



cutting through complexity

“It now seems inevitable that the new revenue standard will be amended before it becomes effective – and that different changes will be made to the IFRS and US versions of the standard.”

**Prabhakar Kalavacherla (PK)**  
KPMG’s global IFRS revenue recognition leader



## Symbolic divergence

**This edition of *IFRS Newsletter: Revenue* examines the latest developments on the new standard, and what the decisions could mean for you.**

Less than a year after publishing their joint standard on revenue recognition, the IASB and the FASB are back in standard-setting mode.

In their February meeting, the Boards agreed to publish proposed amendments to the new standard in the areas of licences and identifying separate performance obligations. The changes are intended to address implementation issues in a wide variety of industries, including media, pharmaceuticals, software and telecommunications.

Crucially, the FASB proposes making more extensive and more detailed changes than the IASB. However, the Boards emphasised that the proposed amendments would represent clarifications to the new standard and are not intended to alter its underlying principles.

The key proposed changes are as follows.

- **Licences:** The IASB and the FASB propose different amendments to the standard to clarify how to assess the nature of a licence and therefore whether revenue from licences should be recognised over time or at a point in time.
- **Sales- and usage-based royalties:** The IASB and the FASB propose amendments to clarify when the exception for sales- and usage-based royalties applies, and to clarify that a single royalty stream should not be split for accounting purposes.
- **Identifying separate performance obligations:** The FASB proposes amending the standard to re-articulate the criteria to assess whether a promised good or service is distinct and to add new examples; the IASB proposes adding new examples but not to amend the standard.

In addition, the FASB proposes a number of other amendments to the standard regarding licences and identifying separate performance obligations that the IASB has decided are not needed.

# CURRENT STATUS OF THE REVENUE PROJECT

## The story so far ...

In May 2014, the IASB and the FASB (the Boards) published their new joint standard on revenue recognition – IFRS 15/ASC Topic 606 *Revenue from Contracts with Customers* (the new standard). This replaces most of the guidance on revenue recognition that currently exists under IFRS and US GAAP.

At the same time, the Boards formed the joint Transition Resource Group for Revenue Recognition (TRG). Its primary purposes are to:

- solicit, analyse and discuss stakeholder issues arising from implementation of the new standard;
- inform the Boards about those implementation issues, which will help them determine what, if any, action will be needed to address those issues; and
- provide a forum for stakeholders to learn about the new standard from others involved with implementation.

The TRG advises the Boards and does not have standard-setting authority. Its members include auditors, financial statement preparers and users with knowledge and experience of revenue recognition under US GAAP and/or IFRS from various industries and geographies. Two KPMG partners are members.

Since its formation, the TRG has met three times – in July 2014, October 2014 and January 2015. It is expected to meet approximately four times annually until 2017 or 2018.

The TRG discussion on most issues considered to date has indicated that stakeholders should be able to understand and apply the new standard. However, in some cases the discussion has identified potential diversity in practice and, as a result, the following issues were referred to the Boards for further consideration:

- licences;
- identifying separate performance obligations; and
- determining whether an entity is acting as an agent or principal.

The [agenda and papers](#) of the TRG are publicly available and all meetings are held in public. A summary of the issues discussed to date by the TRG is included at the back of this newsletter.

## What happened in February 2015?

In February, the Boards met to consider how to address issues that have been referred to them by the TRG in the areas of licences and identifying performance obligations.

At the meeting, the Boards agreed to propose amendments to the new standard to:

- clarify the guidance on determining the nature of a licence of intellectual property;
- clarify when the exception for sales- or usage-based royalties applies; and
- add examples illustrating whether promised goods or services are distinct within the context of the contract.

In addition, the FASB decided to clarify when the licences guidance applies, the implications of contractual restrictions in a licence and the evaluation of materiality when identifying promised goods or services. The FASB also agreed to clarify the guidance on identifying performance obligations and to introduce an accounting policy election for certain shipping and handling services.

The proposed changes will be released by each Board for public comment. The IASB indicated that it will consider additional changes that may arise at future TRG and Board meetings and release a single exposure draft for comment. However, the FASB is expected to issue an exposure draft on its current proposals shortly. The Boards plan to discuss the effective date of the new standard in Q2 2015.

In addition, the Boards have indicated that they are undertaking outreach with stakeholders over whether to defer the effective date – which is currently 2017 under IFRS and for public business entities under US GAAP. They plan to discuss the results of this outreach in Q2 2015.

