2), respectively. The revenue amounts represent the amortization (based on expected claims servicing) of the deferred revenue balance at inception. In other words, Retailer allocated consideration of CU7,660 to the extended warranties and had an expectation of servicing one television in Year 2 and two televisions in Year 3. One third of the revenue is therefore recognized in Year 2 with two thirds being recognized in Year 3.

50. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>38,340</td>
<td>-</td>
<td>2,553</td>
<td>5,107</td>
<td>46,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(32,000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(32,000)</td>
</tr>
<tr>
<td>Warranty expenses</td>
<td>(400)</td>
<td>-</td>
<td>(800)</td>
<td>800</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>(600)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(600)</td>
</tr>
<tr>
<td>Margin</td>
<td>5,340</td>
<td>-</td>
<td>1,753</td>
<td>4,307</td>
<td>11,400</td>
</tr>
<tr>
<td>Cash</td>
<td>45,400</td>
<td>45,000</td>
<td>44,200</td>
<td>43,400</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td></td>
</tr>
<tr>
<td>Warranty liability – statutory</td>
<td>400</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Deferred revenue</td>
<td>7,660</td>
<td>7,660</td>
<td>5,107</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>5,340</td>
<td>5,340</td>
<td>7,093</td>
<td>11,400</td>
<td></td>
</tr>
</tbody>
</table>

Illustration summary

51. Comparing the table above in paragraph 50 to the tables in paragraphs 24 and 38 reveals key differences between current practice and the Measurement and Customer Consideration models in this example. At inception of the contracts, revenue (and margin) is significantly higher under the Measurement model than under the other models. One reason for this difference is that the Measurement model recognizes revenue from obtaining the contracts as well as from delivery of the television whereas current practice and the Customer Consideration model only recognize revenue from delivery of the television.

52. The Measurement and Customer Consideration models treat the statutory warranty as a separate unit of accounting for revenue recognition whereas current practice does not. This means that if only the expected costs of that warranty are accrued, then the entire margin from selling the television with the statutory warranty is recognized when the television is delivered to the customer although Retailer has not performed any of its
warranty servicing obligations under the statutory warranty. In other words, had there been no extended warranty in this example, the pattern of profit recognition might have been more conservative under the Measurement model than under current practice.

53. The measurement of the remaining contractual obligations is also significantly different. Under current practice and the Customer Consideration model, the measurement of remaining obligations at each reporting date is based on the original allocation of customer consideration to those separable deliverables of the contract. That allocation is unaffected by subsequent changes in circumstances such as an increase in the expected number of claims (as occurs in this example) unless the contract is deemed onerous. In contrast, under the Measurement model, if the change in circumstances results in a change in the current exit price (as occurs in this example), then the change in circumstances is reflected in the measurement of remaining obligations.

54. As a result of the change in circumstances, total revenue under the Measurement model does not equal the contract consideration. Revenue reflects the value of the goods and services provided to the customer at the date they were provided. In contrast, under current practice and the Customer Consideration model, total revenue is equal to the contract consideration because the extended warranties obligation was not remeasured for the change in circumstances.

55. The CU100 discount given to each customer for buying the television and the extended warranty is treated differently under the three models. Under current practice, the discount reduces the amount of revenue that otherwise would have been attributed to the obligations to provide the television and the extended warranty. Under the Customer Consideration model, the discount reduces the amount of revenue that otherwise would have been attributed to the television, the extended warranty and also to the statutory warranty. Under the Measurement model, however, the discount reduces the revenue that is recognized at contract inception because it does not affect the exit price of the warranty liability.
HOUSE PAINTING

56. Consider the following facts and assumptions:

PainterCo is a contractor that provides painting services for commercial and private residences. PainterCo contracts with a customer on June 25 to paint the customer’s house for CU3,000. The price is inclusive of all paint, which PainterCo obtains at a cost of CU800. PainterCo’s cost for labor and other painting materials is CU1,600. The customer is given the right to obtain its own paint, although the customer does not opt to do so in this example and instead purchases the paint and painting services jointly.

All paint necessary to complete the contract is delivered to the customer’s house on June 30. PainterCo renders the painting services continuously from July 1 through July 3. In accordance with the contract terms, the customer pays in full upon completion of the house painting.

The time value of money is ignored for simplicity. PainterCo reports monthly.

57. The staff chose this example for the following reasons:

- Although it is a simple illustration, it is similar to construction-type contracts in that the entity provides materials and utilizes those materials in the satisfaction of a subsequent obligation.

- This example highlights the relationship between satisfying obligations in a contract and the derecognition of assets that are transferred to a customer to satisfy those obligations.

Measurement model

Contract inception

58. Upon contract inception, PainterCo incurs obligations to perform according to the terms of the contract and also obtains rights to consideration from the customer in exchange. These remaining contractual rights and obligations are recognized net as either a contract asset or a contract liability. This contract asset or liability is measured at its current exit price, which is the amount that PainterCo would expect to receive or pay to transfer all of its remaining rights and obligations in the contract to a market participant.
59. In this example, the measurement of the contract asset or liability reflects the following:

a. The price a market participant (e.g. a subcontractor) would charge for providing the paint and the painting services (which includes its costs and its margin)

b. The price a market participant would charge to manage the contract (e.g. for engaging the subcontractor and dealing with the customer) and to guarantee a subcontractor’s performance

c. The expected consideration from the customer (adjusted for risk of non-payment).

60. Assume that at contract inception, PainterCo estimates that a subcontractor would provide the paint and the painting services for CU2,800. In addition, PainterCo estimates that a market participant would charge CU100 for managing the contract and for providing performance guarantees. Ignoring the risk of non-payment, a contract asset and revenue of CU100 is recognized (rights of CU3,000 less obligations of CU2,800 and CU100).

\[
\begin{align*}
\text{Dr Contract asset} & \quad 100 \\
\text{Cr Revenue} & \quad 100
\end{align*}
\]

61. The contract asset reflects the fact that PainterCo would expect to be compensated by a market participant for obtaining this contract. In other words, a market participant would be prepared to pay PainterCo CU100 for the remaining rights and obligations because it only needs to fulfill the contract and does not need to incur the costs of obtaining the contract.

62. In that regard, note that the revenue recognized at contract inception would not result in the recognition of a corresponding amount of margin. This is because PainterCo also incurs costs in obtaining the contract. However, because these costs are unlikely to be costs directly attributable to this particular contract, they are excluded from this illustration.
**Period ended June 30**

63. PainterCo acquires the paint for CU800 and records it as inventory.

   Dr Inventory          800  
   Cr Cash               800  

64. At June 30, PainterCo measures the contract asset at the amount it would expect to receive on that date if it transferred all of its remaining contractual rights and obligations to a market participant.

65. In this example, it could be argued that PainterCo’s remaining obligations at June 30 are to provide painting services only. This is because the paint has already been delivered to the customer’s premises and a market participant would be able to use this paint to fulfill the contract. Although in this example the customer would be likely to be able to return the paint if the painting services were not provided, the risk of the paint being returned can be viewed as part of the obligations a market participant would be required to assume on June 30 if the contract was transferred. Furthermore, it could be argued that it is appropriate for PainterCo to derecognize the paint because it could not compel the customer to return the paint. In other words, it no longer controls the paint. (It could not, for instance, use the paint for other contracts).

66. Assume that PainterCo estimates that a subcontractor would provide the painting services for CU2,000 (for simplicity, the price for bearing the risk of the paint being returned is ignored). In addition, PainterCo now estimates that a market participant would charge CU75 for managing the contract and for providing performance guarantees. Since there has been no change in the rights, the contract asset is now measured at CU925 (CU3,000 – CU2,000 – CU75). Therefore, as a result of satisfying obligations in the contract (that is, delivering the paint to the customer and providing some contract management services), the contract asset has increased by CU825, which is recognized as revenue.

   Dr Contract asset 825  
   Cr Revenue         825  

67. The revenue recognized reflects the value of the paint provided to the customer as well as the value of the services provided (i.e. obtaining and delivering the paint).
68. PainterCo also recognizes the cost of the paint when it is taken out of inventory and delivered to the customer’s premises.

   Dr Cost of sales (expense) 800  
   Cr Inventory 800  

69. PainterCo also incurs other costs associated with delivering the paint; however, these are not separately identified in this illustration.

*Period ended July 31*

70. During the period ended July 31, PainterCo completes painting the house and receives payment in full for these services. At this point, PainterCo does not have any remaining rights or obligations. The following entry is therefore recorded to reflect the cash payment and to derecognize the contract asset. The difference is recognized as revenue.

   Dr Cash 3,000  
   Cr Contract asset 925  
   Cr Revenue 2,075  

71. PainterCo also recognizes the costs of providing the painting services:

   Dr Cost of sales (expense) 1,600  
   Cr Cash 1,600  

72. The painting services are provided during a single reporting period. If, however, the services straddled multiple reporting periods, then the revenue recognized in a particular reporting period would be determined by estimating the amount a market participant would require to complete the painting services.

73. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>June 30</th>
<th>July 31</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>100</td>
<td>825</td>
<td>2,075</td>
<td>3,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>-</td>
<td>(800)</td>
<td>(1,600)</td>
<td>(2,400)</td>
</tr>
<tr>
<td>Margin</td>
<td>100</td>
<td>25</td>
<td>475</td>
<td>600</td>
</tr>
<tr>
<td>Cash</td>
<td>-</td>
<td>(800)</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Contract asset</td>
<td>100</td>
<td>925</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>100</td>
<td>125</td>
<td>600</td>
<td></td>
</tr>
</tbody>
</table>
Customer Consideration model

74. The Customer Consideration model recognizes revenue when a performance obligation is satisfied by transferring goods or services to a customer. The contract contains two potential performance obligations—the promise to provide paint and to provide painting services. Both are capable of separate delivery to the customer. However, it is uncertain in this case whether the paint itself is delivered separately from the painting services. Although PainterCo physically delivers the paint to the customer, PainterCo will utilize the paint in the subsequent service and therefore substantially retains the risks and rewards of ownership of the paint. For these reasons, paint is not treated as a performance obligation separate from painting services.

