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THE REVENUE RECOGNITION PROJECT

In May 2002, the FASB added a project on revenue recognition to its technical agenda. That project will develop a comprehensive Statement of Financial Accounting Standards that applies to all industries.

Why Is the Board Undertaking the Project?

Comprehensive guidance on revenue recognition has not previously been developed in the United States. Instead, a variety of standard-setting bodies with different levels of authority have addressed revenue recognition issues, often as ancillary items and in industry-specific literature. The FASB has issued Statements, Interpretations, and Technical Bulletins that provide guidance for certain aspects of revenue recognition. Also, the EITF has issued consensuses, and the FASB staff and SEC staff have issued announcements dealing with certain aspects of revenue recognition that are included in the EITF Abstracts. The AICPA has issued guidance as well through Technical Practice Aids, Statements of Positions, and Practice Bulletins. Before the FASB was created, the AICPA's Accounting Principles Board issued Opinions, and its predecessor, the Committee on Accounting Procedure, issued Accounting Research Bulletins that are still in effect today. Finally, the SEC has also affected revenue recognition through the issuance of staff accounting bulletins and financial reporting releases, as well as through SEC staff speeches. The result has been a voluminous body of detailed guidance that is difficult to retrieve. There currently are more than 140 pieces of authoritative literature that relate to revenue recognition.

Even with such a voluminous body of literature, gaps in guidance still exist. For example, there is no general guidance on recognizing revenues for services. Moreover, revenue recognition issues continue to arise, as evidenced by the recent agenda of the EITF. Examples of the issues recently addressed by the EITF are EITF Issue No. 00-19, "Accounting for Shipping and Handling Fees," EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)," and EITF Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." Moreover, the SEC also has responded to emerging revenue recognition issues by issuing Staff Accounting Bulletin 101, *Revenue Recognition*. The continuing—and growing—need for such guidance illustrates why comprehensive revenue recognition guidance is needed.

Although the FASB's Concepts Statements address revenue recognition, that guidance is broad and can be difficult to operationalize. Moreover, conflicts can arise because of differences in the conceptual guidance. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* states that revenues should not be recognized until it is (a) *realized or realizable* and (b) *earned.* However, *revenues* are defined in FASB Concepts Statement No. 6, *Elements of Financial Statements,* in terms of changes in *assets* and *liabilities,* which also are defined in Concepts Statement 6. As a result, the revenue recognition criteria in Concepts Statement 5 sometimes override the definitions in Concepts Statement 6. For example, application of those criteria may cause revenue to be deferred, with the deferred revenue being reported in the balance sheet as a liability even though no obligation—and, thus, no liability—exists. The Board plans as part of the project to amend its Concepts Statements to eliminate those inconsistencies.

How Is the Project Being Conducted?

The project is being conducted jointly with the International Accounting Standards Board. Some of the key questions being considered are:

- Should revenue recognition be subject to criteria over and above the asset and liability recognition criteria?
- Is the *earnings process* useful as a basis for revenue recognition?
- Is the distinction between revenues and gains useful?

An "assets and liabilities approach" is being used to address the issues rather than a "realization and earnings process approach." Under the assets and liabilities approach, changes in assets and liabilities that have occurred are analyzed to determine 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) income (which includes revenues). In addition, assets obtained and liabilities incurred are measured at their fair values when they are obtained and incurred.

How Do the Assets and Liabilities Approach and the Realization and Earnings Process Approach Differ?

The differences between the assets and liabilities approach and the realization and earnings process approach are best illustrated by means of an example such as the following one.

Retailer 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 also sells warranty contracts that extend beyond the manufacturer's warranty. Retailer 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 can either service the warranties itself or pay reliable third-party administrators to 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 perform the warranty servicing for a price of $30 per contract. On June 2, 2002, Retailer sells 10 television sets with extended warranties and collects the purchase price in full.

What revenues should Retailer 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 has performed the first three 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 immediately engages a third-party administrator to perform the servicing, whereas in Case B, Retailer will perform the servicing itself.

Analysis by Means of the Realization and Earnings Process Approach

As noted above, 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]

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. Accordingly, the amount of revenue recognized on June 1, 2002 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 to service the extended warranties. Accordingly, on June 1 Retailer would recognize revenues of $4,000 [10 @ ($300 + $100)]. It also would recognize cost of goods sold of $2,500 [10 @ $250] and warranty expense of $300 [10 @ $30] for the amount that it will pay the administrator to service the extended warranties, thereby yielding a profit on June 1 of $1,200.

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

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[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, 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.

management intends to have Retailer service the warranties rather than outsource the servicing. As a result, on June 1 Retailer would recognize revenue of $3,000 (for the television sets) and defer revenue of $1,000 (for the extended warranties). It also would recognize cost of goods sold of $2,500 (for the television sets), thereby yielding a profit on June 1 of $500, as compared to $1,200 in Case A. (Retailer would recognize the deferred revenue as revenue over the warranty servicing period and, assuming that the repair costs were $140 as expected, that would result in a profit over that period of $860.)

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 past activities performed. Therefore, regardless of what management intends with respect to servicing the extended warranties, the amount of revenue recognized on June 1 would be the same in both Case A and Case B.

In exchange for obtaining cash of $4,000, Retailer has 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's customers and because they have not obtained ownership interests as a result of the transaction, the $3,700 excess of assets obtained over liabilities incurred represents income stemming from revenues. On June 1, therefore, Retailer would recognize revenues of $3,700. (Retailer also would recognize cost of goods sold of $2,500, thereby yielding a profit of $1,200 on June 1.)

In reality, Retailer 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 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 whether Retailer decides on June 1, a year later, or at any date in between, or what management's intent is at any point during that time. However, under the realization and earnings process approach, what management's intent is with respect to *future* activities is essential for accounting for its *past* activities, and hence its revenues from those past activities. In short, the past effectively depends on the future.

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The Board anticipates that the Revenue Recognition project will take two years to complete. For complete details and a project summary, visit the FASB's website at www.fasb.org.