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# FEBRUARY DECISIONS AT A GLANCE

The Boards agreed to propose amendments on licences and identifying performance obligations.

What's the issue?	IASB decisions	FASB decisions
<b>Licences</b>		
<b>How to determine the nature of an entity's promise in granting a licence?</b>	Clarify the application of the existing criteria for assessing whether licence revenue is recognised over time or at a point in time.	Recharacterise the nature of licences as either functional intellectual property (point-in-time recognition) or symbolic intellectual property (over time recognition).
<b>When does the exception for sales- and usage-based royalties apply?</b>	Clarify that the exception applies whenever the licence is the predominant item to which the royalty relates, and that a single royalty stream should not be split for accounting purposes.	
<b>Does the licences guidance apply when the licence is not distinct?</b>	No action to be taken.	Clarify that in some cases when a licence is not distinct an entity will need to determine its nature in order to appropriately apply the general revenue recognition requirements.
<b>How do contractual restrictions impact the identification of promises?</b>	No action to be taken.	Clarify that contractual restrictions are attributes of the licence and do not affect the identification of the number of promises in the contract.
<b>Identifying performance obligations</b>		
<b>When is a promised good or service 'distinct within the context of the contract'?</b>	Add examples to illustrate the application of the separation guidance.	Add examples to illustrate the application of the separation guidance.  Re-articulate the principle of 'separately identifiable'.  Align the indicative factors with the re-articulation of separately identifiable.
<b>How to identify promised goods or services?</b>	No action to be taken.	Clarify that materiality is assessed at the contract level when identifying separate performance obligations in the contract.
<b>Should shipping and handling services be accounted for as a promised service?</b>	Perform outreach activities.	Clarify that shipping and handling activities before the transfer of control are fulfilment activities.  Add a policy election that allows an entity to consider shipping and handling activities after the transfer of control as fulfilment costs.

# DETERMINING THE NATURE OF A LICENCE

Boards propose to amend the licences guidance – in different ways.

## What's the issue?

### How to determine the nature of an entity's promise in granting a licence?

To determine whether to recognise revenue from a licence of intellectual property over time, an entity considers inter alia whether it continues to be involved with the intellectual property and undertakes activities that *significantly affect* the intellectual property to which the customer has rights. Stakeholders have questioned what attribute of intellectual property – i.e. its form, functionality and/or value – should be significantly affected to meet this criterion.

At the TRG meeting in October 2014, many members thought that the Boards intended 'significantly affects' to capture not just changes in the form or functionality of the intellectual property but also other significant changes. They expressed the view that value may be an appropriate factor to consider but that a high threshold should be met to conclude that activities significantly affect the intellectual property.

However, TRG members were concerned that this interpretation is not apparent from the words in the new standard and as a result there may be diversity in practice.

## What did the Boards decide?

### IASB introduces the concept of 'utility'

The IASB decided to propose amendments to the new standard to clarify that the criterion is whether the contract requires, or the customer reasonably expects, the entity to undertake activities that significantly affect the *utility* of the intellectual property to which the customer has rights. The IASB believes that utility would be affected when either:

- the entity's activities change the form (i.e. design) or functionality (i.e. ability to process a transaction, perform a function or task, or be played or aired) of the intellectual property; or
- the utility of the intellectual property is substantially derived from or dependent on those activities (e.g. a brand name).

The IASB's proposed amendment would also clarify that an entity's ongoing activities do not significantly affect the utility of the intellectual property when that intellectual property has significant stand-alone functionality.

### FASB introduces a new classification of intellectual property

The FASB decided to propose new guidance that would classify intellectual property into two categories, as follows.

Category	Description	Examples
<b>Functional intellectual property (point-in-time revenue recognition)</b>	<ul style="list-style-type: none"><li>• Intellectual property that derives a substantial portion of its utility from its stand-alone functionality</li><li>• Ongoing activities are not part of an integrated promise to the customer in granting a licence</li><li>• The licence is satisfied at a <i>point in time</i></li></ul>	<ul style="list-style-type: none"><li>• Software</li><li>• Biological compounds or drug formulas</li><li>• Media content (films, television shows, music etc)</li></ul>

Category	Description	Examples
<b>Symbolic intellectual property (over time revenue recognition)</b>	<ul style="list-style-type: none"> <li>Intellectual property that does not have significant stand-alone functionality</li> <li>The entity's promise is to both grant the customer rights to use and benefit from the entity's intellectual property and generally continue to support and maintain the intellectual property</li> <li>The licence is satisfied <i>over time</i></li> </ul>	<ul style="list-style-type: none"> <li>Brands</li> <li>Team names</li> <li>Logos</li> <li>Franchise rights</li> </ul>

## What are the implications?

### Increased clarity on when to recognise revenue

The proposed amendments have the potential to clarify when revenue from a licence of intellectual property should be recognised over time or at a point in time. As such, they respond directly to concerns expressed by TRG members that the current guidance could result in diversity in practice, with reasonable people reaching different conclusions for the same fact patterns.

