

REVENUE RECOGNITION AND RELATED ISSUES

Financial Accounting Standards Advisory Council
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**BACKGROUND**

In June 2002, FASAC discussed the responses received on the proposal to add a project to the Board's agenda on issues related to the recognition of revenues and liabilities, as well as the Board's decisions and discussions as of that date. The objective of this joint project with the International Accounting Standards Board (IASB) is to develop a comprehensive statement on revenue recognition that is conceptually based and framed in terms of principles. The Board plans to issue Exposure Drafts on a comprehensive accounting standard on revenue recognition and the related amendments of the Concepts Statements in the latter part of 2004, and to finalize the standard and related amendments in 2005.

For additional information, refer to the revenue recognition section of the FASB website: http://www.fasb.org/project/revenue_recognition.shtml

DISCUSSION AT THE JUNE COUNCIL MEETING

The purpose of this session is to provide Council members with an overview of (1) the "assets and liabilities approach" to the project that the Board is taking, (2) the Board decisions that have been reached since June 2002, and (3) some of the issues that the Board will be addressing in the near future.

THE ASSETS AND LIABILITIES APPROACH

The Board has adopted an approach to the project that will resolve certain conceptual inconsistencies with regard to the existing conceptual criteria for recognizing revenues. Specifically, that approach will amend FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, to eliminate the potential for inconsistencies between the revenue recognition criteria in it and the liabilities definition in FASB Concepts Statement No. 6, *Elements of Financial Statements*.

The Board agreed to work toward eliminating those inconsistencies by taking an assets and liabilities approach to revenue recognition that is consistent with Concepts Statement 6 rather than the approach taken in Concepts Statement 5. That is because revenues are defined in Concepts Statement 6 in terms of changes in assets and liabilities, whereas the revenue recognition criteria in Concepts Statement 5 focus on whether revenues have been realized or are realizable and whether the earnings process has been completed or substantially completed. Thus, even though revenues are defined in terms of assets and liabilities, their recognition is framed in terms of realization and completion of an earnings process. The Board observed that those criteria are not consistent with the definition of revenues and do not implement it, but instead effectively modify it.

In that regard, the Board noted that the *realized or realizable criterion* focuses on a narrower set of changes in assets and liabilities than those contemplated in the definition. That is because *realized* means being converted to cash or claims to cash and *realizable* means being readily convertible to cash or claims to cash.

Additionally, the Board noted that the *earned criterion* necessarily focuses on the reporting entity's business model and the earnings process that is associated with that model. However, each entity or industry arguably has a business model that differs from those of others, which has resulted in a plethora of detailed guidance that often is inconsistent. Applying that criterion sometimes results in deferrals of items that then are recognized as assets or liabilities even though they do not meet the assets or liabilities definitions in Concepts Statement 6.

As a result, the Board has decided not to pursue an approach that focuses on realization and an earnings process, but rather to focus on an assets and liabilities approach that is consistent with and implements the revenues definition. The IASB Board also has agreed to that approach.

The assets and liabilities approach involves analyzing changes in assets and liabilities and determining the source of those changes. For example, if an entity's assets increase, that increase must have resulted from one of the

following corresponding changes: (1) a decrease in other assets, (2) an increase in liabilities, (3) an investment by owners, or (4) revenues (or gains). If the increase in assets did not result from (1), (2), or (3), then it must necessarily have resulted from (4). Illustrative examples of how the assets and liabilities approach might be applied in two cases are included as Attachments A and B.

The assets and liabilities approach is sometimes described as a “balance sheet approach” and is criticized for not focusing on the income statement in which revenues are reported. However, that description is erroneous. The balance sheet reports on the *existing stock* of assets and liabilities, whereas the income statement reports on *changes* in those assets and liabilities (that is, the balance sheet is a statement of “stocks” and the income statement is a statement of “changes” or “flows”). Therefore, because the assets and liabilities approach to revenues being taken in this project focuses on *changes* in assets and liabilities, describing it as a “balance sheet approach” is incorrect.

RECENT BOARD DISCUSSIONS AND DECISIONS

To date, the FASB and IASB have focused on developing (1) a conceptual definition of revenues and (2) conceptual criteria for when revenues should be recognized. The FASB also has agreed that assets acquired and liabilities incurred in revenue transactions should be initially measured at their fair values.

Both Boards have discussed four views of how revenues should be defined and have since narrowed the discussion to two of the views, both of which focus on changes in assets and liabilities. Under the “broad performance view,” revenues arise from the reporting entity’s output of assets in the form of its goods or services that it ultimately sacrifices by transferring them to customers. Under the “liability extinguishment view,” revenues arise from extinguishment of obligations to the reporting entity’s customer for which it is primarily liable.

