

REVENUE RECOGNITION AND RELATED ISSUES

Financial Accounting Standards Advisory Council
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**BACKGROUND**

The FASB continues to pursue the assets and liabilities approach to revenue recognition that was discussed at the December 2003 FASAC meeting. Under that approach, revenues arise from changes in assets and liabilities. Those changes can result from (a) a reporting entity's selling activities ("selling revenues") and (b) the extinguishment of the entity's performance obligations to its customers. Under this approach, the timing of revenue recognition is not affected by notions of the earnings process.

Performance obligations result from the reporting entity entering into enforceable commitments to deliver goods or render services¹ to its customers. The entity may extinguish its performance obligations by providing goods or services itself (direct performance) or by engaging a third party to do so on its behalf (indirect performance). In either case, obligations are extinguished by the *performance* of the promises to provide goods or services, and the reporting entity remains primarily liable for that performance.

Alternatively, the entity might extinguish its performance obligations by transferring them to an unrelated third party that legally assumes those obligations. In that case, performance obligations continue to exist but are now borne by the third party.

The Board agreed that performance obligations whose extinguishment will give rise to revenues should be initially measured at fair value. The fair value of performance obligations should reflect the price that a reporting entity would have to pay a third party to legally assume responsibility for performing those obligations.

¹ *Services* are defined broadly to include rights of use.

PURPOSE OF DISCUSSION

The purpose of the FASAC discussion is to elicit FASAC members' views on two significant issues relating to performance obligations:

1. When is a performance obligation deemed to be extinguished?
2. How can a reporting entity obtain or develop estimates of fair value of its performance obligations?

WHEN IS A PERFORMANCE OBLIGATION DEEMED TO BE EXTINGUISHED?

As discussed above, performance obligations result from a reporting entity's enforceable commitments to its customers. Because those obligations are legal duties, it is important to research and analyze when the entity is deemed to have been legally released from its obligations. Legal release may be achieved by means of direct or indirect performance or by means of legal transfer of the obligations to an unrelated third party. The Board has tentatively concluded that a reporting entity should not recognize revenues for the performance by third parties of its obligations to customers if those obligations are legally assumed by third parties. In all other circumstances, a reporting entity should recognize revenues for the performance by third parties of its obligations to customers. That is, a reporting entity should recognize revenues for all performance for which it is liable.

Legal Transfer of Obligations

The Board has discussed legal transfer as meaning that the reporting entity is no longer liable for the performance obligation. The following two scenarios illustrate the Board's decision.

Scenario 1

Company A enters into a contract to sell and maintain software with Customer for \$5,000. Third Party X legally assumes the obligation to deliver and maintain the software. Once Third Party X assumes the obligation, Company A has no further obligation to Customer. The fair value of the obligation to deliver and maintain the software is \$4,500.

Scenario 2

Assume the same facts as in Scenario 1, except that Company A is the only party named in the contract with Customer as being liable for delivery and maintenance of the software. Company A outsources the delivery and maintenance of the software to Third Party X for \$4,000.

In Scenario 1, Company A is not obligated to perform the software delivery and maintenance services and therefore would record total revenue related only to the selling activities of \$500 (\$5,000 - \$4,500). In contrast, in Scenario 2, the contract between Company A and Customer remains unchanged even though Company A hires a subcontractor. Company A is legally obligated to perform and can do so by either outsourcing its obligations to Third Party X or performing itself. Company A ultimately would record all \$5,000 in total revenues.

Legal transfer of obligations generally is addressed by paragraph 16(b) of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which states:

The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. [Footnote omitted.]

However, the legal community has indicated to the FASB that the meaning of “legally released from being the primary obligor” may not be clear. The FASB plans to clarify this guidance in its project on liability extinguishment.

Performance of Obligations

Depending on contractual terms and conditions, extinguishment of obligations by means of performance may occur at a point in time or over a period of time. Obligations might be legally extinguished at the time of partial delivery, full delivery, or at a later time, depending on the customer’s contractual rights and privileges. For example, extinguishment of obligations in multiple element contracts may occur as each element is delivered, only when full performance is completed, or when the customer’s rights of return are exercised or expire unexercised.