75. Note that the Customer Consideration model would not always preclude the recognition of revenue for the delivery of paint. If the contract (or operation of law) made it clear that the risks and rewards of paint ownership passed to the customer upon physical delivery of the paint, the Customer Consideration model would treat the delivery of paint as a separate performance obligation, the satisfaction of which would give rise to revenue.

Period ended June 30

76. At contract inception, PainterCo has the right to the customer’s performance (measured at CU3000) and allocates this entire measurement to a single performance obligation. As discussed above, the paint is not considered a separate performance obligation, which is why the total consideration is assigned to the combined painting services obligation. PainterCo’s net position in the contract is zero because the rights and obligations are equal.

77. PainterCo pays CU800 to obtain the paint that is recorded in inventory.

\[
\begin{align*}
\text{Dr Inventory} & \quad 800 \\
\text{Cr Cash} & \quad 800
\end{align*}
\]

Period ended July 31

78. During the reporting period ended July 31, PainterCo completes the house painting services and receives payment in full for those services. The payment of cash satisfies
PainterCo’s right to the customer’s future performance and the completion of the painting service satisfies PainterCo’s remaining performance obligation.

| Dr Cash | 3,000 |
| Cr Revenue | 3,000 |

79. PainterCo also recognizes the costs of providing the painting service, including the cost of the paint sold.

| Dr Cost of sales (expense) | 2,400 |
| Cr Cash | 1,600 |
| Cr Inventory | 800 |

80. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>June 30</th>
<th>July 31</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>-</td>
<td>-</td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>-</td>
<td>-</td>
<td>(2,400)</td>
<td>(2,400)</td>
</tr>
<tr>
<td>Margin</td>
<td>-</td>
<td>-</td>
<td>600</td>
<td>600</td>
</tr>
<tr>
<td>Cash</td>
<td>-</td>
<td>(800)</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>-</td>
<td>800</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>-</td>
<td>-</td>
<td>600</td>
<td></td>
</tr>
</tbody>
</table>

Current practice (U.S. GAAP and IFRS)

81. Under current practice, the elements of this arrangement (that is, the paint and the painting services) are considered separate units of accounting because the paint can be sold separately (by PainterCo or by other suppliers) and PainterCo often sells the painting service separately. However, none of the arrangement consideration is allocated to the paint for revenue recognition because the payment terms of the contract suggest that payment for the paint is contingent on successful completion of the painting service.4 Even if consideration was allocable to the paint, it is possible that revenue may have been recognized upon delivery because it is unclear whether PainterCo has relinquished significant risks and rewards of owning the paint (that is, it can be argued that PainterCo does not earn the related revenue at the time of delivery).

---

4 EITF Issue No. 00-21 Revenue Arrangements with Multiple Deliverable, Example 10 and Paragraph 14
82. Upon signing the contract, no revenue is recognized because no revenue is considered to have been earned and realized. In this case, revenue is earned as the painting services are rendered. No painting services were performed at contract inception; so revenue is not recognized.

83. During the reporting period ended June 30, the paint is delivered. But PainterCo does not recognize any revenue for this delivery because none of the contract consideration was originally allocated to this element of the arrangement. That is, revenue was determined to arise from the painting service and no painting services have been rendered at this point.

84. PainterCo records the following entry to reflect the costs of acquiring the paint and delivering it on June 30.

```
Dr Inventory 800  
Cr Cash 800
```

Reporting period ended July 31

85. PainterCo rendered the painting service during the month of July and also received payment in full from the customer. Because realization has occurred and the earnings process is complete, the full amount of consideration received from the customer is recognized as revenue.

```
Dr Cash 3,000 
Cr Revenue 3,000
```

86. PainterCo also recognizes the corresponding cost of sales.

```
Dr Cost of sales 2,400 
Cr Inventory 800
Cr Cash 1,600
```
87. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>June 30</th>
<th>July 31</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>-</td>
<td>-</td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>-</td>
<td>-</td>
<td>(2,400)</td>
<td>(2,400)</td>
</tr>
<tr>
<td>Margin</td>
<td>-</td>
<td>-</td>
<td>600</td>
<td>600</td>
</tr>
<tr>
<td>Cash</td>
<td>-</td>
<td>(800)</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>-</td>
<td>800</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>-</td>
<td>-</td>
<td>600</td>
<td></td>
</tr>
</tbody>
</table>

**Illustration summary**

88. In this example, revenue recognition under current practice (see paragraph 87), the Measurement model (paragraph 73) and the Customer Consideration model (paragraph 80) is different in a few key regards. First, current practice and the Customer Consideration model do not recognize any revenue at contract inception. The Measurement model, on the other hand, recognizes revenue at inception because the obligations are measured at an amount that is less than the rights to the customer’s performance. Whether this generates any margin depends on the expenses that PainterCo incurred in obtaining the contract.

89. Another key difference concerns the different conclusions under each model regarding when an obligation has been satisfied (or when delivery occurs as termed in current practice). Current practice does not consider any revenue to have been earned upon delivery of the paint because PainterCo has a significant remaining obligation to provide the painting service. Similarly, the Customer Consideration model concludes that PainterCo has substantially retained the risks and rewards associated with the paint and therefore does not consider its physical delivery to satisfy a performance obligation. The Measurement model, however, derecognizes the paint at June 30 (and triggers revenue for satisfying the related obligation) because it concludes that PainterCo no longer controls the paint after physical delivery to the customer. Hence, the measurement of the contract after this point explicitly reflects the price to provide the painting services, but not the paint itself.
Consider the following facts and assumptions:

On September 30, 2007, a customer contracts with a boat builder (Entity) for a boat to be delivered to the customer on April 1, 2008, for a fixed price of CU50,000. Under the terms of the contract, the customer is not obligated to pay Entity until delivery of the boat, at which point the title to the boat transfers to the customer. If the customer chooses to cancel the contract prior to delivery, payment must be made to Entity for any work completed up to that time.

The boat is a standard design offered by Entity as well as other boat builders. However, Entity does not typically hold boats in inventory (that is, all boats are built to fulfill specific customer orders).

Entity incurs direct contract acquisition costs of CU1,000. Entity also incurs other costs associated with obtaining the customer and the contract, but these costs are ignored in this example because they are not tied directly to the contract. Entity’s expected and actual costs to build the boat are CU36,000, which consist of raw materials of CU20,000 and labor costs of CU16,000.

The raw materials are all purchased on October 1, 2007. The labor costs are incurred, and the raw materials are consumed, evenly over the period October 1 to March 31. That is, the boat is 50 percent complete at December 31.

The time value of money is ignored for simplicity and Entity reports quarterly.

The staff chose this example for the following reasons:

- This example is similar to construction type contracts in that the entity provides materials and utilizes those materials in the satisfaction of a subsequent obligation. This scenario highlights the difficulty in identifying (for accounting purposes) whether a contract is for the delivery of a good or for a service.

- This example also highlights the relationship between satisfying obligations in a contract and the derecognition of assets as they are transferred to a customer to satisfy those obligations. This example strains this relationship more so than in the paint example because the inventory is being built for the customer on Entity’s site (as opposed to the painting example that featured delivery of paint and painting services on the customer’s site).
Measurement model

Period ended September 30, 2007

92. During the period ended September 30, 2007, Entity performs various activities that result in it obtaining a contract with a customer. As a result of the contract, Entity promises to provide the customer with a boat and in exchange receives the promise of cash consideration of CU50,000.

93. Assume that Entity estimates that a market participant (i.e. another boat builder) would charge CU45,500 on September 30, 2007, to provide a boat on April 1, 2008. In addition, it estimates that the price for managing the contract and the performance guarantee is CU500. In practice, if Entity has no evidence to suggest that its estimates would be inconsistent with market participants, it could use its own inputs.

94. For simplicity, assume that a market participant would not make any adjustments to the consideration due from the customer for the risk of non-payment. Hence, on contract inception, Entity recognizes a contract asset measured at CU4,000 (CU50,000 rights less obligations of CU45,500 and CU500). Entity therefore records the following entry.

\[
\begin{align*}
\text{Dr Contract asset} & \quad 4,000 \\
\text{Cr Revenue} & \quad 4,000
\end{align*}
\]

95. Entity also incurs direct contract acquisition expenses of CU1,000.

\[
\begin{align*}
\text{Dr Contract acquisition expense} & \quad 1,000 \\
\text{Cr Cash} & \quad 1,000
\end{align*}
\]

Period ended December 31, 2007

96. On October 1, 2007, Entity purchases all of the materials required to build the boat.

\[
\begin{align*}
\text{Dr Inventory (raw materials)} & \quad 20,000 \\
\text{Cr Cash} & \quad 20,000
\end{align*}
\]
97. Entity begins constructing the boat during this period. In the process, Entity consumes half of the raw materials (CU10,000) while incurring labor costs of CU8,000. These amounts increase the work-in-process (WIP) boat inventory account.

\[
\begin{array}{rcl}
\text{Dr Boat (WIP)} & 18,000 \\
\text{Cr Cash} & 8,000 \\
\text{Cr Inventory (raw materials)} & 10,000 \\
\end{array}
\]

98. Entity also remeasures its contract asset at this reporting date by considering the remaining rights and obligations in the contract. Entity still has a right to the customer’s promise of cash consideration of CU50,000. However, assume that because of increases in the price of raw materials, Entity now estimates that another boat builder would currently require CU46,000 rather than CU45,500 to provide the boat. Entity’s CU500 estimate for contract management and performance guarantees does not change.