The two Boards favour different approaches to clarifying the guidance. The IASB approach would change fewer words in the new standard and expand on the existing principle. The FASB guidance would introduce new classification terminology and represent a broader re-articulation of the intended approach; it would also be supported by a list of different types of licence and the category into which they are likely to fall.

Each Board believes that its proposal remains true to the principles of the new standard – and both believe that there should not be significant differences in practice between IFRS and US GAAP if their separate proposals are enacted in most cases. However, the Boards acknowledged that differences may arise when an entity is not expected to undertake significant activities after a licence is granted but the licence relates to symbolic intellectual property – e.g. a licence to use the brand of an historical sports team. In this case, the IASB approach may result in point-in-time revenue recognition and the FASB approach in over time revenue recognition.

In addition, there is a risk that the use of non-converged language in the IFRS and US GAAP versions of the new standard could have unintended consequences.

# EXCEPTION FOR SALES- AND USAGE-BASED ROYALTIES

Boards agree to clarify when and how the exception for sales- and usage-based royalties applies.

## What's the issue?

### When does the exception apply?

The new standard includes an exception to the general requirements for variable consideration for sales- or usage-based royalties that are attributable to a licence of intellectual property. Under this exception, an entity recognises revenue at the later of:

- when the subsequent sale or usage occurs; and
- the satisfaction or partial satisfaction of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.

Questions have arisen about the scope and application of this exception.

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## What did the Boards decide?

### Scoping based on the predominant item to which the royalty relates

The Boards decided to propose amendments to the new standard stating that the royalties exception applies when:

- the royalty relates only to a licence of intellectual property; or
- the licence is the *predominant* item to which the royalty relates.

The Boards also agreed to clarify that an entity should not split a royalty into a portion that is subject to the exception and a portion that is not – i.e. the royalty in its entirety either is in scope or is not.

### Example

#### Sales-based royalty in a contract that includes a licence of intellectual property and other goods or services

Film distributor D licenses Cinema operator C the right to show Film F for six weeks. D has agreed to provide memorabilia to C for display at its cinemas and to sponsor radio advertisements in the geographic area. In exchange, D will receive a portion of C's ticket sales for Film F.

In this example, D concludes that there is significantly more value to C from the licence than from the promotional activities, and therefore the licence to show Film F is the predominant component to which the sales-based royalty relates.

D therefore applies the exception for sales- and usage-based royalties and is not required to make an up-front estimate of the expected royalties or include a portion of that estimate in revenue on the date on which it transfers the film rights.

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## What are the implications?

### Resolution of stakeholder issues

The clarifications would avoid the complexity that would arise for preparers and users if a royalty were accounted for under more than one model, and are therefore consistent with the Boards' original rationale for the exception. The amendments would address the issues raised by stakeholders, promote consistency in application and ease implementation of the new standard.

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# OTHER LICENCE ISSUES

The Boards arrived at different conclusions on the need to clarify other licence issues.

## What's the issue?

### Does the licences guidance apply when the licence is not distinct?

Stakeholders have questioned when the licences guidance applies – e.g. whether an entity should consider the nature of a licence even when the licence is not distinct. At the TRG meeting in October 2014, some members expressed the view that an entity may need to consider the nature of its promise in granting a licence even when the licence is not distinct to appropriately determine whether the combined performance obligation is satisfied over time or at a point in time and to determine the measure of progress if it is satisfied over time.

### How do contractual restrictions impact the identification of promises?

In addition, questions have been raised about how certain contractual restrictions in a licence affect the entity's identification of its promises in the contract. For example, a customer may license a film for a three-year period but be restricted to showing it only on a specified public holiday in each of those three years. Some stakeholders have suggested that the new standard is unclear about whether the contract in this example would include a promise to deliver a single licence or multiple licences.

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## What did the Boards decide?

### Differing IASB and FASB views on the extent of amendments required

The IASB decided that no standard-setting action is needed in relation to these issues. Board members agreed that there is adequate guidance in the new standard to help entities determine when to assess the nature of a licence and assess the impact of contractual restrictions.