Because performance obligations are legal commitments, it may not be possible to fully understand the economics of revenue arrangements without first analyzing how the nature of the reporting entity’s legal rights and duties evolves throughout the term of a

contract with its customer. Such legal research and analysis will be performed in the Board's project on liability extinguishment, which will attempt to develop a single model for determining when different types of liabilities are legally extinguished. Once the Board makes sufficient progress in developing that single extinguishment model, it will consider whether to pursue that approach to the extinguishment of performance obligations in the revenue recognition project.

Some of the extinguishment questions that the Board may have to consider in the context of revenue recognition are illustrated in the following examples.

Example 1—Rights of Use

Real Estate Co. enters into a \$100,000 2-year noncancelable prepaid contract with Bank Co. Under that contract, Bank Co.'s name and logo will be displayed on the rooftop of a building owned by Real Estate Co. The contract is signed, cash is received, and the sign is displayed on the same date (December 31).

Questions to be considered:

- (1) Does Real Estate Co. have any remaining performance obligations (legal duties) to Bank Co. once it displays the sign? Does it matter that Real Estate Co. cannot deliver two years of performance on the date the sign is displayed?
- (2) Would the answer change if the cash consideration is not paid upfront, but is payable ratably over the two-year contract term?

Example 2—Products and Services

Seller enters into a prepaid noncancelable \$100,000 contract with Customer for delivery of Machine A, Machine B, and installation services for both products. Seller delivers and installs Machine A on December 31. Delivery and installation of Machine B does not occur until January.

Question to be considered:

What obligations, if any, did Seller extinguish on December 31?

HOW CAN A REPORTING ENTITY OBTAIN OR DEVELOP ESTIMATES OF FAIR VALUE OF ITS PERFORMANCE OBLIGATIONS?

The Board concluded that the most relevant and reliable measure of performance obligations is fair value, which reflects the price that the reporting entity would have to pay an unrelated third party to assume responsibility for performing all of its remaining obligations. The Board agreed that the relative reliability of fair value estimates should be assessed in the context of FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*. That Statement defines reliability in terms of representational faithfulness² and verifiability.³ The Board considered the notion of “precision” and concluded that precision is not a component of the definition of reliability in the conceptual framework. Therefore, it is not appropriate to assess the relative reliability of legal layoff amounts and customer consideration amounts in terms of the relative precision of those measures. Instead, their relative reliability should be assessed in terms of their representational faithfulness and their verifiability.

The examples on the following pages illustrate how performance obligations whose extinguishment gives rise to revenues might be measured at fair value in practice. Specifically, the examples reflect:

- *Estimates of fair value that can be verified by reference to observed prices*—Measures that are based on unadjusted prices in current exchange transactions (direct measures).
- *Estimates of fair value that can be verified by reference to models and inputs*—Measures that are developed by means of valuation models (indirect measures). Such measures can be verified by verifying inputs into the valuation models used and assessing the reasonableness of those models.

Examples 1 and 2 illustrate fair value estimates of performance obligations that can be verified by reference to observed prices. Example 3 illustrates fair value estimates that can be verified by reference to models and inputs.

² *Representational faithfulness* is defined in the glossary of terms of Concepts Statement 2 as “correspondence or agreement between a measure or description and the phenomenon that it purports to represent (sometimes called validity).”

³ *Verifiability* is defined in the glossary of terms of Concepts Statement 2 as “the ability through consensus among measurers to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias.”

At its June 9, 2004 meeting, the Board considered whether the measures illustrated in the examples should be used to measure performance obligations.

Example 1—Prices in Actual Exchange Transactions to Which the Reporting Entity Is a Participant

Retailer A sells custom-made furniture. On March 1, Customer purchases a table for delivery in approximately 2 months. The purchase price of \$1,100 is paid at contract inception. The fee is refundable only if Retailer A fails to perform under the contract.

Retailer A’s list price for the table is \$1,200. Its list price for the delivery service is \$150. The majority of Retailer A’s sales are made at list prices. Because Customer bought the table on sale, she paid only \$1,100 for the table with “free” delivery.

Retailer A places an order with its regular supplier under a standing outsourcing agreement. Retailer A’s cost is \$600 per table, including delivery to its warehouse and factory warranty. Retailer A outsources furniture delivery to customers to an independent contractor under a standing outsourcing agreement. The contractor charges \$80 per table for delivery.

Retailer A purchases an insurance policy that guarantees performance of the furniture supplier and the delivery contractor. The insurance company charges 1 percent of the sales price for that performance guarantee.

