MEMORANDUM 1 OF 3
(IASB AGENDA PAPER 3A)

Financial Accounting Standards Board

To:	Board Members		
From:	Revenue Recognition Team (Johnson, ext. 288 & Manders, ext. 207)		
Subject:	Formal Agreement to Joint Project on Revenue Recognition	**Date:**	September 4, 2002
Time Code:	**A: RR**		
cc:	Leisenring, Bielstein, Smith, Petrone, MacDonald, Mahoney, Swift, Polley, Thompson, Gabriele, Bean (GASB), Lapolla, Intranet (e-mail)		

For Discussion at the
September 18, 2002
Joint FASB-IASB Board Meeting

INTRODUCTION

Both the FASB and IASB Boards have added projects to their agendas on revenue recognition (including related liabilities issues). Both Boards also have expressed interest in pursuing those projects as a joint project. It, therefore, is appropriate at this joint meeting of the Boards to discuss all issues necessary to enable each Board to (1) formally decide to pursue the project jointly and (2) decide on consistent joint objectives and responsibilities for the joint project. This memorandum addresses those matters.

The policies that govern joint projects involving the IASB and national standard setters were established at the IASB's meeting of standard setters on September 10–11, 2001. Agenda Papers 1A and 1B for that meeting describe those policies as follows:

- The Boards agree that the following characteristics should be observable for every joint project:
    1. The project is on the agendas of both Boards and will be fully deliberated by both Boards. *(Initial)*

2. Both Boards will use the same Board papers, and those Board papers should be shared. *(Initial and Ongoing)*
3. The Boards will share comment letters *(Ongoing)*, share the same project task force *(Initial and Ongoing)*, and are jointly represented at public hearings to the extent that those (or other) types of constituent inputs arise on the project. *(Ongoing)*
4. Staff is assigned to the project as a single team. *(Initial)*
5. A project plan for use by both Boards is prepared before commencing work on the joint project that includes an articulation of the project's objective ("the problem to be fixed"), project scope, resource requirements, milestones and deadlines, and the anticipated final product. *(Initial)*

- The Boards agree to identify a group of key staff and Board members who will serve to facilitate cooperation on the joint project. *(Initial)*
- The Boards agree that if they ultimately decide to issue different standards on a joint project, a comparison of the two standards will be included in each Board's standard along with an explanation of why they are different. *(Ongoing)*
- The Boards agree to seek increasing coordination of the pre-agenda process, the agenda-decision process, and other elements of the Boards' due processes as a longer term objective through various means. *(Ongoing)*

In accordance with those policies, each of the foregoing items requiring initial agreement must be agreed to at the outset of the project.

AGREEMENT TO PURSUE PROJECT JOINTLY

Ideally, a joint project would be added to both Boards' agendas simultaneously. However, because both the FASB and the IASB already have revenue recognition on their separate agendas, in order for this to be a joint project, both Boards must agree to pursue their projects as a joint project.

FASB Agenda

At the May 15, 2002 meeting, the FASB agreed to add a project on revenue recognition to its technical agenda. As described in Action Alert:

> The Board decided to add a project to its technical agenda that will develop a comprehensive Statement on revenue recognition. Although that Statement initially is planned to apply to business entities generally, the Board noted that it might later decide to exclude certain transactions or industries that raise issues requiring additional study. In developing that Statement, the Board decided to reconsider, as necessary, the guidance pertinent to revenue recognition in its Concepts Statements. The Board decided that, in the interim while the Statement is being developed, the Emerging Issues Task Force (EITF) should continue to provide guidance on issues related to revenue recognition based on existing literature.

IASB Agenda

IASB Agenda Paper 8 for the May 2001 Board meeting discussed potential topics for projects, citing liability recognition and revenue recognition as two possibilities. Subsequent to that discussion, the IASB expanded its description of the topics of liability and revenue recognition into three possible projects:

1. The first potential project would explore the distinction between liabilities and equity.
2. The second potential project would explore liability recognition, including the need for more robust guidance on whether an item meets the definition of a liability and, if so, under what circumstances it should be recognized in the financial statements.
3. The third potential project would seek to establish workable general principles as a basis for determining when revenue should be recognized in the financial statements.