99. Therefore, the contract asset is now measured at CU3,500 (CU50,000 rights less obligations of CU46,000 and CU500). In other words, a market participant would now be willing to pay CU500 less than at September 30 for the remaining rights and obligations in the contract. The CU500 decrease in the contract asset is recognized as a contract loss.\(^5\)

\[
\begin{array}{rcl}
\text{Dr Contract loss} & 500 \\
\text{Cr Contract asset} & 500 \\
\end{array}
\]

*Period ended March 31, 2008*

100. Entity completes the construction of the boat, using the remainder of the raw materials (CU10,000) and incurring labor costs of CU8,000. These amounts increase the work-in-process (WIP) boat inventory account.

\[
\begin{array}{rcl}
\text{Dr Boat (WIP)} & 18,000 \\
\text{Cr Cash} & 8,000 \\
\text{Cr Inventory (raw materials)} & 10,000 \\
\end{array}
\]

101. Assume that the contract asset is measured at the same amount as it was for the previous quarter.

\(^5\) An alternative approach might treat this as negative revenue but discussion of this approach is outside the objective of this paper.
Period ended June 30, 2008

102. Entity transfers the boat to the customer on April 1 and therefore derecognizes the boat from inventory.

   Dr Cost of sales (expense)  36,000
   Cr Boat (WIP)  36,000

103. Upon delivery of the boat, Entity also satisfies its contractual obligation of CU46,500, which increases the contract asset and therefore results in the recognition of revenue.

   Dr Contract asset  46,500
   Cr Revenue  46,500

104. The net contract asset of CU50,000 then comprises only the right to the customer’s performance, which is settled upon payment from the customer.

   Dr Cash  50,000
   Cr Contract asset  50,000

105. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th>Inception</th>
<th>Dec 31</th>
<th>Mar 31</th>
<th>Jun 30</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>4,000</td>
<td>-</td>
<td>-</td>
<td>46,500</td>
</tr>
<tr>
<td>Cost of sales (expense)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(36,000)</td>
</tr>
<tr>
<td>Contract acquisition expense</td>
<td>(1,000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Contract loss</td>
<td>-</td>
<td>(500)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Margin</td>
<td>3,000</td>
<td>(500)</td>
<td>-</td>
<td>10,500</td>
</tr>
</tbody>
</table>

   | Cash      | (1,000)| (29,000)| (37,000)| 13,000|
   | Inventory (raw materials) | -    | 10,000  | -      | -     |
   | Boat (WIP) | -    | 18,000  | 36,000  | -     |
   | Contract asset | 4,000 | 3,500   | 3,500   | -     |
   | Retained earnings | 3,000 | 2,500   | 2,500   | 13,000|

106. Revenue arises from obtaining the contract and then from satisfying the contractual obligations. Note that the revenue recognized from satisfying these obligations represents the value of the goods and services provided to the customer at the date they were provided rather than the amount the customer was implicitly charged in the contract for those goods and services.
Broadening the model

107. The boat example highlights the two issues noted in the summary of the Measurement model.

- First, profit or loss for the period ended December 31, 2007, gives an incomplete depiction of how the increase in raw materials prices has affected the entity’s assets and liabilities. This is because the contract loss reflects how that increase has affected the price a market participant would demand for fulfilling the obligation to provide a boat. However, profit or loss does not reflect how that increase may affect the price of the raw materials in inventory or how it might increase the amount the entity would demand from a market participant for the partially completed boat on that date. Said more simply, the contract loss depicts Entity as if it had not started building the boat.

- Secondly, because the boat is measured at accumulated cost, profit or loss does not reflect the increase in the value of Entity’s assets from producing the boat until it is transferred to the customer.

108. Suppose that Entity could sell the partially completed boat to a market participant for CU20,000 and CU46,000 at December 31, 2007, and March 31, 2008 respectively. If the WIP was measured at these amounts, and the amount that exceeded the costs incurred was recognized in profit or loss as production income, then the above summary would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Dec 31</th>
<th>Mar 31</th>
<th>Jun 30</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>4,000</td>
<td>-</td>
<td>-</td>
<td>46,500</td>
<td>50,500</td>
</tr>
<tr>
<td>Production income</td>
<td>-</td>
<td>2,000</td>
<td>8,000</td>
<td>-</td>
<td>10,000</td>
</tr>
<tr>
<td>Cost of sales (expense)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(46,000)</td>
<td>(46,000)</td>
</tr>
<tr>
<td>Contract acquisition expense</td>
<td>(1,000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Contract loss</td>
<td>-</td>
<td>(500)</td>
<td>-</td>
<td>-</td>
<td>(500)</td>
</tr>
<tr>
<td>Margin</td>
<td>3,000</td>
<td>1,500</td>
<td>8,000</td>
<td>500</td>
<td>13,000</td>
</tr>
<tr>
<td>Cash</td>
<td>(1,000)</td>
<td>(29,000)</td>
<td>(37,000)</td>
<td>-</td>
<td>13,000</td>
</tr>
<tr>
<td>Inventory (raw materials)</td>
<td>-</td>
<td>10,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Boat (WIP)</td>
<td>-</td>
<td>20,000</td>
<td>46,000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Contract asset</td>
<td>4,000</td>
<td>3,500</td>
<td>3,500</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>3,000</td>
<td>4,500</td>
<td>12,500</td>
<td>-</td>
<td>13,000</td>
</tr>
</tbody>
</table>
109. The point to note is that in comparison to the previous table, the margin attributable to building the boat is recognized as the boat is constructed. This more faithfully depicts the changes in a broader set of the entity’s assets and liabilities throughout the contract.6

**Customer Consideration model**

110. Revenue arises when the contractual performance obligation is satisfied through a transfer of goods or services to the customer. In this case, a performance obligation arises for the construction and delivery of a boat. The contract must be reviewed to determine whether this particular contract is in the form of the delivery of a finished good, or is in the nature of a contract to provide boat constructing services. The boat (or the “good”) would not transfer until it is completed and delivered; the services obligation would be satisfied continuously.

111. This contract states that Entity is entitled to payment if the customer cancels the contract prior to delivery of the boat. The Customer Consideration model assumes that this guaranteed compensation for the WIP indicates that the boat is essentially the customer’s boat. That performance obligation is satisfied as the benefit of the service transfers to the customer (i.e. as the rights to the WIP continuously transfer to the customer).

*Period ended September 30, 2007*

112. At contract inception, Entity identifies and measures its rights and obligations under the contract. Entity has a right to the customer’s future performance measured at CU50,000. Entity also has an obligation for boat construction services that is measured at the same amount as the consideration promised from the customer. The amount of rights and obligations are equal, so no contract asset or liability is recognized at inception.

---

6 Note that the raw material inventory was not remeasured at December 31, 2007. However, discussion of this accounting mismatch is outside the objective of this paper.
113. Entity also incurs direct contract acquisition expenses of CU1,000 that are expensed as incurred.

\[
\begin{align*}
\text{Dr Contract acquisition expense} & \quad 1,000 \\
\text{Cr Cash} & \quad 1,000
\end{align*}
\]

*Period ended December 31, 2007*

114. On October 1, 2007, Entity purchases all of the materials required to build the boat.

\[
\begin{align*}
\text{Dr Inventory (raw materials)} & \quad 20,000 \\
\text{Cr Cash} & \quad 20,000
\end{align*}
\]

115. Entity begins constructing the boat during this period. In the process, Entity consumes half of the raw materials (CU10,000) while incurring labor costs of CU8,000. These amounts increase the WIP boat inventory account.

\[
\begin{align*}
\text{Dr Boat (WIP)} & \quad 18,000 \\
\text{Cr Cash} & \quad 8,000 \\
\text{Cr Inventory (raw materials)} & \quad 10,000
\end{align*}
\]

116. Based on the work completed to date, Entity determines that half of the performance obligation has been satisfied by transferring ownership rights to the WIP to the customer. The total performance obligation was measured at CU50,000 at inception and this amount is not subsequently remeasured. The satisfaction of half this obligation is measured in the amount of CU25,000. This transfer thereby reduces the performance obligation for the same amount and generates revenue. Reducing the contract obligations while the rights remain unchanged gives rise to a contract asset.

\[
\begin{align*}
\text{Dr Contract asset} & \quad 25,000 \\
\text{Cr Revenue} & \quad 25,000
\end{align*}
\]

117. If the risks and rewards of ownership of the boat have transferred to the customer, then the WIP boat balance is derecognized.

\[
\begin{align*}
\text{Dr Cost of sales (expense)} & \quad 18,000 \\
\text{Cr Boat (WIP)} & \quad 18,000
\end{align*}
\]
**Period ended March 31, 2008**

118. Entity completes the construction of the boat, using the remainder of the raw materials (CU10,000) and incurring labor costs of CU8,000. These amounts increase the WIP boat inventory account.

\[
\begin{align*}
\text{Dr Boat (WIP)} & \quad 18,000 \\
\text{Cr Cash} & \quad 8,000 \\
\text{Cr Inventory (raw materials)} & \quad 10,000 \\
\end{align*}
\]