The FASB, however, decided to propose limited amendments to clarify that:

- in some cases, an entity needs to determine the nature of a licence that is not a separate performance obligation in order to appropriately apply the general guidance on whether a performance obligation is satisfied over time or at a point in time and/or the appropriate measure of progress for a combined performance obligation that includes a licence; and
- contractual restrictions are attributes of the licence and do not affect the identification of promised goods or services in the contract – i.e. restrictions define the scope of a licence, rather than changing the number of promises in the contract.

In the case of the example of contractual restrictions noted above, both Boards agreed that the entity would account for a single promised licence.

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## What are the implications?

### Differences between the IFRS and US GAAP standards

These decisions would result in non-converged language in the new standard, with more detailed guidance included in FASB ASC Topic 606. However, despite the proposed differences in wording, the Boards believe that an entity applying IFRS should come to the same conclusion as an entity applying a revised version of the US standard.

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# DISTINCT WITHIN THE CONTEXT OF THE CONTRACT

**Additional guidance to be provided to demonstrate how the Boards intend the separation guidance to be applied.**

## **What's the issue?**

### **When is a promised good or service 'distinct within the context of the contract'?**

Under the new standard, an entity accounts for a promised good or service as a separate performance obligation only if it is separately identifiable from other promises in the contract – i.e. the promised good or service is distinct in the context of the contract. The new standard includes indicators for an entity to consider in assessing whether this criterion is met.

However, the TRG discussion in October 2014 identified that there may be diversity in practice in relation to stakeholders' understanding of one of these indicators – what it means for a good or service to be 'highly dependent on, or highly interrelated with, other goods or services promised in the contract'.

For example, if a machine requires installation at a customer's premises, then some stakeholders believe that because the machine would not function without being installed and/or the installation services are dependent on successfully transferring the equipment, the promises to transfer the machine and to install it are not distinct within the context of the contract.

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## **What did the Boards decide?**

### **Additional examples to be developed, but additional clarification under US GAAP only**

The FASB agreed to propose guidance to clarify the new standard in the following ways.

- Re-articulate the principle of 'separately identifiable' to clarify that the objective when considering whether promised goods or services are separately identifiable from each other is to determine whether the nature of the entity's promise to the customer is primarily to transfer:
  - each of those separate goods or services (i.e. several outputs); or
  - a combined item(s) that incorporates each of those goods or services (i.e. several inputs into a combined item).
- Align the indicative factors with the re-articulated principle to clarify that an entity should evaluate whether two promised goods or services each significantly affect the other – not merely whether one is, by its nature, dependent on the other.
- Add examples that illustrate whether promised goods or services are distinct within the context of the contract.

The IASB agreed to add examples, but decided not to amend the other parts of the new standard. Rather, it believed that education of stakeholders and further explanation of the wording that is already in the new standard would address the issues.



## Example

### Equipment and consumables

Entity X enters into a contract to provide a piece of the 'off-the-shelf' equipment and related specialised consumables to a customer. The equipment does not function without the consumables. The consumables are only produced by X, but are sold separately and are readily available from other entities (e.g. from distributors of X's products and some retailers).

In this example, X determines that the equipment and consumables are each capable of being distinct and that the promises are distinct within the context of the contract. X is not providing a significant integration service of producing a combined item using the equipment and consumables, nor does either promise significantly customise or modify the other from the form in which it is sold separately. Therefore, although the consumables are dependent on transfer of the equipment (i.e. they would be useless without the equipment), they are not highly dependent or inter-related (i.e. inputs into a combined item) because they do not each significantly affect the other.

As a result, X determines that the equipment and consumables are distinct and accounts for them as separate performance obligations.

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## What are the implications?

### Full convergence no longer achieved

Introducing additional examples to accompany the new standard may provide helpful explanation of how the Boards intend the separation guidance to be applied. However, it will be important for the fact patterns used to be selected carefully and for the conclusions reached in the examples to be appropriately linked to the application of guidance in the new standard.

The decisions by the Boards would result in non-converged language between the IFRS and US GAAP versions of the new standard, with a risk of unintended outcomes.

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# OTHER PERFORMANCE OBLIGATION ISSUES

The new standard is not expected to require a significantly greater number of promised goods or services to be identified compared with existing standards.

