

A New Model for Revenue Recognition

FINANCIAL EXECUTIVE BENCHMARKING SURVEY

FASB/IASB Contract Model Edition

RevenueRecognition.com

Revenue Management Resources for Today's Financial Executive

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EXECUTIVE SUMMARY

RevenueRecognition.com recently surveyed senior financial executives from 515 companies about the FASB/IASB discussion paper *“Preliminary Views on Revenue Recognition in Contracts with Customers,”* which would fundamentally change revenue accounting. RevenueRecognition.com worked with staff members from the FASB and IASB revenue recognition project to create a survey based on the key questions raised in the proposal. The survey was conducted on the Internet in April 2009. More than 75% of respondents are senior finance executives including CFOs and Controllers.

References to the data and narrative in this report should be sourced:

www.RevenueRecognition.com, 2009

Key Findings:

- **54% of respondents agree or strongly agree** that a contract-based approach to revenue recognition would clarify the earnings process.
- However, disagreement increases as contracts become more complex.
- **66% said there would be little or no difference in the timing of their revenue recognition** if delivery is defined as the transfer of “control” over goods and services. But for construction, defense, engineering, services, and software companies, the impact could be significant.
- More than **70% agree or strongly agree** that the Boards’ definition of a “performance obligation” as an accounting unit would help them identify components more consistently than existing practice.
- A large majority agree with the Boards’ proposal to use **stand alone pricing** as the basis for allocating revenue recognition.
- A large majority also agree that management should be allowed to use **estimated prices**.
- However, **there are concerns on the matter of estimated prices**. Several write-in responses recommended standard models be established, even if industry specific, and that management be required to disclose how price estimates are made.

A NEW APPROACH TO REVENUE RECOGNITION

Fundamental changes may be in store for US accounting standards, the adoption of IFRS chief among them. There is an enormous philosophical divide between US GAAP and IFRS when it comes to revenue recognition. US GAAP is rules-based and offers thousands of pages of guidance and examples. IFRS on the other hand is principles based and offers only general guidance. The proposed merger of the two calls for a reinvention.

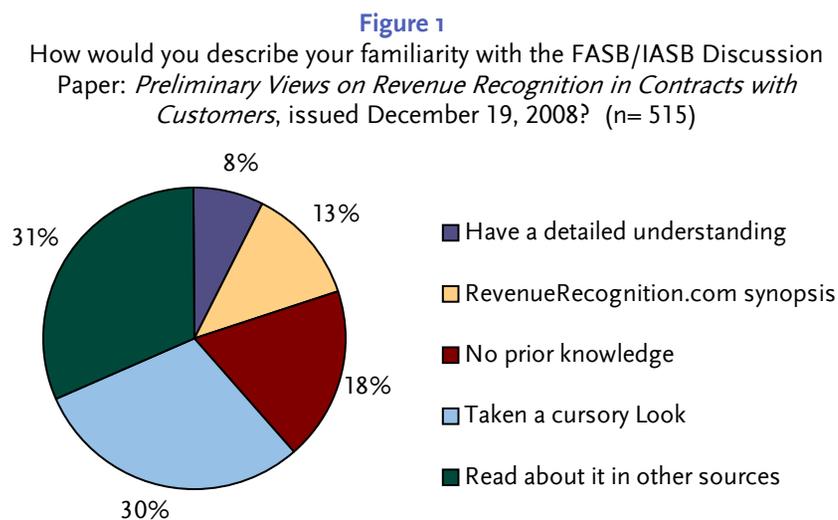
The publication of the FASB/IASB discussion paper “*Preliminary Views on Revenue Recognition in Contracts with Customers*,” implicitly acknowledges that neither system has it right. Ideally a revenue recognition standard would be generally applicable and specific enough to allow companies in similar businesses to account fairly and consistently for the revenue they earn, and for investors to understand the earnings processes of companies in different industries. This is the driving force behind the Boards’ proposal.

The contract based approach makes a key assumption – that contracts embody the intent and definition of business relationships. If so, they should determine when, why, and how much revenue is recognized by vendors. However, respondents raised concerns about the feasibility of this approach because contracts are not always set in stone or fully representative of ever-changing business relationships.

FAMILIARITY WITH THE FASB/IASB PROPOSAL

As a baseline for interpreting the results, we needed to know how familiar corporate finance and accounting professional are with the Boards’ proposal. It was issued December 19th 2008, so it was relatively new at the time of the survey. It also contains over 100 pages of accounting guidance with many questions. So it was not surprising to find as shown in Figure 1 below, that only 8% of respondents reported having a detailed understanding of the paper.