119. Based on the work completed to date, Entity also determines that the remaining CU25,000 of the performance obligation has been satisfied as ownership rights to the boat have transferred to the customer. This transfer of rights reduces the performance obligation and generates revenue.

\[
\begin{align*}
\text{Dr Contract asset} & \quad 25,000 \\
\text{Cr Revenue} & \quad 25,000 \\
\end{align*}
\]

120. As the ownership rights to the boat have transferred to the customer, the remaining boat balance is derecognized.

\[
\begin{align*}
\text{Dr Cost of sales (expense)} & \quad 18,000 \\
\text{Cr Boat (WIP)} & \quad 18,000 \\
\end{align*}
\]

**Period ended June 30, 2008**

121. Upon delivery of the boat, no entry is required to derecognize the boat because this model assumes that the customer already had full ownership rights while the boat was constructed. The satisfaction of the performance obligation, while the rights have remained unchanged, has given rise to a contract asset equal to the measurement of the rights at inception (CU50,000). The contract rights are satisfied on payment by the customer and the contract asset is derecognized.

\[
\begin{align*}
\text{Dr Cash} & \quad 50,000 \\
\text{Cr Contract asset} & \quad 50,000 \\
\end{align*}
\]
122. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Dec 31</th>
<th>Mar 31</th>
<th>Jun 30</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td></td>
<td>-</td>
<td>25,000</td>
<td>25,000</td>
<td>-</td>
</tr>
<tr>
<td>Cost of sales (expense)</td>
<td></td>
<td>- (18,000)</td>
<td>(18,000)</td>
<td>- (36,000)</td>
<td>-</td>
</tr>
<tr>
<td>Direct contract acquisition expense</td>
<td>(1,000)</td>
<td>-</td>
<td>-</td>
<td>- (1,000)</td>
<td>-</td>
</tr>
<tr>
<td>Contract loss</td>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Margin</td>
<td>(1,000)</td>
<td>7,000</td>
<td>7,000</td>
<td>-</td>
<td>13,000</td>
</tr>
<tr>
<td>Cash</td>
<td>(1,000)</td>
<td>(29,000)</td>
<td>(37,000)</td>
<td>13,000</td>
<td></td>
</tr>
<tr>
<td>Inventory (raw materials)</td>
<td>-</td>
<td>10,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Boat (WIP)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Contract asset</td>
<td>-</td>
<td>25,000</td>
<td>50,000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(1,000)</td>
<td>6,000</td>
<td>13,000</td>
<td>13,000</td>
<td></td>
</tr>
</tbody>
</table>

**Current practice (U.S. GAAP and IFRS)**

123. Under U.S. GAAP, this contract qualifies for percentage-of-completion (POC) accounting under the AICPA’s Statement of Position No. 81-1, which provides guidance for construction-type and other production-type contracts. Likewise, this contract qualifies as a construction contract under IFRS (IAS 11) that recognizes revenue and expenses under the POC method.

124. The POC method results in the recognition of revenue (and related costs) as Entity performs under the contract and makes progress toward the completion of the contract. In this case, assume Entity uses an input method to determine progress toward completion. This method is based on costs incurred to date as a proportion of total costs expected to be incurred. This ratio yields the percentage of total revenue recognized during each reporting period.

*Period ended September 30, 2007*

125. At contract inception, Entity has not done any work under the contract and has not made any progress toward completion of the contract. In other words, Entity has not earned any revenue.

126. Entity incurs direct contract acquisition costs of CU1,000. Assume these costs are not included as inputs in the POC calculation because they are selling-related and do not
relate to contract performance (see paragraph 50 of SOP 81-1 and paragraph 20 of IAS 11).

\[
\begin{align*}
\text{Dr Contract acquisition expense} & \quad 1,000 \\
\text{Cr Cash} & \quad 1,000
\end{align*}
\]

Period ended December 31, 2007

127. On October 1, 2007, Entity purchases materials required to build the boat.

\[
\begin{align*}
\text{Dr Inventory (raw materials)} & \quad 20,000 \\
\text{Cr Cash} & \quad 20,000
\end{align*}
\]

128. Entity begins constructing the boat during this period. In the process, Entity consumes half of the raw materials (CU10,000) while incurring labour costs of CU8,000. Such amounts increase the cost of the boat-in-process.

\[
\begin{align*}
\text{Dr Cost of sales (boat-in-process)} & \quad 18,000 \\
\text{Cr Cash} & \quad 8,000 \\
\text{Cr Inventory (raw materials)} & \quad 10,000
\end{align*}
\]

129. The CU18,000 of costs directly assigned to the boat-in-process are included as the inputs to the POC calculation. In other words, CU18,000 of costs have been incurred relative to total expected costs of CU36,000. Based on these amounts, Entity has progressed 50 percent toward contract completion and should therefore recognize 50 percent of the total consideration as revenue.

\[
\begin{align*}
\text{Dr Accounts receivable (unbilled)} & \quad 25,000 \\
\text{Cr Revenue} & \quad 25,000
\end{align*}
\]

Period ended March 31, 2008

130. Entity completes the construction of the boat, using the remainder of the raw materials (CU10,000) and incurring labour costs of CU8,000. Such amounts increase the cost of the boat-in-process.

\[
\begin{align*}
\text{Dr Cost of sales (boat-in-process)} & \quad 18,000 \\
\text{Cr Cash} & \quad 8,000 \\
\text{Cr Inventory (raw materials)} & \quad 10,000
\end{align*}
\]
131. Entity finishes the boat and therefore recognizes the remaining 50% of the total contract consideration as revenue.

\[
\begin{align*}
\text{Dr Accounts receivable (unbilled)} & \quad 25,000 \\
\text{Cr Revenue} & \quad 25,000
\end{align*}
\]

*Period ended June 30, 2008*

132. On April 1, Entity bills the customer and delivers the boat. The customer pays in full at which point Entity derecognizes the outstanding receivable. For simplicity, this entry ignores the reclassification from unbilled to billed accounts receivable.

\[
\begin{align*}
\text{Dr Cash} & \quad 50,000 \\
\text{Cr Accounts receivable} & \quad 50,000
\end{align*}
\]

133. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Dec 31</th>
<th>Mar 31</th>
<th>Jun 30</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td></td>
<td>25,000</td>
<td>25,000</td>
<td></td>
<td>50,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td></td>
<td></td>
<td>(18,000)</td>
<td></td>
<td>(36,000)</td>
</tr>
<tr>
<td>Contract acquisition expense</td>
<td>(1,000)</td>
<td></td>
<td></td>
<td></td>
<td>(1,000)</td>
</tr>
<tr>
<td>Contract loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Margin</td>
<td>(1,000)</td>
<td>7,000</td>
<td>7,000</td>
<td></td>
<td>13,000</td>
</tr>
<tr>
<td>Cash</td>
<td>(1,000)</td>
<td>(29,000)</td>
<td>(37,000)</td>
<td>13,000</td>
<td></td>
</tr>
<tr>
<td>Inventory (raw materials)</td>
<td></td>
<td>10,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td></td>
<td>25,000</td>
<td>50,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(1,000)</td>
<td>6,000</td>
<td>13,000</td>
<td>13,000</td>
<td></td>
</tr>
</tbody>
</table>

**Illustration summary**

134. In this example, total revenue under current practice (see paragraph 133 above) and under the Customer Consideration model (paragraph 122) is less than total revenue under the Measurement model (paragraph 105). This difference arises because total revenue under current practice is equal to the customer consideration while total revenue under the Measurement model represents the value of the goods and services provided to the customer at the time they are provided.

135. Another difference concerns derecognition of the boat. Current practice and the Customer Consideration model derecognize the boat as it is built because it concludes that the risks and rewards of owning the boat transfer to the customer throughout the construction process. Thus, the obligation to provide boat-building services on the customer’s boat is
satisfied as those services are rendered. The Measurement model, however, does not
derecognize the boat inventory because Entity controls the boat and does not satisfy the
related obligation until the boat is delivered. The measurement of the contract at current
exit price therefore reflects the price a market participant would require to take on the
obligation to construct and deliver a boat.

136. To be clear, just as in the painting example, the outcome of the Measurement model here
differs from current practice and the Customer Consideration model both because of the
different measurement approaches and also because of the different conclusions reached
about when the boat actually becomes the customer’s.

137. Comparing current practice to the broader Measurement model summarized in paragraph
108 is also instructive. First, some revenue and profit are recognized in paragraph 108 at
contract inception for obtaining the contract. After contract inception, the margin in
paragraph 108 is based on an assessment of the entity’s outputs—that is, the increase in
the value of the partially completed boat. On the other hand, subsequent performance to
date under current practice is assessed on the basis of the entity’s inputs.

**WIDGET WITH RETURN RIGHT**

138. Consider the following facts and assumptions:

| On December 31, 2007, Entity sells and delivers 100 widgets to 100 customers for CU10
| each. These widgets were carried in Entity’s inventory at CU8 each. The customers pay
| cash at the time of sale but the terms of the contract allow each customer to return the
| widget within one year for any reason and to receive a full refund of the consideration.

| At contract inception, Entity expects five of the 100 widgets sold to be returned. Any
| returned widget can be resold but only at a discounted price of CU5. The fair value of a
| returned widget is CU3.

| Assume five widgets were actually returned during the year.

| Entity reports annually.
139. The staff chose this example because many contracts for the sale of goods contain a right of return. It is important to illustrate how the Measurement and the Customer Consideration models treat these contracts relative to current practice.

