

Technical Line

FASB – proposed guidance

Another step toward a final revenue standard

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What you need to know

- ▶ The FASB and the IASB reached conclusions on estimating the transaction price when variable (uncertain) consideration exists, such as royalty arrangements and potential performance bonuses.
- ▶ The Boards retained the relative standalone selling price method for allocating the transaction price, but said a residual technique could be used to estimate standalone selling prices for some performance obligations and will permit an alternative allocation approach in certain circumstances involving uncertain consideration.
- ▶ The Boards finalized the accounting for licenses and rights to use intangible assets (intellectual property), repurchase options and fulfillment costs.
- ▶ The FASB plans to expose the proposed changes to the Accounting Standards Codification before issuing a final standard.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) are close to completing their redeliberation plan on the revenue recognition Exposure Draft (ED).

In the April meeting, the Boards covered the last of the more significant topics, including the accounting for uncertain (variable) consideration and allocating the transaction price. The Boards also reached conclusions on applying the proposed model to certain unique transactions.

The FASB and the IASB recently said they need a few more months to consider revenue recognition and other joint projects; it is not clear when they will issue final standards. The FASB has said it would expose for comment the proposed changes to the Accounting Standards Codification (the Codification) before issuing final guidance on revenue recognition.

This publication summarizes significant developments since we issued our Technical Line, *New revenue recognition model is taking shape* (SCORE No. BB2110) on 6 April 2011.

Determining the transaction price with uncertain consideration

The ED would have required an entity to estimate the transaction price at the inception of the contract, including uncertain (variable) consideration, based on the probability-weighted amount it expects to receive. Many constituents found this requirement overly complex and felt it could lead to results that were not meaningful. For example, in situations in which an outcome is binary (e.g., a performance bonus in which an entity may receive either 0% or 100% of a specified amount), the likely result using a probability-weighted approach is an amount that is not a potential outcome. Some expressed reservations about including variable amounts in the estimated transaction price at all.

The Boards decided that the probability-weighted approach should be used if it is the best predictor of the ultimate consideration to be received. If not, the transaction price should be estimated based on the most likely amount to be received (although it's not clear what the "most likely" threshold is intended to represent when the potential outcome is not binary).

However, the Boards decided that uncertain consideration would be recognized in revenue only if it is reasonably assured to be received. The Boards concluded that consideration is not reasonably assured if the customer can avoid paying the variable amount without breaching the contract. For example, sales-based royalty payments due to an entity are not reasonably assured until the sale the royalty is based on occurs.

If an entity has no experience with similar types of revenue contracts, or prior experience is not predictive of future outcomes, variable consideration would not be reasonably assured. To determine whether prior experience provides predictive value, the Boards said a number of factors should be evaluated, including time until the uncertainty is resolved, susceptibility to factors outside the influence of the entity and the number and variability of possible consideration amounts.

How we see it

The availability of an alternative model to estimate uncertain consideration should provide preparers a reasonable estimation technique in situations in which a probability-weighted estimate doesn't make sense. Further, the change in the proposed accounting for sales-based royalties will be welcomed by many entities that enter into contracts with extended royalty streams.

Allocating the transaction price

The ED required that the transaction price be allocated to performance obligations on a relative standalone selling price basis. It also indicated that the standalone selling price used for this allocation should be based on observable inputs, where available, or on management's estimate of a standalone selling price. Some respondents questioned their ability to estimate a standalone selling price, especially for performance obligations that are never sold on a standalone basis and are sold at highly variable prices (e.g., software licenses).

Based on this feedback, the Boards noted that when the standalone selling price of a good or service is highly variable, a residual technique could be used to estimate standalone selling price. For example, assume an entity frequently sells software, professional services and maintenance bundled together at prices that vary widely and that it also sells the professional services and maintenance deliverables individually at relatively stable prices. The Boards indicated it may be appropriate to estimate the standalone selling price for the software as the difference between the total transaction price and the estimated selling price of the professional services and maintenance.

The Boards also decided to revise the transaction price allocation approach to deviate from the relative selling price method in certain circumstances involving uncertain consideration. When uncertain consideration exists, the Boards decided that the uncertain consideration would be allocated entirely to a single performance obligation if both of the following conditions are met:

- ▶ The contingent payment relates specifically to the entity's efforts to satisfy that performance obligation
- ▶ The amount allocated (including the change in the transaction price due to the contingent payment) to that particular performance obligation is reasonable relative to all of the performance obligations and payment terms (including other potential contingent payments) in the contract

While the application of this tentative conclusion is clear with respect to changes in uncertain consideration (all changes are allocated to the specified performance obligation), it is less clear how the allocation would be made at inception when allocating both fixed and uncertain consideration.

To illustrate, assume that a vendor sells products A, B and C for fixed consideration of \$35 and a sales-based royalty. The royalty relates only to product C. We believe that the Boards may intend that the performance obligations that are unrelated to the uncertain consideration (A and B) be segmented (similar to the segmenting principle in the original ED) and the transaction price allocated to those performance obligations would be based on their combined estimated selling price (i.e., the price that would be received if selling A and B on a combined basis). Assume that price is \$30, which would be allocated to products A and B on a relative standalone selling price basis. The remainder of the fixed transaction price (\$5), along with any future royalties, would be allocated to product C. While we believe that this is what the Boards may have intended, the Boards' intent will be clarified in a final standard and may differ from this approach.