Discussion

In this example, the prices in Retailer A’s standing outsourcing contracts and its insurance contract could be used to measure the fair values of Retailer A’s performance obligations, even though those prices did not arise in active markets. That is because, *absent evidence to the contrary*, prices in actual current exchange transactions are presumed to be representative of fair value.

Thus, on March 1, Retailer A could measure its performance obligations as follows:

- | | |
|---|--------------|
| • Obligation for the manufacture of the table | \$600 |
| • Obligation for the delivery of the table | 80 |
| • Performance guarantee [.01(\$1,100)] | <u>11</u> |
| | <u>\$691</u> |

In addition, Retailer A has an obligation for managing the activities associated with contract fulfillment. *Contract fulfillment* refers to all of the activities performed after the

customer contract has been obtained. That is, it refers to the activities after the *contract acquisition* activities (those associated with selling or entering into the contract with the customer) are completed.

The contract fulfillment activities are performed in fulfilling the contract with the customer and include the activities associated with the performance obligations identified above. They also include what might be described as “contract management activities,” such as those that a general contractor provides in managing the work of subcontractors under a long-term construction project. In the case of Retailer A, the contract fulfillment activities include procurement (which includes activities with suppliers such as contract negotiations, relationship management, and processing of invoices) and order processing, as well as the physical handling and warehousing of goods.

Retailer A would estimate the amount that marketplace participants would demand for performing those activities. In this example, it is assumed that the amount that would be demanded is 5 percent of direct costs or \$34 [$.05(\$600+\$80)$].⁴

The difference between cash received (\$1,100) and the fair value of the remaining obligations (\$725 [$600+80+11+34$]) is recognized as selling revenue of \$375. Accordingly, contract acquisition activities and contract fulfillment activities are treated as separate elements of the arrangement that each command their own profit margin.

Example 2—Prices in Actual Exchange Transactions to Which the Reporting Entity Is Not a Participant

Assume the same facts as in Example 1, except that Retailer A does not outsource its manufacturing activities. However, Retailer B, Retailer A’s competitor, outsources identical performance obligations to an independent contract manufacturer. Retailer A has been able to ascertain that Retailer B outsources its performance obligations for \$600 per table. Retailer A’s management believes that it could negotiate identical prices if it chose to outsource its performance obligations.

⁴ The same assumption is made for purposes of Example 2. In Example 3, the gross profit markup arises as a result of the reporting entity’s contract fulfillment activities.

Discussion

Because prices in Retailer B’s standing outsourcing agreement can be observed in actual current exchange transactions, Retailer A could base its estimates of fair value on those prices. Thus, on March 1, Retailer A could measure its performance obligations at the same amounts as illustrated in Example 1.

Example 3—Prices in Hypothetical Transactions between Economic Entities

Assume the same facts as in Example 1, except that Retailer A manufactures, sells, and delivers furniture using its internal workforce. Retailer A does not have outsourcing agreements or quotes from third-party suppliers. Retailer A measures its performance obligations by means of the “cost plus gross profit markup” method. Management estimates that direct and indirect costs of manufacturing are \$600. Direct and indirect costs of delivery are \$65. The gross profit markup for manufacturing is estimated at 40 percent. The gross profit markup for delivery is estimated at 35 percent. (The gross profit markup estimate is based on internal margin goals that are believed to be consistent with market profit margins, as supported by data that Company A gathered to confirm the estimate.)

Discussion

The objective of adjusting the costs of performance by a reasonable gross profit markup is to estimate the legal layoff amount of the obligation (that is, the price a third party would charge to legally assume the obligation). When using the “cost plus gross profit markup” method, Retailer A relies on entity-specific inputs that are developed based on internal assumptions or limited information about its competitors.

The fair value of the obligation for the manufacture of the table might be estimated at \$840 [600x140%]. The fair value of the obligation for the delivery of the table might be estimated at \$88 [\$65x135%]. The fair value of performance guarantees would increase those amounts by a total of \$11 to \$939 [\$840+\$88+\$11]. The difference between cash received (\$1,100) and the fair value of the remaining performance obligations (\$939) would be recognized as selling revenue of \$161.

Question to be considered:

Should the fair value estimates described in these examples be used to measure the performance obligations to be reported in Retailer A’s financial statements?