In July 2002, the IASB added the third of those potential projects to its agenda, titling the new project "Revenue—definition and recognition—and related aspects of liabilities." By including liability recognition to the extent that it relates to revenue recognition, the project also includes aspects of the second potential project.

The IASB's first objective for this project is to align the definition and recognition criteria for revenue in its Framework and International Accounting Standard (IAS) 18, *Revenue*, with the Framework generally. Its second objective is to develop standards dealing with revenue recognition for components of complex revenue-generating arrangements. The IASB intends to address whether, and on what basis, revenue should be distinguished from gains. (The IASB decided that its project on Reporting Financial Performance should not attempt to specify criteria for the identification of gains.) In addition, the IASB believes it is very important to pursue international convergence of conceptual frameworks and accounting standards in respect of revenue definition and recognition.

Revenue recognition policies were discussed informally at the meeting of the IASB with national standard setters in May 2002. The group discussed whether an income-statement driven (earnings-based) approach to revenue recognition should be preferred to a balance-sheet driven (asset- and liability-based) approach. The general sentiment of the group was that it would be

inclined to adopt revenue recognition policies that articulate easily with the IASB Framework, which is balance-sheet driven.

Staff Recommendation

As indicated above, the FASB and the IASB agenda projects on revenue recognition are similar. The staff recommends that the FASB and the IASB pursue their projects as a joint project. That project would:

1. Provide comprehensive guidance for revenue recognition at the standards level for application by entities generally
2. Amend the conceptual guidance of the FASB and IASB as it relates to the recognition of revenues to eliminate the potential for inconsistencies with other conceptual guidance.

Joint Project Task Force

Another of the observable characteristics of joint projects that must be decided at the outset concerns the project task force. Even though the policies call for the Boards to share a joint project task force, consideration should be given to the nature of and need for such a task force.

Historically, the role of the FASB's task forces has been to assist in the development of a neutral discussion document of the issues to be addressed in the project. Such documents usually were in the form of a Discussion Memorandum or Invitation to Comment, which are issued for public comment. After the comments received were analyzed, the Board would then deliberate the issues and issue an Exposure Draft of a proposed Statement.

The FASB has gradually moved away from issuing Discussion Memorandums or Invitations to Comment. In part, that has been to streamline and speed its processes so that the FASB can provide needed guidance to its constituents on a more timely basis. Consistent with that movement, a discussion document is not planned as part of the FASB's revenue recognition project.

Moreover, the membership in task forces typically has been drawn from nominations by the FASB's sponsoring organizations. While those memberships reflect a wide variety of perspectives that are useful in preparing a discussion document, they are less useful in providing some of the technical consultation that is needed throughout the project. Although some subgroups of the task force can be helpful in providing that consultation, additional help is more often being obtained by means of informal "working groups."

In addition, task forces are often quite large and, as a result, a bit unwieldy. A joint task force that is drawn from both the FASB's constituencies and the IASB's constituencies for a major project on revenue recognition would likely be unwieldy as well. Moreover, planning, organizing, and conducting meetings of task forces are activities that consume significant amounts of staff time. Accordingly, the Boards may wish to consider whether a formal joint task force for the revenue recognition project is needed.

Staff Recommendation

The staff recommends that a joint task force not be appointed for the project. Instead, the staff would propose to use members of the FASB's Emerging Issues Task Force (EITF) and the IASB's International Financial Reporting Interpretation Committee (IFRIC) as an informal working group, together with others as needed. Both the EITF and IFRIC have been addressing a wide variety of revenue recognition issues in recent years and are continuing to do so. As a result, they are well positioned to provide technical consultation and assistance on the issues in the revenue recognition project. The staff further notes that PricewaterhouseCoopers already is providing dedicated consultative support at the technical partner level to the FASB's project and will continue to do so. Additional informal help can be obtained on an as-needed basis. Accordingly, all of the consultative help necessary should be available, and available on a timely basis.

Joint Project Staff

Another initial observable characteristic of joint projects is that staff is assigned to the project as a single team. As noted in the IASB Agenda Paper 1B, the project team must include one staff person from each of the two standard setters. Both the FASB and the IASB have allocated staff resources to their respective agenda projects. Those two teams could be combined to form the joint project staff.