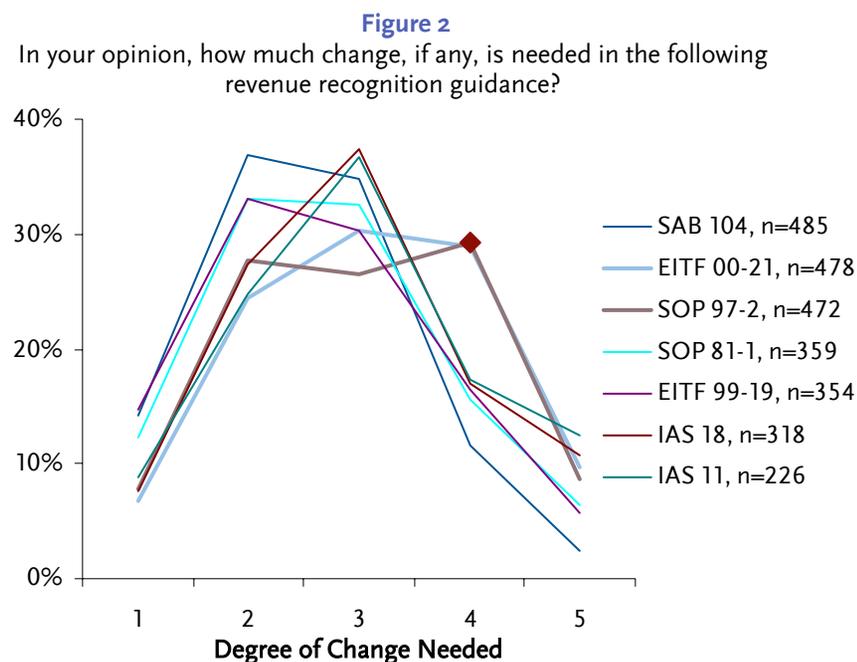
In anticipation of this, the survey included detailed help throughout so respondents could see the full context of the new terms and concepts presented in the paper. This appears to have been successful in helping those with little or no prior knowledge of the paper because there was very high correlation (greater than 0.9) between the answers from all of the segments in Figure 1. As a result, there was no need to disqualify respondents on this basis.



RATING EXISTING STANDARDS

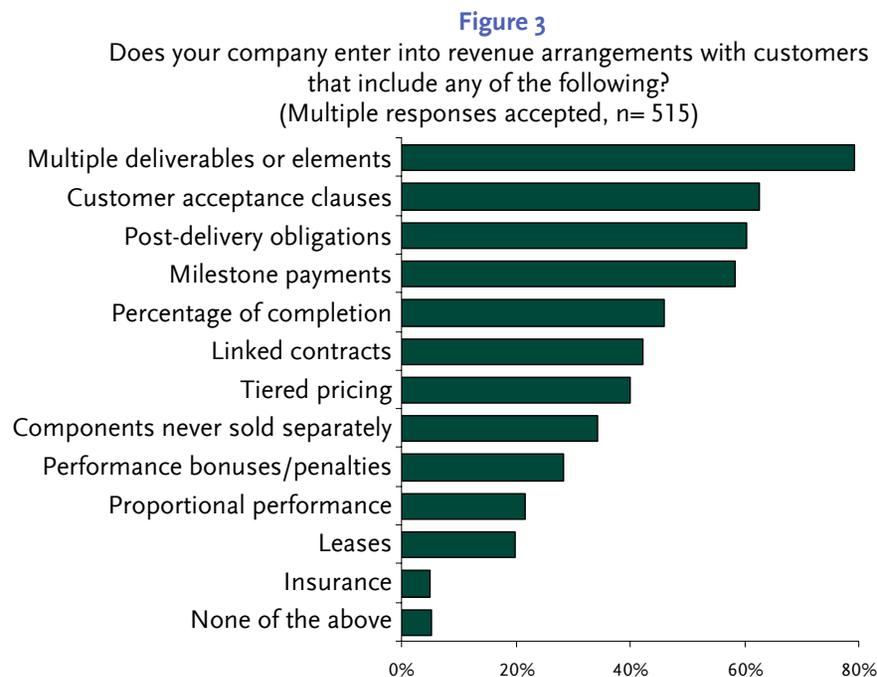
The second key question was to establish familiarity with and opinions on the existing GAAP standards shown in Figure 2. Respondents were given a five point scale where 1 indicates current guidance is adequate/no need for change; and 5 indicates current guidance is completely inadequate and needs to be changed. (Respondents that answered Not Familiar any guidance were not included in that result; those Not Familiar with all of the guidance were disqualified from the survey altogether.)

