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Staff Paper

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Project **Revenue Recognition**

Topic **Redeliberations plan**

Introduction

1. This paper proposes a plan for the Boards' redeliberation of issues that have been identified in comment letters and other outreach activities. The staff is seeking the Boards' views on this plan.

2. This paper is organized as follows:

   (a) Revenue issues (paragraphs 3–10)

   (b) Cost issues (paragraphs 11–12)

   (c) Timeline and strategy (paragraphs 13–16)

   (d) Risks (paragraphs 17)

   (e) Resources (paragraphs 18–21)

Revenue issues

Two fundamental revenue issues

3. Many respondents to the Exposure Draft (ED) support the Boards' efforts to create a comprehensive revenue framework that improves and converges US GAAP and IFRSs. However, many respondents question whether a single model can be applied consistently across the wide range of industries within the scope of the project. In particular, many think that construction contracts are sufficiently different to justify a separate model (or an exception from the scope of the project).

4. The Boards may be able to mitigate some of those concerns through improved implementation guidance. However, the staff thinks that the concerns arise from two fundamental issues that must be resolved:

   (a) **Control**—some respondents questioned whether the basis of revenue recognition should be the activities of an entity rather than the transfer of goods or services to a customer. However, most respondents support the proposed core principle of recognizing revenue only when goods are services are transferred to a customer. Nonetheless, many think the ED is not sufficiently clear to help entities consistently determine when goods or services have been transferred. In particular, they request clarification on how to evaluate control for construction contracts and service contracts.

   (b) **Separation**—nearly all respondents have concerns with the proposed guidance on segmenting a contract and identifying separate performance obligations. Respondents think that the proposals are unclear, impractical, and could result in information that is not useful (i.e. could create units of account that are not consistent with how management of an entity and users of the financial statements view the entity's business).

5. The comment letters on the ED include helpful suggestions on how to resolve those two fundamental issues. On the basis of that input, the staff thinks it may be necessary to articulate the model for services separately from the model for goods. That approach may appear to create more than one model, but the staff thinks that the standard still would be a single model based on the transfer of goods and services, and the basis for conclusions would explain that thinking. However, the standard simply would be drafted in a way that is easier for preparers of financial statements to understand and apply consistently.

6. Using the input from the comment letters and other outreach, the staff plans to prepare recommendations on the two fundamental issues for the Boards to consider at their joint meeting in January 2011. Those issues need to be considered together because they are interrelated.

Other (less fundamental) issues

7. Respondents have raised various other issues with the ED that the staff thinks are less fundamental than the issues of control and separation. Moreover, those issues are less interrelated which allows greater flexibility of their sequencing and staffing. Many of those issues relate to proposals that respondents found to be impractical and not cost-beneficial.

8. The following table summarizes those issues along with preliminary staff analysis of the Boards' alternatives when redeliberating the issues.

Issue	ED Proposal	Preliminary staff analysis
Contract modifications	An entity would account for a modification together with the original contract (with a cumulative adjustment) if the prices of the modification and the contract are interdependent.	The Boards need to reconsider the issue in the light of decisions they make on separation. The issue also relates to allocating changes in the transaction price.

Issue	ED Proposal	Preliminary staff analysis
Collectibility	Collectibility would affect how much revenue is recognized rather than whether to recognize revenue. Subsequent changes in credit risk would be recognized separately from revenue.	The Boards first need to consider whether there should be an explicit recognition hurdle for assessing collectibility (in addition to the entity considering collectibility as part of its assessment of whether a contract exists). Then, they need to consider whether the effects of collectibility should be presented as an expense (as it is today) or as revenue.
Time value of money	An entity would adjust the amount of consideration if the contract has a material financing component.	The Boards need to clarify when it is cost beneficial to reflect separately the effects of the time value of money. For instance, the Boards could use a rebuttable presumption that the effects are not material to the contract if the difference in timing between payment and performance is less than one year, or if the payment terms are in accordance with customary industry practices (e.g. customer retentions in the construction industry and customer prepayments in licensing arrangements).
Variable consideration	The transaction price reflects the probability-weighted amount of consideration that the entity expects to receive from the customer, limited to amounts that can be reasonably estimated.	The Boards need to consider alternatives to probability-weighted estimates, especially for binary incentive fees for a single contract. Also, the Boards need to reconsider the constraint (i.e. reasonable estimates) and its effects in particular circumstances (e.g. royalties, asset management fees).