## What's the issue?

### How to identify promised goods or services?

Some stakeholders have questioned whether the new standard requires an entity to identify a significant number of additional goods or services promised in a contract that are not deliverables or components under existing guidance – e.g. a requirement to stand ready to answer questions about a product via a helpline or a promise to deliver periodic account statements.

Specific concerns have also been raised in the US in relation to the Boards' decision not to explicitly exempt an entity from accounting for performance obligations that the entity might regard as being perfunctory or inconsequential.

### Should shipping and handling services be accounted for as a promised service?

Stakeholders have expressed varying views about whether an entity should account for shipping and handling services ('shipping') that occur after the transfer of control of the related goods as a promised service or, instead, treat them as a cost of fulfilling the promise to deliver goods to the customer.

Stakeholders have also questioned whether, if the Boards think that shipping may be a promised service, additional relief should be provided due to potential operational difficulties.

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## What did the Boards decide?

### FASB to introduce US GAAP relief

The IASB concluded that standard-setting regarding inconsequential or perfunctory performance obligations is not required. It noted that most TRG members did not think the new standard would require a significant increase in the number of promised goods or services to be identified. The IASB plans to conduct outreach on the shipping issue.

In contrast, to relieve potential operational difficulties, the FASB decided to propose amendments to the new standard that would:

- specify that an entity would evaluate materiality at the contract level when determining whether an item or activity promised in a contract should be identified as a promised good or service; and
- introduce a policy election that allows entities to choose to account for shipping that occurs after transfer of control of the goods as a fulfilment cost.

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## What are the implications?

### Differences in approach, but perhaps not outcomes

The Boards noted that they do not expect the amendments proposed by the FASB on materiality to create any significant differences in outcomes between IFRS and US GAAP preparers.

If the IASB ultimately decides not to amend IFRS 15 for shipping and handling, then different outcomes could arise under IFRS and US GAAP if entities under IFRS identify shipping and handling as a promised service but entities using US GAAP elect an accounting policy to treat the same services as a fulfilment cost.

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# ISSUES DISCUSSED BY THE TRG

Date	TRG Ref	Topic discussed	Outcome
18 July 2014	1	Gross vs net revenue: agency indicators	FASB staff to perform additional research and outreach
	2	Gross vs net revenue: amounts billed to customers	FASB staff to perform additional research and outreach
	3	Sales-based or usage-based royalties in contracts with licences and goods or services other than licences	Discussed at joint Board meeting in February
	4	Impairment testing of capitalised contract costs	No further action expected
31 October 2014	5	July 2014 meeting summary of issues discussed and next steps	N/A
	6	Customer options for additional goods and services and non-refundable up-front fees	No further action expected
	7	Presentation of a contract as a contract asset or a contract liability	No further action expected
	8	Determining the nature of a licence of intellectual property	Discussed at joint Board meeting in February
	9	Distinct within the context of a contract	Discussed at joint Board meeting in February
	10	Contract enforceability and termination clauses	No further action expected
26 January 2015	11	October 2014 meeting summary of issues discussed and next steps	N/A
	12	Identifying promised goods or services in a contract with a customer	Discussed at joint Board meeting in February
	13	Collectibility	Boards to consider further*
	14	Variable consideration	No further action expected
	15	Non-cash consideration	Boards to consider further
	16	Stand-ready performance obligations	No further action expected
	17	Islamic financing transactions	Discussions will continue with the IASB Advisory Group
	18	Material rights	To be discussed further at the March TRG meeting
	19	Consideration payable to a customer	To be discussed further at the March TRG meeting
	20	Significant financing component	To be discussed further at the March TRG meeting
	21, 22	Research project update (licences of intellectual property and identifying performance obligations)	Discussed at joint Board meeting in February
	23	Incremental costs to obtain a contract	No further action expected
24	Transition: contract modifications	Boards to consider further	

\* Potential further action is limited to concerns raised about the accounting in circumstances where performance obligations have been satisfied and some, but not substantially all, of the consideration has been received.

A more detailed summary of the issues discussed, the views expressed by TRG members and the FASB/IASB staff's views about those issues, and the Boards' planned next steps, if any, for each of these issues can be found in [agenda paper 5](#), [agenda paper 11](#) and agenda paper 25 (once available).

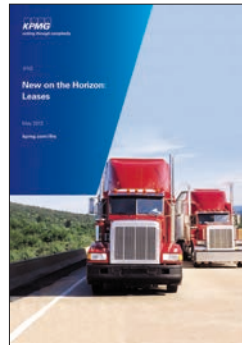
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