The Boards also need to agree on which standard setter will provide the lead staff for the project. The FASB has expressed an interest in providing the lead staff for this project, and the IASB has expressed its interest in having the FASB do so. If the Boards agree to undertake this project jointly with the FASB as the lead, the IASB staff would be assigned the roles of "co-lead" or "support," as described in the IASB Agenda Paper 1B on partnership working arrangements—staff roles on joint projects.

Staff Recommendation

The staff recommends that the Boards agree to combine the project teams and to have the FASB lead the project.

Joint Project Plan

Another initial observable characteristic of a joint project is that a project plan for use by both Boards is prepared before commencing work on the joint project that includes an articulation of the project's objective ("the problem to be fixed"), project scope, resource requirements, milestones and deadlines, and the anticipated final product. Those items are discussed below.

Project Objective

The objective of the project flows from the problems that the project is intended to resolve or "fix." With respect to the joint project on revenue recognition, the problems relate to (a) the magnitude and importance of revenues in financial statements, (b) the gap between concepts and detailed literature in the United States, (c) problems with IAS 18, *Revenue*, and IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, (d) inconsistencies in the conceptual guidance, and (e) the need for convergence.

The Magnitude and Importance of Revenues in Financial Statements

Revenue usually is the largest single item in financial statements. Moreover, studies in the United States indicate that revenue recognition is the single largest category of financial statement restatements. Consequently, issues involving revenue recognition are among the most important—and the most difficult—that standard setters and accountants face.

The Gap between Concepts and Detailed Literature in the United States

In the United States, the lack of a comprehensive standard on revenue recognition has manifested itself in a significant gap between the broad conceptual guidance in the FASB's Concepts Statements and the detailed guidance in the authoritative literature on revenue recognition for particular industries or transactions. Most of the guidance for recognizing revenues is detailed implementation guidance that is applicable to specific transactions or industries. That guidance has been developed largely on an ad hoc basis and promulgated in numerous pronouncements having differing degrees of authority.

Problems with IAS 18 and IAS 20

IAS 18 is the primary current source of international guidance on revenue recognition. IAS 18 contains three general principles for when revenue should be recognized, depending on whether the transaction is the sale of goods, the rendering of services, or the use by others of enterprise assets (yielding interest, royalties, and dividends). Although those broad principles are established, there is also detailed guidance for specific industries or transactions, such as "bill and hold sales," "membership fees," and "franchise fees" provided in IAS 18 and other revenue guidance.

IAS 18 includes the following shortcomings:

1. It does not deal well with transactions involving components (that is, multielement revenue arrangements including the delivery or performance of multiple products, services or rights).
2. Its requirements are not always consistent with the IASB Framework, particularly the Framework's definitions of assets and liabilities. For example, IAS 18 includes a criterion for revenue recognition that the costs incurred or to be incurred to complete the transaction can be measured reliably. This could lead to recognition of deferred credits as liabilities even when they do not meet the definition of a liability in the IASB Framework.

IAS 20 appeals to the earnings process and matching. Under IAS 20, government grants are recognized as income over the periods necessary to match them with the related costs they are intended to compensate. Grants related to assets are either recognized as liabilities (although they do not meet the definition of a liability in the IASB Framework) or netted against the carrying amounts of the related assets.

Inconsistencies in Conceptual Guidance

In the United States, conflicts may arise out of the conceptual guidance related to the recognition of revenues. The present revenue recognition criteria in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, require that revenues be *realized or realizable* (assets must be converted into cash or near-cash form) and *earned* (the entity must have substantially accomplished what it must do to be entitled to benefits). Application of those criteria can result in conflicts with the liabilities definition in FASB Concepts Statement No. 6, *Elements of Financial Statements*, because, in practice,

revenues that do not meet those criteria often are deferred and reported in the balance sheet as liabilities even though no obligation—and thus no liability—exists. As a result, revenue recognition sometimes overrides the liabilities definition even though it should not.

The main shortcoming of the IASB Framework is that its coverage of revenue recognition is relatively undeveloped, particularly for dealing with complex revenue-generating arrangements. In addition, tension exists between the Framework's definition of income (which encompasses revenue and gains) and its guidance on the recognition of revenue. Income is defined by reference to increases in assets and decreases in liabilities, while the guidance states that, in practice, revenue should normally be earned to qualify for recognition.