**Measurement model**

*Period ended December 31, 2007*

140. During the period ended December 31, 2007, Entity performs various activities that result in it obtaining 100 contracts with customers. At inception of these contracts, Entity has an obligation to provide each customer with a widget (including the right to return the widget within a year for a full refund) and in exchange receives rights to the customer’s performance (payment of cash consideration) measured at CU10 per widget.

141. In this situation, each customer pays cash shortly after inception of the contract and by so doing, relinquishes Entity’s remaining rights under the contract. Entity then partially performs by delivering the widgets to the customers. However, Entity retains an obligation to accept any returns that may arise during the year and to refund the contract consideration. This obligation results in a contract liability for Entity.

142. The contract liability is measured at its current exit price—that is, the price that a market participant would require to assume the remaining refund obligation from Entity. Assume for this example that this price is CU50. This measurement of the remaining obligation reflects the amount a market participant would require for:

- a. Refunding the consideration on the returns expected to arise during a year (CU50); plus
- b. Processing the returns (CU5); plus
- c. Bearing uncertainty about the number of returns that may arise (CU10); less
- d. Receiving the benefit of any returned widgets (which, for instance, could then be resold at a discounted price) (CU3 × 5 = CU15).
143. Based on the information above, Entity records the following entry:

```
   Dr Cash                    1,000
       Cr Contract liability  50
       Cr Revenue             950
```

144. Entity also derecognizes its inventory.

```
   Dr Cost of sales           800
       Cr Inventory           800
```

**Period ended December 31, 2008**

145. During the period ended December 31, 2008, Entity stands ready to accept any returns.

Each of the 100 contracts only required these services for a period of one year. Hence, Entity has satisfied its remaining obligations under the contracts by December 31, 2008. Revenue arises from the satisfaction of these obligations and is reported at the amount by which the contract liability has reduced (CU50).

```
   Dr Contract liability      50
       Cr Revenue              50
```

146. Entity also processes five returns as expected. The following entry would be made to record the return of the five widgets and cash refund. For simplicity, the administrative expenses associated with processing the returns are ignored in the illustration, although they would affect the margin reported for the period. The cost of sales amount represents the expense of providing the return service.

```
   Dr Inventory (returns)    15
   Dr Cost of sales          35
   Cr Cash                   50
```

147. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>950</td>
<td>50</td>
<td>1,000</td>
</tr>
<tr>
<td>Cost of sales (expense)</td>
<td>(800)</td>
<td>(35)</td>
<td>(835)</td>
</tr>
<tr>
<td>Margin</td>
<td>150</td>
<td>15</td>
<td>165</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
<td>950</td>
<td></td>
</tr>
<tr>
<td>Inventory (less inventory returns)</td>
<td>(800)</td>
<td>(785)</td>
<td></td>
</tr>
<tr>
<td>Contract liability</td>
<td>50</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>150</td>
<td>165</td>
<td></td>
</tr>
</tbody>
</table>
148.  Consistent with the description of the model, the revenue recognized in 2007 is derived from the change in the contract liability. However, some think Entity’s revenue should not include the portion of that change that is due to refunding customer consideration. In this case, that amount is CU35 and represents consideration refunded (CU50) less the fair value of returned inventory (CU15). Revenue with respect to the returns would then reflect only the price for bearing risk and servicing the returns. The consideration received and refunded to customers is similar to a deposit, the receipt and repayment of which is not normally recognized as revenue and expense. An alternative presentation might record the journal entries in paragraphs 145 and 146 as follows:

   Dr Contract liability  50
   Dr Inventory (returns)  15
   Cr Cash  50
   Cr Revenue  15

149.  The statement of financial position and margin would be the same under both presentations. However, the total amount of revenue recognized under the alternative above would be CU965 rather than CU1,000.

Customer Consideration model

Period ended December 31, 2007

150.  At inception of the 100 contracts, Entity obtains rights to the customers’ consideration. These rights are measured at the amount of consideration expected to be retained. In this example, Entity expects to ultimately retain consideration of CU950 (CU1,000 - CU50) based on the expectation of 5 refunds. Hence, CU950 is allocated to the identified performance obligations.

151.  The performance obligations giving rise to revenue in this example are the obligations to deliver widgets to the customers, net of those widgets expected to be returned. These performance obligations are satisfied on December 31, 2007 when the widgets are delivered to the customer, at which point Entity recognizes revenue in the amount of the customer consideration (CU950) that was allocated to these performance obligations.
152. The CU50 (CU10 \times 5) consideration that Entity receives but expects to refund to customers, is not allocated to a revenue-generating performance obligation because it represents a failed sale. In other words, this portion of the contracts is expected to be cancelled by the customer. This expected refund amount (CU50) is netted against the CU15 (CU3 \times 5) expected value of the future inventory to be returned. That net amount is then recorded as a refund liability.\(^7\)

153. In this example, the cash received (CU1,000) exceeds the sum of the refund liability (CU35) and the performance obligations (CU950) by CU15 (CU1,000 - CU35 - CU950). This difference represents a reduction of the cost of sales for the widgets Entity expects to be returned (CU3 \times 5).

154. Based on the explanations above, the journal entry at this date is as follows:

\[
\begin{align*}
\text{Dr Cash} & \quad 1,000 \\
\text{Cr Refund liability} & \quad 35 \\
\text{Cr Revenue} & \quad 950 \\
\text{Cr Cost of sales} & \quad 15
\end{align*}
\]

155. The widget inventory of CU800 is de-recognized when it transfers to the customers.

\[
\begin{align*}
\text{Dr Cost of sales} & \quad 800 \\
\text{Cr Inventory} & \quad 800
\end{align*}
\]

Period ended December 31, 2008

156. During the period ended December 31, 2008, Entity processes five widget returns, refunds the associated customer consideration (CU50), and receives the widgets into inventory at their reduced value (CU15). The refund liability (CU35) created at contract inception is thereby extinguished. The satisfaction of this liability does not give rise to revenue, however, because it was not identified as a revenue-generating performance obligation. Rather, the expected returns were treated as a failed sale at contract inception.

\[
\begin{align*}
\text{Dr Refund liability} & \quad 35 \\
\text{Dr Inventory} & \quad 15 \\
\text{Cr Cash} & \quad 50
\end{align*}
\]

\(^7\) Differing views might exist on how to measure this refund liability. Consideration of these views, however, is outside the objective of this paper.
157. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>950</td>
<td>-</td>
<td>950</td>
</tr>
<tr>
<td>Cost of sales (expense)</td>
<td>(785)</td>
<td>-</td>
<td>(785)</td>
</tr>
<tr>
<td>Margin</td>
<td>165</td>
<td>-</td>
<td>165</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
<td>950</td>
<td>1,950</td>
</tr>
<tr>
<td>Inventory</td>
<td>(800)</td>
<td>(785)</td>
<td>(1,585)</td>
</tr>
<tr>
<td>Refund liability</td>
<td>35</td>
<td>-</td>
<td>35</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>165</td>
<td>165</td>
<td>330</td>
</tr>
</tbody>
</table>

**Current practice (U.S. GAAP and IFRS)**

*Period ended December 31, 2007*

158. Under current practice, Entity recognizes revenue upon delivery of the widgets if specific requirements are met. One of these requirements states that Entity must be able to reasonably estimate the future returns and must recognize a liability at the time of sale for those expected returns. Entity is deemed to meet these requirements and therefore recognizes revenue of CU1,000 (CU10 × 100) upon delivery of the widgets.

\[\text{Dr Cash} \quad 1,000 \quad \text{Cr Revenue} \quad 1,000\]

159. Cost of sales of CU800 (CU8 × 100) is also recognized for the delivered widgets.

\[\text{Dr Cost of sales} \quad 800 \quad \text{Cr Inventory} \quad 800\]

160. For the units expected to be returned, Entity then reduces revenue by CU50 (CU10 × 5) and recognizes a liability. This liability is measured at CU7 per unit which is the CU10 expected refund less the CU3 fair value of the returned widget. Hence the total liability is CU35 (CU7 × 5) and cost of sales is adjusted for the residual CU15 (CU50 - CU35).

\[\text{Dr Revenue} \quad 50 \quad \text{Cr Refund liability} \quad 35 \quad \text{Cr Cost of sales} \quad 15\]

---

8 See FASB Statement No. 48 *Revenue Recognition When Right of Return Exists* and International Accounting Standard No. 18 *Revenue*.

9 The staff acknowledges that differences in practice might exist between U.S. GAAP and IFRS (and possibly within one or the other) in terms of measuring this liability. For example, some entities might record the liability for the gross amount of consideration expected to be refunded (CU50) rather than the net amount of CU35 (CU50 – CU15) as done here in this example. However, analysis of these differences is outside the scope of this paper.
Period ended December 31, 2008

161. During the period ended December 31, 2008, Entity processes five widget returns, which satisfies the refund liability. Entity also records the returned widgets in inventory at their fair value and refunds the customers’ cash. For simplicity, this example ignores product handling and other incremental administrative expenses that Entity may have incurred.

<table>
<thead>
<tr>
<th>Dr Refund liability</th>
<th>Dr Inventory</th>
<th>Cr Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>35</td>
<td>15</td>
<td>50</td>
</tr>
</tbody>
</table>

162. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>950</td>
<td>-</td>
<td>950</td>
</tr>
<tr>
<td>Cost of sales (expense)</td>
<td>(785)</td>
<td>-</td>
<td>(785)</td>
</tr>
<tr>
<td>Margin</td>
<td>165</td>
<td>-</td>
<td>165</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
<td>950</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>(800)</td>
<td>(785)</td>
<td></td>
</tr>
<tr>
<td>Refund liability</td>
<td>35</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>165</td>
<td>165</td>
<td></td>
</tr>
</tbody>
</table>

Illustration summary

163. Comparing the tables in paragraphs 147, 157 and 162 reveals key differences between the Measurement model and the other two models (Customer Consideration and current practice). The Customer Consideration model and current practice treat the expected returns at inception as a failed sale and therefore exclude their effect from the statement of comprehensive income. The Measurement model, on the other hand, considers the customer’s right to return the widget as a separate contractual obligation whose satisfaction gives rise to revenue. As a result of this difference, total revenue under the Measurement model is equal to the consideration originally received/promised in the contract (CU1,000) while revenue under the Customer Consideration model and current practice is equal to the cash ultimately retained (CU950) after refunding CU50 for the five widgets returned.