In most instances, revenues would be the same under the two views, but they would differ in some instances. For example, having a contract with a customer is essential to the liability extinguishment view, whereas it is not to the broad performance view. As a result, revenues could arise under the broad

performance view for products that the entity produces that are salable at reliably determinable prices without significant effort even absent a contract with a customer, but not under the liability extinguishment view. As another example, performance by the reporting entity is an essential element of the broad performance view, whereas it is not under the liability extinguishment view. As a result, revenues would arise from the performance by subcontractors of the entity's obligations to its customers under the liability extinguishment view, but not under the broad performance view.

The FASB and IASB Boards will continue to explore those views in future meetings.

FUTURE ISSUES TO BE DISCUSSED

At meetings in June and July, the Boards will be considering issues related to contractual rights and obligations. Later, the Boards will consider issues related to linkage, asset and liability specification, and the display of revenues. Additionally, the Boards will address issues of how to measure assets and liabilities at fair value when observable markets are not available. The conceptual guidance developed will be used concurrently to develop the comprehensive standard on revenue recognition.

Questions for Council Members

1. The assets and liabilities approach to revenue recognition differs in several ways from current practice. How can Council members assist the Board in communicating that change to its constituents and educating them about it?
2. Do Council members have any suggestions that the Board should consider in the project?

APPENDIX A: THE REVENUE RECOGNITION PROJECT

Case in Point: Fees Collected in Conjunction with Mortgages

Mortgage Company is a local company that provides residential mortgage loans. It retains about half of the loans that it makes and sells the remainder and buys other loans from other parts of the country to diversify its portfolio. Mortgage Company is indifferent as to which of its loans to sell or retain.

Mortgage Company has been advertising a program of conventional 15-year mortgage loans at a fixed rate of 4 percent per annum. Under that program, applicants are required to pay 2 points as a loan origination fee when they submit their loan applications and 3 additional points as an interest rate buy-down fee when their loans are funded. All points are nonrefundable. Mortgage Company's competitors in the area currently charge similar fees for similar loans.

Attracted by the advertisements, 3 potential homebuyers, A, B, and C, each apply on June 30 for identical mortgage loans of \$100,000, and each pay Mortgage Company the required \$2,000 (2 points). On July 10, Mortgage Company informs A that A's loan application has been denied. On July 15, Mortgage Company informs B and C that their loan applications have been approved. B and C sign the necessary loan papers later that day, pay \$3,000 (3 additional points), and receive their funding. B's and C's loans are identical, and Mortgage Company arbitrarily sells B's loan to Countrywide on a servicing-released basis for its fair market value of \$97,000 and retains C's loan for its own portfolio.

What revenues should Mortgage Company recognize and when should it recognize them?

Analysis

Analyzing this example by means of the realization and earnings process approach and the assets and liabilities approach produces certain differences in accounting.

Realization and Earnings Process Approach

Concepts Statement 5 provides conceptual guidance, requiring that, to be recognized, revenue be (a) *realized* or *realizable* and (b) *earned*. Realization is not at issue in this example because all fees are paid in cash and are paid in advance of the services rendered. Thus, recognition depends on what the earnings process is and whether it is substantially complete.

Guidance at the standards level is provided by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, which was issued two years after Concepts Statement 5.

Under Statement 91, Mortgage Company can recognize the initial 2 points as revenue if the loan application is denied (which is the case with A) or the loan is approved and sold to another financial institution (which is the case with B). However, if the loan is approved and retained rather than sold (which is the case with C), Mortgage Company must defer that fee and subsequently recognize it as an adjustment to the yield on the loan. In that case, the credit that corresponds to the cash debit is viewed as “deferred revenue.”

The earnings processes relative to A, B, and C, therefore, are different. With A, the earnings process culminates on July 10 with its denial of A’s loan application, and thus revenue of \$2,000 (the 2 points collected) can be recognized. With B, the earnings process culminates when Mortgage Company sells B’s loan to Countrywide, and revenue of \$3,000 (the 5 points collected minus the loan funding of \$100,000 plus the loan sale proceeds of \$97,000) can be recognized. With C, the earnings process extends over the term of the loan, with the service (the use of money) being rendered over that term. Accordingly, Mortgage Company will recognize C’s loan at the funded amount of \$100,000 less the deferred revenue of \$5,000 (the 5 points collected), thereby producing a carrying amount of \$95,000. It then will amortize the deferred revenue over the 15-year term of the loan as a yield adjustment on the loan.