The Boards agreed to allow use of a residual technique for estimating the standalone selling price of a delivered item with volatile pricing.

Licensing and rights to use

The ED provided guidance for licenses and rights to use intellectual property (collectively, licenses), specifically how to determine when “control” of the license is transferred to the customer (licensee). Many constituents did not agree with the Boards’ proposal to distinguish between exclusive and non-exclusive licenses, because it could have resulted in distinctly different accounting for similar transactions.

The Boards decided that the final standard would not distinguish between exclusive and non-exclusive licenses. Instead, all promises to grant licenses or rights of use would be accounted for as a single performance obligation in which the entity recognizes revenue when the customer obtains the right to use and benefit from the asset.

However, as many of these agreements include uncertain consideration (e.g., royalty payments), the entity would apply the criteria discussed above. That is, when expected consideration related to the license is reasonably assured, this amount would be recognized when the customer obtains control of the license. When the receipt of uncertain consideration is not reasonably assured at the outset of the agreement, it would not be recognized until it becomes reasonably assured (e.g., the entity would recognize sales-based royalty revenue over the term of the license). This pattern of recognition is similar to current US GAAP in many transactions involving licenses or other rights to use.

Repurchase options

The ED proposed that if the customer has the ability to require the entity to repurchase the asset, the customer has obtained control of the asset (i.e., the customer has the ability to direct the use of the asset) and a sale should be recorded. These arrangements would be treated essentially the same as a sale with the right of return.

Some constituents suggested that, in some cases, options granted to customers are not always at or near the original purchase price. In certain industries, this is because the option is exercisable for an extended period of time (e.g., three to five years after the original purchase date). As a result, the specified repurchase price is set below the original transaction price to reflect the decline in value that occurs based on the customer’s use of the asset during that period. These constituents argued that this structure is not the sale of an asset, but instead a right to use the asset for the option period, which should be accounted for as a lease.

The Boards tentatively decided that if the customer has a significant economic incentive to exercise its right to put the asset, the customer is effectively paying the entity for the right to use the asset for the option period. The Boards concluded that an entity should account for such transactions under the leasing guidance. The Boards will provide factors in the final standard to help determine whether a customer has a significant economic incentive to exercise the repurchase option, including the relationship between the repurchase price and the expected future market value of the asset and the amount of time until the option expires.

Concurrent with this decision, the Boards were also in agreement that the revised revenue guidance would override the scope of the proposed lease guidance in certain transactions. For example, when a transaction involves the sale of an intangible asset with a repurchase option that provides the customer a significant economic incentive as described above, the revenue guidance would require the transaction to be accounted for under the lease guidance. Although the lease guidance specifically excludes intangible assets from its scope, the revenue guidance would override that scope limitation.

Fulfillment costs

In addition to the proposed revenue model, the ED also provided guidance for accounting for an entity's costs incurred in fulfilling a contract. The Boards tentatively affirmed the proposal in the ED, which states that costs incurred that do not give rise to an asset eligible for capitalization in accordance with other authoritative guidance (e.g., inventory, property, plant and equipment, software) may be capitalized if the costs meet all of the following criteria:

- ▶ The costs relate directly to the contract
- ▶ The costs generate or enhance resources of the entity to be used in satisfying performance obligations in the future
- ▶ The costs are expected to be recovered

The Boards tentatively decided to clarify certain aspects of the proposed guidance on "abnormal costs." Specifically, the Boards clarified that costs of abnormal amounts of wasted materials, labor, or other resources *that were not considered in the price of the contract* should be recognized as an expense when incurred.

The Boards also clarified that costs that relate directly to a contract include costs that are incurred before the contract is obtained if those costs relate specifically to an anticipated contract.

Exposure document on changes to Accounting Standards Codification

On 31 March 2011, the FASB announced on its website that it intends to expose for public comment the proposed amendments to the Codification before issuing a final standard. The Boards have not yet discussed whether they will expose for comment the revised model. That decision will be made after all other redeliberations on the revenue recognition project are complete.

How we see it

While it is unclear whether the FASB will seek comment on anything beyond the completeness and accuracy of the proposed amendments to the Codification, we believe this process will offer constituents an opportunity to provide feedback on the entire model. Given the significant changes the Boards have made, it seems likely that constituents may identify concerns with the revised proposal.

Next steps

- ▶ Constituents should consider providing feedback on the changes to the Accounting Standards Codification.
- ▶ Constituents should communicate any significant concerns about the recent decisions to the Boards or their staffs as soon as possible.
- ▶ While the Boards' recent decisions eliminate some of the significant changes that would have resulted from the proposal in the ED, a final standard will still trigger significant accounting changes for many entities. All entities should carefully review the final standard when it is issued and begin preparing for implementation.

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