164. Another difference is that the total margin under the Measurement model is recognized over the life of the contracts. In particular, note that the margin that is attributable to the
service of providing a right of return is recognized over the period that that service is performed. This is different from the Customer Consideration model and from current practice which both recognize total profit upon delivery of the widgets although Entity is providing risk coverage throughout 2007.
BACKGROUND

1. The FASB is currently working on two projects related to FASB Statement No. 133, *Accounting for Derivatives and Hedging Activities*. One project relates to disclosures and the other project relates to hedge accounting.

Derivatives Disclosures

2. The project is expected to amend and expand the disclosure requirements in Statement 133 with the intent to provide an enhanced understanding of (1) How and why an entity uses derivative instruments, (2) How derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (3) How derivative instruments affect an entity’s financial position, results of operations, and cash flows. An Exposure Draft was issued in December 2006 and redeliberations began in May 2007.

3. During redeliberations, the Board reaffirmed that the scope of the project would be limited to only derivatives and all related hedged items accounted for under Statement 133 (not expanded to include all financial instruments). A fourth objective to require information about an entity’s risk exposures and strategy for mitigating those risks also would not be added.

4. The Board agreed to a revised tabular format for the presentation of information about the fair values of derivatives and gains and losses on derivatives. The final standard would tentatively require two tables (balance sheet table reporting fair values of derivatives and income statement table reporting gains and losses on derivatives) instead of up to seven tables, as proposed in the Exposure Draft.

Note: These materials are provided to facilitate understanding of the issues to be addressed at the December 6, 2007 FASAC meeting. These materials are for discussion purposes only; they are not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.
5. The following will be discussed at an upcoming Board meeting:

a. Notional Amounts and Leverage Factors
b. Contingent Features
c. Frequency of Disclosures
d. A possible scope-out to the “income statement” table for derivatives used in an entity’s trading activities with alternative disclosures required for all trading instruments – may require reexposure
e. Whether to require the recommended disclosures on the use of derivatives in the context of the overall risk management profile of the entity (paragraph 44 of the Exposure Draft) – may require reexposure
f. Effective date and transition. The effective date will probably be for fiscal periods beginning after November 15, 2008.

Hedge Accounting

6. Statement 133 provides special accounting for hedging activities because of differences in the way derivative hedging instruments and hedged items or transactions are recognized and measured. However, since the effective date of Statement 133, the FASB has been asked to address numerous issues on many aspects of hedge accounting. As a result, at the January 31, 2007 meeting, the Board directed the staff to research issues causing difficulties in the application of hedge accounting.

7. As a result of that research, Board added a project to its agenda to address the accounting for hedging activities and directed the staff to develop a fair-value-type approach for hedging. The objectives of the project and the fair-value-type approach for fair value hedges and cash flow hedges is as follows:

8. Objectives

a. Resolve hedge accounting practice issues that have arisen under Statement 133
b. Simplify accounting for hedging activities
c. Improve financial reporting
d. Address differences in the accounting for derivative instruments and hedged items or transactions
9. Fair Value Hedges

Scope
The scope of items for fair value hedges is the same as those currently included within the scope of Statement 133.

Requirements for Hedge Accounting
At the inception of the hedging relationship, there is a requirement for formal, contemporaneous documentation of:

a. The hedging instrument
b. The hedged item or items

c. A qualitative evaluation of the nature of the risk that the entity is attempting to hedge and why the derivative should be effective in offsetting changes in the fair value of the hedged item that result from the hedged risk. In order to qualify for hedge accounting, the qualitative evaluation must demonstrate that (i) an economic relationship exists between the hedging instrument and hedged item, and (ii) the derivative should be expected to reasonably offset overall changes in fair value of the hedged item (bifurcation-by-risk not permitted). In certain situations, a quantitative analysis may be more effective in demonstrating the relationship between the derivative instrument and the hedged risk. After inception, an entity would need to reassess effectiveness if circumstances indicate that the hedging relationship is no longer effective. These circumstances would depend on the nature of the hedged item and instrument.

Hedge accounting will be permitted after initial recognition of the asset or liability and dedesignation and redesignation of fair value hedging relationships will be permitted. Further discussion to come on what is meant by dedesignation/redesignation in a fair value hedge.

Measurement of the Hedged Item
The carrying value of the hedged item would be adjusted for changes in the overall fair value of the hedged item (bifurcation-by-risk not permitted) during the hedge period.

Accounting for an Entity’s Own Debt within Fair Value Hedges
For situations in which an entity synthetically creates variable-rate debt by issuing fixed-rate debt and entering into a receive fixed/pay variable interest rate swap, the interest rate swap may be designated as hedging the exposure to changes in fair value of the fixed-rate debt attributable to changes in the designated benchmark interest rate. Designating changes in fair value of the
fixed-rate debt attributable to changes in the designated benchmark interest rate is not permitted if the hedging relationship is entered into subsequent to the initial recognition of the hedged item. An example of this type of hedge is as follows:

On January 1, 2006, an entity borrows $100,000 for five years at a fixed-rate 8 percent. On that date, the entity enters into a 5-year interest rate swap based on the LIBOR swap rate and designates it as the hedging instrument in a fair value hedge of interest rate risk of the $100,000 liability. For purposes of illustration in this example, the entity agrees in the swap terms to receive fixed interest at 6.00 percent. The variable leg of the swap resets each year on December 31 for the payments due the following year. The example assumes that immediately before the interest rate on the variable leg resets on December 31, 2006, the LIBOR swap rate increased by 50 basis points to 6.50 percent.

In measuring the change in fair value of the debt for purposes of hedge accounting, the entity would only consider the changes in fair value attributable to changes in the LIBOR swap rate, which in this situation is 50 basis points. Other changes in fair value of the debt, such as changes in credit quality, would not have to be considered.

10. Cash Flow Hedges

Scope

The scope of items for cash flow hedges is the same as those currently included within the scope of Statement 133.

Requirements for Hedge Accounting

The hedged forecasted transaction must be probable to occur and may be designated as a single transaction or a group of individual transactions. At the inception of the hedging relationship, there is a requirement for formal, contemporaneous documentation of:

a. The hedging instrument
b. The hedged item or items
c. A qualitative evaluation of the nature of the risks that the entity is attempting to hedge and why the derivative should be effective in offsetting the variability in the hedged transaction attributable to all risks. In order to qualify for hedge accounting, the qualitative evaluation must demonstrate that (i) an economic relationship exists between the hedging instrument and hedged forecasted transaction, and (ii) the derivative should be expected to reasonably offset the variability in the hedged cash flows attributable to all risks. In certain situations, a quantitative analysis may be more effective in demonstrating the relationship between the derivative instrument and the hedged risk. After inception, an entity would
need to reassess effectiveness if circumstances indicate that the hedging relationship is no longer reasonably effective. These circumstances would depend on the nature of the hedged transaction and hedging instrument.

Measuring and Reporting Ineffectiveness

Under the fair value approach for cash flow hedges, the measurement of hedge ineffectiveness would be based on a comparison of the change in fair value of the actual derivative designated as the hedging instrument and the change in fair value of a perfect derivative, which would be expected to perfectly offset the hedged cash flows. The change in fair value of the perfect derivative would be regarded as a proxy for the present value of the cumulative change in expected future cash flows on the hedged transaction. The balance of accumulated other comprehensive income would reflect the cumulative change in the fair value of the perfect derivative, effectively requiring that ineffectiveness be reported in earnings for both overhedges (change in value of actual derivative exceeds change in value of perfect derivative) and underhedges (change in value of perfect derivative exceeds change in value of actual derivative).

Accounting for an Entity’s Own Debt within the Fair Value Approach for Cash Flow Hedges

For situations in which an entity synthetically creates fixed-rate debt by issuing variable-rate debt and entering into a receive variable/pay fixed interest rate swap, the interest rate swap may be designated as hedging the exposure to variability in expected future interest cash flows that is attributable to changes in the designated benchmark interest rate. Designating the risk of changes in interest cash flows attributable to changes in the designated benchmark interest rate is not permitted if the hedging relationship is entered into subsequent to the initial recognition of the issued debt.

Next Steps

11. The staff plans to bring the following issues to the Board for consideration:
   a. How foreign currency hedges fit into the fair value hedging model
   b. What is meant by redesignation in fair value and cash flow hedges
   c. How amounts in OCI will be reclassified to earnings in cash flow hedging situations
   d. What disclosures will be required
   e. Effective date and transition
GENERAL DISCUSSION QUESTIONS

Overall
Do you agree with the overall direction and approach that the Board is taking in the derivatives projects?

Disclosures
How important is it for a standard to be issued in January 2008 compared to the need to potentially reexpose to accommodate a scope-out for derivatives included in trading activities of an entity?