Issue	ED Proposal	Preliminary staff analysis
Allocating the transaction price	An entity would allocate the transaction price on a relative standalone selling price basis.	The Boards need to consider whether to allow alternative allocation methods (e.g. residual method) and whether it is appropriate to allocate a discount to all performance obligations. The Boards also need to reconsider the proposal to eliminate the contingent cap from US GAAP (which precludes revenue recognition from a delivered good or service if the consideration is contingent upon delivery of future goods or services). Many telecommunication entities continue to oppose revenue recognition for delivery of a handset in such cases.
Onerous performance obligations	An entity would recognize a liability and a corresponding expense if a performance obligation is onerous.	The Boards need to further consider the consequences of an onerous test for all contracts and reconsider the level at which an entity performs that test.
Warranties	An entity would defer revenue for all product warranties. The amount deferred would depend on the objective of the product warranty (i.e. coverage for latent defects or for faults arising after transfer of the product).	The Boards need to consider whether an entity should account for some warranties as a cost accrual or whether all product warranties should result in the deferral of revenue. If some are accounted for as a cost accrual, the Boards need to clarify how an entity would distinguish between the two types of warranties.
Disclosure	An entity would disclose quantitative and qualitative information about its contracts, and the significant judgments made in applying the proposals to those contracts. Proposed disclosures include a rollforward of contract balances, a disaggregation of revenue, a maturity analysis, and enhanced disclosures about onerous contracts.	The Boards need to consider whether the benefits of the enhanced disclosure requirements would outweigh the costs to preparers of providing those disclosures. If not, the Boards need to consider reducing the amount of disclosures required.
Transition	An entity would apply the requirements retrospectively.	The Boards need to consider whether a less costly transition method should be permitted (in the light of any decision on effective date).

Interaction with the Leases project

9. The Boards also need to consider a couple of issues that are linked to issues in the Leases project. Those issues include:

   (a) Licensing and rights to use—in the revenue ED, the Boards proposed that exclusive licenses would be accounted for similarly to a lease, with revenue recognized during the license term. The Boards need to reconsider the proposal to account for a license differently depending on whether the customer has an exclusive or a non-exclusive right.

   (b) Contracts with a put option—in some contracts, an asset is sold with a put option. The revenue ED suggests that it would be accounted for similarly to the sale of a product with a right of return. However, in some cases the substance of the contract might be a lease or a financing transaction. The Boards need to consider the boundary between the revenue model and the lessor model.

Definition of revenue

10. The Boards previously decided to not reconsider, as part of the revenue project, the existing definitions of revenue from their respective conceptual frameworks. Consequently, each Board used its own definition of revenue in its respective ED. Some respondents to the ED request a converged definition of revenue. The staff agrees that additional work could be done to improve and converge the definition of revenue. However, the staff thinks there are few revenue definitional issues in the context of revenue from contracts with customers. Therefore, the staff continues to recommend that the Boards address the definition of revenue in the Conceptual Framework project.

Cost issues

11. Responses to the ED have identified various issues and concerns with the proposed cost guidance:

    (a) Acquisition costs—some respondents are concerned about the apparent inconsistency of the revenue proposal with other projects. Most think that at least some costs of obtaining a contract should be recognized as an asset (e.g. sales commissions and other direct incremental costs). The Boards need to reconsider their proposal in the light of decisions made in the insurance and leases projects.

    (b) Interaction with other cost guidance—the revenue ED intended to fill a gap in GAAP for some costs (mainly set up costs for services contracts). Many responses have questioned how the proposed guidance interacts with other cost requirements in US GAAP and IFRSs. The Boards need to determine how best to integrate the proposed cost guidance with other requirements.

    (c) Construction and production-type costs—responses to the ED highlight that the withdrawal of the requirements on construction and production-type contracts has resulted in the deletion of guidance that permits the recognition of some intangible assets from the costs of fulfilling a contract (e.g. learning curve costs). Those assets result from the existing focus on the recognition of profit margins throughout the contract rather than on the recognition of revenues. The Boards need to consider carefully input received on this issue (while avoiding a general reconsideration of accounting for inventory and intangible assets) to ensure they do not unintentionally create a void in existing requirements.

12. The FASB has added a full-time staff member to further analyze these cost issues. That analysis can be performed simultaneously with the redeliberation of the revenue issues noted above.

Timeline and strategy

13. The following table contains the staff's recommended sequencing of issues for redeliberations. Appendix A includes additional detail on each topic:

January 2011	Transfer (control) Separation
February 2011	Transfer *(continued)* Separation *(continued)* Measuring progress Contract issues Onerous test Contract costs (acquisition costs) Warranties Specific implementation guidance
March 2011	Transaction price Allocation Contract costs (fulfillment costs) Scope Disclosure Specific implementation guidance
April 2011	Transaction price *(continued)* Allocation *(continued)* Disclosure *(continued)* Rights to use and licenses Contract costs *(continued)* Specific implementation guidance Transition and effective date
May 2011	Other (sweep) issues

User outreach

14. The staff plans to continue its outreach to users of financial statements through the FASB and IASB user advisory groups. In addition, the staff plans to increase outreach to analysts in particular industries as the potential effects on each industry of the final standard become clear. If the accounting in a particular industry would change significantly, the staff plans to increase outreach to users of financial statements for that industry to explain the changes.