As the highlighted data point in Figure 2 shows, EITF 00-21 and SOP 97-2 received the most negative responses. There was little variation in responses to EITF 00-21 by company demographics. On SOP 97-2, there was a negative bias in the High Tech industry as 41% of these respondents gave it a 4 or 5, while only 35% of non-High Tech respondents did. Overall, the results show that a change in revenue recognition rules is not unwelcome.



TYPES OF REVENUE ARRANGEMENTS

To fully appreciate the results of a survey on a contract based approach to revenue recognition, it is important to understand what types of contracts the respondents use in their businesses. As shown in Figure 3, contractual arrangements with complex implications for revenue accounting are pervasive. In fact, 95% of respondents use more than one of the revenue arrangements listed, and 54% use 5 or more of them. This creates enormous challenges for the earnings process that are compounded even more so by the fact individual contracts vary widely and can be amended often – informally as well as formally – and don't always accurately represent the fullness of the business relationship at any point in time. As a result, respondents raised some concerns about whether contracts can be relied upon to provide clear cut definitions for revenue accounting elements.



IS A CONTRACT-BASED APPROACH TO REVENUE RECOGNITION A GOOD IDEA?

The underlying concept in the Boards proposal is that contracts should drive the earnings process directly. The following text from the discussion paper was provided in the online help for the survey:

“In the proposed model, revenue is recognized when a contract asset increases or a contract liability decreases (or some combination of the two). That occurs when an entity performs by satisfying an obligation in the contract.

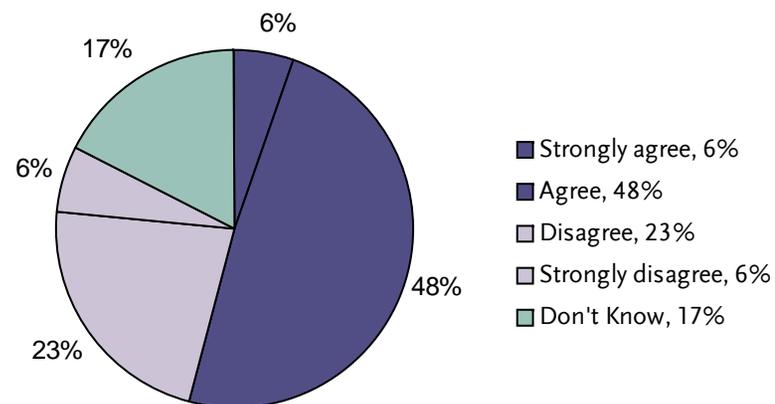
The Boards think there will be more agreement on whether an asset has increased or a liability has decreased than there is currently on what an earnings process is and whether it is complete. This contract-based approach should not fundamentally change current practice for most transactions. But it should provide a set of principles that would simplify U.S. GAAP and provide the guidance lacking in IFRSs.”

Given this definition, 54% of respondents agreed or strongly agreed that this approach would clarify the earnings process, as shown in Figure 4.

A majority of respondents agreed or strongly agreed that a contract-based approach to revenue recognition would clarify the earnings process.

Figure 4

Do you agree that the earnings process can be clarified by focusing on changes in contractual assets and liabilities, as the Boards propose?
(n= 515)



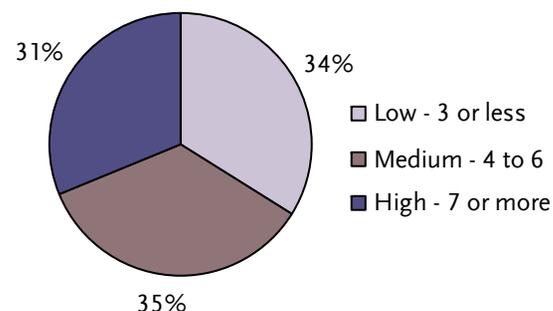
CONTRACT COMPLEXITY AND REVENUE RECOGNITION

While the majority of respondents indicated agreement with the Boards' proposal, 29% disagreed or strongly disagreed - a number that increases as the complexity of revenue arrangements increases. To measure this we created three segments based on contract complexity (Figure 5.) These were defined by how many different types of revenue arrangements respondents use. Those with three or fewer were considered to have relatively low contract complexity; those with 4 to 6 were classified as having relatively moderate complexity; and those using 7 or more different types of revenue arrangements in their businesses were in the high complexity group. This segmentation is crucial to the feasibility of the Boards' model as very complex contracts are used by nearly 1 in 3 respondents.

