

REVENUE RECOGNITION AND RELATED ISSUES

Financial Accounting Standards Advisory Council
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**PURPOSE OF DISCUSSION**

The purpose of this session is to discuss the conceptual model for revenue recognition being developed by the Board. That discussion will be facilitated by an example of the conceptual approach, with emphasis on defining revenues and measuring liabilities arising from contractual obligations. The appendix to this memorandum provides additional project background and an update on the decisions made since the June 2003 FASAC meeting.

BACKGROUND

Revenue is the largest number on most income statements and is viewed by many users of financial statements as a key performance indicator. The complexity of revenue transactions and reporting issues continues to increase, and revenues are disproportionately associated with problematic reporting such as frauds, restatements, and auditing difficulties.

Currently, U.S. GAAP contains no general standard on revenues but contains over 180 pieces of transaction-specific and industry-specific guidance (for example, motion pictures, insurance, long-term construction, real estate, and software). That volume makes the appropriate guidance difficult to retrieve, and similar arrangements are not always accounted for in the same way.

FASB Concepts Statement No. 6, *Elements of Financial Statements*, defines revenue in terms of assets and liabilities. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, adds several recognition criteria specific to revenues, namely that it is realized or realizable (that is, readily convertible to cash or claims to cash) and that the earnings process is complete (that is, the entity has substantially accomplished what it is required to do). The conflict between the two Concepts Statements causes the recording of deferred revenues that are not liabilities, or for which the

recorded amount does not appropriately measure the obligation. In addition, requests for additional guidance would continue to increase under the earnings process approach as new business models are created because earnings processes are specific to business models.

Under the FASB's proposed conceptual model, revenue recognition is based on changes in assets and liabilities, without additional recognition criteria that override those definitions. At the June FASAC meeting, the Board described revenues as arising from changes in assets and liabilities that result from some combination of performance and liability extinguishment (see the appendix for an update of that previous discussion). The Board has agreed that performance obligations should be measured at fair value, in contrast to current GAAP, which often measures those obligations by allocating transaction amounts. However, use of fair values raises concerns about the reliability of measurement.

APPLICATION OF THE CONCEPTUAL MODEL—AN EXAMPLE

The following example demonstrates differences in accounting when a multiple-element transaction is analyzed under (a) current GAAP, (b) the liability extinguishment view of revenues, and (c) the broad performance view of revenues (see discussion of those views in the appendix). Specifically, it demonstrates how the *amount* of revenues varies under each approach; this example does not capture differences in timing.

EXAMPLE—Multiple-element arrangement involving hardware and services

Computer Company manufactures and sells hardware, including computers, servers, and storage devices. Computer Company enters into a noncancelable agreement to provide to Customer a “total customer solution,” consisting of hardware and a 3-year support services contract (maintenance and customer support) for a bundled price of \$3,000. In addition, Computer Company includes its standard one-year manufacturer’s warranty on the hardware.

Computer Company sells the hardware separately (without services) for \$2,000. Its cost to produce the hardware is \$1,500. Identical hardware is produced by third-party manufacturers, and Computer Company sometimes purchases the hardware from those third parties for resale to its customers, such as when it cannot meet customer demand. Those third parties sell the hardware to Computer Company for \$1,600 (at wholesale).

Computer Company sells 1-year renewals of its support services for \$400 (a 3-year renewal is \$1,200). Computer Company's cost to provide the support services contract is estimated to be \$270 a year. Computer Company sometimes outsources its support services (and it sometimes is the outsourcer for contracts sold by its competitors) and can outsource a 1-year support services contract to reliable providers for \$333.

Computer Company's estimated cost of warranty services over the 1-year period is \$150. Computer Company can pay third-party servicers \$250 to take on the 1-year warranty without recourse.

Computer Company pays its sales force a 4 percent commission on the sale.

Analysis

Analyzing this example by means of current GAAP, the liability extinguishment view and the broad performance view produces certain differences in accounting. This analysis illustrates the amounts that would be allocated to each "element" in the arrangement but does not fully describe when each would be recognized. Following the analysis are a number of questions for the Council.

Current GAAP

Based on guidance in EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables," the arrangement consideration (\$3,000) is allocated to each deliverable based on its relative fair value. For purposes of this example, those fair values are determined as the amount at which Computer Company sells each deliverable separately. The revenue amounts would not change if Computer Company outsourced the support and warranty services (unless they were legally assumed by the third-party outsourcer).

The expense line item in the table below assumes that Computer Company did not outsource the hardware, support, or warranty.

