

REVENUE RECOGNITION AND RELATED ISSUES

Financial Accounting Standards Advisory Council (FASAC)
June 2002



BACKGROUND

In March 2002, FASAC discussed the Board's proposal to add a project to the agenda on issues related to the recognition of revenues and liabilities. The comment period for the proposal ended on March 29, 2002. On May 15, 2002, the Board considered the comments received in response to the proposal, discussed issues related to the scope of the project, and decided to add the project to its technical agenda.

DISCUSSION AT THE JUNE COUNCIL MEETING

The June Council meeting will provide FASAC members with an overview of the responses received on the proposal as well as the Board's decisions and discussions to date.

PROPOSED SCOPE OF THE PROJECT

The proposal described a project scope that would develop a comprehensive Statement of Financial Accounting Standards on revenue recognition that applies to business entities generally. The revenue recognition Statement would (a) 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 proposal also indicated that the development of a comprehensive Statement would not preclude issuing more narrowly focused revenue recognition guidance that might be needed in the interim.

Because the proposed revenue recognition Statement must be based on sound conceptual guidance, the proposal indicated that the project also would amend FASB Concepts Statements No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, and No. 6, *Elements of Financial Statements*, to eliminate potential conflicts in the conceptual guidance on

revenues and liabilities and to refine and clarify that guidance. The revenue recognition criteria in Concepts Statement 5 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 Concepts Statement 6 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 criteria sometimes override the liabilities definition. In addition, certain aspects of the definition of liabilities would be refined and clarified.

PROPOSED CONDUCT OF THE PROJECT

Because of the interdependencies of the issues to be addressed, the proposal indicated that the project would consist of two distinct and interrelated phases that would be pursued simultaneously. One phase would take a “top-down” approach that focuses on the conceptual guidance. The other phase would take a “bottom-up” approach that focuses on the authoritative guidance and current practices for revenue recognition and that includes developing a comprehensive inventory of that guidance and those practices. The process of developing guidance at the concepts level and the standards level would be iterative in that tentative conclusions about the conceptual guidance would 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 would not only facilitate the iterative process but also would expedite completion of the project.

SUMMARY OF RESPONSES TO PROJECT PROPOSAL AS OF MAY 15, 2002

A total of 32 comment letters were received, representing the following constituent groups:

CATEGORY	RESPONSES
Academe	2
Industry	13
Public Accounting	11
User	2
Other	<u>4</u>
TOTAL	32

Virtually all respondents agreed with the need for the FASB to address issues associated with the recognition of revenues and liabilities. Many of those supporters reiterated points noted in the proposal and commented on the urgency and significance of this project.

Respondents expressed different views about what the scope of the project should be. A few respondents favored expanding the scope beyond that proposed, to include the development of a comprehensive Statement on liability recognition. The majority of respondents were split in their views. Some favored a project scope more or less as proposed, including the conceptual issues that the Board proposed to address (although some favored amending the Concepts Statements only to eliminate inconsistencies between the revenue recognition criteria and the liabilities definition). Others favored a project scope that focused on developing a comprehensive Statement on revenue recognition, without considering conceptual issues.

Respondents supported framing the comprehensive revenue recognition Statement in terms of general principles as opposed to detailed guidance. A number of respondents commented on the plan to conduct the project by means of an iterative approach consisting of the concurrent pursuit of a top-down phase and a bottom-up phase. All those commenting on that approach supported it.

Many respondents suggested that certain issues be excluded from the scope of the project. Some suggested that certain issues be addressed in other projects, others urged exempting particular transactions or industries from the Statement, and still others recommended reducing or eliminating conceptual issues.

The majority of respondents did not identify additional issues that should be addressed as part of the proposed project. With the exception of requests for guidance on related disclosures, there was little overlap among the additional issues suggested.

Many respondents acknowledged the international character of revenue recognition issues and suggested that, as a goal of the project, the guidance developed in the project should be accepted internationally. Several of those respondents noted the desirability of pursuing the project in cooperation with the International Accounting Standards Board (IASB).

RELATED EITF ACTIVITIES

In response to requests from the staff of the Securities and Exchange Commission (SEC), the Emerging Issues Task Force (EITF) has been addressing certain issues related to revenue recognition. Generally, those issues involve (a) whether revenues should be reported on a net or gross basis and (b) when (and at what amount) revenues should be recognized. The EITF has been more successful in resolving the former than the latter.

The EITF currently is in the process of addressing two significant issues related to revenue recognition: EITF Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables," and EITF Issue No. 02-G, "Recognition of Revenue from Licensing Arrangements on Intellectual Property." Issue 00-21 addresses how to account for arrangements in which a sale may involve the delivery or performance of multiple products, services, and/or rights to use assets and performance may occur at different points in time or over different periods of time. Issue 02-G addresses when to recognize revenue from licensing

arrangements on intellectual property. The Board discussed whether the EITF should continue to address those topics, as well as other topics that may arise prior to the completion of the comprehensive Statement on revenue recognition.

SUMMARY OF BOARD DISCUSSIONS AND DECISIONS

At the May 15, 2002 meeting, the Board decided to add a project to its technical agenda that will develop a comprehensive Statement on revenue recognition. That Statement is planned to apply to business entities generally. However, the Board noted that it might later decide to exclude certain transactions or industries that raise issues requiring additional study, as it did in the business combinations project.

The Board decided to reconsider as necessary, in its work on this project, the guidance pertinent to revenue recognition in its Concepts Statements, particularly that in Concepts Statement 5. The Board observed that revenues are defined in Concepts Statement 6 in terms of changes in assets and liabilities, yet the revenue recognition criteria in Concepts Statement 5 do not focus on those changes. The Board indicated its belief that a focus on changes in assets and liabilities is more likely to be productive in resolving revenue recognition issues (particularly issues of timing) than a focus on whether revenues have been realized or are realizable and whether the earnings process has been substantially completed.

The Board decided to conduct the project by means of the top-down and bottom-up approach as described in the proposal. The Board also decided that the comprehensive Statement should be conceptually based and framed in terms of principles.

The Board decided that while the Statement is being developed, the EITF should continue to provide guidance on issues related to revenue recognition based on the existing literature. In doing so, the Board acknowledged that the guidance that the EITF develops might not be consistent in all cases with the guidance that the Board develops in the Statement.

The Board also decided to explore with the IASB the possibility of working jointly on this project.

Questions for Council Members

1. Should the Board exclude from the scope of the Statement certain transactions or industries that raise issues requiring further study, or should it resolve those issues before issuing the Statement? If so, which transactions or industries should be excluded and why?
2. The existing guidance for revenue recognition is largely detailed guidance at the industry or transaction level. If certain of that guidance is consistent with the principles in the comprehensive Statement that the Board develops, should that detailed guidance be eliminated or retained?
3. Should the Board work jointly on this project with the IASB?