As shown in Figure 6, there is a clear trend of resistance to the contract-based approach as the complexity of contracts increases. Only 19% of those with 3 or fewer types disagreed, 31% of those with 4 to 6 types disagreed, and 35% of those with 7 or more disagreed. This should be an important concern for the Boards as the list used in the survey is by no means comprehensive and there are many ways in which contracts can create very challenging fact sets for revenue recognition. As one respondent explained:

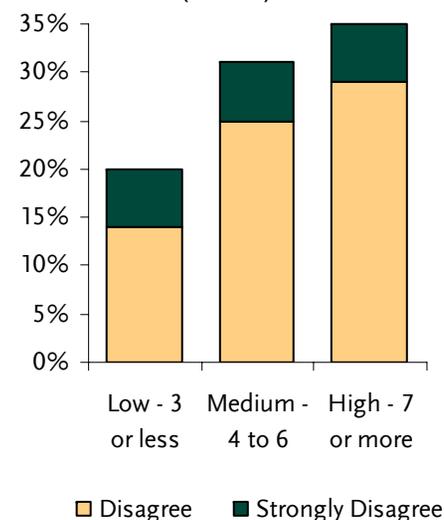
"In my opinion, focusing on changes in contractual assets and liabilities does not capture the essence of an earnings process represented by a company's operations. Additionally, the problems that will be encountered in developing and implementing appropriate guidance for estimating contractual assets and liabilities will be as problematic as developing appropriate guidelines for revenue recognition. [...] all contractual obligations/liabilities should be aligned with some portion of the overall consideration, whether or not it is specifically identified in contract."

Figure 5
Different types of revenue arrangements being used per respondent (n= 515)



Resistance to a contract-based approach to revenue recognition increases as the complexity of contracts increases.

Figure 6
Disagreement with contract-based approach by contract complexity (n= 515)



THE PERFORMANCE OBLIGATION AS AN ACCOUNTING UNIT

The Boards' have proposed a new unit of measurement termed a "performance obligation" as the basis for determining revenue recognition under a contract-based model. As defined by the Boards:

"... a promise to transfer a good or a service is a performance obligation whether that promise is explicit or implicit in the arrangement. A quick test to identify a performance obligation is to identify any good or service in an arrangement that can be sold separately (whether the entity in question does so or not).

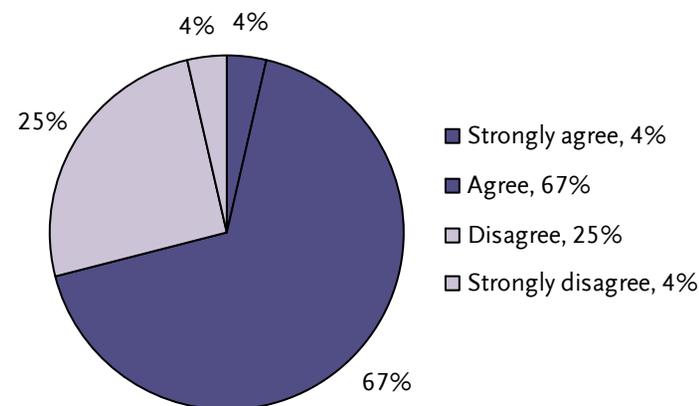
"...when a "bundle" of assets is transferred all at once, all of the related performance obligations are satisfied at once. It is when assets are transferred at separate times that they must be accounted for separately to ensure that the company's revenue represents faithfully the pattern of transfer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

Given this definition, as shown in Figure 7, more than 70% agreed or strongly agreed with this approach. But some respondents found the terminology less specific than current practice and open to too much interpretation. Several wrote that certain contractual obligations such as warranties do not necessarily translate into "performance" per se. The following write in answer was representative of the fundamental objections:

"The issue lies in the definition of "obligation." Many of the gray elements in revenue recognition arise because performance is contingent on events or occurrences that may or may not occur, or may arise from subjective (and often disputable) decisions by people within a customer organization, and where there are insufficient data to develop actuarial or third-party estimates."