Hedging
How important is it for the new approach to permit hedging only interest-rate risk for an entity’s own debt?
PLANNING FASAC INPUT ON FASB AGENDA SETTING: METHODS AND DESIRED OUTPUT

Financial Accounting Standards Advisory Council
December 6, 2007

Objective
The objective of this session is to solicit FASAC members’ input on ways to provide useful, relevant, and timely information to the Board(s) about the prioritization of projects that are on the current and future agendas.

Background
One of the objectives of FASAC is to advise the FASB on the prioritization of the FASB’s agenda projects, including:

1. Which current FASB project(s) or effort(s) is the most important? Which current project(s) or effort(s) provide the most benefit to those that use the financial reporting information?

2. Which area(s) is in need of revisiting in the future and when?

For many years, FASAC has conducted an annual written survey of its members as a means to solicit their input about prioritization and other financial reporting topics. As a refresher, last year’s survey asked for input on the following areas:

- Current financial reporting issues—top five most important, as well as whether any projects should be removed
- Future financial reporting issues
- Simplification of the accounting literature and standard-setting process; principles-based standards

Note: These materials are provided to facilitate understanding of the issues to be addressed at the December 6, 2007 FASAC meeting. These materials are presented for discussion purposes only; they are not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.
• Implementation guidance—should it all come from the FASB, do we issue the right amount, how should the Board decide the issues to address
• Differential standards for private companies

The remaining background describes some of the factors that influence the FASB’s current agenda.

**Agenda Criteria**

The FASB refers to the following seven factors in evaluating whether to add proposed agenda topics to its agenda:

1. **Pervasiveness of the problem**
   a. The extent to which the issue is troublesome to users, preparers, auditors, or others
   b. The extent to which there is diversity of practice
   c. The likely duration of the problem (that is, is it transitory or will it persist)

2. **Alternative solutions**—the extent to which one or more alternative solutions that will improve financial reporting in terms of relevance, reliability, and comparability are likely to be developed

3. **Technical feasibility**—the extent to which a technically sound solution can be developed or whether the project under consideration should await completion of other projects

4. **Practical consequences**—the extent to which an improved accounting solution is likely to be acceptable generally, and the extent to which addressing a particular subject (or not addressing it) might cause others to act, for example, the SEC or Congress

5. **Convergence possibilities**
   a. The extent to which there is an opportunity to eliminate significant differences in standards or practices between the U.S. and other countries with a resulting improvement in the quality of U.S. standards
   b. The extent to which it is likely that a common solution can be reached
   c. The extent to which any significant impediments to convergence can be identified
6. Cooperative opportunities—the extent to which there is international support by one or more other standard setters for undertaking the project jointly or through other cooperative means with the FASB

7. Resources—the extent to which there are adequate resources and expertise available from the FASB, the IASB, or another standard setter to complete the project and whether the FASB can leverage off the resources of another standard setter in addressing the issue (and perhaps thereby add the project at a relatively low incremental cost).

Those factors cannot be evaluated in precisely the same way and to the same extent in every instance, but their identification is intended to bring about consistent decisions regarding the Board’s technical agenda.

**An Evolution of the Current Financial Reporting Environment**

The current financial reporting environment continues to introduce challenges and opportunities for the future direction of standard-setting, such as:

*Convergence.* The desire for the elimination of significant accounting differences between US GAAP and IFRS results in a focus on converging those existing standards. Convergence, as we are continuing to see through the adoption of IFRS by other nations, can take many different paths. For example, some nations plan to fully replace their national GAAP with IFRS in a single step by a specific date; whereas others plan to compare sections of their national GAAP to IFRS, expose the differences for comment, and adopt IFRS in “chunks.”

*Improvement in financial information quality.* There is a continuing need for a well-maintained, robust, and high-quality set of financial reporting standards for all entities. Addressing that need is a fundamental focus of FASB’s standard-setting.

*Improvement in financial information delivery.* New technologies (such as interactive data) introduce much potential future efficiency in the financial reporting system. The FASB has taken steps to make those efficiencies available in the future by working to develop electronic-based platforms and data management systems, such as the codification and XBRL.
In response to these and other environmental factors, some of the projects on the Board’s agenda have multiple objectives (e.g., to both improve and converge). Moreover, the projects on the Board’s agenda seek to address many objectives (some of which are complementary and others which may be contrary).

**Agenda Coordination with the IASB**

The FASB’s and the IASB’s criteria for adding a new agenda project are very similar. The FASB’s and IASB’s process are also similar, but differ in the following ways:

- The IASB considers requests for its agenda once a year. The FASB considers requests for its agenda throughout the year on an ad hoc basis.
- The IASB is required to seek the input of its advisory council on all agenda additions before the IASB considers the addition of a project. The FASB generally seeks the input from FASAC before consideration, but it is not a requirement.

The working relationship between the FASB and IASB necessitate coordination of their agendas. The Norwalk Agreement and the Memorandum of Understanding (MOU) provided a starting point for that coordination. Since that time, the Boards have worked closely together to continue to coordinate their agendas in the future. Discussions at the joint meetings in April and September/October have been the primary forums for that coordination.

**Issues for Discussion**

**Methods and Substance**

Some of the issues of interest for discussion are:

**Question 1:** What is the best way to identify the most important topics on the current FASB agenda? What is the best way to identify the least important topics (or projects that should be removed or scaled back) on the current agenda?

**Question 2:** What is the best way to solicit input about the areas that are “broken” or in need of significant improvement? What is the best way to communicate those needs to the FASB?
**Question 3:** Are there additional criterion that the FASB should consider when adding a project to its agenda? Are any of the existing agenda criteria inconsequential or ineffective? Should FASAC provide further input on the agenda criteria?

**Question 4:** What topics (other than agenda prioritization) should be included in a survey?

**Timing and Outreach**

Some of the issues of interest for discussion are:

**Question 5:** How frequently should FASAC provide input to the Board about the prioritization of its agenda? Annually? Semi-annually before the joint FASB/IASB meetings? More frequently?

**Question 6:** The expectation is that all members of the FASB advisory groups, as well the PCFRC would participate in the survey. Are there members of other groups that should be surveyed? Should the surveying be open to the public (e.g., via the FASB/FASAC website)?
POTENTIAL PROJECT ON INTANGIBLE ASSETS

Financial Accounting Standards Advisory Council
December 6, 2007

BACKGROUND

1. At their first joint meeting in September 2002, the FASB and IASB committed to work together toward the goal of a single set of high-quality international standards. The Norwalk Agreement that resulted from that meeting called for, among other things, the alignment of the Boards’ agendas as a step toward achieving that goal. In their joint meeting in April 2005, the Boards agreed that all new major standards would be developed cooperatively. They identified several areas not yet on their agendas that were candidates for improvement through joint projects—those areas included leasing, post-employment benefits, and intangible assets. In February 2006, the Boards issued a Memorandum of Understanding outlining a workplan, or goals, to be achieved by 2008. Among those goals were agenda decisions in the areas of leasing, postemployment benefits, and intangible assets. In 2005 and 2006, the Boards added projects on leasing and postemployment benefits to their agendas. In December 2007, each Board will consider whether to add a project on intangible assets to their agendas and, if so, the scope and timing of such a project.

2. At the December 2007 FASAC meeting, Board members are soliciting input from Council members on the need for, and relative priority of, a project on intangible assets.

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FASAC DISCUSSION

3. The analysis supporting the agenda decision was prepared for the Boards by the staff of Australian Accounting Standards Board (AASB).\(^1\) That proposal recommends the IASB and FASB add a comprehensive project to their active agendas as soon as resources are available to commit to such a project. It also describes several smaller scoped projects that the Boards might undertake instead of a comprehensive project (those smaller projects might also be viewed as phases of a more comprehensive project). Attachment F-2 summarizes the alternative project scopes.

4. The Executive Summary of the proposal (Attachment F-1) explains that:

The scope of the project should be the initial accounting for identifiable intangible assets other than those acquired in a business combination (with a focus on, but not limited to, internally generated intangible assets) and the subsequent accounting for all identifiable intangible assets. The technical objective of such a project should be to identify appropriate recognition, measurement and presentation/disclosure requirements. In relation to measurement issues (cost versus fair value), we think that they should be resolved as part of the project process, rather than as part of the agenda decision process. If the Boards conclude that resources are not available to undertake such a project now, we would prefer that the project is delayed until resources become available.

... Although our preference is for a single comprehensive project that incorporates a recognition objective, we acknowledge the ambitious nature of such an approach. Accordingly, this paper also contemplates alternative more narrowly scoped projects with less ambitious objectives, including a disclosure-only objective.

5. The FASB staff acknowledges that existing U.S. GAAP guidance for intangible assets is fragmented and incomplete, particularly with respect to the accounting for internally generated intangible assets. However, the Board and its staff have received mixed messages about the relative priority of improvements in this area.

\(^1\) A full draft of the proposal is available at [link to IASB SAC observer notes http://www.iasb.org/NR/rdonlyres/92605135-A1A1-4A75-8B37-6B12EAB87084/0/0711on04a.pdf].
• Some constituents have told the Board a project on intangible assets should be a matter of high priority because many of the most valuable assets of many entities are intangible assets that are not currently recognized in financial reports.

• Others agree that many important intangible assets are not reported, but have told the Board that improvements in other areas are a higher priority.

• Some others have told the Board that investor information needs would be better met through disclosure of nonfinancial information, such as key performance indicators. They believe the SEC should be encouraged to spearhead a project to require disclosure of such nonfinancial information.

QUESTIONS FOR DISCUSSION

6. Question 1: Do council members recommend that the Boards undertake a joint project on Intangible Assets as soon as resources are available to commit to such a project? If so, what should be the scope of that project?