The Need for Convergence

The G4+1 highlighted the need to eliminate differences in concepts internationally, particularly differences in the definitions of elements of financial statements and the criteria for their recognition. The G4+ 1 also observed that current differences could hinder efforts to achieve convergence of accounting standards.

Before the FASB added revenue recognition to agenda, it issued a Proposal on that project to constituents for comment. The Proposal noted that the FASB has determined that all topics considered for its agenda should be assessed to determine whether they provide opportunities for cooperation with the IASB or other national standard setters, such as in the form of a joint project aimed at increasing convergence of accounting standards worldwide. The Proposal further noted that the issues that this project would address are not unique to the United States.

Although the Proposal did not specifically ask respondents for feedback on convergence, the respondents that did comment favored the possibility of achieving greater international convergence with respect to revenue recognition. For example, Johnson & Johnson (#19) stated, "We strongly encourage coordination efforts with the International Accounting Standards Board (IASB) and other national standard setters" (page 3).

Some urged that the FASB take a leadership role with respect to international cooperation. For example, Pfizer (#12) stated:

> We believe that this project, if performed in coordination with the International Accounting Standards Board (IASB) would advance the important cause of international harmonization. We note that the IASB and other standard

> setting organizations consider revenue and liability recognition issues to be important elements of the international harmonization effort. We would like to see the FASB take a leadership role in the development of these standards. [Page 2; emphasis in original.]

Similarly, Deloitte & Touche (#26) stated:

> We believe that the majority of the issues that would be considered in the Proposal are not unique to the United States, therefore, the project provides an opportunity for a cooperative effort with the International Accounting Standards Board (IASB) and perhaps other national standard setters, and such an effort can lead to increased convergence of standards globally. We support any opportunity to converge around high quality standards; however, we also believe that the FASB should ensure that a cooperative undertaking could be completed in a timely manner. [page 1]

The IASB regards it as very important that a unified approach to revenue definition and recognition be adopted by the IASB and national standard setters, including the FASB. It has noted that questions of revenue definition and recognition continue to be among the most difficult in practice, both at the domestic level and at the international level. Like the FASB, the IASB has identified a need to review and extend its conceptual framework in conjunction with developing new or revised accounting standards dealing with revenue. It is critical to the IASB Board that decisions in respect of revenue, and related aspects of liabilities, are consistent with the IASB Framework. The IASB thinks it is vital to address revenue definition and recognition as a high priority.

A joint project on revenue recognition, therefore, would provide a significant opportunity for the FASB and the IASB to converge their accounting standards toward a single high-quality standard that will provide transparency and protection for investors. Because both Boards have given this project a high priority, conducting this project jointly should not delay its completion.

Staff Recommendation

The objectives of the FASB's project on revenue recognition are to (a) develop a comprehensive set of principles for revenue recognition with which to eliminate the inconsistencies in the existing authoritative literature and accepted practices, (b) fill the voids that have emerged in revenue recognition guidance in recent years, and (c) provide guidance for addressing issues that arise in the future. The project also would amend the conceptual guidance in certain of the

FASB's Concepts Statements with respect to the potential inconsistencies related to revenue recognition.

The staff believes that those objectives are appropriate for the joint project and therefore recommends that the Boards adopt those objectives for it. In addition, the staff believes that convergence on revenue recognition guidance between the FASB and the IASB should be added as an objective of the joint project.

Project Scope

The scope of the FASB's revenue recognition project is to comprehensively address revenue recognition issues, with a view to providing guidance for business entities generally. In addition, it will resolve certain conceptual inconsistencies with regard to the existing conceptual criteria for recognizing revenues, specifically, eliminating the potential conceptual inconsistencies between the revenue recognition criteria and the liabilities definition.

Staff Recommendation

The staff believes that such a scope is appropriate for the joint project and recommends that the Boards adopt that scope. In making the recommendation, the staff acknowledges that some issues may arise that are unique to the FASB or the IASB. The staff believes that those issues that are unique to the FASB would be best handled by the FASB staff, and those unique to the IASB by the IASB staff. However, the staff acknowledges that issues unique to one Board could have implications for the joint project and, thus, the Boards will jointly address any such issues as part of the joint project.