Figure 7

Do you think the Boards' proposed definition of a performance obligation would help entities to identify the deliverables in (or components of) a contract more consistently than in existing practice?
(n= 515)



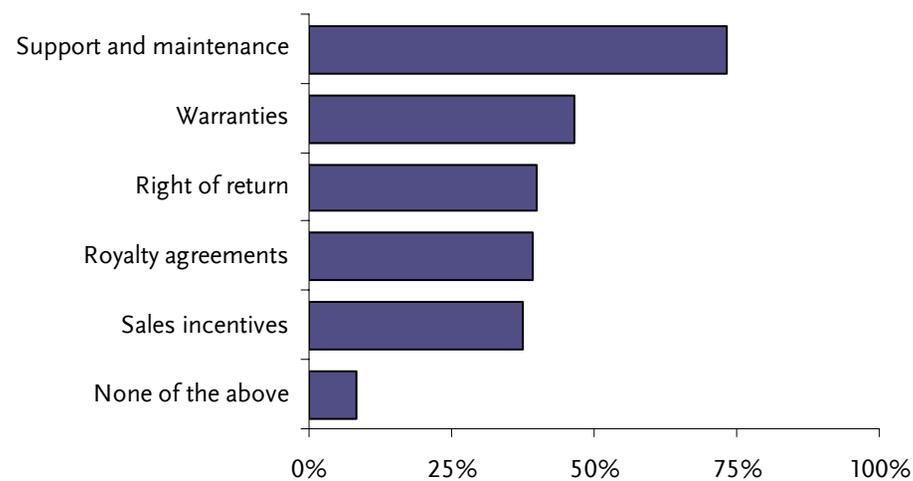
SEPARATION OF PERFORMANCE OBLIGATIONS

To further clarify how revenue should be allocated among performance obligations the model must stipulate what obligations constitute separate accounting elements within the same contract. This is an open question in the discussion paper so respondents were asked to identify categories of obligations (outside of products and services) they believe should be accounted for separately. The results are shown in Figure 8.

Only support and maintenance carried an absolute majority. It was the top choice for all companies across industries and business models (Product sales, Services, Licensing/Royalties, Subscription/Usage, Multi-element contracts, Leasing, and Insurance.) The order of the next four choices varied somewhat by business model but none were identified by a majority in any segment as elements that should be accounted for separately.

That said this question received more write-in opinions than any other, most supporting the view that these items should be separated as they are optional for the customer, have a separate stand alone value, and can be cancelled any time in the future without impacting the initial performance obligation. They are also usually transacted in separate agreements with different terms and conditions. There were a number of opinions that support and maintenance should be further split into two separate elements as support is a service and maintenance is generally an annuity.

Figure 8
In your opinion, which of the following should be accounted for as separate performance obligations?
(Multiple responses accepted, n= 515)



TRANSFER OF "CONTROL" VS "RISKS AND REWARDS"

Another core principle of revenue recognition is the definition of when a customer receives that which has been contractually promised. The Boards propose the concept of control over the asset as opposed to the current GAAP approach based on the transfer of the risks and rewards of ownership. The survey provided the following definition excerpted from the discussion paper:

"Where contracts include rights of return, customer acceptance, or free trials, etc. the risks of owning a good or service can be shared by more than one party in the contract. Applying the risks and rewards notion therefore, can require an entity to judge whether a preponderance (or some other balance) of the risks and rewards of an asset has transferred to the customer. That judgment could vary from one transaction to another.

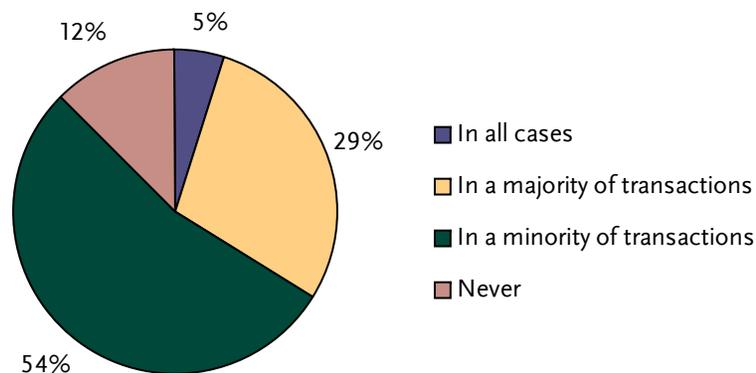
"However control does not always have to coincide with delivery or physical possession. In some cases, an entity may retain physical possession of a good although the entity no longer controls the good. For example, in some bill and hold arrangements, a customer controls the good even though the supplier has physical possession of the good."

66% said there would be little or no difference in the timing of their revenue recognition

This question also received a relatively large volume of write in opinions mostly from industries where long term development projects are contracted and subject to customer acceptance. Less than 8% of respondents from High Tech companies said changing this definition would never impact their revenue recognition. In addition, respondents from construction, defense, services, and software industries expressed some concern that the Boards' proposal eliminates the percentage of completion method for revenue recognition without a clear alternative – other than to rewrite contracts to stipulate transfer of control during partial build phases of projects that are typically large scale, multi-year, and cost intensive. That was perceived as cumbersome from a legal perspective and open to interpretation from an operational perspective.