	<u>Selling Effort</u>	<u>Hardware</u>	<u>Support</u>	<u>Warranty</u>	<u>Total</u>
Revenue	--	\$1,875 (\$2,000/\$3,200) * \$3,000	\$1,125 (\$1,200/\$3,200) * \$3,000	--	\$3,000
Expense	\$120	\$1,500	\$810	\$150	\$2,580
Profit (Loss)	<u>(\$120)</u>	<u>\$375</u>	<u>\$315</u>	<u>(\$150)</u>	<u>\$420</u>

Liability Extinguishment View

Under the liability extinguishment view, Computer Company recognizes the “wholesale” fair value of its performance obligations and recognizes revenue as those obligations are fulfilled. Revenue for the services is recognized by Computer Company regardless of whether it provides those services itself or outsources them to a third party (unless the third party legally assumes the servicing obligations, in which case, Computer Company’s liability is extinguished and revenue is not recognized).

The expense line item in the table below assumes that Computer Company did not outsource the hardware, support, or warranty.

	<u>Selling Effort</u>	<u>Hardware</u>	<u>Support</u>	<u>Warranty</u>	<u>Total</u>
Revenue¹	\$150	\$1,600	\$1,000	\$250	\$3,000
Expense	\$120	\$1,500	\$810	\$150	\$2,580
Profit/(Loss)	<u>\$30</u>	<u>\$100</u>	<u>\$190</u>	<u>\$100</u>	<u>\$420</u>

Broad Performance View

Under the broad performance view, Computer Company recognizes the “wholesale” fair value of its performance obligations and recognizes revenue as those obligations are fulfilled. Computer Company recognizes revenue only for its own performance and does not recognize revenue if it arranges for others to perform.

¹ The amounts for hardware, support, and warranty represent the “wholesale” fair value of those performance obligations (the amount for the selling effort is a residual amount). Those fair values represent the amounts that Computer Company could pay a third party to assume its obligation. In many cases, it will be necessary to estimate that value using market inputs, and the amount to record may need to be chosen from a range of values. The use of such estimates is not unfamiliar in today’s practice. For example, entity-specific fair value estimates are usually derived from the price that an entity sells a deliverable separately. Sometimes, an entity may sell that deliverable within a range of prices, and judgment must be used to select the appropriate amount (this is particularly common in the software industry.) Another example of using estimates to recognize revenues is the use of percentage-of-completion accounting under Statement of Position No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. In addition, estimates often are used in recognizing costs, such as manufacturers’ warranty costs.

If Computer Company did not outsource anything, the amounts of revenue and expense recognized would be the same as the amounts recognized under the liability extinguishment view.

	<u>Selling Effort</u>	<u>Hardware</u>	<u>Support</u>	<u>Warranty</u>	<u>Total</u>
Revenue	\$150	\$1,600	\$1,000	\$250	\$3,000
Expense	\$120	\$1,500	\$810	\$150	\$2,580
Profit/(Loss)	<u>\$30</u>	<u>\$100</u>	<u>\$190</u>	<u>\$100</u>	<u>\$420</u>

However, if Computer Company outsourced the support service and warranty obligations, the amounts of revenue and expense recognized would reflect only the activities that Computer Company performed itself, as illustrated below:

	<u>Selling Effort</u>	<u>Hardware</u>	<u>Support</u>	<u>Warranty</u>	<u>Total</u>
Revenue	\$150	\$1,600	--	--	\$1,750
Expense	\$120	\$1,500	--	--	\$1,620
Profit/(Loss)	<u>\$30</u>	<u>\$100</u>	<u>==</u>	<u>==</u>	<u>\$130</u>

Questions for Council Members

1. When Computer Company signs the noncancelable agreement, what is its obligation?
2. What is the most relevant measure of that obligation and why?
3. Does the broad performance view or the liability extinguishment view better capture revenue?
4. In measuring revenue, does it matter if a company outsources a deliverable, as opposed to performing the deliverable itself?
5. Would it matter that there are observable (market) prices for only some of the elements in an arrangement? For example, if the support services were never sold separately or outsourced to a third party, should another estimate of the fair value of the services be used?
6. Performance obligations in this example are measured at amounts the reporting entity would have to pay a third party to assume responsibility for performing those obligations. An alternative measurement is the amounts at which the reporting entity sold (or could sell) identical or similar products or

services to similarly situated customers. Which measure better captures fair value?

APPENDIX: THE REVENUE RECOGNITION PROJECT

The purpose of this appendix is to provide Council members with background on the revenue recognition project and to present an overview of Board decisions that have been reached through October 2003.

BACKGROUND

At the June 2003 meeting, FASAC discussed the Board's decisions to date with emphasis on the general approach to revenue recognition, termed the "assets and liabilities approach." In addition, FASAC discussed the two views of revenues that the Board is using to develop a definition, 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.

As discussed at the June 2003 meeting, revenues often 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 Board plans to issue Exposure Drafts on a comprehensive accounting standard on revenue recognition and the related amendments of the Concepts Statements in the fourth quarter 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.