Project Conduct

Because of the interdependencies of the issues to be addressed in the FASB's project, it is being conducted in two distinct and interrelated phases that will be pursued simultaneously. One phase takes a "top-down" approach that focuses on the conceptual guidance. The other phase takes a "bottom-up" approach that focuses on the authoritative guidance and current practices for revenue recognition and includes developing a comprehensive inventory of that guidance and those practices. The process of developing guidance at the concepts level and the standards level will be iterative in that tentative conclusions about the conceptual guidance will be tested by applying them to specific revenue recognition issues identified in the inventory, which might

indicate the need for further improvements in the concepts, and so on. The simultaneous pursuit of the two phases will not only facilitate the iterative process but will also expedite completion of the project.

Staff Recommendation

The staff believes that the approach adopted by the FASB for its project is appropriate for the joint project and recommends that the Boards adopt that approach. In doing so, the staff acknowledges that the sources and volume of the existing guidance on revenue recognition is significantly greater in the United States, and that the IASB's approach to the bottom-up portion of the project would not be as extensive. Additionally, because much of the IASB's guidance in specialized areas is similar to the US guidance, that guidance would necessarily be included.

IASB Standards incorporating revenue recognition guidance for which there is no US counterpart include:

1. IAS 40, *Investment Property*, and IAS 41, *Agriculture*. These Standards require biological assets and permit investment properties to be revalued regularly to fair value, with changes in fair value recognized as gains or losses.
2. IAS 16, *Property, Plant and Equipment*. IAS 16 permits items of property, plant, and equipment to be revalued to fair value, with income recognized for any reversal of a previous revaluation decrease that was recognized as an expense.

Formatted

Resource Requirements

As noted previously, the FASB and the IASB have already assigned staff resources to their respective agenda projects on revenue recognition. Specifically, five members of the FASB's staff and two members of the IASB's staff have been assigned (although not all of those assignments are full-time).

Staff Recommendation

The staff believes that by combining the already-assigned FASB and IASB staffs, together with whatever assistance Canada is able to provide, joint project staffing should be sufficient at least for the project activities that are projected through early 2003. Accordingly, the staff recommends that the joint project be staffed by combining the already-assigned FASB and IASB staffs.

Joint Project Facilitation Group

In a joint project, the Boards also need to agree on the participants in a group of key staff and Board members who will serve to facilitate cooperation on the joint project. The IASB Agenda Paper 1A provides recommendations about this group's responsibilities. In summary, this group would be charged to:

1. Identify possible areas of disagreement or potential disagreement between the Boards on technical issues as early as possible
2. Identify procedural impediments to cooperation between the two standard setters (both staff and Board)
3. Recommend procedures for resolving disagreements or overcoming other impediments to the progress of the project
4. Coordinate the implementation of their recommendations
5. Monitor and discuss major developments on the project as they arise and meet periodically throughout the project
6. Provide a forum for staff to air issues geared toward improving the project management process, project planning and developing realistic timetables, and cross-organizational staff relationships.

As indicated in the IASB Agenda Paper 1A, the group would report to the appropriate staff Directors and the Chairs of the two Boards on issues of substance.

Staff Recommendation

If the Boards agree to a joint project with the FASB staff as the lead, the staff recommends the following as the members of the group:

1. The "lead" staff person on the project –Todd Johnson, FASB Senior Project Manager
2. The "support" staff person on the project – Jim Paul, IASB Project Manager
3. A Board member from each of the Boards – Katherine Schipper, FASB Board Member (who is the assigned FASB Board collaborator on the FASB's project) and an IASB Board Member that is to be determined
4. The liaison Board member – Jim Leisenring, IASB Board Member.

Milestones and Deadlines

The staff plans to begin the deliberations on this project by focusing on the development and refinement of conceptual criteria for recognition. That process is expected to lead to amendments to Concepts Statement 5 (and possibly Concepts Statement 6) and to the IASB's Framework. A significant part of that process will involve testing the new criteria against

examples drawn from (a) existing guidance and practice, (b) EITF issues, (c) IFRIC issues, and (d) other issues that have arisen recently, including those reported on in the business media.

Below is a preliminary schedule of expected FASB and IASB discussions of the initial conceptual issues associated with criteria for recognizing revenues.