The basis for conclusions of Statement 91 does not refer to the criteria for revenue recognition in Concepts Statement 5 with regard to this issue. What it does state is as follows:

The Board considered and rejected the argument that loan origination is a separate revenue-producing activity. . . . Revenue is not realized by the acquisition of a loan; it is only realized by holding or selling it. [paragraph 37]

In that regard, the Board presumably meant *earned* rather than *realized*, since loan origination fees usually are collected in cash in advance, as in this example, and thus realization is not at issue.

Paragraph 37 goes on to state that:

. . . the Board disagreed with those respondents who argued that originating a loan is a separate service to the borrower. The efforts of the lender to conclude that the borrower should be financially able to repay the loan and that the lender has satisfactory remedies in the event of default are for the benefit of the lender or subsequent investor rather than the borrower.

Although the lender or subsequent investor no doubt benefits, so does the borrower because the origination activities make the borrower eligible to obtain the loan, which is clearly beneficial to someone seeking one. Because the borrower also benefits, the origination activities therefore can be viewed as constituting a service to him.

Assets and Liabilities Approach

Under the assets and liabilities approach, revenue recognition would focus on those changes in assets and liabilities that have occurred and are reliably

measurable. Under that approach, revenue recognition would be the same as above with respect to A and B.

By July 10, Mortgage Company has \$2,000 more in assets (in the form of cash) as a result of its dealings with A; it also has no obligations with respect to A. Since Mortgage Company's net assets have increased, the corresponding credit of \$2,000 must represent either an investment by owners or income. Because A has not obtained an ownership interest in Mortgage Company, the credit therefore must represent income (in the form of revenue) of \$2,000.

By July 15, Mortgage Company has \$2,000 more in assets (in the form of cash: $\$2,000 + \$3,000 - \$100,000 + \$97,000$) as a result of its dealings with B; it also has no obligations with respect to B. Because Mortgage Company's net assets have increased, the corresponding credit of \$2,000 must represent either an investment by owners or income. Because B has not obtained an ownership interest in Mortgage Company, the credit therefore must represent income (in the form of revenue) of \$2,000.

Although revenue recognition is the same with respect to A and B, it differs with respect to C. Instead of deferring and amortizing \$2,000 of revenue over the life of the loan, Mortgage Company will recognize that as revenue on July 15. By then, Mortgage Company will have increased its assets by \$2,000 as a result of its dealings with C because its cash decreased by \$95,000 ($\$2,000 + \$3,000 - \$100,000$) and loans receivable increased by \$97,000 (which is the fair market value of C's loan, since Mortgage Company could sell the loan for that price); it also has no obligations with respect to C. Because Mortgage Company's net assets have increased, the corresponding credit of \$2,000 must represent either an investment by owners or income. Because C has not obtained an ownership interest in Mortgage Company, the credit therefore must represent income (in the form of revenue) of \$2,000.

Therefore, the assets and liabilities approach results in consistent revenue recognition for all three transactions.

APPENDIX B: THE REVENUE RECOGNITION PROJECT

Case in Point: Consumer Electronics Retailer

Retailer X is a consumer electronics company that sells television sets for \$300 that it buys from the manufacturer for \$250. Like other consumer electronics retailers, Retailer X also sells warranty contracts that extend beyond the manufacturer's warranty. Retailer X charges \$100 for the extended warranty contracts on the sets that it sells, and those contracts add 2 years to the manufacturer's 1-year product warranty. The fees collected in conjunction with those warranties are not refundable.

Retailer X can either service the warranties itself or engage reliable third-party administrators to legally assume the warranty servicing obligations. Past history indicates that 1 in 10 sets will experience a failure during the extended warranty period and that the average incremental cost to repair or replace a defective unit is approximately \$140. Reliable third-party administrators are willing to assume the obligations to perform the warranty servicing for a price of \$30 per contract. On June 1, 2002, Retailer X sells 10 television sets with extended warranties and collects the purchase price in full.

What Revenues Should Retailer X Recognize on June 1?

This example can be analyzed in terms of the activities involved: (1) selling television sets, (2) delivering television sets, (3) selling extended warranties, and (4) servicing extended warranties. On June 1, Retailer X has performed the first 3 of these activities, but the activity of warranty servicing has not yet been performed and will not begin for a year.

The differences in the assets and liabilities approach and the realization and earnings process approach can be illustrated by the differences in revenues recognized on June 1. Those differences stem from how the warranty servicing is to be performed. In Case A, Retailer X immediately engages a third-party administrator to perform the servicing, whereas in Case B, Retailer X will perform the servicing itself.

