Synopsis of FASB and IASB Preliminary Views on Revenue Recognition

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Discussion document would eliminate industry distinctions, "Pillars" of revenue recognition, VSOE. Open for comments by June 19, 2009.

After more than six years of deliberation, the Financial Accounting Standards Board and the International Accounting Standards Board have finally published for review and comment their preliminary views on a new model for revenue recognition. The two boards merged their individual revenue recognition projects in 2002 in an effort to improve consistency in measuring and reporting revenue, and to fix the shortcomings in each existing standard.

The new proposal, issued on December 19, 2008 for discussion, would theoretically achieve both goals. For US GAAP users who must interpret their way through hundreds of sometimes-conflicting standards, reduction and simplification of rules are critical. Conversely, those subject to IFRS apply vague, inconsistent standards that provide no guidance for complex transactions such as multiple-element arrangements. The new model is based on contracts with customers and a single revenue recognition principle. It is written to be broad enough to cover the scope of both standards, simple enough to provide clear guidance unburdened by industry distinctions, and comprehensive enough to guide even complex treatments.

Scope

The model proposed applies to contracts with customers. A contract, according to the proposal's definition, is an agreement between two parties that creates enforceable obligations. The contract does not have to be in writing.

No particular contracts are excluded from the model, but the boards are considering whether the proposed model would provide useful information about the following:

- Financial instruments and some non-financial contracts that otherwise would be within the scope of standards such as IAS 39 *Financial Instruments: Recognition and Measurement* and SFAS 133 *Accounting for Derivatives and Hedging Activities.*
- Insurance contracts that are in the scope of IFRS 4 *Insurance Contracts* and SFAS 60 *Accounting and Reporting by Insurance Enterprises* (and other related US GAAP).
- Leasing contracts that are in the scope of IAS 17 *Leases* and SFAS 13 *Accounting for Leases* (and other related US GAAP).

The boards will revisit this topic after reviewing comments to consider whether any types of contracts should be excluded.

New Revenue Recognition Principle

The cornerstone of the proposal is a single revenue recognition principle based upon changes in contractual assets and liabilities. It would remove all distinctions by industry in both standards and most references to "completion of the earnings process", putting forward instead a contract-based approach in which revenue may be recognized when a company's "net position in a contract increases as a result of satisfying a performance obligation by transferring goods or services to a customer." The assets to which this language refers are contractual rights – so when a contract asset increases because an obligation is satisfied, or a contract obligation decreases (or some combination), then revenue is recognized.

	Net Contract Position	Contract Asset	Contract Liability
Customer pays (reduces remaining rights	Decreases	Decreases	Increases
Entity provides goods and services (reduces remaining obligations	Increases	Increases (entity recognized revenue)	Decreases (entity recognizes revenue)

No More Pillars?

So what's happened to "completion of the earnings process" and the concept of realization, which were quite literally the "Pillars" of Revenue Recognition? While not abandoning the earnings process approach entirely – or so they say – the boards believe that deciding whether a contract asset has increased or a contract liability has decreased provides a clearer, more universally determinable objective than exists presently in making decisions about what constitutes an earnings process and when/how it is realized.

Identification of Performance Obligations

The proposal references the familiar words "deliverables", "components" and "elements" replacing them with "performance obligations". A performance obligation is defined as a promise to transfer an asset to a customer. Goods and services are both defined as assets, though a service may be an asset that is consumed immediately, or that enhances the value of another asset. Every performance obligation in a contract must be identified, even though some may be implicit (i.e. materials required to fulfill a painting contract): if an obligation can be charged for separately – whether the entity in question does so on not – it is a separate performance obligation.

That said, when a "bundle" of assets is transferred all at once, all of the performance obligations can be recognized at once. It is when assets are transferred at separate times that they must be accounted for separately to ensure that the company's revenue represents faithfully the pattern of transfers over the lifetime of the contract.

Every saleable performance obligation in a contract -- explicit or implicit -- must be identified whether the entity charges for it or not.

Satisfaction of Performance Obligations

Since satisfying a performance obligation increases the net contract position – permitting the recognition of revenue – the question of "when" obligations are satisfied is crucial. The boards ultimately rejected the "transfer of risks and rewards" of an asset as the benchmark, in favor of the "transfer of control." When the customer obtains control of a good such that it is now their asset, it will be considered transferred – even if they don't physically possess the good. Service obligations are satisfied when the customer has received the service.

Given these criteria, activities that a company undertakes in fulfilling a contract result in revenue recognition only if they simultaneously transfer assets to the customer. This is of particular importance to the construction industry where performance obligations would be fulfilled during the construction of an asset only if assets are transferred throughout the process.

Customers obtain control of goods when the goods become their assets, even if they don't have physical possession.

Measurement

The boards propose measurement of performance obligations at the transaction price, which is the amount the customer has promised to pay. If there is more than one performance obligation in a contract, then the transaction price must be allocated among them on the basis of the relative stand-alone selling prices of the goods and services. When an obligation is met, then the amount originally allocated to it is recognized. Original amounts allocated would not be altered, or re-measured, in later periods unless the obligation is subsequently deemed "onerous."

For US users operating under EITF 00-21 *Revenue Arrangements with Multiple Deliverables* and SOP 97-2 *Software* Revenue Recognition, this proposed model would present a major departure from present practices: it would permit companies that lack objective and reliable evidence of the selling prices of undelivered items to estimate them during the allocation process. Two methods for estimating prices are proposed: expected cost plus margin, or adjusted market assessment using quoted prices from competitors and adjusting them as necessary to reflect costs and margins.

Use of Estimates

The ability to use estimates constitutes a major departure for US GAAP Users of SOP 97-2 and EIFT 00-21. SOP 97-2 requires revenue to be deferred for delivered items if there is no vendor specific evidence (VSOE) of the selling prices for those obligations not yet delivered. The proposed model would permit estimation of selling prices for undelivered goods and services. This could result in earlier revenue recognition for items delivered but formerly deferred for lack of VSOE.

Potential Effects on Present Practice

The boards expect the proposed model for revenue recognition to cause "little, if any, change" but make note of the following differences from present practice:

A. *Use of Contract-Based Revenue Recognition Principle.* Increases that result from anything other than satisfaction of a performance obligation, such as increases in cash, inventory in the absence of a contract, or inventory under contract but not controlled by the customer would not trigger revenue recognition.
B. *Identification of Performance Obligations.* Entities would account for all contractual promises as performance obligations and recognize revenue for them only when they are satisfied. For example, warranties and other post-delivery services that are currently accounted for as cost accruals would be performance obligations under the new proposal.
C. *Use of Estimates.* In arrangements with multiple elements, entities would be permitted to estimate standalone selling prices of undelivered goods and services and recognize them upon delivery even if there is no objective and reliable evidence of the selling prices of the undelivered items.
D. *Capitalization of Costs.* In the board's model, costs are capitalized only if they qualify for such treatment in accordance with other standards. For example, commissions paid to salespeople typically don't create assets qualifying for recognition; such costs are recognized as expenses.

Next Steps

Comments on the discussion paper are due by June 19, 2009. The discussion paper and project descriptions are available at: www.iasb.org

Source Material

FASB, IASB; *Preliminary Views on Revenue Recognition in Contracts with Customers*; 12/19/2008; © 2008 IASCF; ISBN: 978-1-905590-95-7.

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