- Discuss proposed "working conceptual criteria" for revenue recognition; begin testing proposed criteria against cases identified in the bottom-up phase—FASB October 9, 2002 meeting, IASB October meeting
- Continue discussion of proposed "working conceptual criteria," focusing on criteria related to asset recognition; continue testing proposed criteria by applying to additional cases identified in the bottom-up phase—FASB October 30, 2002 meeting, IASB November meeting
- Continue discussion of proposed "working conceptual criteria," focusing on whether any changes to the definitions of liabilities or assets are needed—FASB November 20, 2002 meeting, IASB December meeting
- Continue discussion of proposed "working conceptual criteria," focusing on linked transactions and accounting for components—FASB December 11, 2002 meeting, IASB December meeting
- Continue discussion of proposed "working conceptual criteria," focusing on measurement issues—FASB January 8, 2003 meeting, IASB January meeting
- Consider definition of revenues and display issues—FASB January 29, 2003 meeting, IASB February meeting
- Wrap up any remaining conceptual issues and direct the staff to prepare the Exposure Draft for Concepts Statement amendment or replacement—FASB February 19, 2003 meeting, IASB March meeting

Following those discussions, the conceptual criteria, as revised and refined, will serve as the foundation for developing a comprehensive revenue recognition standard. The staff expects to be able to complete deliberations and draft Exposure Drafts for issuance in the third quarter of 2003.

The staff notes that no standard setter has previously attempted a project on revenue recognition of this magnitude. As a result, modifications to the preliminary schedule may well be necessary as we learn more about the issues and their implications.

Staff Recommendation

The staff recommends that the Boards agree to the preliminary schedule described above.

Anticipated Final Products

The anticipated final products of the joint project are:

1. A comprehensive standard on revenue recognition that applies to business entities generally. In U.S. guidance, this standard would be in the form of a new Statement of Financial Accounting Standards. For the IASB, this standard would amend or replace IAS 18 with a new International Financial Reporting Standard.
2. An amendment to the conceptual guidance for revenues. In the US guidance, this would amend or replace Concepts Statement 5. For the IASB, this would revise the IASB's Framework.

The staff anticipates issuing these documents in the second quarter of 2004.

Staff Recommendation

The staff recommends that the Boards agree to those final products.

SUMMARY OF STAFF RECOMMENDATIONS

1. The staff recommends that the FASB and the IASB pursue their revenue recognition projects as a joint project. That project would:
   a. Provide comprehensive guidance for revenue recognition at the standards level for application by entities generally
   b. Amend the conceptual guidance of the FASB and IASB as it relates to the recognition of revenues to eliminate the potential for inconsistencies with other conceptual guidance.
2. The staff recommends that a joint task force not be appointed for the project. Instead, the staff would propose to use members of the FASB's EITF and the IASB's IFRIC as an informal working group, together with others as needed.
3. The staff recommends that the Boards agree to combine the project teams, with the FASB leading the project.
4. The staff recommends that the objectives of the joint project should be to:
   a. Develop a comprehensive set of principles for revenue recognition with which to eliminate the inconsistencies in the existing authoritative literature and accepted practices, fill the voids that have emerged in revenue recognition guidance in recent years, and provide guidance for addressing issues that arise in the future
   b. Amend the conceptual guidance with respect to the potential inconsistencies related to revenue recognition

c. Converge the conceptual and authoritative guidance of the FASB and IASB with respect to revenue recognition.

5. The staff recommends that the scope of the project be to comprehensively address revenue recognition issues, and related aspects of liabilities, with a view to providing guidance for business entities generally, as well as to resolve certain conceptual inconsistencies with regard to the existing conceptual criteria for recognizing revenues.

6. The staff recommends that the project be conducted in two distinct and interrelated phases that are pursued simultaneously, with one phase taking a "top-down" approach that focuses on the conceptual guidance and the other phase taking a "bottom-up" approach that focuses on the authoritative guidance and current practices for revenue recognition and includes developing a comprehensive inventory of that guidance and those practices.

7. The staff recommends that the joint project be staffed by combining the already-assigned FASB and IASB staffs.

8. The staff recommends that the joint project facilitation group be formed as described in this memorandum.

9. The staff recommends that the Boards agree to the preliminary schedule as described in this memorandum.

10. The staff recommends that the Boards agree to the final products described in this memorandum.