RECENT BOARD DISCUSSIONS AND DECISIONS

Contractual Rights and Obligations

In current practice, assets and liabilities associated with wholly (or partially) executory contracts often are ignored for financial reporting purposes, but in some instances they are recognized, so there is inconsistency in practice. Because the conceptual approach focuses on changes in assets and liabilities, consideration of contractual rights and obligations that result in assets and liabilities was necessary. The Board has made several decisions on this topic.

Contracts that are not enforceable do not result in assets and liabilities. Unless a contract is enforceable, the rights that it conveys to one of the contracting parties will not meet the definition of assets, and the corresponding obligations that it imposes on the counterparties will not meet the definition of liabilities. More specifically, it is the rights (and corresponding obligations) that are enforceable.

The Board discussed the following three types of contractual rights and obligations:

1. Conditional—Its performance is subject to the occurrence of an event that is not certain to occur (such as performance by the counterparty).
2. Unconditional—Nothing other than the passage of time is required to make its performance due.
3. Mature—It is not subject to any event, including the passage of time.

The Board decided that conditional rights and obligations do not meet the definitions of assets and liabilities and that unconditional and mature rights and obligations *might* meet the definitions of assets and liabilities. This decision is consistent with and is illustrated by FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. Interpretation 45 makes it clear that the noncontingent (unconditional) obligation to stand ready to perform that is associated with the contingent (conditional) obligation to make future payments warrants immediate recognition of a liability, even though it is not probable that

the triggering events will occur that would require that payments be made under the contingent (conditional) obligation.

The Board also discussed the nature of contractual rights and obligations. “Pre-performance” assets and liabilities are any assets and liabilities that arise from unconditional rights and obligations that exist until either party to a contract performs its stated conditional obligation(s) (for example, those that arise in wholly executory contracts). For sale-purchase contracts, pre-performance assets and liabilities are akin to put options obtained and call options written (for the seller) and call options obtained and put options written (for the buyer). “Post-performance” assets and liabilities arise from unconditional rights and obligations that exist after either party performs its stated conditional obligation(s). Post-performance assets and liabilities are familiar assets and liabilities, such as accounts receivable and accounts payable.

Measurement of Performance Obligations

The Board tentatively has concluded that fair value is the relevant measure of assets and liabilities upon initial and subsequent recognition. In the FASB’s fair value measurement project, the Board has decided to revise the definition of fair value to refer to “the amount at which an asset or liability could be exchanged in a current transaction between knowledgeable unrelated willing parties when neither is acting under compulsion.” The fair value of a liability is described as the amount that a willing third party of comparable credit standing currently would demand and could expect to assume all of the duties, uncertainties, and risks inherent in the transferor’s obligation, including a profit element or risk premium. When an entity has access to multiple markets, the fair value is the most advantageous price in a market to which the entity has reasonable access (the reference market).

In the revenue recognition project, the Board decided that the fair value of performance obligations should reflect the price that the reporting entity would have to pay a third party to assume responsibility for performing those obligations. This has been referred to as “wholesale” fair value. However,

certain IASB Board members have expressed the view that performance obligations should be measured at the amounts at which the reporting entity sold (or could sell) identical or similar products or services to similarly situated customers. This has been referred to as “retail” fair value.

Fair Value Hierarchy

The FASB’s fair value measurement project describes three levels of the fair value hierarchy. Measures that are consistent with the principles of that hierarchy are regarded to be fair value or estimates thereof.

That hierarchy prioritizes the market inputs that should be used for all estimates of fair value. In the context of liabilities, at the highest level (Level 1), the measure is based on observable (quoted) market prices for *identical* liabilities at or near the measurement date. At the next level (Level 2), the measure is based on observable (quoted) market prices for *similar* liabilities at or near the measurement date, and some adjustments of those prices might be necessary. At the lowest level (Level 3), adjustments using market inputs would be required to estimate fair value. The estimate might be based on the results of multiple valuation techniques, including a *market approach*, an *income approach*, and (if applicable) a *cost approach*, with all approaches maximizing the use of market information to the extent available and applicable.

In many revenue transactions, “wholesale” fair values of identical or similar performance obligations might not be observable in active markets at Levels 1 and 2 of the fair value hierarchy. However, the “wholesale” fair values might be capable of being estimated at Level 3 of the fair value hierarchy. If the “wholesale” fair value of performance obligations cannot be determined with sufficient reliability, some have suggested that “default measures” of performance obligations (such as retail values) might be used.

Several Board members observed that default measures are not currently well defined. They might be simply less reliable estimates of fair value, in which case labeling them as defaults may be inappropriate because the term *default* implies an inconsistency with the measurement objective of fair value. Alternatively, they

might be measures of convenience that are not consistent with the fair value measurement objective. The FASB and IASB Boards will continue to explore measurement issues at future meetings.