Analysis by Means of the Realization and Earnings Process Approach

The guidance in Concepts Statement 5 requires that revenues be *realized* or *realizable* and *earned*. Because the extended warranties are sold with the television sets, and the purchase price is collected in full and is not refundable, realization is not at issue. Accordingly, revenue recognition depends on what the earnings process is deemed to be and whether it is substantially complete.¹

¹ FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, requires a full deferral method for revenues relating to extended warranty contracts. Under that method, the sales of merchandise and extended warranties are treated as separate transactions (and separate earnings processes) because customers have the option to purchase the television sets with or without the extended warranty. As a result,

In this example, revenue recognition for the activities that have been performed to date depends on how the remaining future activity is to be performed; that is, whether the servicing of the extended warranties is to be performed by an administrator or by Retailer X. Accordingly, the amount of revenue recognized on June 1 depends on management's intent with respect to the performance of that activity.

In Case A, the earnings processes, with respect to both the television sets and the extended warranties, are deemed to be complete at the date of sale because management does not intend for Retailer X to service the extended warranties. Accordingly, on June 1 Retailer will recognize revenues of \$4,000 [10 @ (\$300 + \$100)] or \$3,700 [10 @ (\$300 + \$100 - \$30)], depending on whether Retailer X is viewed as a principal or an agent with respect to the extended warranties.

In Case B, the earnings process for the television sets is deemed to be complete on June 1, but the earnings process for the extended warranties is not deemed to be complete because management intends to have Retailer X service the warranties rather than outsource the servicing. As a result, on June 1 Retailer X will recognize revenue of \$3,000 (for the television sets) and defer revenue of \$1,000 (for the extended warranties).

Note that in both Case A and Case B, Retailer X has performed the same activities, namely, selling and delivering television sets and selling extended warranties. However, under the realization and earnings process approach, on June 1 it would recognize revenue of either \$4,000 or \$3,700 in Case A and revenue of \$3,000 in Case B.

Analysis by Means of the Assets and Liabilities Approach

Because the assets and liabilities approach focuses on the changes in assets and liabilities that have occurred, and measures the assets obtained and liabilities incurred at their fair values, how any subsequent activities are to be performed does not affect the revenue to be recognized for activities that have already been performed. Therefore, regardless of what management intends

revenues from an extended warranty contract are deferred and recognized over the life of the contract (unless historical evidence indicates that costs of providing the protection are incurred in some pattern other than straight line).

However, prior to 1989, retailers typically followed a full recognition method of accounting for extended warranty contracts. At the date of sale, the proceeds from the sale of a contract were immediately recognized as revenue, and a liability for the estimated future costs to service the warranty were accrued, which was also thought to be consistent with the "realized" and "earned" model of revenue recognition because warranty servicing was viewed as being incidental to the central operations (thus the earnings process) of retailers.

In 1989, with the approval of the SEC, retailers began using a partial recognition method. Under that method, only a portion of the proceeds from the sale was recognized as revenue immediately, and the rest was deferred and recognized over the contract period, with the allocation of revenue being based on the relative costs of the product and the servicing. In contrast to the full recognition method, the partial recognition method attributed the same profit margin to the product and the warranty. That is because, under this method, warranty servicing was not viewed as an incidental activity and, thus, the earnings process encompassed both the product and servicing.

with respect to servicing the extended warranties, the amount of revenue recognized on June 1 would be the same in Case A and Case B.

Retailer X obtained cash of \$4,000 and incurred a liability for warranty servicing having a fair value of \$300 (the price that reliable, third-party administrators charge). Because the transaction was with Retailer X's customers and because they did not obtain ownership interests as a result of the transaction, the excess of assets obtained over liabilities incurred represents revenue. On June 1, Retailer X has received assets (cash of \$4,000) and incurred a liability (warranty obligation of \$300); therefore, revenue of \$3,700 [$\$4,000 - \300] would be recognized in both Case A and B.

In reality, Retailer X does not need to decide on June 1 whether to outsource the servicing of the extended warranties or perform the servicing itself because the warranties do not take effect until the one-year manufacturer's warranties expire. Thus, Retailer X has up to a year to decide which course of action to take. Under the assets and liabilities approach, it does not make any difference what Retailer X decides or intends on June 1, a year later, or at any date in between. However, under the realization and earnings process approach, it is essential to know what management's intent is regarding Retailer X's *future* activities in order to be able to account for its *past* activities, and hence, its revenues from those *past* activities.²

² This example illustrates a case in which some revenue might be recognized sooner than under current practice. However, in other cases, revenue might be recognized later. In Case B, the \$700 is recognized as revenue from the sales effort—the performance of the activity of selling the extended warranty. If Retailer X performs the warranty servicing activity, it would recognize revenues of \$300 when it performs that activity.