Testing of the model

15. The staff intends to continue its targeted outreach during redeliberations by using the network of contacts from previous outreach efforts and those who have expressed in their comment letters a willingness to contribute to the standard-setting process. That ongoing outreach will allow the Boards to test specific aspects of the standard as they are developed and refined.

16. Some respondents to the ED and many participants at the roundtables have asked the Boards to conduct further testing of the model after redeliberations are substantially complete but before the standard is finalized. Those respondents appreciate the Boards' previous outreach efforts and intention to continue targeted outreach during redeliberations. However, they think there is risk of unintended consequences because of the wide scope of the project. Accordingly, they encourage the Boards to take additional time to minimize that risk and increase the quality of the final standard by testing a draft of the final standard. The Boards will need to consider, at a later date, whether that additional testing is necessary.

Risks

17. The staff sees the following risks with the proposed timeline:

    (a) aggressive timing—there is a risk that the staff will not be able to analyze the issues and prepare the Board papers in time for the monthly Board meetings. There is also a risk that the Boards will not make a decision (or will not make consistent decisions) on a particular topic.

    (b) implementation guidance—many respondents have requested additional guidance on particular situations or contracts. Developing that implementation guidance will take time, but also might identify additional issues that the Boards may need to redeliberate. The staff thinks the Boards should consider additional or revised implementation guidance for topics such as:

(i) Real estate,

(ii) Breakage and gift cards,

(iii) Customer loyalty programs,

(iv) Rate-regulated activities,

(v) Telecommunication services,

(vi) Asset management fees,

(vii) Licenses and rights to use (software, franchisors, media and entertainment),

(viii) Pharmaceutical and biotechnology arrangements, and

(ix) Disclosures.

Resources

18. The project team has the following resources at present.

FASB	IASB
Kenny Bement, Project Manager *Prasadh Cadambi, Practice Fellow *Liz Gagnon, Assistant Project Manager (private entity focus) Phil Hood, Project Manager Mike Breen, Practice Fellow *Libby Biittner, PTA *Stephanie Stoviak, PTA	*Henry Rees, Technical Principal Glenn Brady, Senior Technical Manager April Pitman, Technical Manager Allison McManus, Technical Manager
* works part-time on other project(s)	

19. Two full-time staff have been added to the project team at the FASB (Phil and Mike). They will work primarily on (a) analyzing cost issues, and (b) implementation guidance for the final standard.

20. One additional staff member has just been added at the IASB (Allison). In addition, other resources may be available early next year to work on issues such as disclosures, cross-cutting issues with other projects, or other issues that can be analyzed relatively discretely.

21. The staff thinks that with these additional resources, the project will be adequately staffed.

Appendix A Additional detail on topics for redeliberations

Transfer	Core principle of model
	Determining when a good or service is transferred
	Measuring progress
Separation	Segmenting a contract
	Identifying distinct goods or services
	Perfunctory performance obligations & promotional/marketing deals
Contract issues	Definition & existence of a contract
	Constructive performance obligations
	Contract modifications
	Combination of contracts
Transaction price	Measuring uncertain consideration
	Constraining estimates of uncertain consideration
	When is uncertainty a recognition event versus a measurement event (royalties etc.)
	Collectibility
	Time value of money
	Consideration payable to a customer (Co-op dividends)
Allocation	Allocating the transaction price (initially & subsequently)
Scope	Financial instrument fees
	Boundary of revenue recognition model & receivables accounting
	Risk-sharing (collaborative) arrangements
Disclosure	Revenue disclosures
Onerous test	Level at which onerous test should apply
	Which costs should be included in onerous liability
Costs	Acquisition costs
	Assets arising from fulfillment costs
	Impairment of assets arising from fulfillment costs
	Disclosures
Transition and effective date	Transition methodology
	Effective date & early adoption
Implementation guidance	Analysis of industry issues (from letters and ED guides)
	Warranties
	Gift cards & breakage
	Rate-regulated activities
	Nature of a PO in a license/right to use
	Repurchase agreements
Other	Cost benefit considerations and other sweep issues
	Telecommunication entities (additional industry considerations)
	Retail real estate (Asia/Brazil)
	Private sector considerations