Figure 9

In your business, how often do you think the transfer of "control" as defined by the Boards would occur at a time different from the transfer of "risks and rewards" under current rules? (n= 515)



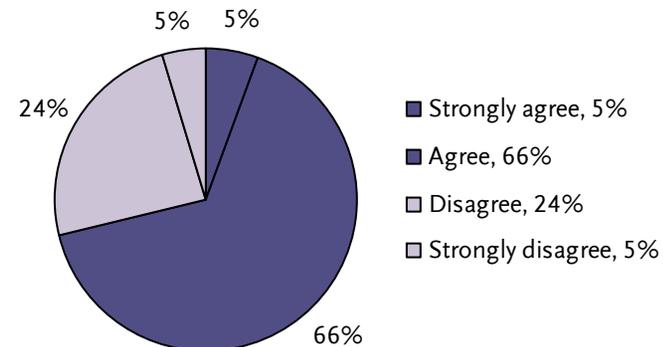
PRICING: THE \$64,000 QUESTION, OR WAS IT \$65,000?

The question of how prices are determined can be extremely complex for companies that sell bundled solutions involving multiple products, components, services, subscriptions, royalties, etc. some of which may never be sold separately. Fair value and vendor specific objective evidence (VSOE) provide current guidance but they come with an arguably disproportionate amount of complexity.

The Boards' seem intent on simplifying the pricing problem in the contract based model. But there are major issues. The next four questions all pertain to the pricing problem, the first of which asked about the use of stand alone prices for the purposes of allocating revenue. Although a large majority agreed with this proposition as shown in Figure 10, there was a vocal minority that found this infeasible due to the lack of stand alone prices for some items, as one respondent explained:

“In some case, e.g. routine warranties, there are third-party providers and relatively efficient markets where a stand-alone selling price can be determined or reasonably estimated. Except in these instances, there are few rational bases for estimating the stand-alone selling prices of the promised future performance obligations. Hence the proposed rule would introduce a whole new level of guessing and estimates that would add more to uncertainty about financial figures than they would help clarify them.”

Figure 10
Do you agree that the allocation of the customer's consideration to multiple performance obligations should be based on the stand-alone selling prices for the promised goods/services? (n= 515)



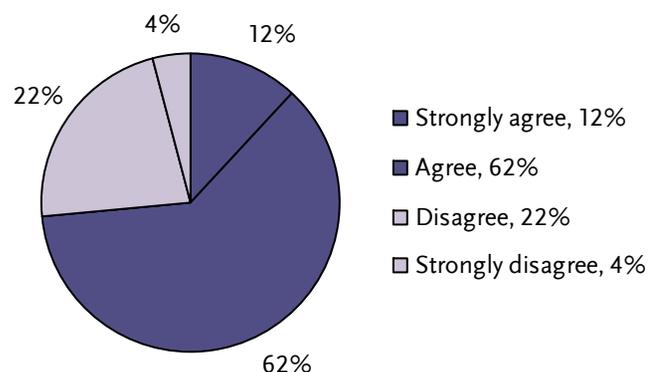
ESTIMATED PRICES

When goods or services are not sold separately and therefore stand alone prices are not available, revenue accounting becomes much more problematic. One element of a large contract that lacks a clear and supportable pricing rationale can cause the entire revenue stream to be deferred, which certainly does not reflect economic reality in most cases. Estimated prices are the obvious choice, but this approach comes with some moral hazard as companies are under tremendous pressure to show revenue growth.

74% of respondents agree or strongly agree that management should be allowed to apply estimates for goods/services that are not sold separately.

Figure 11

Do you agree that if goods/services are not sold separately, the allocation of consideration should be based on management's estimates of the stand-alone selling prices for those items? (n= 515)



There was a great deal of concern that management be required to use a defined methodology, even if it is industry-specific, and that the methodology be disclosed in financial reports. Two respondents offered the following perspectives on the risks of using management estimates:

“The nature of the undelivered goods or services should be considered. In some cases a proportional performance method or a method that focuses on the predominant deliverable could be appropriate. Because of wide variety of ways companies sell products and services, I don't think there is a “one-size fits all” model that works. I believe industry practice is an appropriate consideration, even when there are inconsistencies between certain industries. [...] Without this, I think comparability within industries will decrease.”