7. Question 2: If FASB resources were not available at this time (and the FASB staff Directors believe they are not), is the priority of a project on intangible assets sufficiently high that the Board should suspend work on another project to undertake it? If so, what project or projects should be suspended? (Attachment F-3 is a listing of the Board’s current agenda projects.)
Executive Summary

1. The IASB’s Due Process Handbook (March 2006) sets out the five criteria to be considered in deciding whether to add a potential item to the IASB’s agenda. The FASB has similar agenda criteria. For convenience, this paper is structured around the IASB criteria.

2. Criterion 1 the relevance to users of the information involved and the reliability of information that could be provided: We conclude that intangible assets are an increasingly significant class of assets for a wide range of entities across many jurisdictions and that information about intangible assets is important to the needs of users. The issues are pervasive and, to the extent that the current requirements in IAS 38 are inadequate (see Criterion 2), the current accounting treatment will give rise to problems that are frequent and material unless resolved. Information about intangible assets that is not currently provided under IAS 38 is relevant to users and can be provided in a reliable way. We acknowledge that balancing the diverse views of users and others that currently exist on how best to account for intangible assets in a way that provides the most relevant and reliable information will be challenging for the Boards. The feasibility of arriving at a solution is considered in Criterion 4.

3. Criterion 2 existing guidance available: Our view is that many of the current requirements relating to intangible assets are considerably out of date and the information they generate does not appropriately reflect economic conditions or results. Minor amendments to current requirements would not be sufficient to adequately address these deficiencies. Consequently, we propose a fundamental review of current requirements.

4. Criterion 3 the possibility of increasing convergence: We conclude that, given the importance of intangible assets, there is a good prospect that an Intangible Assets project will gain support from national standard setters and regulators. Furthermore, conducting the project as an IASB/FASB joint project has the potential to facilitate convergence with respect to the accounting for intangible assets.

5. Criterion 4 the quality of the standards to be developed: Although it is necessarily a subjective assessment, on balance, we are persuaded that there is a range of potential project scopes and objectives that would lead to varying degrees of improvements to current requirements and satisfaction of users’ needs.
Irrespective of the scope and objective, we think that the benefits of improved financial reporting would exceed the costs.

6. Criterion 5 resource constraints: This criterion is addressed in the cover memorandum to the agenda proposal session.

7. We think that the relative urgency with which an Intangible Assets project should be initiated should have regard to the views of the SAC and FASAC and Criterion 5 resource constraints. Based on our assessment of the agenda criteria, our view is that an Intangible Assets project should be added to the Boards’ active agendas as soon as resources are available to commit to such a project. The scope of the project should be the initial accounting for identifiable intangible assets other than those acquired in a business combination (with a focus on, but not limited to, internally generated intangible assets) and the subsequent accounting for all identifiable intangible assets. The technical objective of such a project should be to identify appropriate recognition, measurement and presentation/disclosure requirements. In relation to measurement issues (cost versus fair value), we think that they should be resolved as part of the project process, rather than as part of the agenda decision process. If the Boards conclude that resources are not available to undertake such a project now, we would prefer that the project is delayed until resources become available.

8. Given the significance of the possible changes to current requirements if a comprehensive recognition-based project is undertaken, we do not think it is appropriate to move directly to an Exposure Draft. Instead, we propose that a Discussion Paper exploring the issues and setting out the preliminary views of the Boards is initially developed. A target period for developing the Discussion Paper is four years. An outline of the issues that might be addressed in the Discussion Paper is provided in Appendix 2. We also suggest that a Working Group (including users, preparers and regulators with practical experience and expertise in relation to identifiable intangible assets) is established to act in an advisory capacity.

9. Although our preference is for a single comprehensive project that incorporates a recognition objective, we acknowledge the ambitious nature of such an approach. Accordingly, this paper also contemplates alternative more narrowly scoped projects with less ambitious objectives, including a disclosure-only objective.

10. Given the range of possible scopes and objectives, paragraph 85 of this paper provides a decision aid to help facilitate the Boards’ discussions.
Summary of the Alternative Project Scopes
[Excerpt from the draft of the proposal prepared for the Boards by the staff of Australian Accounting Standards Board]

It is useful to categorise the intangible assets considered in this paper in a way depicted in Table 1 below. As reflected in the Table, this paper considers:

(a) the initial accounting for intangible assets (other than those acquired in a business combination) that would be recognised if they were to be acquired in a business combination; and
(b) the subsequent accounting for all intangible assets.

<table>
<thead>
<tr>
<th>INITIAL AND SUBSEQUENT ACCOUNTING</th>
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<tbody>
<tr>
<td>A: Internally generated</td>
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<tr>
<td>Arising from a discrete plan</td>
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<tr>
<td>Research and development (as defined in IAS 38)</td>
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<tr>
<td>In process</td>
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<tr>
<td>Contractual or other legal rights (eg patents)</td>
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<td>Proprietary techniques (eg secret formula)</td>
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<td>Other</td>
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<tr>
<td>In process</td>
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<td>Contractual or other legal rights</td>
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<td>Proprietary techniques</td>
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<td>Relationships (eg customer list)</td>
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<tr>
<td>Arising other than from a discrete plan</td>
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<td>Contractual or other legal rights</td>
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<tr>
<td>Proprietary techniques</td>
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<td>Relationships</td>
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<td>B: Separately acquired, including those acquired in exchange for a non-monetary asset or assets</td>
</tr>
<tr>
<td>C: Acquired by way of a government grant</td>
</tr>
<tr>
<td>D: Acquired in a group of assets or net assets that is not a business</td>
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<th>SUBSEQUENT ACCOUNTING</th>
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<td>E: Acquired in a business combination</td>
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In perceived ascending order of the degree of change from current requirements, on the assumption that a disclosure-only objective is less radical than a recognition-based objective, an Intangible Assets project may have a primary objective of:

(a) specifying disclosures for internally generated intangible assets. These disclosures may be:

(i) qualitative; and/or

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(ii) quantitative, including measurement at:
   A. cost; and/or
   B. fair value.

The FASB has already done some work in this area as part of its own, since discontinued, Disclosures About Intangible Assets project.

(b) **resolving major definition, recognition and measurement shortcomings**
with IAS 38, including a review of one, some or all of the following issues:
   (i) the current research and development recognition criteria, with a focus on
       the suitability of ‘technical feasibility’ as a criterion (see paragraph
       49(c)(i));
   (ii) the current restrictions on revaluations of recognised intangible assets
       (see paragraph 49(d)); and
   (iii) the application of the current definition of intangible assets in certain
       areas, including the distinction between intangible assets and:
       A. financial instruments (for example core deposits); and
       B. lease assets (for example land usage rights);

   [Further input to be incorporated prior to December IASB meeting.]

(c) **specifying recognition and disclosure of intangible assets developed from a discrete plan,** initially and/or subsequently measured at:
   (i) cost; or
   (ii) fair value; and

(d) **specifying recognition and disclosure of internally generated intangible assets, irrespective of the manner in which they arise.** Within this approach, different initial and subsequent measurement bases that could be considered include:
   (i) cost for all (which is effectively equivalent to the potential project (c)(i)
       above, because cost is unlikely to be available for intangible assets that
       do not arise from a discrete plan);
   (ii) cost for internally generated intangible assets that arise from a discrete
       plan and fair value for others; or
   (iii) fair value for all. From an initial accounting perspective, this could result in
       the principles adopted in IFRS 3 being applied to intangible assets
       acquired in a business combination being applied to internally generated
       intangible assets.

. . .

Relative to each other, all of these possible projects have the potential to achieve, to varying degrees, improvements to current requirements and satisfaction of perceived users’ needs.
### Listing of the FASB's Current Agenda Projects

Source: [http://72.3.243.42/project/index.shtml](http://72.3.243.42/project/index.shtml)

<table>
<thead>
<tr>
<th>JOINT FASB/IASB PROJECTS:</th>
<th>2007</th>
<th>2008</th>
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<td>4Q</td>
<td>1Q</td>
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**Conceptual Framework Project**  
(Updated November 12, 2007)

- Objectives and Qualitative Characteristics (Phase A): E
- Elements and Recognition (Phase B): PV
- Measurement (Phase C): PV
- Reporting Entity (Phase D): PV
- Presentation and Disclosure, including Financial Reporting Boundaries (Phase E): PV
- Framework Purpose and Status in GAAP Hierarchy (Phase F): PV
- Applicability to the Not-for-Profit Sector (Phase G): PV
- Entire Framework (Phase H): PV

**Standards Projects:**

<table>
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<tr>
<th>Business Combinations</th>
<th>2007</th>
<th>2008</th>
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- **Applying the Acquisition Method**  
  (Updated November 19, 2007)
- **Noncontrolling Interests**  
  (Updated November 27, 2007)
- **Earnings per Share**  
  (Updated November 27, 2007)
- **Liabilities and Equity**  
  (Updated November 13, 2007)
- **Income Taxes**  
  (Updated July 17, 2007)
- **Financial Statement Presentation**  
  (Updated November 7, 2007)
- **Revenue Recognition**  
  (Updated November 27, 2007)
- **Accounting for Leases**  
  (Updated November 15, 2007)

**Research Projects:**

- **Accounting for Insurance Contracts**  
  (Updated November 7, 2007)

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<th>GAAP Hierarchy</th>
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<th>Accounting for Certain Nonfinancial Liabilities</th>
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<th>Recognition and Measurement (Phase 2)</th>
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<th>Insurance Risk Transfer</th>
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**Codes:**
- C – Comment Deadline
- E – Exposure Document
- F – Final Document
- I – Initial Due Process Document
- PV – Preliminary Views

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