“...it may be difficult or impossible to calculate an estimated Stand-alone price as the item could have different selling prices based on the different combinations it could belong to (In configuration A, the sub-product 1 may have an estimated price of \$3000, but in configuration B, it may have an estimated price of \$1000.) This is due to fact that while it may be required for both configurations, the first configuration allows for the sub-product 1 to provide more value, thus increasing the price to the client.”

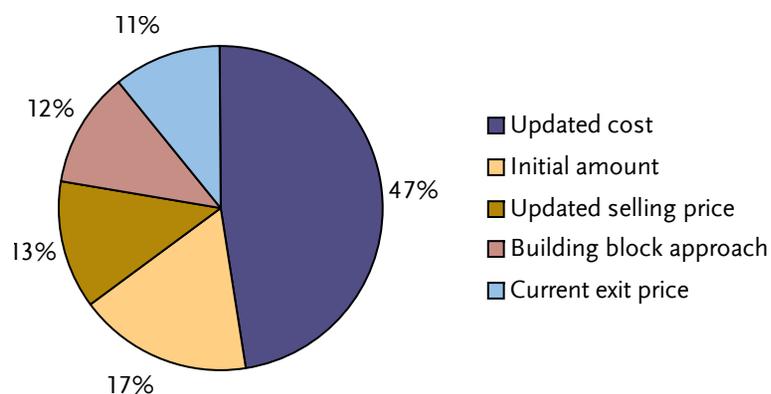
RE-MEASURING PRICES

Prices for future or long-term obligations frequently change. Therefore, a methodology is required not only for how estimated prices are to be established but also for how they are to be updated. The Boards propose that prices should be adjusted only when the cost of providing the goods or services exceeds the carrying amount of the obligation. In this case, the discussion paper offers several alternatives.

Respondents were asked to select only one method listed in Figure 12. Nearly half showed a preference for using updated cost. But this issue varies by industry. Respondents from software companies prefer initial amount, financial services prefer updated selling price, healthcare prefer the building block approach, while services prefer current exit price. As a result, this is clearly an issue where the Boards will have to provide more guidance.

Figure 12

If the cost of providing goods/services becomes greater than the carrying amount of the performance obligation, how should the performance obligation be re-measured? (n= 515)

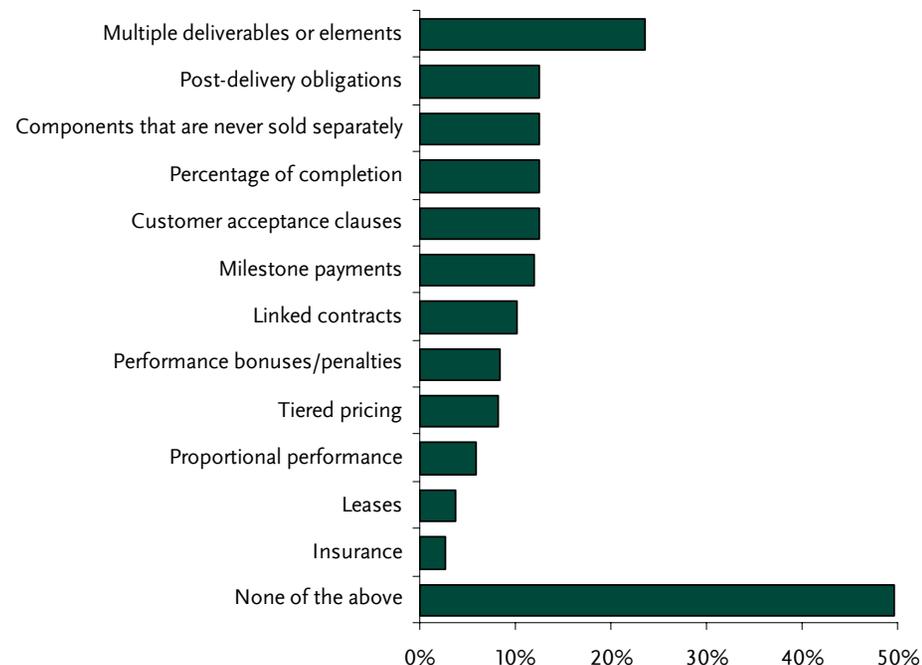


ALLOCATED TRANSACTION PRICING

When asked about exceptions for the feasibility of an allocated transaction pricing method, half of the respondents indicated that there were none in their business. Only 23% of respondents said contracts with multiple deliverables or elements would make an allocated transaction price impractical, a very small number considering 79% use multiple deliverables in their contracts. In addition, only 12% see any of next four items in Figure 13 as a challenge, even though an average of more than 50% use the these types of revenue arrangements.

Figure 13

Are there any types of contracts in your business for which an allocated transaction price approach would not be a practical basis for revenue recognition? (n= 515)



SUMMARY

There may be no more apt use of the axiom that the exception makes the rule than in accounting. The results of this survey indicate that a contract-based approach to revenue recognition as proposed by the FASB and IASB has merit and would be welcomed by a majority of respondents. But the test for an accounting standard is never limited to the majority; it will apply to and be used by everyone. The dissenters provide a great deal of insight into some of the key concerns such an approach may raise for companies in certain types of businesses – in particular those with long term contracts involving undelivered items and indeterminate prices.

The key objections expressed by our respondents all question the fundamental premise of the Boards' proposal and that is whether or not contracts truly reflect the economic reality of the business relationships they define. Business contracts are a highly flexible vehicle for documenting the compensation and performance commitments of two parties in an economic exchange. Contracts are not explicitly set up as accounting vehicles, but they could be.

The Boards' proposal would rely on the adoption of new contracting practices, particularly in industries such as construction, defense and engineering, services, and software. This may be the least onerous requirement that any fundamental change in revenue recognition accounting could be expected to have, and fundamental change is a necessary precursor to the adoption of IFRS.

One of the key issues to keep in mind about this, or any other proposal for new revenue recognition guidelines is that the earnings process will remain largely unchanged. Companies with complex business models will have complex revenue processes – the challenge is how can accounting rules more accurately reflect economic activity in an increasingly complex world? If contracts can be more effectively linked to operations, then much of the dissent to the Boards' proposal may recede.

THANK YOU TO FASB/IASB PROJECT STAFF

In their discussion paper, the FASB/IASB presented many questions about key points of the proposed contract-based approach to revenue recognition. RevenueRecognition.com is grateful to FASB and IASB staff members for being so receptive to the idea of creating a survey based on these questions, and even more so for their generous contributions to reformulating them into a useful survey instrument. We hope the Boards find the results of this effort informative in their discussions about the merits and feasibility of the contract-based approach to revenue recognition.

DEMOGRAPHICS

Figure 14
What is your title?
(n= 515)



Figure 15
What was your company's approximate revenue?
(n= 515)

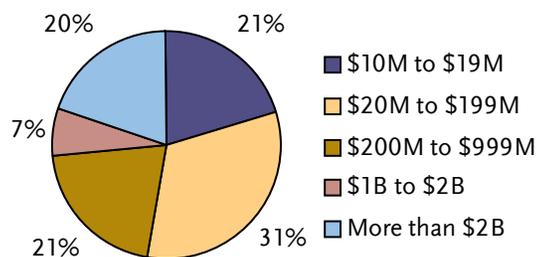


Figure 17
What is the ownership structure of your company?
(n= 515))

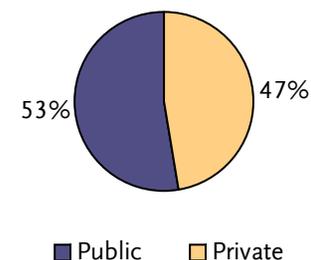


Figure 16
What are your company's primary business models?
(Multiple responses accepted, n=515)

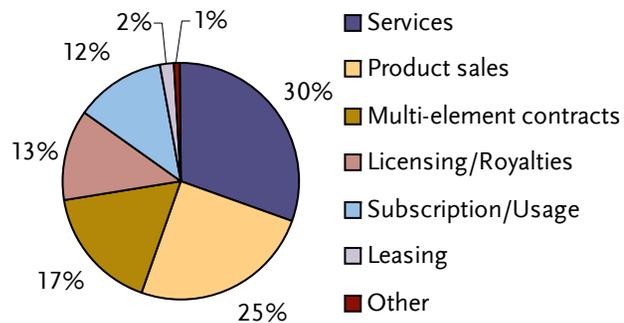
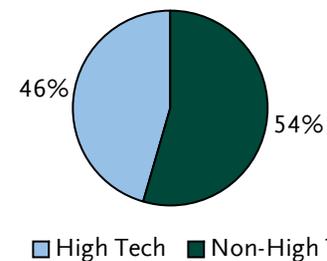


Figure 18
What is your company's main industry?
(n= 515)



ABOUT REVENUERECOGNITION.COM

RevenueRecognition.com is dedicated to educating finance professionals on revenue management and related issues. The site focuses on revenue accounting; revenue recognition; revenue reporting and forecasting; internal controls; Sarbanes-Oxley compliance; SEC, FASB, and international accounting guidelines; contract management; and industry specific revenue challenges. Contact us at:

info@revenuerecognition.com.

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